

## **IMPACT OF SFAS 141 ON MERGERS: A CASE STUDY**

Robert Eaton, Chairman and Chief Executive Officer of Chrysler Corporation, sat in his office at Chrysler's headquarters in Auburn Hills, Michigan pondering the future of the car industry, Chrysler, and his own. It was early January, 1998. In front of him were a number of reports, including one about 1997 production of cars by the largest 15 car companies [See Exhibit 1] and the financial statements of Chrysler Corp. for the year ended December 31, 1997. The results of 1997 were not, by any standards, too bad; the company assembled 2.7 million vehicles, earned almost \$60 billion in revenue and generated about \$5 billion of operating profit, \$3 billion net earnings, and \$8 billion cash from operations [See Exhibit 2].

Despite this performance, Eaton worried about the future of Chrysler. Chrysler was the smallest of the three car manufacturers in the US; furthermore, competition from Japanese, Korean, and European car manufacturers was getting stronger every year. The reports in front of him related to trends in the car industry at the global level enforced his fears about the future. These reports showed capacity of all the car companies in the world at approximately 66 million cars, with world demand standing at only 51 million cars. The excess capacity of about 11 million cars was approximately four times the annual production of Chrysler. The situation was going to get even worse in the future. The reports indicated that, by the year 2002, supply side might reach 79 million cars and demand increase to 61 million cars, an excess capacity of 18 million cars. If this projection were accurate, six companies of the size of Chrysler could fail. The report stated that about 40 assembly plants worldwide would not be needed in the future [Vlasic & Stertz, 2000].

Just about the same time that Robert Eaton was reviewing these reports in Auburn Hills, Michigan, Jürgen Schrempp, the Chairman and Chief Executive Officer of Daimler-Benz in Stuttgart, Germany, was doing the same thing and coming up with almost the same conclusion: survival could not be taken for granted. 1997 was also a good year for Daimler. It sold almost one million cars; revenue was about DM124 billion, net income was DM8 billion, (exchange rate on 12/31/97 was DM1.79:\$1) and cash from operations was DM11.2 billion [See Exhibit 2]. In spite of this performance Schrempp thought that, unless Daimler broadened its base and emphasis from luxury cars to a full line of all kinds of cars, it would not survive in the future.

## **CHRYSLER CORPORATION**

On the fifteenth floor of Chrysler headquarters in Auburn Hills, Michigan there is a life-size oil painting of an imposing man with a round face, a prominent nose, large oval eyes, and a thick neck. The painting is of Walter P. Chrysler, the founder of Chrysler Corporation. Mr. Chrysler was born in Wamego, Kansas in 1875 to a railroad engineer. Walter himself began an apprenticeship as a railroad engineer with Union Pacific in Ellis, Kansas in 1892, at the age of 17. In 1912, at the age of 37, he became production manager of the Buick Motor Company in Flint, Michigan. In 1917, he became president and general manager of the Buick division and, in 1919, became the first vice-president of GM in charge of production. In 1920, due to differences with GM chief William C. Durant, he resigned his GM post. In 1921 he became the chairman of Maxwell Chalmers Motor Co. In 1922 the company was renamed Maxwell Motor Corporation, and in 1925 was renamed Chrysler Corporation.

Under Chrysler's leadership, the company grew steadily as a result of introducing a new car (the Plymouth) and by acquiring other car companies, such as Dodge. By 1929 Chrysler Corporation was the third largest car company in the US. In the same year Mr. Chrysler constructed the Chrysler Building in New York, with 77 floors, then the world's tallest building. In 1936 Chrysler Corp. production reached a million vehicles a year. In 1938 its production comprised a quarter of all cars produced in the US. During World War II all car companies, including Chrysler, survived by converting their production to military vehicles. In 1940 Walter P. Chrysler died at the age of 65.

After WWII, Chrysler resumed its production of civilian vehicles. In 1958 Chrysler took the first formal step toward globalization by buying into the French car firm Simca, and began selling it in the US. In the 1970s Chrysler tried to increase its operations overseas. It bought Talbot and Rootes, two European automakers that were in financial trouble, but Chrysler failed to rebuild them and sold them in the late 1970s. In the late 1970s, due to a slowing economy and foreign competition, a sharp decline in sales nearly bankrupted the company. In 1978 Lee A. Iacocca became the president of Chrysler. In 1979 Chrysler's board of directors selected Iacocca as its chairman and CEO to lead the company during the stormy 1970s. When car sales slumped again in 1979 and Chrysler was nearly bankrupt, Iacocca negotiated a \$1.5 billion federal bailout. In the same year, Chrysler negotiated a merger with Volkswagen, an effort by Iacocca to globalize Chrysler and to compete with GM and Ford; however, early disclosure of the merger sent stock prices of both companies up and made the merger uneconomical. In 1980, the company proposed a merger with Ford Motor Co., but the proposal was rejected by Ford. In late 1980, the company came

close to negotiating a deal with the Italian automaker Fiat, but the proposed merger failed over management control [Higgins, 1998].

In 1983 Chrysler paid off the loans that had been guaranteed by the federal government seven years earlier. In 1984, Chrysler introduced a line of minivans, Dodge Caravan and Plymouth Voyager, and by doing this created a completely new market segment. In 1987, Chrysler acquired American Motor Corporation. The acquisition of AMC put the Jeep brand under Chrysler's name [Higgins, 1998]. Shortly after acquiring Jeep the company developed the Jeep Cherokee, which was the first SUV developed by any car company. As a result of introducing the minivans and the SUV, Chrysler gained a reputation for being innovative that made it a very profitable company starting late in the 1980s to the mid-1990s. As the result of bad blood between Iacocca and Lutz (who was president of Chrysler for many years and was expected to be Chrysler's CEO when Iacocca retired), Iacocca brought Robert Eaton from General Motors in 1992. In 1993, Eaton was appointed as Chairman and CEO of Chrysler Corporation.

