1. (25 points)

(a) Masulis shows that leverage-decreasing recapitalizations are associated with a drop in stock prices. Why would management voluntarily choose to make these changes in capital structure if they know that stock prices are going to fall?
(b) Since Masulis shows that leverage increasing recapitalizations are associated with increases in stock prices, why wouldn't all firms want to do this to increase their stock prices?

(c) Briefly, evaluate the role that tax deductibility of interest payments has in explaining the change in stock prices associated with recaps.
(d) Briefly, evaluate the role that expected cost of financial distress has in explaining the change in stock prices associated with recaps.

2. (20 points)

Read the article below from the *Wall Street Journal* and then answer the question below it.

**IBM Plots Another Share Buyback**

By WILLIAM M. BULKELEY  
*February 27, 2008; Page B2*

International Business Machines Corp. announced its second $15 billion stock-buyback plan in less than a year, boosting its share price and igniting a stock-market rally.

The announcement helped convince investors that IBM, which had a strong fourth quarter, is confident in its strategy and outlook and believes its stock is underpriced. IBM shares rose $4.30, or 3.9%, to $114.38 in 4 p.m. composite trading on the New York Stock Exchange, leading a rally that boosted the Dow Jones Industrial Average by nearly 1%.

Few companies have relied on share buybacks as much as IBM. The Armonk, N.Y., company has spent $46.2 billion the last five years on repurchasing its shares -- a sum equal to about 30% of its current market capitalization, or stock-market value, and more than twice the $20 billion it spent on acquisitions during that period.

The latest buyback comes as Samuel J. Palmisano enters his sixth year as chief executive officer. During the early years of his tenure, IBM went through a rocky period of lowered forecasts and divestitures of businesses including its disk-drive and personal-computer units. Until recently, its stock was stuck at less than its level when Mr. Palmisano took over, while chief rival Hewlett-Packard Co. has seen a sharp rise in its share price.

IBM's growing profits from an expanded line of software, steady services business and sales in foreign markets have helped the company produce a lot of cash. Last year, it reported free cash flow of $12.4 billion, and it had $16.1 billion in cash at the end of the year.

IBM said it expects to spend about $12.4 billion of the latest authorized buyback amount during the current year. Funds will come from operations. It said the reduction in shares will increase its per-share earnings by five cents to at least $8.25 for the current year, up at least 16% from 2007. It has forecast $10 to $11 a share in 2010.
"The willingness to make continued share buybacks speaks to strong faith in the business model," said Thomas Smith, an equity analyst with Standard & Poor's who recommends the stock. Andrew Neff, an analyst with Bear Stearns Cos., said, "We like where they're positioned, in big markets where they have a compelling advantage." He said that IBM has been successful in purchasing software companies and increasing their sales by training its huge sales force to peddle the programs.

Last year, IBM spent $18.8 billion on stock buybacks, including a $12.5 billion accelerated share repurchase in May for which it borrowed money through a foreign subsidiary in order to avoid U.S. taxes. The Internal Revenue Service prohibited further use of that technique, which was known as a "Killer B" because it was designed to circumvent IRS Section 367 (b) covering U.S. tax on repatriated foreign earnings.

Despite the big gain in IBM shares yesterday, buybacks don't have a very good recent record of providing superior returns to shareholders and are sometimes criticized as poor uses of corporate cash. S&P said that 423 members of the S&P 500-stock index did buybacks in the 18-month period ended June 30, 2007, but only one-quarter of them, including IBM, outperformed the S&P index through Sept. 30. Buybacks reached record-setting levels in the first half of last year.

Ed Barbini, an IBM spokesman, said the company isn't stinting on investment in its operations and has increased spending on research and development in all but one of the past five years. He noted IBM also has been aggressively purchasing small companies, especially software makers. The company raised its dividend 33% last year.

(a) If you were the CFO of a firm with the type of free cash flow described by this story, would the argument put forward in this article cause you to recommend a stock repurchase program for your company?
(b) Is there any evidence in the papers you studied in FIN 423 that suggests that higher earnings per share is one of the important reasons why companies pursue stock repurchases?

(c) Is it surprising that firms engaging in repurchases have not out-performed the S&P index so far this year?
3. (15 points)

Read the article below from the Wall Street Journal and then answer the question below it.

