**Chapter 11 - Suggested Answers to the questions for discussion in class**

1. **What is deal structure?**

The deal-structuring process involves satisfying as many of the primary acquirer and target objectives and determining how risk will be shared.

1. **When to use cash as the form of payment?**

“Acquirers may use cash if the firm has significant borrowing capacity, a high credit rating, and undervalued shares and wishes to maintain control. Surprisingly, there is little correlation between the size of an acquirer’s cash balances and the likelihood it would make a cash offer in a takeover. In fact, cash-rich acquirers are often more likely to make stock rather than cash offers than acquirers with smaller cash holdings. This seeming anomaly may reflect the target’s preference for acquirer’s stock due to its perceived growth potential or for a tax-free deal. A cash purchase is more likely to be financed from borrowing if the firm has a high credit rating due to its comparatively low borrowing costs”

1. **When to use stock as the form of payment?**

“The use of stock is more complicated than cash because of the need to comply with prevailing securities laws. The acquirer may choose to use stock if it is believed to be overvalued and has limited borrowing capacity and excess cash balances. Acquirer’s stock also may be used as the primary form of payment when the integration of the target firm is expected to be lengthy in order to minimize the amount of indebtedness required to complete the takeover. By maintaining the ability to borrow, the acquirer is able to finance unanticipated cash outlays during the integration period and to pursue investment opportunities that might arise.

 Firms whose actual leverage exceeds their desired leverage are more likely to use some form of payment other than cash in making acquisitions. Furthermore, acquirer’s stock may be a useful form of payment when valuing the target firm is difficult, such as when the target has hard-to-value intangible assets, new product entries, or large R&D outlays. In accepting acquirer’s stock, a seller may have less incentive to negotiate an overvalued purchase price if it wishes to participate in any appreciation of the stock it receives.

 Other forms of noncash payment include real property, rights to intellectual property, royalties, earnouts, and contingent payments. Overvalued stock has been shown to be an important predictor of the form of payment chosen by acquirers. The extent to which a firm’s share price is overvalued can be measured by the amount of short interest in the stock. Stock acquirers have significantly higher short interest in their shares prior to the announcement of a merger, up to 6 months prior to the merger, than do cash acquirers.

1. **Sellers often demand acquirer shares as the primary form of payment. Why?**

 Sellers often demand acquirer shares as the primary form of payment due to the ability to defer the payment of taxes. Acquirer shares might be especially attractive if their growth prospects are favorable. There is the ever-present danger to selling shareholders that the acquirer shares may be overvalued and decline in value over time toward their true value.

1. **Seller shareholders do not want debt as the form of payment. Why**

Seller shareholders may find debt unattractive because of the acquirer’s perceived high risk of default. Debt or equity securities issued by nonpublic firms may also be illiquid because of the small size of the resale market for such securities

1. **When do shareholders prefer a combination of cash and stock?**

Some target shareholders may want a combination of acquirer’s stock and cash if they are unsure of the appreciation potential of the acquirer’s stock. Others may prefer a combination of cash and stock if they need the cash to pay taxes due on the sale of their shares. Also, acquirers, unable to borrow to finance an all-cash offer or unwilling to absorb the dilution in an all-stock offer, may choose to offer the target firm a combination of stock and cash.

1. **Why do sellers accept buyer’s overvalued stocks as payment?**

Acquirers also may be motivated to offer their shares if they believe they are overvalued, since they are able to issue fewer shares. Overvaluation refers to the excess of the acquirer’s current share price over its intrinsic value. Target firm shareholders may be willing to accept overvalued acquirer shares because the overvaluation may not be obvious or the acquirer’s stock may reduce the degree of post merger leverage of the combined firms. If investors believe the combined firms are less risky because of the reduction in leverage, the intrinsic value of the acquirer shares may rise reflecting the combined firm’s lower cost of capital. The resulting rise in their intrinsic value may reduce or eliminate the overvaluation of the acquirer shares.

