Economics 234C

Financial Decision-Making in Firms

Spring 2007
Tuesday 10-12, 289 Cory Hall

Instructor
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Syllabus

Course Overview

The content of Economics 234C combines of several strings of research in financial economics. First, the course provides a theoretical and empirical introduction of the core topics in Corporate Finance, including: internal corporate investment, external corporate investment (= mergers & acquisitions); capital structure and financial contracting; bankruptcy; corporate governance. Second, the course puts a major emphasis on empirical methodology in applied microeconomics, some of which has not even been applied in Corporate Finance (so far). As such, the course will link to empirical literature in labor economics, public finance, development economics and other fields of applied micro. Third, the course emphasizes research in Behavioral Corporate Finance. Behavioral Corporate Finance is a novel and growing area of research that aims at integrating insights from psychology into our understanding of financial decision-making in firms.

Concretely, the course differs from traditional courses (and textbooks) in Corporate Finance as follows:

(1) Topics related to neighboring fields (e.g. labor, development, public finance) and to corporate governance issues will receive more attention, for example the role of the media. We will cover a number of papers which are not part of the traditional corporate finance curriculum. As such, the course is intended to help doctoral students whose research focuses on those neighboring fields to explore links to financial economics and to benefit, for example, from data and methodology in finance. And it is also intended to introduce doctoral students in finance to methodologies and related research in those related fields.

(2) We will cover research in Behavioral Corporate Finance wherever it speaks to the current topic. Behavioral Corporate Finance comprises (i) research on rational managerial decision-making in light of investor sentiment, e.g. market timing of security issuances, and (ii) research on biased managerial decision-making, e.g. the role of managerial overconfidence in merger decisions.

(3) The course is likely to be more empirical and methodological than the typical Corporate Finance class. Students will also have to complete a larger empirical project as part of the requirements. (See below.)

Course Assignments and Grading
There will be a few longer assignments, at least one of which involves data work, most likely using Compustat. (Get a login now! See instructions at wrds.wharton.upenn.edu.)
We will also have a mid-term and a final exam. They will contain theoretical and empirical questions about the material covered in class.
The grade composition will be as follows:

40% for theoretical & empirical assignments;
20% for the midterm exam;
40% for the final exam;

Finally, I will count class participation (including evidence of intelligently reading the required papers and discussing them) by adding or subtracting up to 10 points to the rest of the grades.

For 3rd-years and higher (who have passed field exams and are preparing for orals or beyond):
You can substitute the assignments with a paper. You should only do so if you are already working on a (serious) paper and are sure that you will be able to submit a complete paper at the end of the course.
(Even if you fall into this category, it is not clear you should choose this option. Hands-on work on problem sets is very often the start of a thesis paper …)

Required Background
As a general rule, you should have a solid training in econometrics at the level of 240A and 240B. For example, you should be familiar with OLS estimation, panel data models, and discrete-choice models, and you should have no uncertainty as to what fixed effects do in a regression. You will be required to use STATA for the mandatory homework assignment. Although it is not a requirement for this course, I strongly recommend taking at least one empirical course or course sequence: labor, public, development. In addition, I recommend 244 for advanced training in econometrics.

Second, the course draws heavily on contract theory and some game theory. I expect the first-year graduate sequence in micro-theory as background.

Third, I strongly recommend taking Adam Szeidl's Asset Pricing class (234A). While not a prerequisite, it will ease the understanding of financial markets and finance-specific techniques such as the calculation of abnormal returns. If you are planning to take Financial Economics as a field, you have to take Asset Pricing. Also, if your main interest lies in the area of micro or macro theory you should take Asset Pricing. If, instead, your interest lies in the areas of labor economics / public finance / development / political economy / behavioral economics it is less crucial.

Fourth, I extra-strongly recommend going to finance-related seminars. Nothing conveys better what is new and exciting in finance than the ongoing research. There are two options. First of all, Haas has a regular finance seminar, held on Thursdays in Haas. Email me if you want to get on the distribution list of seminar announcements. Second, starting with this semester, I will organize a seminar in "Financial Economics." This seminar serves two purposes: first, it simply coordinates with neighboring fields (theory, public, development, psych & econ, labor) and points to those seminars with finance content. In those weeks, the seminar will be "joint with Financial Economics." In addition, we also have a few speakers of our own. This semester, I mostly want to introduce the people who are doing finance-related research among the Berkeley faculty, e.g. Adam Szeidl, Ben Hermalin, Bob Anderson, Marko Tervio. So: please watch out for those announcements and try to go to at least one such seminar each week.

