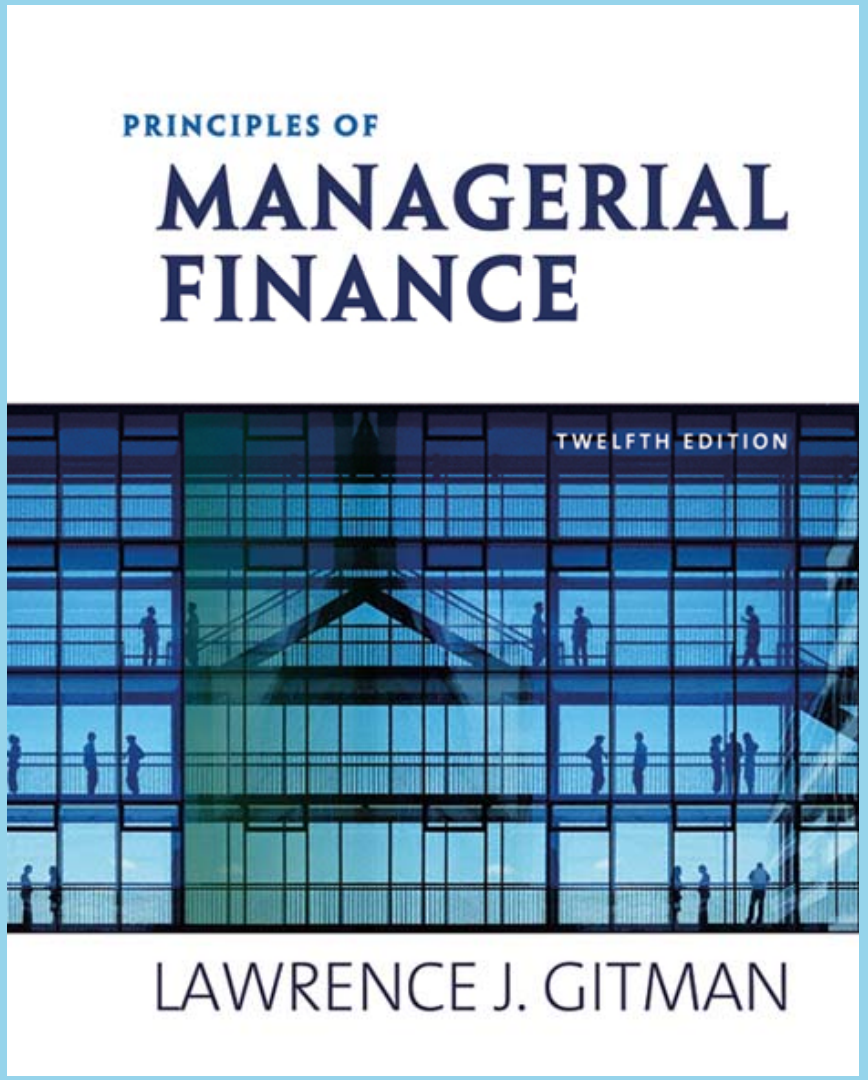
Chapter 17

Mergers, LBOs, Divestitures, and Business Failure



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Learning Goals



1. Understand merger fundamentals, including terminology, motives for merging, and types of mergers.
2. Describe the objectives and procedures used in leveraged buyouts (LBOs) and divestitures.
3. Demonstrate the procedures used to value the target company, and discuss the effect of stock swap transactions on earnings per share.

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Learning Goals (cont.)



4. Discuss the merger negotiation process, holding companies, and international mergers.
5. Understand the types and major causes of business failure and the use of voluntary settlements to sustain or liquidate the failed firm.
6. Explain bankruptcy legislation and the procedures involved in reorganizing or liquidating a bankrupt firm.

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Merger Fundamentals



- While **mergers** should be undertaken to improve a firm's share value, mergers are used for a variety of reasons as well:
  - To **expand externally** by acquiring control of another firm
  - To **diversify product lines**, geographically, etc.
  - To **reduce taxes**
  - To **increase owner liquidity**

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Merger Fundamentals: Terminology



- **Corporate restructuring** includes the activities involving expansion or contraction of a firm's operations or changes in its asset or financial (ownership) structure.
- A **merger** is defined as the combination of two or more firms, in which the resulting firm maintains the identity of one of the firms, usually the larger one.
- **Consolidation** is the combination of two or more firms to form a completely new corporation

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Merger Fundamentals: Terminology (cont.)



