

Finance 555: Financing Decisions, Payout Policy and Corporate Control

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Spring 2009
Office Hours: T and Th 1-2
and by appointment

This course provides a general economic and financial framework for analyzing the effects of financing decisions, as opposed to investment decisions, on corporate value. The material extends and enhances the frameworks covered in the Core Finance component and the Bridge course. Specifically, we will study decisions involving capital structure, payout policy, management compensation, ownership structure, and the distribution of control rights – virtually anything related to the way that contracts are structured within the corporation.

This class parallels much of the subject matter of Finance 552 (but not financial planning, which 552 does cover). There is a large difference of approach, however, between the two classes. While Finance 552 works on getting the students to apply the principles that they learned in the Core and Bridge classes, the focus of this class is to extend the frameworks developed there. Finance 555 will also do some application, but it will primarily be application of this new material.

Readings

There will be one required textbook, R. Brealey, S. Myers, and F. Allen, Principles of Corporate Finance (9th edition), which is abbreviated BMA in the outline below. This is a classic textbook that anyone serious about a finance career should own. It does an excellent job explaining institutional details and established theories. Previous editions of the book (some authored by Brealey and Myers only) are usually OK to use (with adjustments to chapter numbers) but probably not always.

Because the course investigates new theories and goes into much more detail than BMA in some areas, the class will not be primarily textbook based. Instead there will be other readings that will be required, and class handouts will be used to supplement the material when necessary. In addition there will be optional readings that should be read by students with a specific interest in a topic. Class handouts are required reading. A class packet will be available soon that will contain other required readings. Optional readings will be in the library, with some on reserve. Some newer readings can be found on www.ssrn.com, www.jstor.org, or other library resources when accessed from the library terminals.

Required Work and Evaluation

Students should read the required material before the class covering that material. Reading the required material before class should enable you to make the most out of the lecture. All students are responsible for the material covered in class, as well as the material in the handouts and required readings for each class, regardless of whether they were able to attend the class.

Evaluation in this course will be determined by written assignments, class participation, and examinations. The percentages for grading will be

Written Assignments	25%
Class Participation	10%
Midterm	30%
Final	35%

Written Assignments will be two write-ups done about cases and two or three homeworks. Students are encouraged to work in groups on the cases, with two to five people in a group. Homeworks must ultimately be done individually, although I recommend that students discuss how to *approach* the questions with fellow students.

Class Participation grades will be determined primarily by the **quality** of participation and also somewhat by student attendance.

The examination questions will require a student to apply the course material to real situations. Some of these questions will be set in relatively unstructured situations. They will thus test whether you can discern the correct concepts to apply, as well as whether you can apply these concepts correctly. Exams will be **closed book and closed notes**. Some key formulas will be written on the face of the exam to discourage memorization.

Other Matters: Attitudes, Inflexibility, and Idiosyncrasies

A few matters that may concern students relate to my philosophy towards teaching, classroom sessions, and grading. First, I enjoy teaching itself -- that is, communicating ideas to students eager to learn. Teaching is one of the two key inputs in the production of your knowledge. I get a thrill from having an impact on the way many bright young people will think and act. I also usually learn quite a few things myself in the process.

Different teaching techniques seem to work best for different teachers. I find my teaching to be most effective when students actively participate in class. This means that students must think along with me during class sessions. There must be substantial student-teacher interaction-- typically through student questions, comments, and answers to my questions. Students should have a strong impact on the class session.

The worst part of teaching is the grading and evaluating required of teachers. Grading consumes a large portion of professorial time and student attention despite the fact that, in the long run, grades are of little importance to anyone. Consider how disproportionate the time spent on grades is, given that nobody ever asks about your grades once you have been out of school for more than a year or two. (As proof of this latter proposition, consider my own situation. When I took introductory MBA Corporate Finance, I received the equivalent of a C. Yet in my first 25 years at UW no one asked me about this grade, or any other grades, when deciding whether I should teach this class.) De-emphasizing grades and emphasizing learning would seem to be in the interest of all of us.

Finally, I expect all of us in the class to behave responsibly. People who behave irresponsibly, imposing costs on others, should expect to bear the consequences of their actions. These attitudes, and other factors, give rise to the following policies:

1. I may use a grader to do some of the grading, but will make sure that any grader is highly competent.

2. I will be happy to go over exam questions with students to explain the correct answer and/or where they went wrong. However, I refuse to listen to grade complaints. Complaints are

almost always unsuccessful and a waste of everyone's time. In over two decades of teaching, never has a student complaint caused me to change a grade I have given (except when scores were added incorrectly).

3. I will expect all students to be prepared for class and to turn in assignments on time. Similarly, students can expect me to be prepared for class and to present them with assignments, handouts, and course materials on time.

4. I will encourage students to ask questions and otherwise participate in class. In some instances, "votes" on particular questions will be taken. All students will be expected to vote.