Schedule of classes

Date	Class	Topic
Tuesday, 1/16	1	Overview: Topics and Tool
Tuesday, 1/23	2	Internal Investment (1): Empirics; Financial Constraints
Tuesday, 1/30	3	Internal Investment (2): Asymmetric Information
Tuesday, 2/6	4	Internal Investment (2, continued): Asymmetric Information – other empirical applications & theoretical treatment of debt Internal Investment (3): Agency
Tuesday, 2/13	5	Internal Investment (4): Overconfidence External Investment (1): Stylized Facts about M&A
Tuesday, 2/20	6	External Investment (2): Corporate Control and Voting External Investment (3): Market Timing
Tuesday, 2/27	7	External Investment (4): Managerial Hubris Capital Structure (I): Modigliani-Miller Theorem, Debt Overhang Capital Structure (II): Asymmetric Information and Pecking Order Capital Structure (III): Biased Investors [Market Timing] and Biased Managers
Tuesday, 3/6	8	Dividends and Repurchases
Tuesday, 3/13	9	***Mid-term***
Tuesday, 3/20	10	Financial Contracting (Costly State-Verification)
Tuesday, 3/27	*Spring Recess*	
Tuesday, 4/3	11	Executive Compensation
Tuesday, 4/10	12	Corporate Governance (I)
Tuesday, 4/17	13	Corporate Governance (II): Media
Tuesday, 4/24	14	Financial Distress
Tuesday, 5/1	15	"Law, Politics & Finance" (Financial development &growth)
Tuesday, 5/8	16	Finishing up & Discussion of empirical assignment

Readings

Textbooks:
- Tirole, Corporate Finance.
- Hart, Firms, Contracts, and Financial Structure

Class 2 Internal Investment

A. *Is investment sensitive to cash-flow?*
B. *Similar puzzles in other fields of economics: macro, development*
C. *Why is investment sensitive to cash-flow (I): Financial Constraints*

Stein Jeremy C. (*forthcoming*), "Agency, Information and Corporate Investment," in: G. Constantinides, M. Harris and R. Stulz (eds.), *Handbook of the Economics of Finance*, Amsterdam, North-Holland.

* Fazzari, S. M., R. G. Hubbard and B.C. Petersen (1988), "Financing Constraints and Corporate Investment," *Brookings Papers on Economics Activity*, pp. 141-195.

* Kaplan, Steven N. and Luigi Zingales (1997), "Do Investment-Cash Flow Sensitivities Provide Useful Measures of Financing Constraints?" *Quarterly Journal of Economics* 112, pp. 159-216.

Rauh, Joshua, (2006), "Investment and Financing Constraints: Evidence from the Funding of Corporate Pension Plans," *Journal of Finance* 61, pp. 33-71.

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

Blanchard, Olivier; Lopez-de-Silanes, Florencio; and Shleifer, Andrei (1994), "What do firms do with cas windfalls?" *Journal of Financial Economics* 36, pp. 337-360.

Class 3 Internal Investment (II)

A. *Introduction to WRDS and other finance-related data sets.*
B. *Why is investment sensitive to cash-flow (2): Asymmetric information*

WRDS documentation!

* Myers, Stewart and N. Majluf (1984), "Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have," *Journal of Financial Economics* 13, pp. 187-222.

Class 4 Internal Investment (III)

A. *Why is investment sensitive to cash-flow (2 continued):Asymmetric information – more on the empirics (I/collateral sensitivity) and more on the theory (modeling debt)*
B. *Why is investment sensitive to cash-flow (3 + 4): Agency Costs and Overconfidence*

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

* Jensen, Michael (1986), "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76, pp. 323-329.

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

Rajan, Raghuram, Henri Servaes and Luigi Zingales (2000), "The Cost of Diversity: The Diversification Discount and Inefficient Investment," *Journal of Finance* 55, pp. 35-80.

Stein, Jeremey (1996), "Rational Capital Budgeting in an Irrational World," *Journal of Business* 69, pp. 429-455.

Class 5 Internal Investment (IV), External Investment (I)

A. *Why is investment sensitive to cash-flow (4): CEO Overconfidence*
B. *External Investment (1): Stylized facts on mergers and acquisitions.*

* Heaton, J.B. (2002), "Managerial Optimism and Corporate Finance," *Financial Management* 31, pp. 33-45.

* Malmendier, Ulrike and Geoffrey Tate (2005), "CEO Overconfidence and Corporate Investment", *Journal of Finance* 60, pp. 2661-2700.

Stein, Jeremy (1989), "Efficient Capital markets, Inefficient Firms: A Model of Myopic Corporate Behavior," *Quarterly Journal of Economics* 104, pp. 655-669.

* Andrade, Gregor, Mark Mitchell and Erik Stafford (2001), "New Evidence and Perspectives on Mergers," *Journal of Economic Perspectives* 15, pp. 103-120.