- A **holding company** is a corporation that has voting control of one or more other corporations.
- **Subsidiaries** are the companies controlled by a holding company.
- The **acquiring company** is the firm in a merger transaction that attempts to acquire another firm.
- The **target company** in a merger transaction is the firm that the acquiring company is pursuing.

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Merger Fundamentals: Terminology (cont.)



- A **friendly merger** is a merger transaction endorsed by the target firm's management, approved by its stockholders, and easily consummated.
- A **hostile merger** is a merger not supported by the target firm's management, forcing the acquiring company to gain control of the firm by buying shares in the marketplace.
- A **strategic merger** is a transaction undertaken to achieve economies of scale.

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Merger Fundamentals: Terminology (cont.)



- A **financial merger** is a merger transaction undertaken with the goal of restructuring the acquired company to improve its cash flow and unlock its hidden value.

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Motives for Merging



- The overriding **goal** for merging is the **maximization of the owners' wealth** as reflected in the acquirer's share price.
- Firms that desire rapid growth in size of market share or **diversification** in their range of products may find that a merger can be useful to fulfill this objective.
- Firms may also undertake mergers to achieve **synergy** in operations where synergy is the economies of scale resulting from the merged firms' lower overhead.

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Motives for Merging (cont.)



- Firms may also combine to enhance their **fund-raising ability** when a “cash rich” firm merges with a “cash poor” firm.
- Firms sometimes merge to increase **managerial skill or technology** when they find themselves unable to develop fully because of deficiencies in these areas.
- In other cases, a firm may merge with another to acquire the target’s **tax loss carryforward** (see Table 17.1) because the tax loss can be applied against a limited amount of future income of the merged firm.

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Motives for Merging (cont.)



Table 17.1 Total Taxes and After-Tax Earnings for Hudson Company without and with Merger

	Year			Total for 3 years
	1	2	3	
Total taxes and after-tax earnings without merger				
(1) Earnings before taxes	$300,000	$300,000	$300,000	$900,000
(2) Taxes [0.40 × (1)]	120,000	120,000	120,000	360,000
(3) Earnings after taxes [(1) − (2)]	$180,000	$180,000	$180,000	$540,000
Total taxes and after-tax earnings with merger				
(4) Earnings before losses	$300,000	$300,000	$300,000	$900,000
(5) Tax loss carryforward	300,000	150,000	0	450,000
(6) Earnings before taxes [(4) − (5)]	$ 0	$150,000	$300,000	$450,000
(7) Taxes [0.40 × (6)]	0	60,000	120,000	180,000
(8) Earnings after taxes [(4) − (7)]	$300,000	$240,000	$180,000	$720,000

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Motives for Merging (cont.)



- The merger of two small firms or a small and a larger firm may provide the owners of the small firm(s) with **greater liquidity** due to the higher marketability associated with the shares of the larger firm.
- Occasionally, a firm that is a target of an unfriendly takeover will acquire another company as a **defense** by **taking on additional debt**, eliminating its desirability as an acquisition.

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Types of Mergers



- Four types of mergers include:
- The **horizontal merger** is a merger of two firms in the sale line of business.
- A **vertical merger** is a merger in which a firm acquires a supplier or a customer.
- A **congeneric merger** is a merger in which one firm acquires another firm that is in the same general industry but neither in the same line of business not a supplier or a customer.
- Finally, a **conglomerate merger** is a merger combining firms in unrelated businesses.

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LBOs and Divestitures



- A **leveraged buyout (LBO)** is an acquisition technique involving the use of a large amount of debt to purchase a firm.
- LBOs are a good example of a **financial merger** undertaken to create a high-debt private corporation with improved cash flow and value.
- In a typical LBO, 90% or more of the purchase price is financed with debt where much of the debt is secured by the acquired firm's assets.
- And because of the high risk, lenders take a portion of the firm's equity.

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LBOs and Divestitures (cont.)



- An attractive candidate for acquisition through an LBO should possess three basic attributes:
  - It must have a **good position in its industry** with a solid profit history and reasonable expectations of growth.
  - It should have a relatively low level of debt and a high level of "bankable" assets that can be used as loan collateral.
  - It must have stable and **predictable cash flows** that are adequate to meet interest and principal payments on the debt and provide adequate working capital.

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LBOs and Divestitures (cont.)



