

**University of Illinois**  
**College of Commerce and Business Administration**

**Finance 454: Corporate Finance Research**

Professor Michael Weisbach  
Fall 2004

This is an advanced course in corporate finance. Its goal is to bring Ph.D. students to the frontier of knowledge so that they can start doing their own research in this field. Since about the 1970's, researchers have realized that financial contracts are best viewed as part of the nexus of contracts that make up the firm. To understand them, one must first understand the firm's contractual nature. The course will begin with the classic Modigliani/Miller arguments, and follow the literature in discussing the implications of violations of MM assumptions. We will then study the traditional corporate finance issues, including financial distress, corporate payout policy, and the capital acquisition process. We will then move into some topics that have become prominent in the literature in recent years: interactions between product and capital markets, corporate governance/control, special issues in governance/control raised by international differences, and, finally, internal capital markets and the logic of diversification.

Much recent research has argued that one important factor in most corporate decisions, especially financial ones, is the nature of managerial control. The study of corporate control addresses questions such as what managers' incentives are, what is the process by which they are chosen and fired, and what types of internal and external markets are there by which control can be affected. The second part of the course will discuss these issues directly. Topics to be discussed will be the interaction of capital markets and product markets, management entrenchment, internal mechanisms of control such as boards of directors and incentive contracts, and external mechanisms of control.

**Course Requirements:**

I would like each of you to become an "expert" on one topic in the field of corporate finance. In doing so, I would like you to do a detailed reading of the literature in this field. I expect that this reading will go well beyond the readings indicated in the syllabus. I would like you to lead the **discussion** of this topic during the class session devoted to it. In doing so, you should give some serious thought to what the issues are that have been researched in this field, what we have learned, why the literature has developed the way it has, and what is the next step towards making further progress. Your discussion will be graded, and the grade will count for approximately 20% of your grade.

I would also like you to write up a **literature survey** of the field. There are no length requirements or restrictions on this survey. There is no need to present entire models, but you should understand them and discuss them clearly and concisely. I would like to see some discussion of the models' realism or lack of, their testable implications and ways that could be extended, or supplanted with better models. You should also summarize the main results existing empirical literature, explain why or why not you find the results interesting/persuasive,

and describe how and why it developed the way it did. Do data requirements preclude the best possible analysis? Did the literature start as "fact-finding" and then later develop into more formal hypothesis testing? Does the empirical literature address the issues raised by the theoretical literature? This literature survey will be due one week following your presentation and will count for approximately 20% of your grade.

After you finish your literature survey, I would like you to write up a **research proposal**, ideally on some issue related to topic you researched. This research must be feasible and be an attempt to extend the research frontier. In other words, research proposals that require obtaining unobtainable data or solving unsolvable models are unacceptable. Nor are simply replications of existing papers on slightly different data sets. Students will present their proposals during finals week. These proposals will count for approximately 20% of the final grade.

There will be two **referee reports** due on articles that I will hand out. Write the report as a reviewer for potential publication in a major academic finance journal, up to three well-spaced pages. Part 1 of each report should succinctly state each of the paper's important contributions in the best possible light. Part 2 should constructively critique any shortcomings. Part 3 should make suggestions for improvements. This report should be accompanied with a short letter to the editor (me), recommending that I reject the paper, request a revision, or accept the paper and why. Each report will count for 10% of the grade.

The remaining 20% of the grade will depend on **class participation**. Students are expected to come to class, having read the required readings for that class session. In a small class like this, the quality of the discussion will have a major impact on everyone's learning, so it is particularly essential that you come to class prepared. In addition, since the main goal of this class is prepare you to do research in class, I expect all students to attend the Departmental Finance Seminar each week. Part of your participation grade will be based on your attendance in the weekly Finance Seminar.

### **Course Materials:**

This course will be based on academic articles. Many of the articles listed below are available on the web in one place or another. Forthcoming papers in *The Journal of Finance* and *Journal of Financial Economics* can be downloaded for free, as can many older papers. Other good sources are [ssrn.com](http://ssrn.com) (containing working papers from academics all over the world), [nber.org](http://nber.org) (where papers of NBER Research Associates can be downloaded) and individual faculty members' web sites. To find a faculty member's web site, the easiest way is to go to their university's web site, or to use a directory of finance faculty that available at "<http://fisher.osu.edu/fin/findir/>".

## Reading List

Note: Readings with a \* will be emphasized in the class discussion. Unless noted in class, these articles should be read prior to the class discussing the relevant topic.

### Introduction - The Theory of the Firm and Incomplete Contracts

\* Jensen, M. (1993) "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," *Journal of Finance*, 48, 831-880.

