

**MARSHALL SCHOOL OF BUSINESS  
UNIVERSITY OF SOUTHERN CALIFORNIA**

FBE 531  
Corporate Financial Policy  
and Corporate Control  
Fall 2006

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**Course objectives:** This course focuses on the development of a framework that is useful for understanding a broad range of major corporate financial decisions. Substantial emphasis will be placed on (i) the determinants of corporate debt and dividend policies, (ii) the allocation and value of corporate voting rights and the relation to issues of corporate governance, and (iii) alternative methods of security issuance and retirement. The discussion will include application of the theory to issues such as:

- common stock repurchases
- methods of selling stock to the public
- initial public offerings
- equity carve-outs
- spinoffs
- tracking stock arrangements
- rating-contingent puttable debt
- the role of Wall Street analysts in marketing corporate equity
- stock market manipulation and the corporate cost of capital
- reputation, trust, and access to the capital markets
- Enron and its aftermath
- corporate control consolidation techniques
- large block stock ownership
- hostile and friendly takeovers
- takeover defenses
- the politics of finance
- junk bond financing
- derivatives and corporate financial policy
- management buyouts
- executive compensation
- the relation between financial leverage and investment policy
- private versus social consequences of investment policy

The framework and applications will be useful to those who will work for corporations, those who will serve as outside consultants to corporations on appropriate financial policies, and those who will work as external financial analysts (whose primary focus is on understanding and evaluating the financial decisions made by corporate management).

**Course structure:** The course format will be lecture with classroom discussion. Students are responsible for material discussed during class meetings, assigned readings (see below), seven problem sets, a midterm examination, and a final examination.

**Midterm and final examinations:** The **midterm** will be given during the regularly scheduled class meeting on **Tuesday, October 3**. The **final** will be given on **Thursday, December 7** from 8 a.m. until 10 a.m. Attendance at both of these exams is a requirement of the course.

**Grading:** Course grades will be determined by approximately curving the total points earned on three class requirements:

	Point range
1. Problem sets	0 to 35
2. Midterm examination	0 to 100
3. Final examination	0 to 125
Total	0 to 260

**Problem sets:** There will be seven graded problem sets which are to be done in groups of three to five students. The problem sets are due at the beginning of class on the following dates:

Problem set	Due date	Points
1	August 31	4
2	September 12	4
3	September 19	4
4	September 26	4
5	October 31	4
6	November 21	4
7	November 30	11

Note that Problem set 7 is due at the last class meeting of the semester. You should be ready to begin work on problem set 7 after we cover the material on IPOs, and you are encouraged to start working early on this problem set. [You will also need to draw on material from the first half of the course.]

**University policy on disabilities:** Any student requesting academic accommodations based on a disability is required to register with Disability Services and Programs (DSP) each semester. A letter of verification for approved accommodations can be obtained from DSP. Please be sure the letter is delivered to me as early in the semester as possible. DSP is located in STU 301 and is open 8:30 a.m. - 5:00 p.m., Monday through Friday. The phone number for DSP is (213) 740-0776.

**Topic Outline and Reading Assignments:** In the course outline set forth below, reading assignments fall into two categories:

- R: required reading.
- NR: not required (suggested supplementary) reading.

Some classroom time will be spent discussing issues that are treated in the suggested supplementary readings. These classroom discussions will be entirely self-contained so that it will not be necessary for you to work through the NR readings. The NR references are provided here as source documents for those people interested in a more detailed treatment of a given subject. Copies of the NR readings will be available on “library reserve.”

The outline also gives the location of each reading:

P: course packet.  
L: library reserve desk.  
Sm: Smith book of readings.  
CD: to be distributed in class.

A packet of course materials will be available for purchase at the USC Bookstore. The packet includes required readings that are not included in the Smith book of readings:

Smith, Clifford W., Jr., The Modern Theory of Corporate Finance, second edition, 1990, McGraw Hill, New York.

A substantial amount of additional material will be distributed in class throughout the semester.