### **Robert J. Eaton**

Bob Eaton was born on February 13, 1940 in Buena Vista, Colorado. His father worked as a conductor and brakeman on the Rio Grande Railroad and, later, the Santa Fe. The Eatons moved to Arkansas City, Kansas, a town of thirteen thousand people near the Oklahoma border when Bob was a little boy. He delivered the *Arkansas City Daily Traveller* at the age of nine. He also used to spend his summers on his grandfather's farm. He helped his grandfather with the work on the farm

and, in his spare time and on weekends, he hunted for quail and rabbits. From a young age, he enjoyed the quiet life on the farm and being alone.

As a young man he showed aptitude in mechanics and engineering. He started by dismantling an old Maytag washing machine, and then a 1933 Chevrolet and a number of old used cars and motorcycles. He worked in a pea cannery in Oregon to save up for college. He went to the University of Kansas where he got a degree in mechanical engineering. After he graduated from the University of Kansas in 1963 he received an offer from General Motors to work as an engineer. In 1973 he became chief engineer of General Motors' new front wheel drive compacts known as X-cars. In 1982 he became vice-president of advanced engineering. In 1988 he became president of General Motors Europe. In 1992 Iacocca brought him to Chrysler. He became CEO and Chairman of Chrysler when Iacocca retired in March, 1993 [Vlasic & Stertz, 2000].

## **DAIMLER-BENZ AG**

In 1885 Gottlieb Daimler, a Stuttgart engineer, invented a wooden two-wheel gasoline powered vehicle. He registered the vehicle on August 29, 1885 as Reitwagen (riding carriage). It was the world's first motorcycle. Karl Benz registered a patent for a three-wheeled gas driven automobile in Mannheim on January 29, 1886. In 1890, Daimler established Daimler-Motoren-Gesellschaft AG as a German stock corporation in Cannstatt, near Stuttgart, Germany for manufacturing an internal combustion engine vehicle. In 1901, Emil Jellinek persuaded Daimler to name its car after his 10-year-old daughter, Mercedes. On June 28, 1926 Daimler and Benz merged

their two companies. The first joint Daimler-Benz car was the Model 8 introduced at the Berlin automobile Show on October 29, 1926.

In January, 1952, Daimler-Benz established its presence in the North American car market through an agency agreement with Macmillian Hoffman. Two hundred fifty-three cars were sold in 1952. With the exception of the Brazilian Daimler-Benz plant which was built in São Bernardo do Compo in September 28, 1956 and until the mid-1970s, all of the Daimler-Benz plants were located in Germany. In 1962, the company's production of cars reached the one million car mark. In 1965 Daimler-Benz AG became the biggest commercial vehicle manufacturer in the European community. On February 17, 1988, the company's production of cars reached the ten million per year mark.

In the mid-1980s, in an effort to reduce its dependence on the cyclical market conditions of the world's car industry, Daimler-Benz started a strategy of diversification by expanding into other lines of business. In 1985 Daimler-Benz acquired the remaining 50% equity interest in Motoren-und Turbinen-Union Munchen GmbH (MTU-M), a company primarily engaged in the manufacture of turbines and large diesel engines. Later in 1985, the company acquired a majority of the voting stock of the German aerospace company Dornier GmbH. In 1986, Daimler-Benz acquired the majority of the voting stock of AEG Aktiengesellschaft, an electronic company. On May 19, 1989, Dornier GmbH, MTU and two sectors of AEG were merged to form Deutsche Aerospace AG (Dasa) as a 100% subsidiary of Daimler-Benz. On June 29, 1989, Daimler-Benz was reorganized so that Mercedes became a separate subsidiary. Under the reorganization plan, Daimler-Benz became a

holding company of three subsidiaries: Mercedes-Benz, AEG, and Deutsche Aerospace. In July 1990 Daimler-Benz Inter Services (Debis) was established as the fourth Daimler-Benz subsidiary. Debis is the financial service, information technology and business unit arm of Daimler-Benz. On May 24, 1995 Jürgen E. Schrempp became the new Chairman of Board of Management of Daimler-Benz AG.

### **Jürgen Schrempp**

Jürgen Schrempp was born in Freiburg, a university town in southwestern Germany, on September 15, 1944. As a boy, Jürgen did not do well in school. He repeated a grade and dropped out from school to work as a mechanic at the local Mercedes dealership. He played the trumpet in nearby night clubs to supplement his income from the dealership. He is a tall man, stands six feet, has blue eyes, lanky build with a bass voice, and contagious laughter. He commands any party, and people gravitate to him. He likes outside activities and association with famous people. He climbed the Italian Alps with the famous Reinhold Meissner, the first mountaineer to scale Mount Everest without oxygen. He played chess with the Russian chess champion Gary Kasparov. While he was in South Africa he became friends with Nelson Mandela, the famous South African leader.

At Daimler-Benz AG he worked very hard, chain-smoked Marlboros all day, and ate and drank wine late into the night. He started by servicing truck customers on warranty issues and repairs. In 1974 he moved with his wife and two young sons to work at the sales office of Daimler-Benz in South Africa. Schrempp had a company car, a house, and a large territory of dealership and salesmen to run. He drove in a military-like Mercedes Gelandewagen deep into the savanna, a pistol at his side to fend off whatever wild beast he might run into. When the racial struggle broke out in

south Africa, foes of apartheid pressured Daimler to leave in protest as Ford and General Motors had done, but Schrempp would have none of it. Finally Gerhard Liener, Daimler's CFO, pulled Schrempp out of South Africa and sent him to run a new truck division in Cleveland, Ohio.

Schrempp never liked, but tolerated, Cleveland for two years. He sold the dealership at a huge profit. Liener liked the deal that Schrempp made, and sent him back to South Africa as chairman of the South Africa operation. In 1989, Schrempp was chosen to be the CEO of Daimler-Benz Aerospace (DASA) because of his energy and leadership, not his bottom-line results. The sales of Mercedes cars in South Africa slumped in South Africa during Schrempp's tenure, but this fact did not affect Schrempp's reputation as a driven and fearless leader. He was considered an important player in the future of Daimler, and the right man to build DASA. In 1994, Schrempp was appointed CEO of Daimler-Benz [Vlasic & Stertz, 2000].