\* Zingales, L. (2000) "In Search of New Foundations," *Journal of Finance*, 55, 1623-1654.

Berle, A. and G. Means (1932) *The Modern Corporation and Private Property*, Chapters I, V, and VI.

Coase, R. (1937) "The Nature of the Firm," *Economica*, 386-405.

Grossman, S. and O. Hart (1986) "The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration," *Journal of Political Economy*, 94, 691-719.

### I. Capital Structure

Survey and Overview:

Harris, M. and A. Raviv (1991) "The Theory of Capital Structure," *Journal of Finance*, 46, 297-355.

\* Stein, J. (2001) "Agency, Information and Corporate Investment," (read part 1), forthcoming in *Handbook of the Economics of Finance*, edited by G. Constantinides, M. Harris, and R. Stulz. North-Holland: Amsterdam.

\* Graham, J. and C. Harvey, "The Theory and Practice of Corporate Finance: Evidence from the Field," *Journal of Financial Economics*, 60, 187-243.

#### A. M&M and Tax-Based Theories of Optimal Capital Structure

Brealey, R. and S. Myers (1991) *Principles of Corporate Finance*, Chaps. 17-18. - This reviews the basic M-M theory.

\* Graham, John (2003), "Taxes and Corporate Finance, A Review," *Review of Financial Studies*.

\* Miller, M. (1977) "Debt and Taxes," *Journal of Finance*, 32, pp. 261-275.

\* MacKie-Mason, J. (1991) "Do Taxes Affect Corporate Financing Decisions?" *Journal of Finance*, 45, pp. 1471-1493.

Rajan, R. and L. Zingales (1995) "What do we know about Capital Structure? Some Evidence from International Data," *Journal of Finance*, 50, 1421-1460.

## *B. Other Theories of Optimal Capital Structure*

### 1) Signalling Theories

Leland, H. and D. Pyle (1977) "Informational Asymmetries, Financial Structure, and Financial Intermediation," *Journal of Finance*, 32, pp. 371-387.

Ross, S. (1977) "The Determination of Financial Structure: The Incentive Signalling Approach," *Bell Journal of Economics*, 8, 23-40.

### 2) Agency-Based Theories

\* Jensen, J. and W. Meckling (1976) "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, 3, pp. 305-360.

\* Myers, S. (1977) "Determinants of Corporate Borrowing," *Journal of Financial Economics*, 5, 147-175.

\* Parrino, R. and M. Weisbach (1999) "Measuring Investment Distortions Arising from Stockholder-Bondholder Conflicts," *Journal of Financial Economics*, Vol. 53 (July, 1999), pp. 3-42.

\* Jensen, M. (1986) "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review*.

Parrino, R., A. Poteshman, and M. Weisbach (2002) "Measuring Investment Distortions when Risk-Averse Managers Decide Whether to Undertake Risky Projects," Working Paper, University of Illinois.

### 3) The Pecking Order Hypothesis

\* Myers, S. (1984) "The Capital Structure Puzzle," *Journal of Finance*, 39, 575-592.

\* Myers, S. and N. Majluf (1984) "Corporate Financing and Investment Decisions When Firms have Information That Investors do not Have," *Journal of Financial Economics*, 13, 187-221.

Dybvig, P. and J. Zender (1991) "Capital Structure and Dividend Irrelevance with Asymmetric Information," *Review of Financial Studies*, 4, 201-219.

Stein, J., (1992) "Convertible Bonds as Backdoor Equity Financing," *Journal of Financial Economics*, 32, 3-21.

### 4) Behavioral Approaches

\* Baker, M. and J. Wurgler (2002) "Market Timing and Capital Structure," *Journal of Finance*,

57, 1-32.

Welch, I., (2004) "Capital Structure and Stock Returns," *Journal of Political Economy*.

## **II. Financial Distress**

### *A. Theory*

\* Gertner, R. and D. Scharfstein (1991) "A Theory of Workouts and the Effects of Reorganization Law," *Journal of Finance*, 46, 1189-1222.

\* Shleifer, A. and R. Vishny (1992) "Liquidation Values and Debt Capacity: A Market Equilibrium Approach," *Journal of Finance*, 47, 1343-1366.

### *B. Empirical Evidence*

\* Weiss, L (1990) "Bankruptcy Resolution: Direct Costs and Violation of Priority of Claims," *Journal of Financial Economics*, 27, 419-444.

\* Pulvino, T. (1998) "Do Asset Fire Sales Exist? An Empirical Investigation of Commercial Aircraft Transactions," *Journal of Finance*, 53, 939-978.