- A **divestiture** is the selling an operating unit for various strategic motives.
- An **operating unit** is a part of a business, such as a plant, division, product line, or subsidiary, that contributes to the actual operations of the firm.
- Unlike business failure, the motive for divestiture is often positive: to generate cash for expansion of other product lines, to get rid of a poorly performing operation, to streamline the corporation, or to restructure the corporations business consistent with its strategic goals.

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LBOs and Divestitures (cont.)



- Regardless of the method or motive used, the **goal of divesting** is to create a more lean and focused operation that will enhance the efficiency and profitability of the firm to enhance shareholder value.
- Research has shown that for many firm's the **breakup value**—the sum of the values of a firm's operating units if each is sold separately—is significantly greater than their combined value.
- However, finance theory has thus far been unable to adequately explain why this is the case.

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Analyzing and Negotiating Mergers: Valuing the Target Company



- Determining the value of a target may be accomplished by applying the capital budgeting techniques discussed earlier in the text.
- These techniques should be applied whether the target is being acquired for its assets or as a going concern.

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Analyzing and Negotiating Mergers: Acquisition of Assets



- The price paid for the acquisition of assets depends largely on which assets are being acquired.
- Consideration must also be given to the value of any **tax losses**.
- To determine whether the purchase of assets is justified, the acquirer must estimate both the **costs and benefits** of the target's assets

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Analyzing and Negotiating Mergers: Acquisition of Assets (cont.)



Clark Company, a manufacturer of electrical transformers, is interested in acquiring certain fixed assets of Noble Company, an industrial electronics firm. Noble Company, which has tax loss carryforwards from losses over the past 5 years, is interested in selling out, but wishes to sell out entirely, rather than selling only certain fixed assets. A condensed balance sheet for Noble appears as follows:

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Analyzing and Negotiating Mergers: Acquisition of Assets (cont.)



Noble Company
Balance Sheet

Assets		Liabilities and Stockholders' Equity	
Cash	$ 2,000	Total liabilities	$ 80,000
Marketable securities	0	Stockholders' equity	120,000
Accounts receivable	8,000	Total liabilities and stockholders' equity	$200,000
Inventories	10,000		
Machine A	10,000		
Machine B	30,000		
Machine C	25,000		
Land and buildings	115,000		
Total assets	$200,000		

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Analyzing and Negotiating Mergers: Acquisition of Assets (cont.)



Clark Company needs only machines B and C and the land and buildings. However, it has made inquiries and arranged to sell the accounts receivable, inventories, and Machine A for $23,000. Because there is also $20,000 in cash, Clark will get $25,000 for the excess assets.

Noble wants $100,000 for the entire company, which means Clark will have to pay the firm's creditors $80,000 and its owners $20,000. The actual outlay required for Clark after liquidating the unneeded assets will be $75,000 [($80,000 + $20,000) - $25,000].

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Analyzing and Negotiating Mergers: Acquisition of Assets (cont.)



The after-tax cash inflows that are expected to result from the new assets and applicable tax losses are $14,000 per year for the next five years. The NPV is calculated as shown in Table 17.2 on the following slide using Clark Company's 11% cost of capital. Because the NPV of $3,072 is greater than zero, Clark's value should be increased by acquiring Noble Company's assets.

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Analyzing and Negotiating Mergers: Acquisition of Assets (cont.)



Table 17.2 Net Present Value of Noble Company's Assets

Year(s)	Cash inflows (1)	Present value factor at 11% (2)	Present value [(1) × (2)] (3)
1–5	$14,000	3.696[a]	$51,744
6	12,000	0.535[b]	6,420
7	12,000	0.482[b]	5,784
8	12,000	0.434[b]	5,208
9	12,000	0.391[b]	4,692
10	12,000	0.352[b]	4,224
		Present value of inflows	$78,072
		Less: Cash outlay required	75,000
		Net present value[c]	$ 3,072

[a]The present value interest factor for an annuity, *PVIFA*, with a 5-year life discounted at 11% obtained from Table A–4.

[b]The present value interest factor, *PVIF*, for $1 discounted at 11% percent for the corresponding year obtained from Table A–2.

[c]When we use a financial calculator, we get a net present value of $3,063.

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Analyzing and Negotiating Mergers: Acquisitions of Going Concerns



- The methods of estimating expected cash flows from a **going concern** are similar to those used in estimating capital budgeting cash flows.
- Typically, pro forma income statements reflecting the postmerger revenues and costs attributable to the target company are prepared.
- They are then adjusted to reflect the expected cash flows over the relevant time period.