* Holmström, Bengt and Steven Kaplan (2001), "Corporate Governance and Merger Activity in the U.S.: Making Sense of the 80's and 90's," *Journal of Economic Perspectives* 15, pp. 121-144

* Moeller, Sara, Frederik Schlingemann, and René Stulz, (2005), "Wealth destruction on a massive scale? A study of acquiring-firm returns in the recent merger wave," *Journal of Finance* 60, pp. 757-782.

<u>Class 6</u> External Investment (II)

A. *External Investment (2): Free-riding theories*
B. *External Investment (3): Misvaluation theories*

* Grossman, Sanford and Oliver Hart (1980), "Takeover Bids, the Free Rider Problem and the Theory of the Corporation," *Bell Journal of Economics* 11, pp. 42-69.

* Grossman, Sanford and Oliver Hart (1988), "One Share, One Vote and the Market for Corporate Control," *Journal of Financial Economics* 20, pp. 175-202.

* Shleifer, Andrei and Robert Vishny (2003), "Stock Market Driven Acquisitions," *Journal of Financial Economics* 70, pp. 295-311.

Savor, Pavel (2006), "Do Stock Mergers Create Value for Acquirers?" *Working Paper*.

Morck, Randall, Andrei Shleifer and Robert Vishny (1990), "Do Managerial Objectives Drive Bad Acquisitions?" *Journal of Finance* 45, pp. 31-48.

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

<u>Class 7</u> External Investment (III) + Capital Structure

* Roll, Richard (1986), "The Hubris Hypothesis of Corporate Takeovers," *Journal of Business* 59, pp. 197-216.

* Malmendier, Ulrike and Geoffrey Tate (2005), "Who Makes Acquisitions? CEO Overconfidence and the Market's Reaction", *Working Paper*.

Modigliani, Franco and Merton H. Miller (1958), "The Cost of Capital, Corporation Finance, and the Theory of Investment," *American Economic Review* 48, pp. 261-297.

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

Miller, Merton H. (1977), "The Modigliani-Miller Propositions After 30 Years," *Journal of Economic Perspectives* 2, pp. 99-120.

Graham, John R. (2000), "How Big Are the Tax Benefits of Debt?" *Journal of Finance* 55, pp. 1901-1941.

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

Rajan, Raghuram and Luigi Zingales (1995), "What Do We Know About Capital Structure? Some Evidence from International Data," *Journal of Finance* 50, pp. 1421-1460.

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

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

Myers, Stewart and N. Majluf (1984), "Corporate Financing and Investment Decisions when Firms Have Information that Investors Do Not Have," *Journal of Financial Economics* 13, pp. 187-222.

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

Fama, Eugene and Kenneth French (2002), "Testing Tradeoff and Pecking Order Predictions About Dividends and Debt," *Review of Financial Studies* 15, pp. 1-33.

Choe, Hyuk, Ronald Masulis and Virkam Nanda (1993), "Common Stock Offerings Across the Business Cycle: Theory and evidence," *Journal of Empirical Finance* 1, pp. 3-33.

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

Baker, Malcolm and Jeffrey Wurgler (2000), "The Equity Share in New Issues and Aggregate Stock Returns," *Journal of Finance* 55, pp. 2219-2257.

Baker, Malcolm and Jeffrey Wurgler (2002), "Market Timing and Capital Structure," *Journal of Finance* 57, pp. 1-32.

<u>Class 8</u> Dividends and Repurchases

Lintner, John (1956), "Distributions of Incomes of Corporations Among Dividends, Retained Earnings and Taxes," *American Economic Review* 46, pp.97-113.

Miller, Merton H. and Kevin Rock (1985), "Dividend Policy Under Information Asymmetry," *Journal of Finance* 40, 1031-1051.

LaPorta, Rafael, Florencio Lopez-de-Silanes, Andrei Shleifer and Robert Vishny (2000), "Agency Problems and Dividend Policies Around the World," *Journal of Finance* 55, pp. 1-33.

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

Alon Brav, John R. Graham , Campbell R. Harvey, and Roni Michaely (2005), "Payout Policy in the 21st Century," *Journal of Financial Economics* 77, pp. 483-527.

Chetty, Raj and Emmanuel Saez (2005), "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," *Quarterly Journal of Economics* 120, pp. 791-833.

<u>Class 10</u> Agency Problems, Financial Contracting, Costly State Verification

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

Jensen, Michael (1986), "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers," *American Economic Review* 76, pp. 323-329.

Townsend, Robert (1979), "Optimal Contracts and Competitive Markets with Costly State Verification," *Journal of Economic Theory* 21, pp. 265-293.

Gale, Douglas and Martin Hellwig (1985), "Incentive-Compatible Debt Contracts: the One-Period Problem," *Review of Economic Studies* 52, pp. 647-663.

Aghion, Phillipe and Patrick Bolton (1992), "An Incomplete Contracts Approach to Financial Contracting," *Review of Economic Studies* 59, pp. 473-494.