**New York Times to Meet Dissidents' Slate**

By ROBERT MACMILLAN  
*February 27, 2008; Page C3*

The committee at New York Times Co. charged with vetting candidates for the board will meet as early as next week with nominees put forward by a dissident shareholder group.

The meeting could be a first step toward a decision to recommend a vote for some of the group's nominees. Such a decision could avert a threatened proxy fight by the shareholders, Harbinger Capital Partners and Firebrand Partners, which Monday disclosed they had raised their stake in the publishing company to 19%.

At that level, the group has a reasonable chance of winning the proxy contest for four seats on the Times' 13-member board.

Harbinger's push for Times board seats is one of two proxy contests it is mounting in the newspaper sector. The other company being pursued by the hedge fund -- newspaper and TV concern Media General Inc. -- yesterday advised shareholders to reject Harbinger's bid for three seats on its board. The company has called the hedge funds' actions "ill advised" and questioned the candidates' qualifications.

At the New York Times, electing some or all of the dissident's slate is unlikely to lead to immediate change at the publisher because nine of the board members are elected by the Sulzberger family, which controls the company through its supervoting stock. Still, it would introduce an element to the board that doesn't necessarily adhere to the family's strategy for the company.

The nominees are expected to meet the Times board's nominating and governance committee, company spokeswoman Catherine Mathis said. After that, the committee would decide if any of them merit support. News of the planned meeting was reported by TheStreet.com.

So far the Times' public stance has been clear opposition to election of the dissident slate. The company said in a preliminary proxy statement filed with the Securities and Exchange Commission that shareholders shouldn't vote for the group's nominees and should vote for the company's nominees. But Ms. Mathis said the company hasn't ruled out the possibility of recommending the rival directors.

By meeting with the rival slate, the board committee indicates its mind may still be open. "It could potentially be in a situation like this that they're getting to know their new directors," said Eleanor Bloxham, president of Corporate Governance Alliance, a board education and advisory firm.

Harbinger and Firebrand, which began accumulating stock as Times shares fell, argue that the Times should contemplate selling noncore assets and juicing up its digital strategy.

Lehman Brothers analyst Craig Huber, who has an "underweight" rating on the stock, estimated that the Times could raise $1.7 billion after taxes if it sold its local papers, Manhattan headquarters and interest in New England Sports Ventures, which includes its Boston Red Sox baseball-club stake -- but said it was a short-sighted move that would dent income.

"What is the rush to sell the headquarters building? To get a one-day or one-week pop in the stock price?" he wrote in a report this week. "Who loses money on Manhattan real estate over a long period of time?"
(a) The *New York Times* has a dual-class voting structure that gives control to the founding family stockholders (the Sulzbergers). Given that fact, what does a shareholder like Harbinger hope to accomplish by seeking a minority position on the Board of Directors?

(b) How, if at all, would you expect the relative prices of the different classes of *New York Times* stock to change during a proxy fight? *Explain.*
Kerkorian's Tracinda Again Cuts Stake in GM

Separately, Sale of 51% of GMAC Is Completed

By JOHN STOLL and TONY COOKE
November 30, 2006 1:03 p.m.

Billionaire investor Kirk Kerkorian has disclosed that, for the second time in a little more than a week, he is significantly scaling back his investment in General Motors Corp.

Mr. Kerkorian's Tracinda Corp. investment vehicle said in a Securities and Exchange Commission filing that it has sold another 14 million shares, for $28.75 a share or about $400 million, equivalent to a third of his remaining stake in the world's largest auto maker. Tracinda also reported the sale of 14 million shares of the company last week.

Before the sales, both of which were to undisclosed buyers, Kerkorian held 9.9% of GM's shares. After the most recent sale closes on Friday, Mr. Kerkorian will hold a 4.95% stake, relieving him of the disclosure requirements associated with holding a stake of 5% or more in the company.

The swift reduction may indicate that Mr. Kerkorian, an 89-year-old investor who has a long history of auto-industry activism, has given up on the GM investment and plans to continue selling.