### **KERKORIAN'S OFFER TO BUY CHRYSLER**

Kirk Kerkorian was the largest Chrysler shareholder. He owned approximately 10% of Chrysler's outstanding stock. He believed that Chrysler's stock was undervalued in 1995 given Chrysler's performance and earnings. In 1995 Chrysler was the most profitable car company in the US. It was the leading company in introducing sport utility vehicles and minivans; its pickup trucks had also been best sellers in the US for many years. Its sedans were the cheapest of the three major US companies. Its Jeep Cherokees were the strongest brand in the sport utility segment of the market. Chrysler's market share of minivans reached 40%, more than any other car company. The

company had nearly tripled its share of the market for pickup trucks. In spite of this success, Chrysler's price-earnings ratio was one of the lowest in the industry [Vlasic & Stertz, 2000].

Kerkorian had on several occasions urged Robert Eaton to use the large cash reserve (\$7.5 billion) that Chrysler had been investing in low yielding short-term investments to increase dividends or buy treasury stock. Kerkorian believed that purchase of treasury stock by Chrysler would increase earnings per share, increase investors' confidence in Chrysler stock, and increase the stock price in the market. Robert Eaton rejected Kerkorian's proposal and argued that the purpose of this reserve was to see the company through the next slump without slowing new product development.

When Kerkorian's efforts to convince Eaton to use the cash reserve to either purchase treasury stock or to increase the level of dividends failed, he (through Tracinda Corporation that he controlled) offered to purchase the remaining ninety percent of Chrysler's stock at \$55 per share in cash on April 12, 1995, a premium of approximately 40% over the closing price of common stock on April 11, 1995. In response to Kerkorian's offer, Chrysler's price per share went up \$13 just minutes after the offer was made public.

Eaton reacted negatively to Kerkorian's offer. He announced that the offer was unsolicited, that Kerkorian did not have the financial backing to execute the offer, and "that Chrysler management is in no way involved in Tracinda's proposal." He added, "We've worked hard to build this company's financial strength, to increase shareholders' value, and to build the confidence of

customers, employees, dealers, and suppliers. We have no desire to reverse the process.” To be sure that Kerkorian could not execute his offer, Eaton had an emergency meeting with bankers in New York and warned them that if they joined Kerkorian, they would never do business with Chrysler again [Vlasic & Stertz, 2000].

## **THE DAIMLER/CHRYSLER MERGER AGREEMENT**

On May 7, 1998, the managements of Chrysler and Daimler-Benz announced that they had signed an agreement to merge their two companies into one. They claimed that the merger would generate an annual synergy of about \$1.4 billion in 1998 and \$3.0 billion starting in 1999, and that the merger would not cause any layoffs or plant closings. They declared that the merger would be accounted for by the pooling-of-interests method. According to the merger agreement, Chrysler stockholders would receive approximately 430 million shares, 43% of the stock of the new company, Daimler Chrysler, and Daimler-Benz stockholders would receive approximately 570 million shares, 57% of DaimlerChrysler stock. In addition, Chrysler executives were given cash and stock options in the new company. According to the agreement, the exchange ratio was .6235 share of Daimler Chrysler to be exchanged for each share of Chrysler Company, and 1.005 share of the new company for each share of Daimler-Benz Company.

The agreement established that the new entity, DaimlerChrysler, was to be a publicly-traded German stock corporation incorporated under the laws of the Federal Republic of Germany and that the annual stockholders meeting would take place in Germany. According to the agreement Robert Eaton and Jürgen Schrempp were to serve as co-chairmen of the new company, with the agreement

that Eaton would retire after three years. The new entity would be managed by two boards. One is the Board of Management, responsible for managing day-to-day operations. It has eighteen members, with eight members representing former Daimler-Benz and eight members representing Chrysler; in addition, two appointees represent Daimler-Benz's nonautomotive business. Members are appointed for five-year terms. The other board is the Supervisory Board, which oversees the Management Board. It has twenty members, ten elected by DaimlerChrysler stockholders and ten elected by DaimlerChrysler employees. The merger agreement was approved by the European commission on July 23, 1998 and the Federal Trade Commission on July 31, 1998. On September 18, 1998, 97.5% of Chrysler shareholders and 99.9% of Daimler-Benz shareholders approved the merger. The stock of DaimlerChrysler began trading on stock exchanges on November 17, 1998 under the symbol DCX.

## **WHY MERGE?**

At the time of merger, Chrysler was considered by many analysts as the most profitable of the three US car companies and the lowest cost car producer in the US, specializing in sport utility vehicles, pickup trucks, and low-priced cars. Daimler, on the other hand, produced high-priced luxury cars. Some argued that, because there was so little overlap between the two companies, the deal was a good fit. Jürgen Hubbert, Daimler-Benz board member and head of the Mercedes-Benz passenger car unit said, "The geographical overlaps are smaller than they would have been with any other partner. Secondly, in the past few years Daimler-Benz has become the most American-thinking corporation in Europe. Chrysler, on the other hand, is the most European-thinking company, and is process-oriented and really focused on product development." Dieter Zetsche, who

was in charge of sales and marketing at Daimler-Benz and presently the President and CEO of Chrysler stated that, “The No. 1 reason by far for choosing Chrysler was because there was no product overlap. The two companies also fit on regional basis. They are strong in US; we are strong in Europe. We both have some work to do in Asia...It’s a good fit, because as a premium manufacturer we develop new ideas and bring them to market. Our problem has been that costs are high for these new technologies because of our low volume. We always lost the technology to competitors because our good friends at Bosch (German auto supplier Robert Bosch GmbH) said we didn’t give them the numbers they wanted...Chrysler will give us the volume. We can stay No. 1 in developing technology--and take it as soon as possible to Chrysler...We think there is potential for the Chrysler organization’s performance to be further developed in Europe. There may be something we can learn from the strength they have in their home market.” Robert Eaton, Chairman and CEO of Chrysler said, “Mercedez-Benz can help us with our quality...Chrysler engineers will help to develop a Mercedez minivan that could share some components with Chrysler.” [Automotive News, 1998]

