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Key for Quiz C: 10/15/12

Assume that PanditOut Inc. announces plans to issue additional debt and use the proceeds to repurchase shares of common stock. At the announcement, the prices of PanditOut's common shares rose but the prices of its outstanding bonds fell. Excluding tax issues, how would you explain these reactions?

The additional debt (increases the chance that stockholders will have an incentive to steal from bondholders)

by:

1) Investing in (high-risk projects)

=> (bondholders have a fixed claim) so that the (upside of risk doesn't benefit them) but the (downside hurts them)

=> (stockholders have a residual claim) with (limited liability) so the (upside benefits them) and the (downside may not hurt them)

2) (Paying out cash to stockholders)

=> the value of stocks and bonds fall when the firm pays out cash

=> (stockholders have a net gain) since they (get all of the cash but only part of the loss in value of the firm)

8 = 75
7 = 73
6 = 71
~~AA~~
4 = 66
3 = ~~64~~ 63
2 = ~~60~~ 61
- 1 = 58
0+ = 54
0+ = 52