Mr. Kerkorian began buying GM shares in 2005 and gradually upped his stake and increased pressure on GM management. His associate Jerome York held a seat on GM's board for about eight months in 2006, but abruptly quit after GM ended talks with Nissan Motor Co. and Renault SA that Mr. Kerkorian had initially proposed.

The uncertainty surrounding Mr. Kerkorian's intentions for his remaining stake has presented a new challenge for GM Chief Executive Rick Wagoner. He has been stepping up efforts to convince investors that GM's recovery from its $10.6 billion 2005 loss is gaining steam.

Still, GM's third-quarter financial results showed the company's core auto business continuing to burn cash, and many forecasters expect a drop in U.S. new-vehicle demand in the coming year.

GMAC Sale Completed

Separately, GM said it has completed its sale of a 51% interest in General Motors Acceptance Corp. to a consortium led by Cerberus FIM Investors LLC.

The company expects to receive roughly $14 billion in net cash proceeds and distributions over three years from the sale of its controlling interest in GMAC.

The deal, which was announced in April, includes a $7.4 billion purchase price, a $2.7 billion cash dividend from GMAC and other transaction-related cash flows. GM will retain a 49% stake in GMAC.
(a) It appears that Mr. Kerkorian sold his GM stock at about the lowest price observed during that last 10 days. Based on this fact, it seems that he was unable to find another buyer interested in acquiring a large block of GM stock for a control premium. Why do you think that this happened, and how does this differ from the evidence you have seen in FIN 423?

(b) The intraday graph of GM’s stock price shows that GM’s stock price did not react negatively to the story that Mr. Kerkorian was selling? Is this surprising to you? If so, Why?
Diebold Rejects Offer By United Technologies

By ROBERT DANIEL
March 4, 2008; Page A4

Diebold Inc. yesterday rejected United Technologies Corp.'s $2.63 billion buyout offer, made public over the weekend, saying it significantly undervalued the company's potential.

Diebold called UTC's offer an opportunistic attempt to buy the company at a time when shareholders don't have enough data to measure its value. Diebold hasn't filed financial statements with the Securities and Exchange Commission for almost a year because of a continuing investigation into its revenue-recognition practices.

"The board believes that it would be irresponsible to engage in discussions with UTC at this time," said Diebold's nonexecutive chairman, John Lauer.

"We are confident that executing on our strategy will create substantially greater value for shareholders than UTC's proposal," Mr. Lauer said.

United Technologies said late Sunday it had been courting the maker of automated-teller machines and electronic security products for two years with no headway, and made public its $40-a-share bid for the company to enlist the help of Diebold shareholders.

The bid represents a 66% premium to Diebold's closing price on Friday. If Diebold conducts a due-diligence financial review, United Technologies said it might be prepared to boost the $40-a-share offer.

Diebold's rejection of its offer leaves UTC with two options: either a proxy battle to replace the company's board with supporters, or make a hostile bid by offering to buy shares directly from stakeholders. However, a hostile takeover is unlikely as Diebold has in place a shareholders-rights plan, also called a "poison pill," which would make an unwelcome purchase significantly more expensive.

Diebold's shares, prior to news of the unsolicited offer, had been trading slightly above a seven-year low at $24.07. Yesterday, Diebold shares were up 61% at $38.84 as of 4 p.m. in New York Stock Exchange composite trading. Shares of United Technologies, part of the Dow Jones Industrial Average, were at $69.40, down 1.6%, in Big Board composite trading.

United Technologies, based in Hartford, Conn., said Diebold has businesses and strategies that would complement its own, and that it would benefit from UTC's global footprint and disciplined operating systems.

Diebold's leading business is building and servicing automated-teller machines, primarily in the U.S., though emerging-market opportunities have been robust, said Kartik Mehta, a Diebold analyst with FTN Midwest.
Diebold

United Technologies

(a) Based on this story from the *Wall Street Journal*, and from everything you have learned in FIN 423, does it look like Diebold’s poison pill is expected to prevent a hostile takeover by United Technologies? *Why, or why not?*
(b) Is it likely that Diebold’s management will “just say no,” and wait for United Technologies to go away? *Why, or why not?*

(c) Under what circumstances, if any, would you expect United to pursue a proxy contest to replace some or all of Diebold’s Board?