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Analyzing and Negotiating Mergers: Acquisitions of Going Concerns (cont.)



Square Company, a major media firm, is contemplating the acquisition of Circle Company, a small independent film producer that can be purchased for $60,000. Square company has a high degree of financial leverage, which is reflected in its 13% cost of capital. Because of the low financial leverage of Circle Company, Square estimates that its overall cost of capital will drop to 10%.

Because the effect of the less risky capital structure cannot be reflected in the expected cash flows, the postmerger cost of capital of 10% must be used to evaluate the cash flows expected from the acquisition.

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Analyzing and Negotiating Mergers: Acquisitions of Going Concerns (cont.)



The postmerger cash flows are forecast over a 30-year time horizon as shown in Table 17.3 on the next slide. Because the resulting NPV of the target company of $2,357 is greater than zero, the merger is acceptable. Note, however, that if the lower cost of capital resulting from the change in capital structure had not been considered, the NPV would have been -$11,854, making the merger unacceptable to Square company.

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Analyzing and Negotiating Mergers



Table 17.3 Net Present Value of the Circle Company Acquisition

Year(s)	Cash inflows (1)	Present value factor at 10%[a] (2)	Present value [(1) × (2)] (3)
1–10	$ 5,000	6.145	$30,725
11–18	13,000	(8.201 − 6.145)[b]	26,728
19–30	4,000	(9.427 − 8.201)[b]	4,904
		Present value of inflows	$62,357
		Less: Cash purchase price	60,000
		Net present value[c]	$ 2,357

[a]Present value interest factors for annuities, *PVIFA*, obtained from Table A–4.

[b]These factors are found by using a shortcut technique that can be applied to annuities for periods of years beginning at some point in the future. By finding the appropriate interest factor for the present value of an annuity given for the last year of the annuity and subtracting the present value interest factor of an annuity for the year immediately preceding the beginning of the annuity, the appropriate interest factor for the present value of an annuity beginning sometime in the future can be obtained. You can check this shortcut by using the long approach and comparing the results.

[c]When we use a financial calculator, we get a net present value of $2,364.

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Analyzing and Negotiating Mergers: Stock Swap Transactions



- After determining the value of a target, the acquire must develop a proposed **financing package**.
- The simplest but least common method is a **pure cash purchase**.
- Another method is a **stock swap transaction** which is an acquisition method in which the acquiring firm exchanges shares for the shares of the target company according to some predetermined ratio.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



- This ratio affects the various financial yardsticks that are used by existing and prospective shareholders to value the merged firm's shares.
- To do this, the acquirer must have a sufficient number of shares to complete the transaction.
- In general, the acquirer offers more for each share of the target than the current market price.
- The actual **ratio of exchange** is the ratio of the amount paid per share of the target to the per share price of the acquirer.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



Grand Company, a leather products concern whose stock is currently selling for $80 per share, is interested in acquiring Small Company, a producer of belts. To prepare for the acquisition, Grand has been repurchasing its own shares over the past 3 years.

Small Company's stock is currently selling for $75 per share, but in the merger negotiations, Grand has found it necessary to offer Small $110 per share.

Therefore, the ratio of exchange is 1.375 ($110 ÷ $80) which means that Grand must exchange 1.375 shares of its stock for each share of Small's stock.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



- Although the focus is must be on cash flows and value, it is also useful to consider the effects of a proposed merger on an acquirer's EPS.
- Ordinarily, the resulting EPS differs from the permerger EPS for both firms.
- When the ratio of exchange is equal to 1 and both the acquirer and target have the same premerger EPS, the merged firm's EPS (and P/E) will remain constant.
- In actuality, however, the EPS of the merged firm are generally above the premerger EPS of one firm and below the other.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



As described in previously, Grand is considering acquiring Small by swapping 1.375 shares of its stock for each share of Small's stock. The current financial data related to the earnings and market price for each of these companies is described below in Table 17.4.

Table 17.4 Grand Company's and Small Company's Financial Data

Item	Grand Company	Small Company
(1) Earnings available for common stock	$500,000	$100,000
(2) Number of shares of common stock outstanding	125,000	20,000
(3) Earnings per share [(1) ÷ (2)]	$4	$5
(4) Market price per share	$80	$75
(5) Price/earnings (P/E) ratio [(4) ÷ (3)]	20	15

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



To complete the merger and retire the 20,000 shares of Small company stock outstanding, Grand will have to issue and or use treasury stock totaling 27,500 shares (1.375 x 20,000).