Topic Outline -- (Dates are approximate; later readings are tentative)

Goals, the Nature of the Firm, and Tool-Building – March 31 and April 2

- ◆ The Firm as a Nexus of Contracts
- ◆ Wealth Creation by the Firm
- ◆ Fisher Diagram
- ◆ Alternative Firm Goals
- ◆ Stakeholders and the Firm
- ◆ States of the World Models and Pricing

Required: BMA Chapter 2, especially early edition (on reserve).
Class Handouts

Optional Readings: Martin, Cox, and MacMinn, 1988, Chapter 2, "Financial Decisions and the Theory of Choice," and part of Chapter 3, in *The Theory of Finance: Evidence and Applications*, pp. 19-46, 70-72.(on reserve)
Copeland and Weston, "State-Preference Theory," Chapter 5 of *Financial Theory and Corporate Policy*, 3rd Edition. (on reserve)

Capital Structure with Fixed Investment Decisions – April 7 to April 23

- ◆ Perfect Markets (M & M)
- ◆ Weighted Average Cost of Capital
- ◆ Corporate Taxes
- ◆ Personal Taxes
- ◆ Financial Distress Costs
- ◆ Signaling

Required: BMA Chapters 18 and 19, and Sections 20.1, 20.3, 24.3, and 33.4
Grinblatt and Titman, 2002, "Capital Structure and Corporate Strategy," in *Financial Markets and Corporate Strategy*, 2nd Edition, Chapter 17, 595-621.

Written Assignment: American Home Products Case

- Optional Readings:** DeAngelo and Masulis, 1980, "Optimal Capital Structure under Personal and Corporate Taxation," *Journal of Financial Economics*, Vol. 8.
- Merothra, Mikkelson, and Partch, 2003, "The Design of Financial Policies in Corporate Spin-offs," *Review of Financial Studies*, Vol. 16, No. 4.
- Opler and Titman, 1994, "Financial Distress and Corporate Performance," *Journal of Finance*, Vol. 49.
- Andrade and Kaplan, 1998, "How Costly Is Financial (Not Economic) Distress? Evidence from Highly Leveraged Transactions That Became Distressed," *Journal of Finance*, Vol. 53, No. 5.
- Warner, 1977, "Bankruptcy Costs: Some Evidence," *Journal of Finance*, Vol. 32.
- Chalmers, 1998, "Default Risk Cannot Explain the Muni Puzzle: Evidence from Municipal Bonds that are Secured by U.S. Treasury Obligations," *Review of Financial Studies*, Vol. 11, No. 2.
- Ross, 1977, "The Determination of Financial Structure: The Incentive Signaling Approach," *The Bell Journal of Economics*, Vol. 8, No. 1. (Read first 8 pages or so)
- Graham and Harvey, 2001, "The theory and practice of corporate finance: evidence from the field," *Journal of Financial Economics*, Volume 60, Issues 2-3, May, Pages 187-243.
- Barclay and Smith, 2005, "The Capital Structure Puzzle: The Evidence Revisited," *Journal of Applied Corporate Finance*, Winter, Vol. 17, No. 1, pp. 8-17.
- Hackbarth, Hennessy, and Leland, 2007, "Can the Trade-Off Theory Explain Debt Structure?" *Review of Financial Studies*, Vol. 20, No5.

Capital Acquisition – April 28 to May 5

- ◆ Overview of Financing Alternatives
- ◆ Venture Capital
- ◆ How Securities are Issued
- ◆ Stock Price Reactions to Capital Structure Decisions

Required: BMA Chapters 15, 16, and 25

- Tim Loughran and Jay Ritter, 2004, "Why Has IPO Pricing Changed Over Time?" *Financial Management*, Autumn.
- Cliff Smith, 1986, "Raising Capital: Theory and Evidence," *Midland Corporate Finance Journal*, Vol. 4.
- Bro Utal, July 21 1986, "Inside the Deal that made Bill Gates \$350,000,000," *Fortune*.

- Optional Readings:** Asquith and Mullins, 1986, "Equity Issues and Offering Dilution," *Journal of Financial Economics*, Vol. 15.
- Sahlman, 1990, "The Structure and Governance of Venture Capital Organizations," *Journal of Financial Economics*, Vol. 27.
- Gompers and Lerner, 2001, "The Venture Capital Revolution," *Journal of Economic Perspectives*, Vol. 15, No. 2.
- Jay Ritter and Ivo Welch, 2002, "A Review of IPO Activity, Pricing, and Allocations," *Journal of Finance*, Vol. 57.

MIDTERM EXAM – May 7

Capital Structure Theory with Informational Inefficiency and Costly Arbitrage – May 12

- ◆ Market Inefficiency and Arbitrage Costs
- ◆ Recent Evidence
- ◆ Implications for Capital Structure

Required: BMA Sections 14.3 and 14.4

Jeffrey Pontiff, 2006, "Costly Arbitrage and the Myth of Idiosyncratic Risk," *Journal of Accounting and Economics*, October.

Optional Readings: Shleifer and Vishny, 1990, "Equilibrium Short Horizons of Investors and Firms," *American Economic Review*, Vol. 80.

Loughran and Ritter, 1995, "The New Issues Puzzle," *Journal of Finance*, Volume 50, pp. 23-51.

Lowry and Schwert, 2002, "IPO Market Cycles: Bubbles or Sequential Learning," *Journal of Finance*, vol. 57, No. 3.

