Quiz B: 7/28/16 Name ______________________________

Assume there is a 20% chance that Guardian Inc. will have an EBIT of $100,000 per year, a 35% chance it will have an EBIT of $250,000 per year, a 25% chance it will have an EBIT of $400,000 per year, and a 20% chance it will have an EBIT of $600,000 per year. Assume also that the corporate tax rate equals 35%, that the tax rate on personal interest income is 40%, and that the tax rate on personal equity income is 20%.

Assume that Guardian currently has $3,000,000 of outstanding bonds that pay an interest rate of 5%.

a. Assume that Guardian issues an additional $1,000,000 of bonds that pay an interest rate of 5% and that the firm uses the proceeds to repurchase stock. What are the tax implications of these actions on the value of Guardian?
b. Why might this additional debt give the firm an incentive to take excessive risks? How will this hurt the firm's bondholders? How might bondholders attempt to prevent the firm from taking excessive risks?
c. Why might this additional debt better align the interests of the firm's owners and managers?