Key for Quiz B: 03/18/13

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

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

With less leverage the stockholders have less incentive to steal from bondholders

1) Less incentive to invest in high-risk projects

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

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

2) Less incentive to pay out cash to shareholders

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

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

Scale:

11 = 50	5 = 39
10 = 48	3 = 36
9 = 46	2 = 34
8 = 44	1 = 30
6 = 41	0+ = 20