CHAPTER 1

INTRODUCTION TO BUSINESS COMBINATIONS

QUESTION SOLUTIONS

1-1. One reason external expansion may be preferred over internal expansion is that internal expansion is often a slow process because the entity may be required to develop a distribution system, generate demand for its new product, and/or build new production facilities to support new products or expanding sales. A second reason is that internal expansion may be viewed as risky in that the development and marketing of new products is often a difficult task.

1-2. Expansion from a regional market to a nationwide market is more likely to occur with external expansion because the entity would be required to develop a distribution system, generate demand for its new product, and build new production facilities to support new products or expanding sales if internal expansion occurs. External expansion can occur by acquiring a company that already has a distribution system, and production facilities in the desired marketplace.

1-3. Economies of scale exist when the cost of conducting business does not increase proportionately to the increased size of the entity. For example, the corporate advertising department may not double in size if the size of the entity doubles. As a result, less than double the number of people are required to accomplish the work for an entity that is twice as large.

1-4. The difference between the purchase of a piece of machinery and the acquisition of a company is that projecting the future cash flows may be more involved in the acquisition of a company. In addition to the directly measurable cash flows, the acquisition of another company may result in benefits not directly measurable such as (1) a readily available supply of scarce inputs, (2) production and/or marketing expertise, (3) established market share for products, and (4) the potential synergy resulting from sales of complementary products.

1-5. Control over an entity represents a greater involvement than investing in an entity in that control enables the investor to direct the use of individual assets in a manner that will result in the maximum benefit to the controlling entity. In particular, control enables the acquiring

entity to a) direct the use of the controlled entity's assets by having the power over policy making that guide how the assets are used; and b) enforce the budgets and policies by selecting, compensating, and terminating those responsible for implementing decisions.

1-6. A horizontal combination exists when an entity acquires another company in the same industry. This type of combination often permits the acquirer to increase sales by entering new product markets, increasing production capacity, and expanding into new geographic regions.

1-7. A vertical business combination occurs when an entity acquires another company where there is a potential buyer-seller relationship. This type of combination often occurs when a company is attempting to improve the efficiency of operations by acquiring suppliers of inputs or purchasers of the company's outputs.

1-8. A conglomerate combination occurs when an entity acquires another company in an unrelated industry. One reason for the rise of conglomerates is that management has become more aware of the increased income stability provided by diversifying the entity's asset base as well as its products and services offered. Another reason for the increase in conglomerate combinations is that it is more difficult for the government to challenge a conglomerate business combination on the basis of antitrust regulations.

1-9. The Sherman Act was passed because Congress determined that business combinations may concentrate economic power in the hands of fewer entities resulting in an industry having only a small number of dominant entities. One result of the concentration of economic power may be business practices that are contrary to the public interest.

1-10. The Sherman Act is worded in such a way that combinations could not be prevented, only broken up after the fact. The Clayton Act is worded in a manner that prevents "the acquisition" when "the effect of such acquisition may" be contrary to the public policy of insuring free competition. Thus, the government can anticipate restraint of trade and legally stop proposed mergers based on arguments concerning the potential results instead of having to break up combinations after they have already occurred.

1-11. A friendly takeover occurs when the business combination is accomplished by negotiations between the management of the acquirer and the acquiree. If negotiations between the management of any two entities considering a combination do not result in mutually agreeable terms, the acquirer will either withdraw the proposal or make the proposal directly to the stockholders of the acquiree. A tender offer that is opposed by the acquiree's management is viewed as a hostile bid for the acquiree.

1-12. A white knight is a friendly replacement acquirer that rescues the acquiree from an undesirable acquirer. This approach may be of interest if there is another company that would be perceived as a better match for the acquiree. The packman defense occurs when the potential acquiree attempts to purchase the acquirer. This defense can take on two

forms. First, the target may make a tender offer for some of the acquirer's shares. Second, the target may purchase the acquirer's shares in the open market. Either approach indicates that the target intends to purchase the acquirer rather than be the acquiree.

1-13. A kamikaze strategy exists when an acquiree engages in a broad plan to make itself less desirable to the acquirer. Under this strategy the potential acquiree takes action to reduce its value to the acquirer. Three common ways to implement a Kamikaze strategy is through the sale of the crown jewels, the scorched earth defense, and the fatman defense. The sale of the crown jewels and the scorched earth defense both concentrate on selling assets to make the company less desirable while the fatman defense is based on purchasing assets that are currently not highly productive to make the company less desirable for potential acquirers.