In some instances, the reading list indicates that you should review material in an introductory finance textbook. For convenience, the reading list gives the page numbers for review in the Ross-Westerfield-Jaffe textbook. The relevant page or chapter numbers in RWJ are given in parentheses in the following format. [RWJ: pages xxx-yyy] where RWJ refers to:

Ross, Stephen A., Westerfield, Randolph W., and Jeffrey Jaffe, Corporate Finance, seventh edition, 2005, McGraw Hill, New York.

As opportunities arise, class time will be allocated to discussion of current events in the world of corporate finance that relate to the general issues covered in the course. Our discussion and analysis of current corporate finance events should be considered an integral part of the course (and may therefore be covered on examinations). Accordingly, you are strongly encouraged to subscribe to The Wall Street Journal and to read it consistently and carefully.

Student subscriptions to the Wall Street Journal may be obtained at: <http://subscribe.wsj.com/semester>. For the zip code, type in 900. For school, highlight U STHRN CAL LS ANG. For professor, highlight DEANGELO, HARRY.

## **Topic Coverage and Reading Assignments**

### **1. Key Building Blocks**

#### **The Efficient Markets Hypothesis**

R/CD Handout on Applications of the Efficient Markets Hypothesis

R Read the discussion of the Efficient Markets Hypothesis that is contained in the textbook you used for introductory finance. Emphasize the general concepts, not the findings of particular empirical studies. [RWJ: chapter 13, especially sections 13.1-13.4 and the summary table on page 376.]

### **The Market Value Rule**

- R Read your introductory textbook's discussion of why stockholders would prefer managers to maximize market value (follow the NPV-maximization rule). [RWJ: Appendix 4A, especially section 4A.3]

### **Foundations of Dividend Policy Analysis**

- R Read your introductory textbook's discussion of the MM dividend irrelevancy proposition. [RWJ: section 18.3]

- R/P DeAngelo, Harry and Linda DeAngelo, "The Irrelevance of the MM Dividend Irrelevance Theorem," Journal of Financial Economics, February 2006, pp. 293-315.

Focus on pp. 293-296 (including the first full paragraph of section 2), p 300 (starting with Objection #1) through p.301 (middle), pp. 305 (starting with "In general") through p. 307 (end of section 3), and sections 5 and 6. Do not worry about mastering the equations in the paper. Focus your efforts on understanding the intuition in section 6 (and use the pages cited above to help you understand the material in that section).

- R/P Problem set 1**

## **2. Dividend Policy: Tax and Signaling Considerations**

- R/Sm Black, Fischer, "The Dividend Puzzle," The Journal of Portfolio Management, Winter 1976, pp. 5-8.

- R/Sm Brickley, James A., "Shareholder Wealth, Information Signaling, and the Specially Designated Dividend," in Smith's book of readings.

Focus on sections 1 and 7 and Tables 1-4. Skim the other material to fill in your understanding of regular versus specially designated dividends. Here and throughout the course you should emphasize the intuition of the numbers, not the details of statistical test methodology.

- R/P Fama, Eugene F. and Kenneth R. French, "Disappearing Dividends: Changing Firm Characteristics or Reduced Propensity to Pay?," Journal of Financial Economics, April 2001, pp. 3-43. [Excerpts in packet.]

- R/P DeAngelo, Harry, Linda DeAngelo, and Douglas J. Skinner, "Are Dividends Disappearing? Dividend Concentration and the Consolidation of Earnings," Journal of Financial Economics, June 2004, pp. 425-456.

Do not get bogged down in trying to master all of the numbers. Emphasize Figure 1 and Tables 1, 2, 3, and 10. Most importantly, focus on the main points presented in section 7.

- R/P Buckman, Rebecca, "Microsoft, Awash in Cash, Declares Its First Dividend," Wall Street Journal, January 17, 2003, p. A1.
- R/P Wayne, Leslie, "Arms Makers Find Being Cash-Heavy Is Mixed Blessing," New York Times, May 12, 2005.