## **EVENTS SUBSEQUENT TO MERGER**

### **Cultural Clash**

In every merger, even in mergers of companies of the same nationality, there is some degree of cultural clash. Each company is unique. In some companies, for example, authority and responsibility are more decentralized than others; in such companies many mid-level managers are

given more freedom and authority than the mid-level managers in centralized companies. Some companies have a formal code for dressing; others do not. These differences might cause cultural clashes when two companies of different cultures merge. In the case of cross-border mergers this problem is exacerbated by differences in language, food, customs, and other factors. In the case of the merger between Chrysler and Daimler, there were many obstacles that the executives and employees of each company had to overcome. Articles in the popular press reported many instances in which the two cultures clashed. The first big shock was the difference between executive compensation in the US and Europe. For example, Schrempp's total compensation in 1997 (the year before the merger) was \$2 million, while Eaton's total compensation was \$11 million. Chrysler's employees and executives ate in the cafeteria. Daimler-Benz had a system of three-tier restaurant services for executives and employees, depending on their rank in the management hierarchy: a first class restaurant (gold-spoon restaurant) for top executives; a second class restaurant (silver-spoon restaurant) for middle management; and a third class restaurant (plastic-spoon restaurant) for the rest of the employees. Mid-level managers in Chrysler were used to walking in and out of offices of their superiors whenever they had to report information and/or receive instructions. In contrast, German executive offices were staffed with layers and layers of secretaries that middle managers had to go through if they needed to see their immediate bosses. Americans were used to drinking water or iced tea at lunch, while Germans preferred wine or beer. Americans called each other by first names, while Germans used formal titles such as "Doctor" or "Professor." Americans were used to running from their offices to their bosses in shirt sleeves, while Germans had to put on ties and coats. Also, while many German executives were willing to relocate in the United States, American executives refused to relocate in Stuttgart, Germany. There were also some reports that

US executives' wives were offended by the behavior of Schrempp toward his secretary, Lydia Deininger, during receptions and dinner parties. One article reported that Schrempp, at the end of one of the parties, carried his then-secretary over his shoulder, grabbed a bottle of wine, and wished everybody in the party (wives of American executives included) good night [Vlasic & Stertz, 2000].

### **Chrysler Executive Exodus**

Bob Lutz, who was president of Chrysler for many years, left Chrysler shortly before the merger to become chairman and CEO of battery maker Exide. Dennis Pawley, another Chrysler executive, took early retirement shortly after the deal. Mr. Thomas Stallkamp, the president of Chrysler since the merger of the two companies, was replaced by Mr. James Holden in September, 1999. Mr. Stallkamp's departure came as a blow to Chrysler employees. People familiar with Mr. Stallkamp said that his style of management was to build consensus among his subordinates, that he was against moving too rapidly to meld Daimler and Chrysler cultures and operations together. Investors worried that his departure could prompt other top US executives to leave, taking along with them their expertise in low-cost product development. Mr. Schrempp did not think that Mr. Stallkamp had given him enough support, especially for the Smart Car project that Daimler was developing or on the proposal to acquire an interest in Nissan [Ball & Miller, September 24, 1999].

On January 26, 2000 Robert Eaton, DaimlerChrysler co-chairman since the merger, announced his intention to retire as of March 31, 2000. Mr. Eaton's original plan was to stay as co-chairman of the company for three years. In his announcement of early retirement, he said he decided to leave earlier because "the merger is complete." In many observers' opinion, Mr. Eaton's early retirement meant that DaimlerChrysler was now an indisputably German company [Ball, January 27, 2000].

On September 27, 2000, Thomas Gale, Chrysler design chief who oversaw the styling of such hits as the Dodge Ram pickup truck and the PT Cruiser, confirmed that he would retire at the end of the year. Mr. Gale said his retirement "in no way reflects the difficulties that may lie ahead" for the former Chrysler. He said he intends to stay on as a consultant to DaimlerChrysler for two years and will not work for any other automaker during this time [Ball & Miller, September 28, 2000].

In November 2000, James Holden, the president of Chrysler, was replaced by Dieter Zetsche, who was head of Daimler's commercial vehicle business. Mr. Holden's sudden replacement was the second high profile management shake-up at DaimlerChrysler's US operations in a year. One of the reasons given for his replacement was his decision to grant massive discounts on many Chrysler cars, especially on the 2000-model-year version of the company's minivan. But the decision to replace Mr. Holden so soon after the November, 1999 firing of Thomas Stallkamp did not help to enforce the merger-of-equals image that the merger portrayed. Chrysler workers and dealers were upset and worried about the implications. Martin McInerney, a Detroit-area dealer stated, "I guess

the Germans are going to make it a subsidiary and send in their own people to run it.” The replacement of Mr. Holden reduced the American representation on DaimlerChrysler’s management board to only two. One of them is Thomas Gale, who announced that he will retire at the end of 2000 [Miller, November 15, 2000].

On November 20, 2000 the company announced that three members of James Holden’s team are also leaving: Theodor Cunningham, the top sales-and-marketing executive; Kathleen Oswald, Mr. Holden’s chief administrative officer; and Tony Cervone, head of Chrysler’s communication staff [Ball & Miller, November 21, 2000].

### **Financial Performance**

Financial performance of the company subsequent to the merger is presented in summary form in Exhibit 3. In the 1998 Annual Report, the two CEOs declared that they had made a great start. “Revenues grew to €131.8 billion, up 12% compared to combined 1997 results. Operating profits increases to €8.6 billion, up 38%. Net income, excluding extra-ordinary one-time costs related to the merger, grew to €5.2 billion, up 29%. Earnings per share grew by 30% to €5.58 billion, again excluding extra-ordinary one-time costs related to the merger. We sold more than 4.4 million cars, light trucks and commercial vehicles, and gained market share in virtually every market in which we operate--despite intense competition...In 1998, the stellar performance of our business returned 11.6% RONA after tax at corporate level, compared to 10.2% in 1997...All told, we are well on track to delivering our synergy target of €1.3 billion in bottom-line profit improvement for 1999...” In mid-September 1999 Mr. Gentz, DaimlerChrysler’s chief financial officer, told financial

analysts that synergies from the company's merger might be eroded by difficulties in the car and truck business. Analysts read that Mr. Gentz suggested that the synergies would be reduced by losses at the Smart Car project, incentives the company was offering to buyers of Chrysler cars in the US, and difficulties in truck operations in Brazil and Turkey. Mr. Gentz didn't indicate how much those factors would reduce the synergy gains. Some analysts estimated that the Smart Car would cause a loss of \$416 million and that the complete takeover of the railroad company Adtranz cost another \$416 million [Miller, September 17, 1999].