Once the merger is completed, Grand will have 152,500 shares of common stock (125,000 + 27,500) outstanding. Thus the merged company will be expected to have earnings available to common stockholders of $600,000 ($500,000 + $100,000). The EPS of the merged company should therefore be $3.93 ($600,000 ÷ 152,500).

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



It would seem that the Small Company's shareholders have sustained a decrease in EPS from $5 to $3.93. However, because each share of Small's original stock is worth 1.375 shares of the merged company, the equivalent EPS are actually $5.40 ($3.93 x 1.375).

In other words, Grand's original shareholders experienced a decline in EPS from $4 to $3.93 to the benefit of Small's shareholders, whose EPS increased from $5 to $5.40 as summarized in Table 19.5.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



Table 17.5 Summary of the Effects on Earnings per Share of a Merger between Grand Company and Small Company at $110 per Share

	Earnings per share	
Stockholders	**Before merger**	**After merger**
Grand Company	$4.00	$3.93[a]
Small Company	5.00	5.40[b]

[a] $$\frac{\$500{,}000 + \$100{,}000}{125{,}000 + (1.375 \times 20{,}000)} = \$3.93$$

[b] $\$3.93 \times 1.375 = \$5.40$

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



The postmerger EPS for owners of the acquirer and target can be explained by comparing the P/E ratio paid by the acquirer with its initial P/E ratio as described in Table 17.6.

Table 17.6 Effect of Price/Earnings (P/E) Ratios on Earnings per Share (EPS)

Relationship between P/E paid and P/E of acquiring company	Effect on EPS: Acquiring company	Effect on EPS: Target company
P/E paid > P/E of acquiring company	Decrease	Increase
P/E paid = P/E of acquiring company	Constant	Constant
P/E paid < P/E of acquiring company	Increase	Decrease

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



Grand's P/E is 20, and the P/E ratio paid for Small was 22 ($110 ÷ $5). Because the P/E paid for Small was greater than the P/E for Grand, the effect of the merger was to decrease the EPS for original holders of shares in Grand (from $4.00 to $3.93) and to increase the effective EPS of original holders of shares in Small (from $5.00 to $5.40).

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



- The long-run effect of a merger on the EPS of the merged company depends largely on whether the EPS of the merged firm grow.
- The key factor enabling the acquiring firm to experience higher future EPS than it would have without the merger is that the earnings attributable to the target company's assets grow more rapidly than those resulting from the acquiring company's pre-merger assets.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



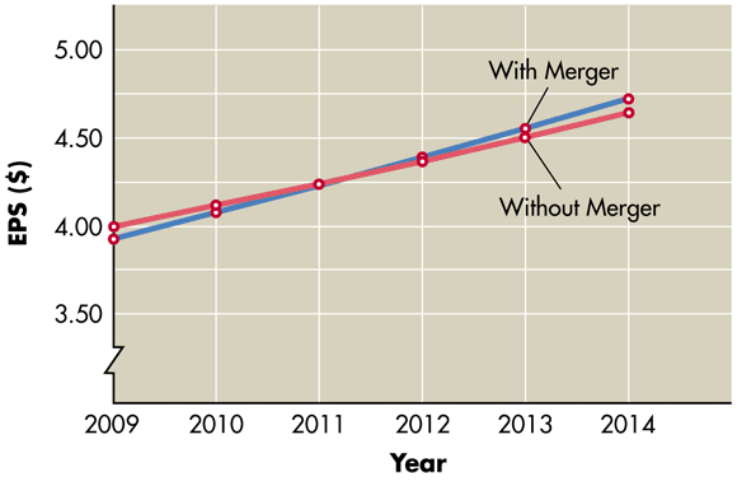
In 2006, Grand Company acquired Small Company by swapping 1.375 shares of its common stock for each share of Small Company. The total earnings of Grand Company were expected to grow at an annual rate of 3% without the merger; Small Company's earnings were expected to grow at 7% without the merger. The same growth rates are expected to apply to the component earnings streams with the merger. The Table in Figure 17.1 shows the future effects of EPS for Grand Company without and with the proposed Small Company Merger.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



Figure 17.1
Future EPS



Year	Without Merger: Total earnings[a]	Without Merger: Earnings per share[b]	With Merger: Total earnings[c]	With Merger: Earnings per share[d]
2009	$500,000	$4.00	$600,000	$3.93
2010	515,000	4.12	622,000	4.08
2011	530,450	4.24	644,940	4.23
2012	546,364	4.37	668,868	4.39
2013	562,755	4.50	693,835	4.55
2014	579,638	4.64	719,893	4.72

[a]Based on a 3% annual growth rate.
[b]Based on 125,000 shares outstanding.
[c]Based on a 3% annual growth in the Grand Company's earnings and a 7% annual growth in the Small Company's earnings.
[d]Based on 152,500 shares outstanding [125,000 shares + (1.375 × 20,000 shares)].