1. **What is fixed share exchange rate? What is fixed value (floating rate) agreement?**

Fixed share-exchange agreements, which preclude any change in the number of acquirer shares exchanged for each target share, are commonly used in share exchanges because they involve both firms’ share prices, allowing each party to share in the risk or benefit from fluctuating share prices. The acquirer’s risk is that its shares will appreciate between signing and closing, raising the cost of the deal. The seller’s risk is a potential drop in the value of the ASP, resulting in a lower-than-expected purchase price. While the buyer will know exactly how many shares will have to be issued to complete the deal, the acquirer and the target will be subject to significant uncertainty about the final value of the deal. Alternatively, a fixed-value agreement fixes the value of the offer price per share by allowing the share-exchange ratio (SER) to vary or float. An increase in the value of the ASP results in fewer acquirer shares being issued, to keep the value of the deal unchanged, while a decrease would require that additional shares be issued. Both fixed-value and fixed-share-exchange agreements sometimes include a collar arrangement. For fixed-value agreements, the SER is allowed to vary within a narrow range; for fixed-share-exchange agreements, the offer price per share (deal value) is allowed to fluctuate within narrow limits.

1. **What is an asset purchase?**

An asset purchase involves the sale of all or a portion of the assets of the target to the buyer or its subsidiary in exchange for buyer’s stock, cash, debt, or some combination. The buyer may assume all, some, or none of the target’s liabilities. The purchase price is paid directly to the target firm.

1. **What is a stock purchase?**

A stock purchase involves the sale of the outstanding stock of the target to the buyer or its subsidiary by the target’s shareholders. Unlike an asset purchase, the purchase price is paid to the target firm’s shareholders. This is the biggest difference between the two methods, and it has significant tax implications for the seller’s shareholders

1. **Amazon acquiring whole foods is an example of direct merger. Describe what is a direct merger?**

A statutory or direct merger involves the combination of the target with the buyer or a subsidiary formed to complete the merger. One corporation survives the merger and the other disappears. The surviving corporation can be the buyer, the target, or the buyer’s subsidiary. Merger terminology usually refers to the bidder as the surviving corporation and to the target as the disappearing corporation. Knowing which company is to survive is critical under merger law because of successor liability. This legal principle states that the surviving corporation receives by operation of law all rights and liabilities of both the bidder company and the target company in accordance with the statutes of the state in which the combined businesses will be incorporated

1. **Direct merger requires shareholders approval?**

State statutes usually require shareholder approval by both the bidder and target firms in a merger. However, no acquirer shareholder vote is required if the form of payment is cash, the number of new acquirer shares issued is less than 20% of the firm’s outstanding shares, or the number of shares previously authorized is sufficient to complete the deal.

1. **What is asset purchase? Advantage and disadvantage from the perspectives of both seller and buyer.**

An asset purchase may be the most practical way to complete the transaction when the acquirer is interested only in a product line or division of the parent firm with multiple product lines or divisions that are not organized as separate legal subsidiaries. The seller retains ownership of the shares of stock of the business. Only assets and liabilities identified in the agreement of purchase and sale are transferred to the buyer.

Advantages to the buyer include being able to be selective as to which target assets to purchase and not being responsible for the seller’s liabilities unless assumed under the contract. However, the buyer can be held responsible for certain liabilities, such as environmental claims, property taxes, and, in some states, substantial pension liabilities and product liability claims. Another advantage is that asset purchases enable buyers to revalue acquired assets to market value under the purchase method of accounting. This increase in the tax basis of the acquired assets to fair market value provides for higher depreciation and amortization expense deductions for tax purposes.

Among the disadvantages to a purchase of assets is that the buyer loses the seller’s net operating losses and tax credits, and rights to assets such as licenses, franchises, and patents cannot be transferred, which are viewed as owned by the target shareholders.

