Quiz B for 2:30 Class: 10/23/13

Short Answer 1 (15 points): Gamma Air’s stock has a market value of $100 million and its debt has a market value of $50 million. You currently own $110,000 of Gamma Air stock and $40,000 of Gamma Air bonds. What transactions would be required for you to have an unlevered position in Gamma Air?

Short Answer 2 (15 points): Briefly explain why it will be rational for managers to expend less effort than is optimal for stockholders.

Problem (75 points): Space Balloon Inc. has a 20% chance of earning $5 million, a 40% chance of earning $9 million, a 30% chance of earning $17 million, and a 10% chance of earning $29 million. If the corporate tax rate equals 35%, the personal tax rate on equity income equals 10%, and the personal tax rate on ordinary income equals 30%, what is the optimal level of interest expense for Space Balloon?

Note: Calculations required. You will only receive partial credit if you show your work.

Wall Street Journal Questions are on the back of this page.