In the 1999 Annual Report, the company's CEO declared that "This was a year of record sales across our brands, of expanded market shares, technological innovations, and major advances in the way we design and build our business portfolio. All of our major automotive brands -- Mercedes-Benz, Chrysler, Jeep, Dodge, Freightlines, Sterling, Setra -- as well as our services company debis and Dasa, our aerospace division, had a great year. Profit growth once again outstripped revenue growth by more than we had anticipated. Net income is 19% up on 1998, and we have proposed a dividend of €2.35 per share. Adjusted net income also rose by 16% to €6.2 billion. This made us one of the most profitable of the major automotive groups in 1999...In 1999 we made €1.4 billion in synergies."

In the 2000 Annual Report, the CEO stated that "The year 2000 was one in which decisive strategic decisions were taken. At the same time the company was faced with enormous operational challenges in North America. These arose principally from the dramatic fall in profits at the Chrysler Group." The operating profit for DaimlerChrysler fell from 11 to 9.8 billion euros, while

the operating profit of the Chrysler Group fell from 5 to 0.5 billion euros. The Board of Management of DaimlerChrysler presented a comprehensive turn-around plan for the Chrysler Group to the Supervisory Board, which was approved on February 26, 2001. The plan was composed of a number of measures aimed at cutting costs and increasing revenues. The turn-around plan is intended to generate additional benefits through annual savings and profit improvements of € 3.3 billion (US \$3.1 billion) in 2001, rising to €5.2 billion in 2002, and €7.2 billion in 2003. The plan included job cuts involving 26,000 employees over the next three years, and closing six plants within two years.

In the 2001 Annual Report, the company reported an operating loss of €1.3 billion, compared to an operating profit of €9.8 billion in the prior year. The management explained that 2001 was affected by sizable expenses for restructuring measures and the extremely competitive market in North America. In February 2001, the Supervisory Board of DaimlerChrysler AG approved the turnaround plan for Chrysler, which resulted in a charge of €3.1 billion. The company reported that Mercedes-Benz achieved an operating profit of €3.0 billion, exceeding 2000's result by €0.8 billion. However, Chrysler posted an operating loss of €5.3 billion in 2001, compared to an operating profit of €0.5 billion in 2000. The operating loss included restructuring charges of €3.1 billion. The restructuring charges were primarily related to workforce reductions, asset write-downs, and contract cancellation costs.

### **The Decrease in the Percentage of Stock Owned by US Investors**

In mid-March 1999, less than a year after the merger, the percentage of US shareholders decreased from 44% to 25%. One reason for the sharp decrease in such a short time is the removal of DaimlerChrysler stock from the Standard & Poor's 500-stock index. Standard & Poor's removed DaimlerChrysler stock from its index because DaimlerChrysler was incorporated in Germany. This removal forced many mutual fund managers that track the Standard & Poor's to remove the company's stock from their portfolios. Another reason for the decline in the percentage of US investors is, according to some analysts, the time difference of approximately six hours. The management of Daimler-Chrysler made public certain financial and important information about the company early in the morning Germany's time, while US investors and analysts were still sleeping [Ball, March 24, 1999].

### **Market Price Performance**

DaimlerChrysler shares were first traded on November 11, 1998 at \$83.8125. The price per share increased to \$103.62 in January, 1999 and reached a low of \$38.44 in November, 2000. Publicly, company officials blamed the decline in the market price on the interest of investors in recent years in the stock of Internet companies and boredom with the stock of the traditional brick and mortar companies. Another reason for the drop in price is the lack of US investors' and mutual fund managers' interest in the stock as a result of its removal from the Standard & Poor's 500 stock index. Andy William, a portfolio manager of Philadelphia-based Glenmede Trust Co., for example, announced on July 25, 2000, "We're out of it. We sold it all." A few weeks before his announcement he sold about \$30 million worth of DaimlerChrysler shares [Ball & Miller, July 26, 2000].

## Suggested Questions

1. What reason(s) motivate executives to merge their corporations with other corporations? What reason(s), in your opinion, motivated Robert Eaton to merge with Daimler-Benz? What reason(s) motivated Schrempp to seek the merger?
2. What is synergy? What are some of the ways in which a merger might produce synergy? In your opinion, what might be the sources of the estimated \$1.4 billion and \$3.00 billion synergy mentioned in the case for 1998 and 1999 respectively?
3. How does the acquiring company determine what price to offer the target company? How much did Daimler-Benz pay for Chrysler? What was the amount of premium paid? In your opinion, was the premium paid justified? Explain.
4. FASB has recently issued SFAS 141, *Business Combinations*, and SFAS 142, *Goodwill and Intangible Assets*. What were the reasons for issuing these pronouncements?
5. Prepare a schedule to compare operating income, net income, cash flow from operations, total assets, equity, RRA, and RRE for the following cases: (a) as reported by DaimlerChrysler (APBO 16--pooling); (b) assume the merger was accounted for as a purchase, the difference between the price paid over book value is attributed to goodwill, and goodwill is amortized over 3 years; (c) same as (b), except that goodwill is amortized over 20 years; and (d), same as (b), except that goodwill has indefinite life and is not subject to amortization according to SFAS 141 and 142. Comment on the results in the schedule.
6. The merger between Chrysler Corporation and Daimler-Benz AG was meant to be a “merger of equals.” In retrospect, and given the information provided in the case, was the merger, in your opinion, a merger of equals?

## **TEACHING NOTE**

The objectives of the case are to: (1) expose students to various issues that mergers and business acquisitions, especially cross-border mergers, raise; and (2) challenge students to find solutions for these issues. Among the issues raised in mergers and acquisitions are: (1) what motivates CEOs to merge; (2) how to determine the price to be paid by the acquirer for the target company; (3) the accounting for mergers and acquisitions; and (4) discussion of the new position taken by the FASB in SFAS 141 and 142 as to the accounting for business acquisitions and intangibles, especially goodwill. The case can be used in an MBA financial reporting course, in the advanced accounting course for undergraduate accounting majors, finance courses, or a graduate seminar on financial accounting. A recommended number of questions and suggested approaches for discussing them is included in the teaching note along with a selected bibliography. Some of the questions are directly related to the material in the case, and some may require further reading and research. Instructors using the case may eliminate or add other questions to make the case more relevant and focused on their course needs.