Among the advantages, sellers are able to maintain their corporate existence and thus ownership of tangible assets not acquired by the buyer and of intangible assets such as licenses, franchises, and patents. The seller retains the right to use all tax credits and accumulated net operating losses to shelter future income from taxes. The disadvantages include the potential double taxation of the seller. If the tax basis in the assets is low, the seller may experience a sizeable gain on the sale; if the corporation subsequently is liquidated, the seller may be responsible for the recapture of taxes deferred as a result of the use of accelerated rather than straight-line depreciation. If the number of assets transferred is large, the amount of state transfer taxes may become onerous**.**

1. **What is cash for assets acquisition?**

In a cash-for-assets acquisition, the acquirer pays cash for the seller’s assets and may choose to accept some or all of the seller’s liabilities. Seller shareholders must approve the transaction whenever the seller’s board votes to sell all or “substantially all” of the firm’s assets and the firm is liquidated. After paying for any liabilities not assumed by the buyer, the assets remaining with the seller and the cash received from the acquiring firm are transferred to the seller’s shareholders in a liquidating distribution.

1. **What is stock for assets acquisition?**

 In a stock for-assets transaction, once approved by the seller’s board and shareholders, the seller’s shareholders receive buyer’s stock in exchange for the seller’s assets and assumed liabilities. In a second stage, the seller dissolves the corporation following shareholder ratification of such a move, leaving its shareholders with buyer’s stock.

1. **What is stock purchase? Advantage and disadvantage from the perspectives of both seller and buyer?**

In cash-for-stock or stock-for-stock transactions, the buyer purchases the seller’s stock directly from the seller’s shareholders. For a public company, the acquirer would make a tender offer, because public company shareholders are likely to be too numerous to deal with individually. A purchase of stock is the approach most often taken in hostile takeovers. If the buyer is unable to convince all of the seller’s shareholders to tender their shares, then a minority of seller shareholders remains outstanding. The target firm would then be viewed as a partially owned subsidiary of the acquiring company. No seller shareholder approval is required in such transactions because the seller’s shareholders are expressing approval by tendering their shares. *Advantages and Disadvantages from the Buyer’s Perspective Advantages* include the automatic transfer of all assets with the target’s stock, the avoidance of state asset transfer taxes, and the transfer of net operating losses and tax credits to the buyer. The purchase of the seller’s stock provides for the continuity of contracts and corporate identity. However, the consent of some customers and vendors may be required before a contract is transferred if it is stipulated in the contract. While the acquirer’s board normally approves any major acquisition, approval by shareholders is not required if the purchase is financed with cash or debt. If stock that has not yet been authorized is used, shareholder approval is required. Among the disadvantages, the buyer is liable for all unknown, undisclosed, or contingent liabilities. The seller’s tax basis is carried over to the buyer at historical cost; therefore, there is no step-up in the cost basis of assets, and no tax shelter is created.

*Sellers often prefer a stock purchase to an asset purchase* because the seller is free of future obligations, because all liabilities transfer to the buyer, and the seller is able to defer paying taxes if the form of payment is mostly buyer’s stock. Disadvantages for the seller include the inability to retain certain assets and the loss of net operating losses, tax credits, and intellectual property rights.

1. **What is tender offer?**

An alternative to a traditional one-step (or long-form) merger is the two-step merger. In the first step, the acquirer buys through a stock purchase the majority of the target’s outstanding stock from its shareholders in a tender offer; in the second step, a squeeze out/freeze-out merger or back-end merger is approved by the acquirer as majority shareholder. Minority shareholders are required to sell their shares. The two-step merger usually is faster (if the buyer can get enough votes in the tender offer to qualify for a short-form merger) than the more traditional one-step merger that requires shareholder approval (with some exceptions) by both acquirer and target shareholders. The one-step merger process may take several months to close as a proxy statement must be prepared and reviewed by the SEC, mailed to shareholders, and a shareholder vote must be obtained. The length of the process creates deal uncertainty due to the potential for competing bids. An important disadvantage of the two-step merger in the past has been the delay and cost of consummating the back-end merger necessary to acquire the shares that were not purchased in the initial tender offer. If the buyer failed to own 90% of the target’s stock after the tender, the buyer was not permitted to use a short form merger that requires a target board but not shareholder approval. Instead the buyer had to prepare, file, and mail a proxy statement following SEC review and hold a stockholder meeting.

This process could result in a two-step merger taking longer than a one-step merger. Buyers and sellers have utilized a number of negotiated contract provisions to limit the risk of a protracted backend merger. These included the top-up option and dual track structure.