Ikenberry, Lakonishok, and Vermaelen, 1995, "Market Underreaction to Open Market Share Repurchases," *Journal of Financial Economics*, Vol. 39.

Baker and Wurgler, 2002, "Market Timing and Capital Structure," *Journal of Finance*, vol.57, Issue 1.

Dividend Policy with Fixed Investment Decision – May 14 and 19

- ◆ Perfect Markets (M & M)
- ◆ Personal Taxes
- ◆ New Issue Costs
- ◆ Portfolio Rebalancing Costs
- ◆ Signaling

Required: BMA Chapter 17

Optional Readings: Miller and Rock, 1985, “Dividend Policy Under Asymmetric Information,” *Journal of Finance*, Vol. 40.

Skinner, 2008, “The evolving relation between earnings, dividends, and stock repurchases,” *Journal of Financial Economics*, Vol. 87, no. 3.

Agency Problems and Changes in Investment Policy due to Financial Structure – May 21 to 28

- ◆ Agency Theory
- ◆ Agency Costs of Debt
- ◆ Agency Costs of Equity
- ◆ Agency Costs and Dividend Policy
- ◆ Financial Contracting
- ◆ Management Compensation

Required: Byrd, Parrino, and Pritsch, 1998, “Stockholder-Manager Conflicts and Firm Value,” *Financial Analysts Journal*, Vol. 54, No. 3.

Jensen and Meckling, 1976, “Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure,” *Journal of Financial Economics*, vol. 3 (Beginning up to figure 1 – remaining is optional).

BMA Sections 13.1 and 13.3

Hall and Murphy, 2003, “The Trouble with Stock Options,” *Journal of Economic Perspectives*, Summer, vol. 17, no. 3.

Optional Readings: Smith and Warner, 1979, “On Financial Contracting: An Analysis of Bond Covenants,” *Journal of Financial Economics*, vol. 7.

Rajan and Zingales, 1995, “What Do We Know about Capital Structure? Some Evidence from International Data,” *Journal of Finance*, vol.50.

Jensen, 2005, “The Agency Costs of Overvalued Equity,” *Financial Management*, Spring.

Knopf, Nam, and Thornton, 2002, “The Volatility and Price Sensitivities of Managerial Stock Option Portfolios and Corporate Hedging,” *Journal of Finance*, vol.57.

DeAngelo and DeAngelo, 2006, “The irrelevance of the MM dividend irrelevance theorem” *Journal of Financial Economics*, Vol. 79.

Ang, Cole, and Lin, 2000, “Agency Costs and Ownership Structure,” *Journal of Finance*, vol.55, No. 1.

Parrino and Weisbach, 1999, “Measuring investment distortions arising from stockholder–bondholder conflicts,” *Journal of Financial Economics*, Volume 53, Issue 1, July, Pages 3-42.

Murphy, 1999, “Executive Compensation,” *Handbook of Labor Economics*, Ashenfelter and Card, Vol.3.

Oyer and Schaefer, 2005, “Why do some firms give stock options to all employees? An empirical examination of alternative theories,” *Journal of Financial Economics*, Volume 76, Issue 1, April, Pages 99-133.

- *W. Maxwell and C. Stephens 2003, "The Wealth Effects of Repurchases on Bondholders," *Journal of Finance*, Vol. 58, No. 2, April, pp. 895-919.
- Bebchuk and Fried, 2003, "Executive Compensation as an Agency Problem," *Journal of Economic Perspectives*, 71-92.

Ownership Structure and Corporate Control –June 2 and 4

- ◆ Corporate Takeovers – Tender Offers and Mergers
- ◆ Large Blockholders
- ◆ Leveraged Buyouts and Recapitalizations
- ◆ Dual Class Shares
- ◆ Spinoffs, Carve-Outs and Split-Ups
- ◆ Antitakeover Measures

Required: BMA Chapters 32 and 33

- Gompers, Ishii, and Metrick, 2003, "Corporate Governance and Equity Prices," *Quarterly Journal of Economics*, February.

Written Assignment: Kennecott Copper Case

Optional Readings: DeAngelo and Rice, 1983, "Antitakeover Charter Amendments and Stockholder Wealth," *Journal of Financial Economics*, vol. 11.

- Field and Karpoff, 2002, "Takeover Defenses of IPO Firms," *Journal of Finance*, vol.57, October.

Jensen and Ruback, 1983, "The Market for Corporate Control: The Scientific Evidence," *Journal of Financial Economics*, vol. 11.

Partch, 1987, "The Creation of a Class of Limited Voting Common Stock and Shareholder Wealth," *Journal of Financial Economics*, vol. 18.

BMA Chapter 34

Moeller, Schlingemann, and Stulz, 2004, "Firm Size and the Gains from Acquisitions," *Journal of Financial Economics*, Vol. 73.

Harford, 1999, "Corporate Cash Reserves and Acquisitions," *Journal of Finance*, Vol. 54, No. 6, December, pp. 1969-97.

FINAL EXAM – Friday, June 12, 2:30 – 4:30 PM, unless changed by class consensus