## Suggested Class Discussion

### Question 1:

*What reason(s) motivate executives to merge their corporations with other corporations? What reason(s), in your opinion, motivated Robert Eaton to merge with Daimler-Benz? What reason(s) motivated Schrempp to seek the merger?*

The reasons that motivate executives to merge vary from sound business and economic reasons to merely personal and selfish reasons. A CEO may have a vision of growth or improving the performance of the company through acquiring another company that possesses a patent, a software, an idea that is underutilized. Mergers among companies could, in some cases, exploit the economy of scale by eliminating redundant resources or utilizing undercapacity. A merger may also open new markets for the company, especially in foreign countries. On the other hand, an executive might be motivated toward merger to increase his or her compensation, prestige, or power.

The second part of the question is very subjective; however, from reading the case, one could speculate that Mr. Eaton's decision to merge with Daimler-Benz was probably personal. At the time of merger (May 1998), Eaton was 58 years old. He had been associated with the auto industry for at least 35 years. The hostile attempt by Kerkorian in 1995 to take over the company probably exhausted him and made him realize that he could lose control of his company and probably his job.

The merger with Daimler-Benz would give him an opportunity to negotiate a good retirement package, which it did. The merger agreement stipulated that Eaton would be retiring in three years and provided a very golden parachute for him. Actually, as the section of the case entitled "Chrysler Executive Exodus" shows, Eaton retired on March 31, 2000 (less than two years after the merger). It is also possible that his decision to merge with Daimler-Benz was in the best interest of Chrysler.

He was aware that there were more car companies and more capacity to produce cars than there was demand for them (See the introduction section of the case). Chrysler was the smallest of the three US auto companies, and its ability to compete and survive in the future was in doubt unless it associated itself with a major player in the market (The section entitled “Chrysler Corporation” shows several trials to do this.). He might have had a vision that an association with a prestigious car company such as Daimler-Benz would make Chrysler more visible and accessible in foreign markets.

The reason for the decision made by Schrempp to merge with Chrysler was to broaden the company’s base and change emphasis from luxury cars to a full line of all kinds of cars. Daimler-Benz was spending huge amounts of money on research and development and selling too few cars. If they could increase their volume, they would be able to lower their cost by spreading their overhead costs over a larger volume. Chrysler, with its record of success in producing SUVs and minivans, could broaden the company’s base. Schrempp also was an ambitious man and probably saw in the merger an opportunity to increase his prestige and power.

**Question 2:**

*What is synergy? What are some of the ways in which a merger might produce synergy? In your opinion, what might be the sources of the estimated \$1.4 billion and \$3.00 billion synergy mentioned in the case for 1998 and 1999 respectively?*

Synergy simply means that the combined entities will produce greater returns than the sum total of the returns produced by each entity independently. In theory at least, this means more returns for stockholders, higher compensation for executives and employees, much better products

and services for customers, more taxes for the government, and/or value added to the society. The increase in return of the combined entities can be achieved through eliminating redundant resources, fully utilizing underutilized production, marketing, and research and development resources and facilities.

Literature on mergers and acquisitions is, however, not conclusive as to whether a merger's synergy is fact or fiction. A number of empirical studies have shown that mergers and acquisitions increase the wealth of stockholders of both the target and acquiring corporations [Dodd & Ruback, 1977; Bradley, 1980]. On the other hand, a study by Roll shows that the gains to stockholders of the target company represents wealth transferred from the stockholders of the acquiring company, and is not a net gain. This is known as the "Hubris Hypothesis" [Roll, 1986]. Bradley, Desai, and Kim (1988) find support for the existence of positive abnormal returns to the shareholders of target corporations at the takeover announcement and also shows evidence that profit from acquisition is transferred from the acquiring firm to the target corporation [Bradley, Desai, & Kim, 1988].

Unfortunately, the verification of claimed synergy cannot be made at the inception of the acquisition, but can be done only subsequent to acquisition. Many promising proposals of merger have ended up in failure. Some of the failure examples in recent history include the acquisition of WordPerfect by Novell. Novell acquired WordPerfect for \$1.4 billion, which was \$700 million more than the bid that Lotus made. The merger did not work and Novell sold WordPerfect for \$200 million to Corel two years later, resulting in a loss of \$1.2 billion [Sirower, 1997].

Even though this case does not provide the sources of the projected synergy of \$1.4 billion in 1998 and \$3.00 billion in 1999, the information in the case made it clear that there would be no layoff of employees or closing of plants. Therefore, the sources of this synergy appeared to be from increases in sales.

**Question 3:**

*How does the acquiring company determine what price to offer the target company? How much did Daimler-Benz pay for Chrysler? What was the amount of premium paid? In your opinion, was the premium paid justified? Explain.*

A business acquisition decision has to be viewed as a capital investment decision, a big capital investment decision! The price to be paid to the target company is the investment or the cash outflow. It must produce cash inflow. The cash inflow to the acquirer must not only exceed the cash outflow, but provide a return that is at least equal to the present return that the acquiring company is making in order for the acquiring company to maintain its level of profitability and shareholders' value..

The price (including premium) paid by the acquiring company to the target company or its shareholders is the investment. The form of payment (stock or cash) should not make any difference in making the business acquisition decision.

As shown in Exhibit 2, the DaimlerChrysler share was worth \$91.77 on May 7, 1998, Chrysler share was worth \$41.43, and the number of Chrysler common shares outstanding at “the

date of merger” was 690 million shares, the price and premium paid for acquiring Chrysler Corporation can be determined as follows:

Price: $690 \times 0.6235 \times 91.77$	\$39,481 million
Market value of Chrysler Corporation At the date of merger: $690 \times 41.43$	<u>27,897</u> million
Premium paid for Chrysler Corporation	<u>\$11,584</u> million

The amount of premium paid for Chrysler Corp. should be viewed as the price for the expected synergy that will be generated from the merger. According to the synergy theory [Bradley, Desai & Kim, 1988; Seth, 1990], a successful merger generates more earnings and cash flow than the sum total of the earnings and cash flow generated by each entity separately. This can be accomplished by generating more revenues given the existing resources or by decreasing expenses as a result of eliminating redundant resources, or both.

