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Merger of Equals

The so-called "merger of equals" is currently receiving confused coverage by the financial press. It seems that the press became so accustomed to the "takeovers", "acquisitions" and "sales of control", that were typical in the high-flying 90s, that it forgot that a well-conceived and well-structured common stock merger could benefit equally the shareholders of both companies. Indeed, one of the fundamental reasons why many acquisitions are not successful for the acquiring company and its shareholders is that too high a premium is paid to the shareholders of the acquired company. While the shareholders who receive a premium benefit at the expense of the shareholders of the company that pays the premium, in many cases – particularly mergers of large companies that are in the major indexes – the shares of both companies are held by the same investors and, on balance, those investors would be better served by a no-premium common stock merger than by a high-premium acquisition that results in poor performance by the acquiring company. In addition, if there were a deemphasis on the premiums paid in acquisitions and no criticism of managements that enter into no-premium mergers, there could be a significant increase in mergers generally to the benefit of all shareholders and the economy as a whole.

In a well conceived no-premium merger, the shareholders of each company receive a premium. Their premium is their fair share of the synergies resulting from the elimination of redundant costs and expenses and the other benefits of the combination. Since the merger ratio is determined by the relative market prices of the shares of the merging companies at about the time the merger agreement is signed, each share of each company receives its exact proportionate interest in the merged company. To illustrate:

Company A has 100,000,000 shares outstanding selling at $50 per share for a total market capitalization of $5,000,000,000

Company B has 1,000,000,000 shares outstanding selling at $10 per share for a total market capitalization of $10,000,000,000

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Upon the merger of A and B, each A share receives 5 shares of AB (5 x $10 = $50) and each B share receives one share of AB (1 x $10 = $10). The former shareholders of a A continue to have a total market capitalization of $5,000,000,000, equal to 1/3 of the total market capitalization of $15,000,000,000 of AB and the former shareholders of B continue to have a total market capitalization of $10,000,000,000 equal to 2/3 of the total market capitalization of AB.

If the stock market values the merger synergies at $3,000,000,000, the former A shares receive 1/3 (500,000,000 shares of the total of 1,500,000,000 AB shares) or $1,000,000,000 equal to $2 per AB share or $10 per original A share or a 20% premium on the $50 price of the A share at the time the merger was signed; and the former B shares receive 2/3 (1,000,000,000 shares of the total of 1,500,000,000 AB shares) or $2,000,000,000 equal to $2 per AB share or a 20% premium on the $10 price of the B share at the time the merger was signed.

Thus, each share of both companies was treated equally and received the same percentage premium — 20%. From an economic standpoint this is a true merger of equals and not a takeover of A by B, even though B had twice the market capitalization of A.

In addition to the merger ratio, common stock mergers raise so-called "social issues":

(1) composition of the board of directors;
(2) designation of CEO (and other senior officers);
(3) name of merged company; and
(4) location of headquarters.

These issues should not be confused with the no-premium aspect of a merger. Just because one of the merger partners contributes one, two or even all of the resolutions of the "social issues", does not mean that partner "took over" the other, or that it was not a true merger of equals in the economic sense. In this connection it should be noted that it is well settled that there is absolutely no legal duty on the part of the smaller company or the company that does not "win" the social issues to obtain a premium in a typical common stock merger where there is no controlling shareholder of the company resulting from the merger.

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