Bolton, Patrick and David Scharfstein (1996), "Optimal Debt Structure and the Number of Creditors," *Journal of Political Economy* 104, pp.1-25.

Hart, Oliver (1995), *Firms, Contracts, and Financial Structure*, Oxford University Press: London. Chapter 5.

Hart, Oliver and John Moore (1994), "A Theory of Debt Based on the Inalienability of Human Capital," *Quarterly Journal of Economics* 109, pp. 841-879.

Hart, Oliver and John Moore (1998), "Default and Renegotiation: A Dynamic Model of Debt," *Quarterly Journal of Economics* 113, pp. 1-41.

<u>Class 11</u> Executive Compensation

Ariely, Dan; Gneezy, Uri; Loewenstein, George; and Nina Mazar (2005). "Large Stakes and Big Mistakes," *Working Paper*.

Aggarwal, Rajesh, and Andrew Samwick (1999) "Executive compensation , strategic competition, and relative performance: Theory and evidence," *Journal of Finance* 54, pp. 1999-2043.

Bertrand, Marianne and Mullainathan, Sendhil (2006) "Enjoying the Quiet Life: Corporate Governance and Managerial Preferences," *Journal of Political Economy* (forthcoming)

Hall, Brian, and Jeffrey Liebman (1998), "Are CEOs really paid like bureaucrats?" *Quarterly Journal of Economics* 113, pp. 623-692.

Murphy, Kevin (1999), "Executive Compensation", *Handbook of Labor Economics*.

<u>Class 12</u> Corporate Governance (I)

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

Gompers, Paul, Joy Ishii, and Andrew Metrick (2003), "Corporate Governance and Equity Prices," *Quarterly Journal of Economics* 118, pp. 107-155.

Adams, Renee; Heitor Almeida, and Daniel Ferreira (2002), "Powerful CEOs and their Impact on Corporate Performance," *Working paper*.

Brickley, James, Jeffrey Coles, and Rory Terry (1994), "Outside Directors and the Adoption of Poison Pills," *Journal of Financial Economics* 35, pp. 371-390.

Byrd, John and Kent Hickman (1992), "Do Outside Director Monitor Managers?" *Journal of Financial Economics* 32, pp. 195-221.

Hermalin, Benjamin E., and Michael S. Weisbach (1988), "The Determinants of Board Composition," *Rand Journal of Economics* 19, pp. 589-606.

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

<u>Class 13</u> Corporate Governance (II): Media

Dyck, Alexander and Luigi Zingales (2002), "The Corporate Governance Role of the Media," *Working Paper*.

Malmendier, Ulrike and Geoffrey Tate (2005), "CEO Superstars," *Working Paper*.

<u>Class 14</u> Financial Distress

Cutler, David, and Lawrence H. Summers (1988), "The Costs of Conflict Resolution and Financial Distress: Evidence from Texaco-Pennzoil Litigation," *RAND Journal of Economics* 19, pp. 157-172.

Gertner, Robert and David Scharfstein (1991), "A Theory of Workouts and the Effects of Reorganization law," *Journal of Finance* 46, pp. 1189-1222.

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

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

Andrade, Gregor and Steven Kaplan (1998), “How Costly is Financial (Not Economic) Distress? Evience from Highly Leveraged transactions That Became Distressed,” *Journal of Finance* 53, pp. 1443-1493.

<u>Class 15</u> Law and Finance

Malmendier, Ulrike (2007). “Law and Finance `At the Origin’,” *Working Paper*.

Jayaratne, J. and Strahan, Philip E. (1996) “The Finance-Growth Nexus: Evidence from Bank Branch Deregulation.” *Quarterly Journal of Economics* 111, pp. 639-70.

King, Robert G. and Levine, Ross (1993). “Finance and Growth: Schumpeter Might Be Right.” *Quarterly Journal of Economics* 108, pp. 305-60.

King, Robert G. and Levine, Ross (1993). “Finance, Entrepreneurship, and Growth,” *Journal of Monetary Economics* 32, pp. 513-42.

La Porta, Rafael; Lopez-de-Silanes, Florencio; Shleifer, Andrei and Vishny, Robert W. (1998), “Law and Finance,” *Journal of Political Economy* 106, pp. 1113-1155.

La Porta, Rafael; Lopez-de-Silanes, Florencio; Shleifer, Andrei and Vishny, Robert W. (1997) “The Legal Determinants of External Finance,” *Journal of Finance* 53, pp. 1131-50.

Levine, Ross (1997). “Financial Development and Economic Growth: Views and Agenda,” *Journal of Economic Literature* 35, pp. 688-726.

Rajan, Raghuram G. and Zingales, Luigi (1998). “Financial Dependence and Growth,” *American Economic Review* 88, pp. 559-86.