In the Daimler/Chrysler merger, management projected an initial synergy of \$1.4 billion for 1998, and \$3.0 billion starting in 1999. (See page 9.) The \$1.4 billion synergy in 1998 amounted to 11.6% rate on the \$12 billion dollar premium paid. The synergy is estimated to reach \$3.0 billion in 1999, 25% of the \$12 billion dollar premium. Given that Daimler-Benz operating income in 1997 was \$2.4 billion dollars and the market value of its equity was \$52.1 billion (568 million shares x \$91.77 per share), as shown in Exhibit 2, the rate of return on market value of its equity was 4.6%, which was much lower than the 11.6% or 25% rate on the premium paid for the expected merger synergy. So one must conclude, assuming that the projection of the synergy was accurate, that Daimler made a good decision.

**Question 4:**

*FASB has recently issued SFAS 141, Business Combinations, and SFAS 142, Goodwill and Intangible Assets. What were the reasons for issuing these pronouncements?*

The reasons for issuing these two statements are to: (1) improve financial reporting of combined corporations; (2) increase the comparability of entities by requiring all companies to use one method only for accounting for the business combination; and (3) provide more information about intangible assets. Before the issuance of SFAS 141, two methods of accounting for business combination were used by businesses: (1) the pooling-of-interests method; and (2) the purchase method.

Under the pooling method, the merger is viewed as if the only change taking place is one of legal form rather than economic substance. The assets, liabilities, and equity of each of the merging entities are combined at their present book values; no valuation of the assets, liabilities and equity of the acquired (target) entity or the acquirer is needed. As a matter of fact, there is no target company or acquiring company; it is a merger of equals.

When the merger is accounted for as a purchase, the acquiring company must remeasure all of the target company's assets and liabilities at their respective fair market values. If the price paid by the acquiring company exceeds the fair market value of the target company's net assets (assets minus liabilities), the difference is treated as goodwill (premium). After acquisition the balance sheet of the acquirer includes the assets (including goodwill) and liabilities of the acquired company at their fair market values.

The two methods vary as to their impact on the method of paying for the acquisition by the acquirer, on the valuation of assets, liabilities, and equities of the acquirer and/or the target company subsequent to acquisition, on recognition of goodwill, on amount of retained earnings reported, amount of future earnings, and on rate of return on assets.

SFAS 141 eliminated the use of pooling-of-interest for accounting for business combinations; all combinations have to be accounted for using the purchase method. As a result of this new standard, market value of the assets of the acquired company and any goodwill resulting from the acquisition have to be reported on the balance sheet of the consolidated financial statements. Also, the depreciation and amortization of these assets would have to be deducted in the consolidated income statements.

Many companies raised strong opposition to the proposed standard because the depreciation of the market value of the assets acquired and amortization of acquired goodwill would decrease income and make the disparity between income and cash flow from operations so wide. As a result, FASB issued SFAS 142 which required that goodwill not be amortized, but reviewed for impairment periodically.

**Question 5:**

*Prepare a schedule to compare operating income, net income, cash flow from operations, total assets, equity, RRA, and RRE for the following cases: (a) as reported by DaimlerChrysler (APBO 16--pooling); (b) assume the merger was accounted for as a purchase, the difference between the price paid over book value is attributed to goodwill, and goodwill is amortized over 3 years; (c)*

*same as (b), except that goodwill is amortized over 20 years; and (d), same as (b), except that goodwill has indefinite life and is not subject to amortization according to SFAS 141 and 142. Comment on the results in the schedule.*

Exhibit 4 shows proforma financial measures and ratios of DaimlerChrysler under the four cases: (1) actual results; (2) if the business acquisition were treated as a purchase, assuming goodwill to be amortized over 3 years; (3) if the business acquisition were treated as a purchase, assuming goodwill to be amortized over 20 years; and (4) if the business acquisition were accounted for under the provisions of SFAS 141 and 142.

Students should observe that operating profit, RRA, and RRE are higher under pooling than under purchase, as a result of goodwill amortization. Also the results produced by the purchase method vary depending on the period over which goodwill is amortized (which is a very subjective decision). Students also should notice that the cash flow from operations is the same whether the company uses pooling or purchase, and is not affected by the period over which goodwill is amortized. Students should also notice that under SFAS 141 and 142, the income reported is equal to the income under pooling, while goodwill is reported on the balance sheet.

**Question 6:**

*The merger between Chrysler Corporation and Daimler-Benz AG was meant to be a “merger of equals.” In retrospect, and given the information provided in the case, was the merger, in your opinion, a merger of equals?*

The merger between Chrysler Corporation and Daimler-Benz AG was supposed to be a “merger of equals.” In retrospect, however, the merger between the two companies was not, in the opinion of many merger and acquisition experts, a merger of equals. From the merger agreement as well as from the events subsequent to the merger, it appears that the transaction was clearly an acquisition of Chrysler by Daimler, rather than a merger of equals. Some of the facts that enforce this conclusion are: (1) the name of the company is DaimlerChrysler, not ChryslerDaimler; (2) the company is a German stock corporation; (3) it is publicly incorporated under the law of the Federal Republic of Germany; (4) the annual stockholders meeting would take place in Germany; (5) the Board of Management which is responsible for managing day-to-day operations consists of eight Americans and 10 Germans; (6) the merger agreement stated that Robert Eaton, the chairman of Chrysler at the time of the merger and co-chairman of the new entity DaimlerChrysler, was to retire within three years (he actually retired earlier, on March 31, 2000); (7) many Chrysler executives left the company shortly after the merger (see the section entitled “Chrysler Executive Exodus”); and (8) the percentage of ownership of the new entity stock by Americans went down from 44% at the time of merger to 20%. A merger of equals is a merger where there is a continuity of business, ownership, and management. The merger between Chrysler and Daimler does not seem to have maintained the continuity of either ownership nor management.