Warner, J. (1977) "Bankruptcy Costs: Some Evidence," *Journal of Finance*, 32, 337-348.

Franks, J. and W. Torous (1989) "An empirical investigation of United States firms in reorganization," *Journal of Finance*, 44, 747-769.

Gilson, S., K. John, and L. Lang (1990) "Troubled Debt Restructurings: An Empirical Study of Private Restructurings of Firms in Default," *Journal of Financial Economics*, 27, 315-353.

Cutler, D. and L. Summers (1988) "The Costs of Conflict Resolution and Financial Distress: Evidence from Texaco-Pennzoil Legislation," *RAND Journal of Economics*.

## **III. Corporate Payout Policy**

\* Black, F. "The Dividend Puzzle", *Journal of Portfolio Management*, 2, 5-8.

Bhattacharya, Suddipto (1979) "Imperfect Information, Dividend Policy and 'The Bird in the Hand' Fallacy" *Bell Journal of Economics*, 259-270.

Allen, F. and R. Michaely (forthcoming). Payout policy. North-Holland Handbooks of Economics. G. Constantinides, M. Harris and R. Stulz.

Miller, M. and K. Rock (1985) "Dividend Policy under Asymmetric Information," *Journal of Finance*, 42, 889-911.

Ikenberry, D., J. Lakonishok, and T. Vermaelen "Market Underreaction to Open Market Share Repurchases," *Journal of Financial Economics*, 39, 181-208.

\* Fama, E. and K. French (2001) "Disappearing Dividends: Changing Firm Characteristics or Lower Propensity to Pay?" *Journal of Financial Economics*, 60, 3-43.

Healy, P. and K. Palepu (1988) "Earnings Information Conveyed by Dividend Initiations and Omissions," *Journal of Financial Economics*, 149-175.

\* Stephens, C. and M. Weisbach (1998) "Actual Share Repurchases in Open-Market Repurchase Programs," *Journal of Finance*, 53, 313-333.

Stephens, C., Jagannathan, and M. Weisbach (2000) "Financial Flexibility and The Choice Between Dividends and Stock Repurchases", *Journal of Financial Economics*, Vol. 57 (September, 2000) pp. 355-384.

#### **IV. Raising Capital**

Overview:

Ritter, J. (2003) "Investment Banking and Securities Issuance," forthcoming in *Handbook of the Economics of Finance*, edited by Constantinescu, Harris, and Stulz. Downloadable from <http://bear.cba.ufl.edu/ritter> .

##### *A. Initial Public Offerings*

\* Rock, K (1986) "Why New Issues are Underpriced?" *Journal of Financial Economics*, 15, 187-212.

\* Benveniste, L, and Spindt (1989) "How Investment Bankers Determine the Offer Price and Allocation of New Issues," *Journal of Financial Economics*, 24, 343-362.

\* Pagano, M., F. Panetta, and L. Zingales (1998) "Why do Companies Go Public? An Empirical Analysis" *Journal of Finance*.

Zingales, L., (1995) "Insider Ownership and the Decision to go Public," *Review of Economic Studies*, 62, 425-448.

##### *B. Issuing other Securities*

Asquith, P. and D. Mullins (1986) "Equity Issues and Offering Dilution," *Journal of Financial Economics*, 15, 61-89.

\* Loughran, T. and J. Ritter (1995) "The New Issues Puzzle," *Journal of Finance*, 50, 23-51.

##### *C. Financing New Ventures*

Gompers, P. and J. Lerner (1999) *The Venture Capital Cycle*, MIT Press.

\* Sahlman, W. (1990) "The Structure and Governance of Venture-Capital Organizations," *Journal of Financial Economics*, 473-521.

\* Kaplan, S. and P. Stromberg, (2003) "Financial Contracting meets the Real World: Evidence from Venture Capital Contracts," *Review of Economic Studies*.

Lerner, J. (1994) "Venture Capitalists and the Decision to Go Public," *Journal of Financial Economics*, 293-216.

Gompers, P. (1995) "Optimal Investment, Monitoring, and the Staging of Venture Capital," *Journal of Finance*, 50, 1461-1489.

## **V. Interactions of Product Market and Capital Market**

### *A. Theory*

\* Brander, J. and T. Lewis (1986) "Oligopoly and Financial Structure: The Limited Liability Effect," *American Economic Review*, 76, 956-970.

Maksimovic, V. (1988) "Capital Structure in Repeated Oligopolies," *RAND Journal of Economics*, 19, 389-402.

