The Ohio State University
Fisher College of Business

Finance 8230: Corporate Finance Theory

Professor Michael Weisbach
Spring 2017, First Half of Semester

The course will begin with the classic Modigliani/Miller arguments, and follow the literature in discussing the implications of violations of MM assumptions and capital structure more broadly. There will be classes devoted to areas in which theory has important insights in corporate finance, including the theory of the firm, financial intermediation, financial constraints, and takeover markets.

This is a Ph.D. level class, and will presume knowledge of Ph.D. level microeconomic theory and an understanding of how financial markets work. Most of the course will be devoted to formal models.

The class will cover of 7 main topics, each of which will take up about 2 class sessions. There will be a final exam, which will count for 70% of the course grade. Class participation counts for the remaining 30%. To earn full credit for the participation grade, it is important to read the articles and think about them prior to each session.

Auditors are always welcome to attend, and advanced students who have seen some but not all of this material are encouraged to attend the sessions covering material that they have not seen previously.

Course Materials:

The main focus of the course is on academic articles. I will hand out slides from which the lectures are based. From time to time, I will use material from Tirole's *The Theory of Corporate Finance*, which was published by Princeton University Press in 2006. I also will use some material from Hart's *Firms, Contracts, and Financial Structure*, which was published by Oxford University Press in 1995. I would highly recommend purchasing these two books.

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.

Topic 1: MM, Tradeoff Model, Stockholder/Bondholder Conflicts

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

Miller, M., F. Modigliani, 1961, “Dividend Policy, Growth, and the Valuation of Shares,” Journal of Business, 34, 411-433.

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

Harris, Raviv (1991), “The Theory of Capital Structure,” Journal of Finance, 46, 297-355.

Graham, John (2003), “Taxes and Corporate Finance, A Review,” Review of Financial Studies, 16, pp. 1074-1128.

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.

Leary, Mark T. and Michael R. Roberts (2005) “Do Firms Rebalance Their Capital Structures,” Journal of Finance, 60, pp. 2575-2619.

* Myers (1977) “Determinants of Corporate Borrowing” Journal of Financial Economics, 5, 147-175.

Fama, Eugene F. and Merton H. Miller, The Theory of Finance, Chapter 4 pages 179-181.

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

* 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.

Topic 2: Capital Structure and Agency Problems

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

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

* Hart, Oliver and John Moore (1995) “Debt and Seniority: An Analysis of the Role of Hard Claim s in Constraining Management,” American Economic Review, 85, 567-585.

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

* Hart, Moore (1994) “A Theory of Debt Based on the Inalienability of Human Capital,” QJE, 109, 841-879.

* Hart, O. (1995) *Firms, Contracts and Financial Structure*, Chapter 5.

Bolton, Scharfstein (1990) “A Theory of Predation Based on Agency Problems in Financial Contracting,” AER, 80, 93-106.

Hart, Moore (1998) “Default and Renegotiation: A Dynamic Model of Debt,” Quarterly Journal of Economics, 113, 1-41.

Stulz, R. (1988) “Managerial Control of Voting Rights: Financing Policies and the Market for Corporate Control,” Journal of Financial Economics, 20, 25-54.

Stulz, R. (1990) “Managerial Discretion and Optimal Financing Policies,” Journal of Financial Economics, 26, 3-27.

Topic 3: Capital Structure and Asymmetric Information

* Leland, Pyle (1977) “Informational asymmetries, financial structure, and financial intermediation,” Journal of Finance, 32, 371–387.

* Ross (1977) “The Determination of Financial Structure: The Incentive Signaling Approach,” Bell Journal of Economics, 8, 23-40.

Miller, Rock (1985) “Dividend Policy under Information Asymmetry,” Journal of Finance, 40, 1031-1051.

* Myers (1984) “The Capital Structure Puzzle,” Journal of Finance, 39, 575-592.

* Myers, Majluf (1984) “Corporate Financing and Investment Decisions when Firms Have Information That Investors Do Not Have,” Journal of Financial Economics, 13, 187-222.

Stein, J. (1992) “Convertible Bonds as Backdoor Equity Financing,'' Journal of Financial

Economics, 32, 3-21.

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

Fama, French (2002) “Testing Tradeoff and Pecking Order Predictions about Dividends and Debt,” Review of Financial Studies, 15, 1-33

Topic 4: Theory of the Firm, Contracting, Learning Models of Incentives.

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

Alchian, A. and H. Demsetz (1972) “Production, Information Costs and Economic Organization," American Economic Review, 62, 777-705.

* Klein, B., Crawford, and Alchian, A. (1978), “Vertical Integration, Appropriable Rents and the Competitive Contracting Process", Journal of Law and Economics, 297-326.

* 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.

Oliver Hart and John Moore (1990) “Property Rights and the Nature of the Firm,” Journal of Political Economy, 98, 1119-1158.

Rajan, R. and L. Zingales, (1998), “Power in a Theory of the Firm", Quarterly Journal of Economics, 387-432.

* Holmstrom, B. (1979) “Moral Hazard and Observability,” Bell Journal of Economics, 10, 74-91.

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

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

* Chung, J., B. Sensoy, L. Stern and M. Weisbach (2012) “Pay for Performance from Future Fund Flows: The Case of Private Equity,” *Review of Financial Studies*, 25, 3259-3304.

* Hermalin, B. and M. Weisbach (2014) “Understanding Corporate Governance Through Learning Models of Managerial Competence.” Working Paper.

Topic 5: Financial Intermediation

* Diamond, D. (1984) “Financial Intermediation and Delegated Monitoring,” Review of Economic Studies, 51, 393-414.

* Diamond, D. and P. Dybvig (1983) “Bank Runs, Deposit Insurance, and Liquidity,” Journal of Political Economy, 91, 401-419.

Rajan, R. (1992) “Insiders and Outsiders: The Choice between Informed and Arm’s Length Debt,” Journal of Finance, 47, 1367-1400.

Holmstrom, B. and J. Tirole (1997) “Financial Intermediation, Loanable Funds, and the Real Sec tor,” Quarterly Journal of Economics, 112, 663-691.

Topic 6: Liquidity Management

Tirole (2006), Chapter 3.

* Almeida, H., M. Campello, I. Cunha, and M. S. Weisbach (2014) “Corporate Liquidity Management: A Conceptual Framework and Survey,” Annual Review of Financial Economics, 6, 135-162.

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

* Kaplan, Stephen N. and Luigi Zingales, (1997) “Do Investment-Cash flow Sensitivities provide useful measures of Financing Constraints?” Quarterly Journal of Economics, 112, 169-215.

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

* Almeida, Heitor, Murillo Campello and Michael S. Weisbach (2004), “The Cash Flow Sensitivity of Cash,” Journal of Finance, 59, 177-1804.

Sufi, Amir, (2009), “Bank Lines of Credit in Corporate Finance: An Empirical Analysis,” Review of Financial Studies, 22, 1057-1088.

* Opler, Tim, Lee Pinkowitz, Rene Stulz and Rohan Williamson (1999), “The Determinants and Implications of Corporate Cash Holdings,” Journal of Financial Economics, 52, 3-46.

Topic 7: Takeover Markets and Free Rider Issues

* Grossman, S. and O. Hart (1980), "Takeover Bids, the Free Rider Problem, and the Theory of the Corporation," Bell Journal of Economics, 11, 42-64.

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

* Grossman, S. and O. Hart (1988), “One Share, One Vote and the Market for Corporate Control ,” Journal of Financial Economics, 20, 175-202.