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



- The **market price** per share does not necessarily remain constant after the acquisition of one firm by another.
- Adjustments in the market price occur due to changes in expected earnings, the dilution of ownership, changes in risk, and other changes.
- By using a ratio of exchange, a **ratio of exchange in market price** can be calculated.
- It indicates the market price per share of the target firm as shown in Equation 17.1

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



$$MPR = \frac{MP_{\text{acquiring}} \times RE}{MP_{\text{target}}}$$

MPR = market price ratio of exchange

$MP_{\text{acquiring}}$ = market price per share of the acquiring firm

MP_{target} = market price per share of the target firm

RE = ratio of exchange

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



The market price of Grand Company's stock was $80 and that of Small Company was $75. The ratio of exchange was 1.375. Substituting these values into Equation 17.1 yields a ratio of exchange in market price of 1.47 [($80 x 1.375) ÷ $75]. This means that $1.47 of the market price of Grand Company is given in exchange for every $1.00 of the market price of Small Company.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



- Even though the acquiring firm must usually pay a **premium** above the target's market price, the acquiring firm's shareholders may still gain.
- This will occur if the merged firm's stock sells at a P/E ratio above the premerger ratios.
- This results from the improved risk and return relationship perceived by shareholders and other investors.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



Returning again to the Grand-Small merger, if the earnings of the merged company remain at the premerger levels, and if the stock of the merged company sells at an assumed P/E of 21, the values in Table 17.7 can be expected.

Although Grand's EPS decline from $4.00 to $3.93, the market price of its shares will increase from $80.00 to $82.53.

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Analyzing and Negotiating Mergers: Stock Swap Transactions (cont.)



Table 17.7 Postmerger Market Price of Grand Company Using a P/E Ratio of 21

Item	Merged company
(1) Earnings available for common stock	$600,000
(2) Number of shares of common stock outstanding	152,500
(3) Earnings per share [(1) ÷ (2)]	$3.93
(4) Price/earnings (P/E) ratio	21
(5) Expected market price per share [(3) × (4)]	$82.53

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Analyzing and Negotiating Mergers: The Merger Negotiation Process



- Mergers are generally facilitated by **investment bankers**—financial intermediaries hired by acquirers to find suitable target companies.
- Once a target has been selected, the investment banker negotiates with its management or investment banker.
- If negotiations break down, the acquirer will often make a direct appeal to the target firm's shareholders using a **tender offer**.

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Analyzing and Negotiating Mergers: The Merger Negotiation Process (cont.)



- A **tender offer** is a formal offer to purchase a given number of shares at a specified price.
- The offer is made to all shareholders at a premium above the prevailing market price.
- In general, a desirable target normally receives more than one offer.
- Normally, non-financial issues such as those relating to existing management, product-line policies, financing policies, and the independence of the target firm must first be resolved.

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Analyzing and Negotiating Mergers: The Merger Negotiation Process (cont.)



- In many cases, existing target company management will implement **takeover defensive actions** to ward off the hostile takeover.
- The **white knight** strategy is a takeover defense in which the target firm finds an acquirer more to its liking than the initial hostile acquirer and prompts the two to compete to take over the firm.
- A **poison pill** is a takeover defense in which a firm issues securities that give holders rights that become effective when a takeover is attempted.

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Analyzing and Negotiating Mergers: The Merger Negotiation Process (cont.)



- **Greenmail** is a takeover defense in which a target firm repurchases a large block of its own stock at a premium to end a hostile takeover by those shareholders.
- **Leveraged recapitalization** is a takeover defense in which the target firm pays a large debt-financed cash dividend, increasing the firm's financial leverage in order to deter a takeover attempt.

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Analyzing and Negotiating Mergers: The Merger Negotiation Process (cont.)