### *B. Empirical Tests*

\* Chevalier, J. (1995) "Capital Structure and Product-Market Competition: Empirical Evidence from the Supermarket Industry," *American Economic Review*.

\* Chevalier, J. (1995) "Capital Structure and Product Market Competition: An Empirical Study of Supermarket Pricing," *Journal of Finance*.

Phillips, G. (1995) "Increased Debt and Industry Product Markets: An Empirical Analysis," *Journal of Financial Economics*, 37, 189-238.

\* Campello, M. (2003) "Capital structure and product markets interactions: Evidence from business cycles," *Journal of Financial Economics*.

## **VI. Corporate Governance and Control**

\* Shleifer, A. and R. Vishny, (1997) "A Survey of Corporate Governance," *Journal of Finance*, 52, 737-783.

### *A. The Entrenchment Problem*

Demsetz, H. (1983) "The Structure of Ownership and the Theory of the Firm," *Journal of Law and Economics*.

Shleifer, A. and R. Vishny (1989) "Managerial Entrenchment: The Case of Firm-Specific Assets," *Journal of Financial Economics*.

\* Morck, R., Shleifer, A. and R. Vishny (1988) "Management Ownership and Market Valuation: An Empirical Analysis," *Journal of Financial Economics*.

Holderness, C., R. Kroszner, and D. Sheehan (1999) "Were the Good Old Days that Good? Changes in Managerial Stock Ownership Since the Great Depression," *Journal of Finance*, 54, 435-469.

## *B. Internal Mechanisms of Control*

### 1) Incentive Contracts and Other Direct Incentives

\* Jensen, M. and K. Murphy (1990) "Performance Pay and Top-Management Incentives," *Journal of Political Economy*, 98, 225-264.

\* Hall, B. and J. Liebman (1998) "Are CEOs Really Paid Like Beaucrats?" *Quarterly Journal of Economics*, 113, 653-691.

Haubrich, J. (1994) "Risk Aversion, Performance Pay, and the Principal-Agent Problem," *Journal of Political Economy*.

Hall, B. and K. Murphy (2003) "The Trouble with Stock Options," *Journal of Economic Perspectives*, 17, (Number 3), 49-70.

Bebchuk, L. and J. Fried (2003) "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*, 17, (Number 3), 71-92.

### 2) Boards of Directors

\* Hermalin, B. and M. Weisbach (1998) "Endogenously Chosen Boards of Directors and Their Monitoring of Management", *American Economic Review*, Vol. 88 (March, 1998), pp. 96-118.

\* Weisbach, M. (1988) "Outside Directors and CEO Turnover," *Journal of Financial Economics*, 20, 431-460.

Hermalin, B. and M. Weisbach "Boards of Directors as an Endogenously-Determined Institution: A Survey of the Economic Evidence," *Economic Policy Review*, 9, Number 1.

Shivdasani, A. and David Yermack (1999) "CEO Involvement in the Selection of New Board Members: An Empirical Analysis," *Journal of Finance*, 54, pp. 1829-1854.

### 3) Management Turnover

\* Weisbach (1995) "CEO Turnover and the Firm's Investment Decisions," *Journal of Financial Economics*.

\* Denis, D. and D. Denis (1995) "Performance Changes Following Top Management Dismissals," *Journal of Finance*.

Hadlock, C. and G. Lumer (1997) "Compensation, Turnover, and Top Management Incentives" *Journal of Business*.

#### 4) Managerial Labor Markets

\* Fama, E. (1980) "Agency Problems and the Theory of the Firm," *Journal of Political Economy*, 88, 288-307.

\* Holmstrom, B. (1999) "Managerial Incentive Problems - A Dynamic Perspective," *Review of Economic Studies*, 66, 169-182.

#### *C. External Mechanisms of Control*

##### 1) Proxy Voting and Institutional Activism

\* Zingales, L. (1995) "What Determines the Value of Corporate Votes?" *Quarterly Journal of Economics*, 110, 1047-1073.

Zingales, L. (1994) "The Value of the Voting Right: A Study of the Milan Stock Exchange," *Review of Financial Studies*, 7, 125-148.

\* Del Guercio, D. and J. Hawkins (1999) "The Motivation and Impact of Pension Fund Activism," *Journal of Financial Economics*, 52, 293-340.

DeAngelo, H. and L. DeAngelo (1989) "Proxy Contests and the Governance of Publicly Held Corporations," *Journal of Financial Economics*, 23, 29-60.

Carleton, W., J. Nelson, and M. Weisbach (1998) "The Influence of Institutions on Corporate Governance through Private Negotiations: Evidence from TIAA-CREF" *The Journal of Finance*, 53, pp. 1335-1362.