1-14. Shark repellant is a term applied to a number of techniques management may choose to make the acquiree more difficult to purchase. These defenses may include staggering the term of the board of directors thereby preventing an acquirer from attaining control quickly. This defense will buy time and thus, better enable the potential acquiree to implement other defensive strategies if necessary. Another approach is to have additional requirements for membership on the board of directors such as residency. A third approach many entities have implemented is a supermajority (greater than 50 percent) for approving business combinations. This percentage may be as high as 75 to 95 percent. As a result, hostile takeover of a company that requires a supermajority is more difficult to attain. Another technique often used to deter an unfriendly takeover is the use of golden parachutes. This maneuver results in significant compensation to the acquiree's top executives if a "change in control" of the acquiree occurs and the executive is terminated from the position currently held. As a result, golden parachutes transfer assets from the target to the executives making the target less attractive.

1-15. A golden parachute is a maneuver that results in significant compensation to the acquiree's top executives if a "change in control" of the acquiree occurs and the executive is terminated from the position currently held. This technique transfers assets from the target to the executives making the target less attractive. Such a policy may not be in the best interest of stockholders if a valid result of an acquisition is to have a change in the management of the company.

1-16. Control is the "power to use or direct the use of the individual assets of an entity to achieve the objectives of the controlling entity." Control enables the acquiring entity to a) direct the use of the controlled entity's assets by establishing capital and operating budgets and policies supporting these budgets; and b) enforce the budgets and policies by selecting, compensating, and terminating those responsible for implementing decisions. Control over the net assets of an entity may be accomplished in either of two ways. The acquirer may purchase the acquiree's net assets or the acquiree's voting stock which represents ownership of the assets. The form of the transaction may differ but the end result is the same.

1-17. The total capitalization of the acquirer does not depend on whether the net assets or stock of the acquiree is acquired. The method of the acquisition by the acquirer determines the impact on the acquirer's total capitalization. If the acquisition is accomplished by issuing new shares of the acquirer's common stock, the acquirer's total capitalization increases. All other methods of acquisition do not impact the acquirer's total capitalization.

1-18. The acquiree's balance sheet is nothing more than a skeleton when there has been an acquisition of assets. The consideration given by the acquirer is all that is left on the acquiree's books. The stockholders of the acquiree have not changed so they control how to reinvest or manage the cash or stock received. Alternatively, they have the option of declaring a liquidating dividend, distributing all of the assets among themselves, and disbanding the corporation.

1-19. Regardless whether the net assets or voting common stock is acquired, the acquirer controls the acquiree's net assets. The difference that exists between an acquisition of assets and an acquisition of stock is the ownership of the acquiree. The original owners of the acquiree still control the acquiree if there is an acquisition of assets. The only change is the composition of the assets under the acquiree's control. The acquirer is the owner of the acquired entity if there is an acquisition of stock.

1-20. Sometimes one less company results when two companies combine but that does not always occur. There are several different legal forms that may result when a business combination occurs. The acquirer can choose to purchase the acquiree's assets or stock. If the assets are acquired, the acquiree's owners determine if the acquiree is going to cease business. If the acquirer purchases the acquiree's stock, two companies may still remain in existence. This form of combination is called a stock acquisition. The acquirer may choose to terminate the acquiree's business and fold the acquiree into the acquirer. This form of business combination is call a statutory merger. The acquirer and the acquiree can both cease to exist and form a new third company. This form of business combination is called a statutory consolidation.

1-21. A statutory consolidation may be considered when the combining companies do not have name recognition or a stock structure that management wants to retain. A statutory consolidation permits the combining entities to create a completely new legal entity and thus have a fresh start with a new name and new par value stock.

1-22. The parent company is the entity in control after the completion of a stock acquisition. The entity not in control is called the subsidiary.

1-23. The subsidiary is the entity not in control after the completion of a stock acquisition. The entity in control is called the parent company.

1-24. A contingency based on the value of securities given by the acquirer does not impact the acquisition cost to the acquirer. The issuance of additional shares of stock does not increase the total market value of the acquisition above the original agreed amount. The only adjustment made for the issuance of the new shares is a reallocation between *Capital Stock* and *Additional Paid-in Capital* on the acquirer's books.