- **Golden parachutes** are provisions in the employment contracts of key executives that provide them with sizeable compensation if the firm is taken over.
- **Shark repellants** are antitakeover amendments to a corporate charter that constrain the firm's ability to transfer managerial control of the firm as a result of a merger.

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Analyzing and Negotiating Mergers: Holding Companies



- **Holding companies** are firms that have voting control of one or more firms.
- In general, it takes fewer shares to control firms with a large number of shareholders than firms with a small number of shareholders.
- The primary advantage of holding companies is the **leverage effect** that permits them to control a large amount of assets with a relatively small dollar amount as shown in Table 17.8.

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Analyzing and Negotiating Mergers: Holding Companies (cont.)



Table 17.8 Balance Sheets for Carr Company and Its Subsidiaries

Assets		Liabilities and Stockholders' Equity	
Carr Company			
Common stock holdings		Long-term debt	$ 6
Company X	$10	Preferred stock	6
Company Y	14	Common stock equity	12
Total	$24	Total	$24
Company X			
Current assets	$ 30	Current liabilities	$ 15
Fixed assets	70	Long-term debt	25
Total	$100	Common stock equity	60
		Total	$100
Company Y			
Current assets	$ 20	Current liabilities	$ 10
Fixed assets	140	Long-term debt	60
Total	$160	Preferred stock	20
		Common stock equity	70
		Total	$160

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Analyzing and Negotiating Mergers: Holding Companies (cont.)



- A major disadvantage of holding companies is the **increased risk** resulting from the leverage effect
- When economic conditions are unfavorable, a loss by one subsidiary may be magnified.
- Another disadvantage is **double taxation**.
- Before paying dividends, a subsidiary must pay federal and state taxes on its earnings.
- Although a **70% dividend exclusion** is allowed on dividends received by one corporation from another, the remaining 30% is taxable.

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Analyzing and Negotiating Mergers: Holding Companies (cont.)



- In some cases, holding companies will further magnify leverage through **pyramiding**, in which one holding company controls others.
- Another advantage of holding companies is the **risk protection** resulting from the fact that the failure of an underlying company does not result in the failure of the entire holding company.
- Other advantages include certain state tax benefits and protection from some lawsuits.

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Analyzing and Negotiating Mergers: International Mergers



- Outside the United States, hostile takeovers are virtually non-existent.
- In fact, in some countries such as Japan, takeovers of any kind are uncommon.
- In recent years, however, Western European countries have been moving toward a U.S.-style approach to shareholder value.
- Furthermore, both European and Japanese firms have recently been active acquirers of U.S. companies.

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Business Failure Fundamentals: Types of Business Failure



- **Technical insolvency** is business failure that occurs when a firm is unable to pay its liabilities as they come due.
- **Bankruptcy** is business failure that occurs when a firm's liabilities exceed the fair market value of its assets.

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Business Failure Fundamentals: Major Causes of Business Failure



- The primary cause of failure is **mismanagement**, which accounts for more than 50% of all cases.
- **Economic activity**—especially during economic downturns—can contribute to the failure of the firm.
- Finally, business failure may result from **corporate maturity** because firms, like individuals, do not have infinite lives.

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Business Failure Fundamentals: Voluntary Settlements



- A **voluntary settlement** is an arrangement between a technically insolvent or bankrupt firm and its creditors enabling it to bypass many of the costs involved in legal bankruptcy proceedings.
- An **extension** is an arrangement whereby the firm's creditors receive payment in full, although not immediately.
- **Composition** is a pro rata cash settlement of creditor claims by the debtor firm where a uniform percentage of each dollar owed is paid.

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Business Failure Fundamentals: Voluntary Settlements (cont.)



- **Creditor control** is an arrangement in which the creditor committee replaces the firm's operating management and operates the firm until all claims have been satisfied.
- **Assignment** is a voluntary liquidation procedure by which a firm's creditors pass the power to liquidate the firm's assets to an adjustment bureau, a trade association, or a third party, which is designated as the assignee.

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Reorganization and Liquidation in Bankruptcy: Bankruptcy Legislation



- **Bankruptcy** in the legal sense occurs when the firm cannot pay its bills or when its liabilities exceed the fair market value of its assets.
- However, creditors generally attempt to avoid forcing a firm into bankruptcy if it appears to have opportunities for future success.
- The **Bankruptcy Reform Act of 1978** is the current governing bankruptcy legislation in the United States.