##### 2) Takeovers

Manne, H. (1965) "Mergers and the Market for Corporate Control," *Journal of Political Economy*.

\* Grossman, S. and O. Hart (1980) "Takeover Bids, the Free-Rider Problem, and the Theory of the Corporation," *Bell Journal of Economics*.

\* Shleifer, A. and R. Vishny (1986) "Large Shareholders and Corporate Control," *Journal of Political Economy*, 94, 461-88.

Scharfstein, D. (1988) "The Disciplinary Role of Takeovers," *Review of Economic Studies*, 60, 185-199.

\* Mitchell, M. and K. Lehn (1990) "Do Bad Bidders make Good Targets?" *Journal of Political Economy*, 98, 372-398.

Servaes, H. (1994) "Do Takeover Targets Overinvest?" *Review of Financial Studies*, 7, 253-277.

## **VII. International Corporate Governance and Protection of Shareholders' Interests**

\* La Porta, R., F. Lopez-de-Silanes, A. Shleifer, and R. Vishny (1998) "Law and Finance," *Journal of Political Economy*, 52, 1131-1150.

La Porta, R., Lopez-de-Silanes, F., Shleifer, A., Vishny, R., 1997. "Legal Determinants of External Finance" *Journal of Finance* 52, 1131-50.

La Porta, R., F. Lopez-de-Silanes, A. Shleifer and R. Vishny (2000) "Agency Problems and Dividend Policies Around the World," *Journal of Finance*, 55, 1-33.

Johnson, S., La Porta, R., Lopez-de-Silanes, F., Shleifer, A., (2000) "Tunneling" *American Economic Review Papers and Proceedings*, 90, 22-27.

Dyck, A., and L. Zingales (2003) "Private Benefits of Control: An International Comparison," *Journal of Finance*, forthcoming.

Reese, W. and M. Weisbach (2002) "Protection of Minority Shareholder Interests, Cross-Listings in the United States, and Subsequent Equity Offerings," forthcoming, *Journal of Financial Economics*.

Doidge, C., Karolyi, G.A., Stulz, R.M., 2001. "Why are foreign firms listed in the U.S. worth more?" *Journal of Financial Economics*, forthcoming.

Lombardo, D., Pagano, M., 2000. "Law and Equity Markets: A Simple Model." Working Paper, CSEF and University of Salerno.

Benos, E. and M. Weisbach (2003), "Private Benefits and Cross-Listings in the U.S.," Working Paper, University of Illinois.

Henderson, B., N. Jegadeesh, and M. Weisbach (2003) "World Markets for Raising New Capital," Working Paper, University of Illinois.

## **VIII. Allocation and Misallocation of Internal Resources**

Survey:

Stein, J. (2001) "Agency, Information and Corporate Investment," (read part 2), forthcoming in *Handbook of the Economics of Finance*, edited by G. Constantinides, M. Harris, and R. Stulz.

North-Holland: Amsterdam.

Theory:

\* Stein, J. (1989) "Efficient capital markets, inefficient forms: A model of myopic corporate behavior," *Quarterly Journal of Economics*, 104, 655-669.

\* Stein, J. (1997) "Internal Capital Markets and the Competition for Corporate Resources," *Journal of Finance*, 52, 111-133.

Scharfstein, D. and J. Stein (2000) "The Dark Side of Internal Capital Markets: Divisional Rent-Seeking and Inefficient Investment," *Journal of Finance*, 55, 2537-2564.

Evidence:

Lamont, O. (1997) "Cash Flow and Investment: Evidence from Internal Capital Markets," *Journal of Finance*, 52, 83-109.

\* Stulz, R and H. Shin (1998) "Are Internal Capital Markets Efficient?" *Quarterly Journal of Economics*, 113, 531-552.

\* Chevalier, J. "What do we know about cross-subsidization? Evidence from the Investment Policies of Merging Firms," Working Paper, University of Chicago.

Lang, L. and R. Stulz (1998) "Tobin's q, Corporate Diversification, and Firm Performance," *Journal of Political Economy*, 102-1248-1280.

Rajan, R., H. Servaes, and L. Zingales (2000) "The Cost of Diversity: The Diversification and Inefficient Investment," *Journal of Finance*, 55, 35-84.

\* Schoar, A. (2001) "Effects of Corporate Diversification on Productivity," forthcoming, *Journal of Finance*.

Lamont, O. and C. Polk (2002) "Does Diversification Destroy Value: Evidence from Industry Shocks," forthcoming, *Journal of Financial Economics*.