1-25. A business combination is viewed to be a nontaxable exchange if it qualifies as a reorganization. Reorganizations can occur regardless of whether the combination is accomplished via the acquisition of assets or the acquisition of stock. Furthermore, reorganizations can also occur regardless of whether the combination is structured as a statutory merger, statutory consolidation, or the acquisition of stock. For a combination to qualify as a reorganization it must meet three criteria. First, the owners of the acquiree must continue to have an indirect ownership interest in the acquiree (i.e., the acquiree's stockholders cannot sell their ownership interest in the acquired entity). Second, the acquirer must continue the acquiree's business or employ a significant portion of the acquiree's net assets in an ongoing business. Third, the combination (reorganization) must occur for a valid business purpose. It cannot occur just to avoid the payment of taxes.

1-26. The three different types of tax deferred exchanges are Types A, B, and C. The benefit of a Type A reorganization is that the acquirer only has to give 50 percent of the consideration in stock, the remainder can be in any form. One disadvantage of the Type A reorganization is that the acquirer becomes liable for all known and contingent liabilities of the acquiree. In a Type B reorganization, the acquirer's voting common stock must be exchanged for the acquiree's outstanding stock. The acquirer must also own at least 80 percent of the acquiree's stock after the reorganization is completed. A type C reorganization permits the acquirer to gain possession of the acquiree's assets through contract rather than through the provisions of the state of incorporation. As a result, the acquirer does not become liable for contingent liabilities that are not expressly accepted as part of the agreement. The negative aspect of the Type C reorganization is that 100 percent of the consideration given to the acquiree must be the acquirer's voting common stock. In addition, the acquiree must distribute the stock to its shareholders and, in essence, terminate the operations of the target corporation.

1-27. One advantage of a Type A reorganization is that the acquirer only has to give 50 percent of the consideration in stock, the remainder can be in any form. One disadvantage of the Type A reorganization is that the acquirer becomes liable for all known and contingent liabilities of the acquiree. In addition, another issue managers must consider when accomplishing a Type A reorganization is that statutory mergers and statutory consolidations must be approved by the stockholders of both entities.

1-28. One advantage of a Type B reorganization is that it is accomplished with a stock for stock exchange. A disadvantage is that the acquirer must also own at least 80 percent of the acquiree's stock after the reorganization is completed. One provision that the acquirer's

management must consider carefully is that any acquisition of the acquiree's stock prior to the reorganization for consideration other than stock may result in denial of the nontaxable exchange.

1-29. One advantage of a Type C reorganization is that it permits the acquirer to gain possession of the acquiree's assets through contract rather than through the provisions of the state of incorporation. As a result, the acquirer does not become liable for contingent liabilities that are not expressly accepted as part of the agreement. The negative aspect of the Type C reorganization is that the acquirer's voting common stock must be issued for 100 percent of the consideration given to the acquiree. In addition, the acquiree must distribute the stock to its shareholders and, in essence, terminate the operations of the target corporation.

MULTIPLE CHOICE SOLUTIONS

1-1. Answer: c. a, b, and d are all involve the acquisition of another company, a form of external expansion.

1-2. Answer: a.

1-3. Answer: d.

1-4. Answer: b.

1-5. Answer: d.

1-6. Answer: a.

1-7. Answer: d. The change in acquiree net assets will depend on the acquisition price and book value of the acquiree's assets.

1-8. Answer: d.

1-9. Answer: b.

1-10. Answer: b

EXERCISE SOLUTIONS

Exercise 1-1.

East Coast Yachting: Bibby, Dyer, and Lozeau.

East Bay Sailing: Clarke and Hartling.

An asset for asset exchange does not result in any change in the ownership structure of either company.

Exercise 1-2.

Pete's Yard Maintenance: DeSimone and Murphy.

Independent Lawn Service: Fortier, Miranda, Rush, and Pete's Lawn Maintenance.

Independent Lawn Service issued stock to acquire Pete's Yard Maintenance's assets. DeSimone and Murphy indirectly own stock in Independent Lawn Service.

Exercise 1-3.

HealthCare Magazine: HealthCare Review.

HealthCare Review: Perreault, Richards, and Sheldon.

HealthCare Review purchased HealthCare Magazine's stock from its owners so Armstrong and Hart no longer own stock of either company.

Exercise 1-4.

Shawn's Clothing: Casual Clothing

Casual Clothing: Best, Creeden, Eikman, Stafford, and Vargas.

All of the stockholders now own stock in Casual Clothing and thereby indirectly have an ownership interest in Shawn's Clothing

Exercise 1-5.

Shares of Minor Location	250,000
Exchange ratio	.6
Shares of Mega Markets	150,000
Per share market price of Mega Markets	$20
Investment account balance as a result of the stock swap	$3,000,000

Shares of Minor Location	250,000
Exchange ratio	.75
Shares of Mega Markets	187,500
Per share market price of Mega Markets	$20
Investment account balance as a result of the stock swap	$3,750,000

The investment account will increase because Mega agrees to pay more if Minor's profitability significantly increases.