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Reorganization and Liquidation in Bankruptcy: Bankruptcy Legislation (cont.)



- **Chapter 7** is the portion of the Bankruptcy Reform Act that details the procedures to be followed when liquidating a failed firm.
- **Chapter 11** bankruptcy is the portion of the Act that outlines the procedures for reorganizing a failed (or failing) firm, whether its petition is filed voluntarily or involuntarily.
- **Voluntary reorganization** is a petition filed by a failed firm on its own behalf for reorganizing its structure and paying its creditors.

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Reorganization and Liquidation in Bankruptcy



- Reorganization in Bankruptcy (Chapter 11)
  - **Involuntary reorganization** is a petition initiated by an outside party, usually a creditor, for the reorganization and payment of creditors of a failed firm and can be filed if one of three conditions is met:
    - The firm has past-due debts of $5,000 or more.
    - Three or more creditors can prove they have aggregate unpaid claims of $5,000 or more.
    - The firm is **insolvent**, meaning the firm is not paying its debts when due, a custodian took possession of property, or the fair market value of assets is less than the stated value of its liabilities.

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Reorganization and Liquidation in Bankruptcy (cont.)



- Reorganization in Bankruptcy (Chapter 11)
  - Upon filing this petition, the filing firm becomes a **debtor in possession (DIP)** under Chapter 11 and then develops, if feasible, a reorganization plan.
  - The DIPs first responsibility is the valuation of the firm to determine whether reorganization is appropriate by estimating both the **liquidation value** and its value as a **going concern**.
  - If the firm's value as a going concern is less than its liquidation value, the DIP will recommend liquidation.

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Reorganization and Liquidation in Bankruptcy (cont.)



- Reorganization in Bankruptcy (Chapter 11)
  - The DIP then submits a plan of reorganization to the court and a disclosure statement summarizing the plan.
  - A hearing is then held to determine if the plan is fair, equitable, and feasible.
  - If approved, the plan is given to creditors and shareholders for acceptance.

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Reorganization and Liquidation in Bankruptcy (cont.)



- Liquidation in Bankruptcy (Chapter 7)
  - When a firm is adjudged bankrupt, the judge may appoint a trustee to administer the proceeding and protect the interests of the creditors.
  - The **trustee** is responsible for liquidating the firm, keeping records, and making final reports.
  - After liquidating the assets, the trustee must distribute the proceeds to holders of provable claims.
  - The order of priority of claims in a Liquidation is presented in Table 17.9 on the following slide.

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Reorganization and Liquidation in Bankruptcy (cont.)



- Liquidation in Bankruptcy (Chapter 7)
  - After the trustee has distributed the proceeds, he or she makes final accounting to the court and creditors.
  - Once the court approves the final accounting, the liquidation is complete.

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Table 17.9 Order of Priority of Claims in Liquidation of a Failed Firm



1. The expenses of administering the bankruptcy proceedings.
2. Any unpaid interim expenses incurred in the ordinary course of business between filing the bankruptcy petition and formal action by the court in an involuntary proceeding. (This step is *not* applicable in a voluntary bankruptcy.)
3. Wages of not more than $4,650 per worker that have been earned by workers in the 90-day period immediately preceding the commencement of bankruptcy proceedings.
4. Unpaid employee benefit plan contributions that were to be paid in the 180-day period preceding the filing of bankruptcy or the termination of business, whichever occurred first. For any employee, the sum of this claim plus eligible unpaid wages (item 3) cannot exceed $4,650.
5. Claims of farmers or fishermen in a grain-storage or fish-storage facility, not to exceed $4,650 for each producer.
6. Unsecured customer deposits, not to exceed $2,100 each, resulting from purchasing or leasing a good or service from the failed firm.
7. Taxes legally due and owed by the bankrupt firm to the federal government, state government, or any other governmental subdivision.
8. Claims of secured creditors, who receive the proceeds from the sale of collateral held, regardless of the preceding priorities. If the proceeds from the liquidation of the collateral are insufficient to satisfy the secured creditors' claims, the secured creditors become unsecured creditors for the unpaid amount.
9. Claims of unsecured creditors. The claims of unsecured, or general, creditors and unsatisfied portions of secured creditors' claims (item 8) are all treated equally.
10. Preferred stockholders, who receive an amount up to the par, or stated, value of their preferred stock.
11. Common stockholders, who receive any remaining funds, which are distributed on an equal per-share basis. If different classes of common stock are outstanding, priorities may exist.

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