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The Case of
The Suddenly Sensitive Stock Price

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The Case of the Suddenly Sensitive Stock Price

The Board of Directors of Mature Products, Inc. (MPI) has adopted a strategic plan calling for business line diversification. The stated business aim is to enhance earnings growth while reducing industry-related risk. As the initial step for strategy implementation, MPI's Executive Management requests that its New York investment banking firm suggest suitable candidates for acquisition. The company has experienced a long synergistic relationship with the particular investment banking firm; indeed, this firm holds a minority equity interest in MPI and several of MPI's current executives have previous experience working for the investment banker.

As its second step for strategy implementation, Executive Management assembles a small, elite analytical staff that can be assigned to acquisition analysis of target companies and their competitive industries. John Stag is recruited to head and organize this staff. John is a 28 year-old MBA with 5 years of experience in corporate planning and acquisition analysis with another corporation, one with a solid track record in diversification.

Several months after John Stag assumes his new position, MPI's investment banker identifies a target company, ABC, Inc., a regional transportation firm traded on the American Stock Exchange. For the past year, ABC's common shares have generally traded within a narrow range between \$18 to \$20 per share. After thorough industry and company analysis by his staff, John concludes that ABC, Inc., would meet MPI's criteria based on a range of acquisition prices. He recommends that a reasonable offer price would be \$24 million, representing a 20% premium over the high end of ABC's recent trading range.

Senior Management decides to offer to purchase ABC, with the investment banker serving as intermediary for negotiations. Because this is to be MPI's first acquisition and will require entry into a new industry with different markets, its Board desires that the process be "friendly," better assuring successful integration of the firms and more harmonious relationships between their respective employees. John Stag and the analytical staff are not included in the negotiation sessions held in the New York City offices of the investment banker. However, they are asked to interact with designated senior officials of the target who have offered to supply information about their firm.

From the day he becomes manager, John Stag and his staff members are careful to respect the sensitivity and confidentiality of the negotiations and their analytical efforts. They do not discuss the target company with anyone inside or outside the company other than designated executives privy to the process. The staff even assigns a code name to the target company, referring to the target only by this code name, even in staff discussions. John also verifies that no one on his staff has a financial interest or personal relationship involving the target company.

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Negotiations between MPI executives and ABC executives proceed intermittently over a six-week period, with all face-to-face interaction being conducted at the New York offices of MPI's investment banker. Then, one morning, an excited staff analyst asks to meet with John Stag. He shows the manager a simple graph plotting ABC's daily closing prices over the past six weeks. Clearly evident is that on the two days immediately after an acquisition negotiation session in New York, ABC's closing common share price jumps about \$5 per share. Over the next week, when it turns out that no acquisition deal is announced, because new negotiating hurdles are raised, delaying or even potentially killing the deal, the share price declines back to approximately \$20 where it remains until the next negotiating session in New York. The cycle of a \$5 jump followed by a gradual return to the original level is repeated three times, with the jumps coinciding with the dates of MPI Executive Management trips to visit the NY investment banker.

Seeing this graph troubles John. Although the evidence is circumstantial, it points to possible leaks or insider trading that could very well cost MPI shareholders \$6 million if the acquisition were consummated (assuming that a positive decision to go ahead would at least drive the price up by the past jumps of \$5 per share).

$$\text{\$ } 20 + \text{\$ } 4 \text{ premium} = \text{\$ } 24 \times 1 \text{ million shares} = \text{\$ } 24 \text{ million}$$

vs.

$$\text{\$ } 25 + \text{\$ } 5 \text{ premium} = \text{\$ } 30 \times 1 \text{ million shares} = \text{\$ } 30 \text{ million}$$

Difference: \$6 million

* *What should John do?*

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John Stag decides that MPI's Executive Management needs to see the ABC stock price graph. John therefore contacts his CEO's Executive Secretary, requesting a private meeting to communicate some important new information possibly affecting the acquisition. He does not show the graph to his own immediate supervisor, who has not been involved in the confidential process of acquisition negotiations.

The CEO sends John a message asking him to come to his private office. After inviting John to sit, the CEO asks to see the new information. John hands the ABC stock price graph to the CEO, who reviews it and, after some time for thought, asks John what he thinks it means. John responds that there seems to be circumstantial evidence pointing to speculation based on knowledge of the times and general purpose of the meetings in New York. When the CEO asks John who might be trading on this information, John answers that it must be someone working for or with MBI's investment banking firm. The CEO asks if he may keep the graph, thanks John, and excuses him.

- * Does John act correctly? Why or why not?
What else might be done?*
- * Is John correct in suspecting that the investment banker was the source of the leak and/or improper trading activity?
Who else might possibly be involved?*

Subsequent Developments:

Two days later, John is startled when one of his staff members angrily storms into his office. The complaint is that members of an internal investigative team are checking the background and recent activities of everyone on the acquisition staff. John Stag says that this is news to him, but soon confirms through the grapevine that an internal investigation indeed is underway, although John is never officially notified that this is the case. He is not informed of the investigation's purpose nor its findings.

A month later, the financial press reports that ABC agrees to accept MPI's acquisition offer of \$33 per share (\$33million), based on a 20% premium over ABC's closing price of \$27.50 the day before the announcement. John and his staff are assigned to continue with their analytical efforts and to take an active role in the planning needed to integrate ABC successfully into MPI's corporate structure.

- * Has MPI paid too much for ABC?*
- * If the acquisition proves to be a profitable one for MPI, doesn't this justify the decision to go ahead without raising public objections based on atypical stock price movements?*

Postlude

After negotiating the sale of ABC, Inc., Herbert Justice, ABC's founder and CEO, retires to Florida. Because of his long-time association and friendship with his former employees, he continues in close communication with them. When invited to MPI's first Board of Directors Meeting after the ABC acquisition, Mr. Justice agrees to attend. Following a presentation of MPI's new strategic plan, Mr. Justice offers observations on the ethical importance and long-term financial benefits resulting from fair treatment and respect for one's employees. He also complains that, to date, MPI is not fully honoring commitments he had made to ABC employees prior to the acquisition. The members of the MPI Board of Directors make no comment, continuing to enjoy their food and other refreshments.

- * Assuming that Mr. Justice bases his observations on accurate information, what can he now do to see that MPI honors the previous commitments to which he refers?*
- * What might he have done differently prior to signing the acquisition agreement?*