Exercise 1-6.

Investment Account amount if no price change occurs

Shares of Reynolds	500,000
Exchange ratio	1.5
Shares of Phillips	750,000
Per share market price of Phillips	$20
Investment account balance as a result of the stock swap	$15,000,000

Part a.

Investment Account amount if Phillips stock price increases from $20 - $24

Shares of Reynolds	500,000
Exchange ratio	1.25
Shares of Phillips	625,000
Per share market price of Phillips	$24
Investment account balance as a result of the stock swap	$15,000,000

The investment account will not change. The change in the exchange ratio maintains the acquisition price at the amount agreed by management of Phillips and Reynolds.

Part b.

Investment Account amount if Phillips stock price decreases from $20 - $12.50

Shares of Reynolds	500,000
Exchange ratio	2.4
Shares of Phillips	1,200,000
Per share market price of Phillips	$12.50
Investment account balance as a result of the stock swap	$15,000,000

The investment account will not change. The change in the exchange ratio maintains the acquisition price at the amount agreed by management of Phillips and Reynolds.

Part c.

Investment Account amount if Phillips stock price decreases from $20 - $19	
Shares of Reynolds	500,000
Exchange ratio	1.5
Shares of Phillips	750,000
Per share market price of Phillips	$19
Investment account balance as a result of the stock swap	$14,250,000

The stock price change in this part is less than 10 percent. As a result, no change in the exchange ratio (number of shares exchanged) occurs. Thus, the investment account balance will change from $15,000,000 to $14,250,000.

PROBLEM SOLUTIONS

Problem 1-1

Part a.

Company	Shareholders	Percentage	Market Value
Han's	Conlan, Jackson, and Perron	100	$2,500,000
Mass	Hartley and Munson	100	$150,000

Part b.

Company	Shareholders	Percentage	Market Value
Universal	Alberto and Amato	100	$4,437,500*
Random	Davis, Hurd, and Ringrose	75	$13,312,500**
	Universal	25	$4,437,500**

* $\frac{\$15,000,000 + \$2,750,000}{320,000} \times 80,000$

** $15,000,000 + $2,750,000

Part c.

Company	Shareholders	Percentage	Market Value
Heritage	Levin and Levy	100	$10,750,000
City	Heritage	100	$3,600,000

Part d.

Company	Shareholders	Percentage	Market Value
Chambers	Olympia	100	$1,250,000
Olympia	Forest and Gump	80	$5,000,000
	Chambers and Garrett	20	$1,250,000

Problem 1-2

	TYPES OF EXCHANGES							
	Chester's assets for Monti's assets		Chester's assets for Monti's stock		Chester's stock for Monti's assets		Chester's stock for Monti's stock	
	Monti's	Chester's	Monti's	Chester's	Monti's	Chester's	Monti's	Chester's
Shareholder s	Brewer and Herold	Dorsey, Lawlor, and O'Flaherty	Chester's	Dorsey, Lawlor, and O'Flaherty	Brewer and Herold	Dorsey, Lawlor, and O'Flaherty / Monti's	Chester' s	Dorsey, Lawlor, and O'Flaherty / Brewer and Herold
Percentage ownership	100	100	100	100	100	80 / 20	100	80 / 20

Problem 1-3

The stockholders of Home Construction Company would receive 208,000 (320,000 x .65) shares of Ace Building Products' stock valued at $5,720,000. This is also the amount that Ace would recognize as an investment. If net income increases by at least 15 percent, the stockholders of Home Construction Company would receive 224,000 (320,000 x .70) shares of Ace Building Products' stock valued at $6,160,000. The issuance of these additional shares of stock would increase Ace's investment in Home Construction Company because the stock issued by Ace would have a greater market value.

Problem 1-4

Microsoft is currently considering issuing 4,500,000 (5,000,000 x .90) shares of stock in exchange for all 5,000,000 shares of Intuit. This exchange will result in the recognition of an investment of $405,000,000. If the market value of Microsoft's stock decreases from $90 to $67.50 per share (a 25 percent decrease), the exchange ratio of Microsoft stock for Intuit stock will increase from .90 to 1.20 (.9/.75). As a result of this decrease in the market value of Microsoft stock, Microsoft would issue 6,000,000 shares of stock. The investment in Intuit would remain at $405,000,000 (6,000,000 x $67.50) because of the decrease in the value of Microsoft's stock.