## **EXHIBIT 1**

### **1997 PRODUCTION OF CARS BY THE LARGEST 15 CAR COMPANIES**

	<b>Company</b>	<b>Cars Produced (in thousands)</b>
1.	General Motors	7,774
2.	Ford Motor	6,543
3.	Toyota	4,013
4.	Volkswagen	3,931
<b>5.</b>	<b>CHRYSLER</b>	<b>2,695</b>
6.	Nissan	2,612
7.	Fiat	2,432
8.	Honda	2,291
9.	Peugeot	1,608
10.	Mitsubishi	1,448
11.	Renault	1,421
12.	Hyundai	1,287
13.	BMW	1,143
<b>14.</b>	<b>DAIMLER-BENZ</b>	<b>909</b>
15.	Daewoo	738

*SOURCE: Autofacts Unit of Coopers & Lybrand Consulting*

**EXHIBIT 2****SELECTED INFORMATION ABOUT  
DAIMLER/CHRYSLER MERGER AT  
TIME OF MERGER**

	<b>DAIMLER-BENZ</b>	<b>CHRYSLER</b>
Production of cars in 1997 (in thousands)	2,695 <sup>1</sup>	909 <sup>1</sup>
Revenues (in billion)	\$68.92 <sup>2</sup>	\$61.15 <sup>2</sup>
Operating profit (in billion)	\$2.40 <sup>2</sup>	\$4.72 <sup>2</sup>
Net income (in billion)	\$4.47 <sup>2</sup>	\$2.81 <sup>2</sup>
Cash flow from operations (in billion)	\$6.25 <sup>2</sup>	\$8.0 <sup>2</sup>
Market price per share (5/7/98)	\$91.77 <sup>3</sup>	\$41.43 <sup>3</sup>
EPS	3.42 <sup>3</sup>	4.15 <sup>3</sup>
P/E	27	10
Number of common shares outstanding (in million)	568 <sup>3</sup>	690 <sup>3</sup>
Stockholders' equity per balance sheet (in billion)	\$19.49 <sup>2</sup>	\$11.36 <sup>2</sup>
Total assets (in billion)	\$76.17 <sup>2</sup>	\$60.42 <sup>2</sup>
Number of employees	300,168 <sup>2</sup>	121,000 <sup>2</sup>

- (1) Autofacts Unit of Coopers & Lybrand Consulting
- (2) Chrysler and Daimler-Benz Financial Statements
- (3) Davis Phillips and Bradley Stertz, "Daimler Deal Reshapes the Auto Industry," *The Detroit News* (May 7, 1998)

**EXHIBIT 3**

**SELECTED INFORMATION ABOUT DAIMLER CHRYSLER  
SUBSEQUENT TO THE MERGER**

	<b>In Million Euros</b>				
	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2001</b>
Revenues	127,572	131,782	149,985	162,384	152,873
Operating Profit (Loss)	6,230	8,593	11,012	9,752	(1,318)
Net Income	6,547	4,820	5,746	7,894	(662)
Cash Flow From Operations	12,337	16,681	18,023	16,017	15,944
Assets	124,831	136,149	174,667	199,274	207,410
Equity	27,960	30,367	36,060	42,409	39,004
Diluted Earnings per Share	4.21	4.91	5.69	7.80	(.66)
Cash Dividends per Share	---	2.35	2.35	2.35	1.00
Debt-to-Equity Ratio	123%	133%	179%	200%	233%
Current Ratio	85%	79%	66%	67%	64%
Long-Term Credit Rating:					
Standard & Poor's	---	A+	A+	A	BBB+
Moody's	---	A1	A1	A2	A3
Number of Employees	421,661	433,939	463,561	449,594	379,544
Exchange Rate (\$1:€)	---	.8522	.9930	1.0753	1.1217
Share Price 12/31, Frankfurt (€)	---	83.60	77.00	44.74	48.35
Share Price 12/31, New York (\$)	---	96.06	78.25	41.20	41.67

*Source: 2001 Annual Report*

## EXHIBIT 4

### PRO FORMA FINANCIAL MEASURES AND RATIOS

MEASURES AND RATIOS	1998				1999				2000			
	APBO 16			SFAS 141 & 142	APBO 16			SFAS 141 & 142	APBO 16			SFAS 141 & 142
	As reporte d (Pool- ing)	Purchase			As reporte d (Pool- ing)	Purchase			As re- ported (Pool- ing)	Purchase		
		Goodwill Amortized Over		Goodwill Amortized Over		Goodwill Amortized Over						
	3 years	20 years		3 years	20 years			3 years	20 years			
Operating Income	10,082	9,117 <sup>(1)</sup>	9,937 <sup>(1)</sup>	10,082	11,089	7,228	10,510	11,089	9,155	5,294	8,576	9,155
Net Income	5,656	5,050 <sup>(2)</sup>	5,565 <sup>(2)</sup>	5,656	5,785	3,735 <sup>(2)</sup>	5,478 <sup>(2)</sup>	5,785	7,411	5,276 <sup>(2)</sup>	7,201 <sup>(2)</sup>	7,411
Cash Flow from Opera- tions	19,571	19,571	19,571	19,571	18,149	18,149	18,149	18,149	15,037	15,037	15,037	15,037
Total Assets	159,738	170,357 <sup>(3)</sup>	171,177 <sup>(3)</sup>	171,322 <sup>(4)</sup>	175,889	182,647 <sup>(3)</sup>	186,749 <sup>(3)</sup>	187,473 <sup>(4)</sup>	187,078	189,975 <sup>(3)</sup>	197,359	198,662
Equity	35,629	35,023	35,538	35,629	36,313	34,263	35,322	36,313	39,814	37,679	39,604	39,814
RRA	3.5%	3.0%	3.3%	3.3%	3.3%	2.0%	2.9%	3.1%	4.0%	2.7%	3.6%	3.7%
RRE	15.9%	14.4%	15.7%	15.9%	15.9%	10.9%	15.5%	15.9%	18.6%	14.0%	18.2%	18.6%

<sup>(1)</sup> Assuming amortization of goodwill for 3 months

<sup>(2)</sup> After deducting amortization of goodwill net of tax (using 37.2%, 46.9%, and 44.7%, the average tax rates for 1998, 1999, & 2000 respectively)

<sup>(3)</sup> Asset reported plus balance of goodwill at the end of the year

<sup>(4)</sup> Assuming no impairment

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