MERGER ANTITRUST LAW

LAWJ/G-1469-05
Georgetown University Law Center
Fall 2020

Tuesdays and Thursdays, 3:00–5:00 pm
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CLASS 5 WRITTEN ASSIGNMENT—INSTRUCTOR'S ANSWER

Instructions

Submit by email by 3:30 pm on Tuesday, September 15
Send to wdc30@georgetown.edu
Subject line: Merger Antitrust Law: Assignment for Class 5

Assignment

Calls for short answers in short paragraphs that the average person can understand. Math is neither required nor desired.

Company A wants to acquire 100% of Company B through a negotiated merger. The proposed plan of merger calls for Company A to pay cash to the Company B shareholders as consideration for their interests in Company B. Company B is a widely held Delaware corporation that only issues common stock. Company B's stock is traded on the New York Stock Exchange.

1. Explain what is meant by Company B's "market capitalization."
2. Explain why Company A will have to pay a premium above Company B's market capitalization in order to acquire Company B. (There are two reasons.)
3. Explain how Company A will determine the maximum price per share it would be willing to pay for Company B's stock.
4. Explain how Company B might try to bargain with Company A for a high purchase price.
5. Once the two companies have reached an agreement on price and signed a definitive merger agreement, explain how another company can make a bid for Company B that Company B's board of directors must consider.

If you have any questions, send me an e-mail. See you in class.

INSTRUCTOR'S ANSWER

1. Explain what is meant by Company B's "market capitalization."

    Market capitalization is the aggregate value of the outstanding capital stock of the company measured by the number of shares times the trading price for each share.[1] For example, if Company B only has one class of capital stock (common stock), has 100,000 shares outstanding (issued) of this stock, and the trading price is $76 per share, then Company B's market capitalization is 100,000 times $76 or $7,600,000. If Company B has multiple classes of capital stock, its market capitalization is the aggregate value of all classes of the outstanding stock. A company's market capitalization changes with changes in either the number of shares of capital stock outstanding and in the stock price.

2. Explain why Company A will have to pay a premium above Company B's market capitalization in order to acquire Company B. (There are two reasons.)

    First, the trading price of a company's shares is the price at which demand for the stock is equal to the supply, so that (in principle) there is no trading. In other words, there is no stockholder that is willing to sell one or more of its shares at a price that a buyer is willing to pay. This means that every shareholder values the shares it owns at least at the trading price and some shareholders are likely to value their shares at a much higher price (that is, they expect the company to do better than the trading price would predict). This generates an upward-sloping supply curve for the stock. If Company A is going to purchase a certain quantity of Company B's shares and if it cannot discriminate in the prices it pays to the sellers, it will have to offer a price sufficiently above the current trading price to induce Company B's existing shareholders to sell the number of shares that Company A wants to buy.

    Second, Company A will have to pay Company A will want to buy Company B only if Company A believes that Company B will be more valuable in Company A's hands than the price Company A will have to pay (including the amount necessary to induce trading on the supply curve) to acquire Company B. Call this the "gains from trade" of Company A acquiring Company B. If Company B can block the sale,[2] then Company B can bargain for a portion of these gains from trade in terms of higher consideration to be paid to Company B's shareholders. This is an additional force that will require Company A to pay more than the market price for Company B's shares.

    The difference between the price Company A pays to acquire a share of Company B and the current trading price is called the *premium per share*. The aggregate amount of this premium Company A will have to pay is the *premium over market capitalization*.

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[1] Capital stock is the number of common and preferred shares that a company is authorized to issue under its corporate charter. The outstanding capital stock are the shares that the company has actually issued.

[2] In the case where Company B is the wholly owned subsidiary of Company C, Company C can simply refuse to sell unless Company A gives some of the gains from trade with Company C. In the case of a widely held public company, Company B's board of directors may be able to influence the willingness of Company B's shareholders to sell their stock through its recommendations to Company B's shareholders.

3. Explain how Company A will determine the maximum price per share it would be willing to pay for Company B's stock.

   As explained above, Company A will be willing to acquire Company B only if Company A believes that Company B will be more valuable in Company A's hands. The maximum price per share Company A would be willing to pay for Company B's stock is the amount that would make Company A indifferent to acquiring or not acquiring Company B. For example, if Company B has a current market capitalization of $7,600,000 and Company A believes that the acquisition of Company B would yield $400,000 in synergies, then Company A would be willing at most to pay $8,000,000 for Company B.

4. Explain how Company B might try to bargain with Company A for a high purchase price.

   As explained above, if Company B can block Company A's acquisition of Company B's shares, then Company B refuses to deal with Company A unless Company A pays a higher price.

   Moreover, if there are other potential buyers for Company B, then Company B can "play off" Company A and the other potential buyers against each other and thereby obtain a higher price. As a matter of bargaining theory, assuming Company A has the highest willingness to pay for Company B, then Company B should be able to bargain for a purchase price equal to the second highest maximum willingness to pay of the remaining bidders.

5. Once the two companies have reached an agreement on price and signed a definitive merger agreement, explain how another company can make a bid for Company B that Company B's board of directors must consider.

   Company B is a Delaware corporation and the transaction is a state law merger, which will require approval by a shareholder vote. Under Delaware corporate law, Company B's directors would violate their fiduciary duties to Company B's shareholders if they did not retain the right to terminate the purchase agreement with Company A prior to Company B's shareholders vote to accept a superior offer by another bidder.