### 3. Taxes and Capital Structure

- R Read your introductory textbook's discussion of (i) the MM capital structure irrelevancy proposition, (ii) MM on corporate taxes, (iv) bankruptcy costs and capital structure, and (iv) Miller's "Debt and Taxes" analysis. [RWJ: chapters 15, 16.1-16.4, and 16.9. Do not get bogged down in numbers or equations. Our ultimate objective is to have a strong understanding of the logic underlying Figures 16.1, 16.4, and 16.5.]
- R/CD Outline Notes on Basic Capital Structure Theory
- R/P Miller, Merton H., "Debt and Taxes," Journal of Finance, May 1977, pp.261-276.
- Emphasize the material in section III that explains how personal taxes influence the gains from leverage. Do not spend a great deal of time on section IV's discussion of market equilibrium. We will extract the main points of Miller's analysis in class.
- NR/Sm DeAngelo, Harry and Ronald W. Masulis, "Optimal Capital Structure Under Corporate and Personal Taxation," in Smith's book of readings.

#### R/P **Problem set 2**

### 4. Bankruptcy Costs and Capital Structure

- R/Sm Warner, Jerold B., "Bankruptcy Costs: Some Evidence," in Smith's book of readings.
- NR/L Gilson, Stuart C., "Management Turnover and Financial Distress," Journal of Financial Economics, December 1989, pp. 241-262.
- R/P Weiss, Lawrence A. and Karen H. Wruck, "Information Problems, Conflicts of Interest, and Asset Stripping: Chapter 11's Failure in the Case of Eastern Airlines," Journal of Financial Economics, April 1998, pp. 55-97. [Excerpts in packet.]
- R/P "Bankruptcies, Workouts, and Turnarounds," Transcript of Roundtable Discussion, Journal of Applied Corporate Finance, Summer 1991.
- R/P **Problem set 3**

## 5. Agency Theory and Corporate Financial Policy

R/Sm Jensen, Michael C. and William H. Meckling, “Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure,” in Smith’s book of readings.

The Jensen and Meckling article presents the agency theory approach to analyzing corporate finance issues and identifies some very important concepts that will be used repeatedly throughout the course. You should read the article because it is a classic, and because it provides the best available treatment of agency theory. Unfortunately, the article is quite long and too technical (for present purposes) in places. The best strategy is to study the article for the intuition and skim the technical parts only to the extent necessary to preserve continuity in your reading. You should focus in particular on the intuition of the discussion in sections 1-2.2, 2.6, 3, 4, and 6.1-6.4.

R/CD Outline Notes on Agency Costs of Debt

NR/Sm Smith, Clifford W., Jr. and Jerold B. Warner, “On Financial Contracting: An Analysis of Bond Covenants,” in Smith’s book of readings.

Section 1.1 provides a good summary of sources of potential conflict between stockholders and bondholders. Sections 2 through 4 provide a useful summary of major bond covenants.

NR/Sm Myers, Stewart C., “Determinants of Corporate Borrowing,” Journal of Financial Economics, in Smith’s book of readings.

Sections 1-3 of the Myers paper provide a useful (expanded) discussion of the underinvestment problem.

## 6. Equity Financing, Capital Structure, and Managerial Access to Funds

### Public Offerings of Seasoned Stock

R/Sm Smith, Clifford W., “Investment Banking and the Capital Acquisition Process,” in Smith’s book of readings.

Read only sections 1 and 2 for now. Focus on the evidence summarized in Table 1. Familiarize yourself with the nature of the broad range of information provided in Tables 2-4, but do not memorize these findings. It will be useful from time to time to refer back to this literature summary. Skim the section 2 data interpretations.

Important reminder: In reading this paper (and all other empirical papers assigned in this course), focus on understanding the broad-brush empirical regularities. Do not memorize particular numbers or focus on details of statistical methods.

Other sections of the Smith paper are referenced below when they are useful for topics discussed later in the course.

**The Issue-Invest Decision and Benefits of Financial Flexibility**

R/Sm Myers, Stewart C. and Nicholas S. Majluf, “Corporate Financing and Investment Decisions When Firms Have Information That Investors Do Not Have,” in Smith’s book of readings.

Focus on the intuitive parts of the discussion in sections 1-2.4, 4.2-4.3, and 6. Read the technical material only to the extent necessary to understand the intuition of the argument.

**R/P Problem set 4**

NR/L Myers, Stewart C., “The Capital Structure Puzzle,” Journal of Finance, July 1984, pp. 575-592.

This article provides a useful alternative discussion of the intuition of the Myers and Majluf analysis.

**Managerial Discretion and the Costs of Financial Flexibility**

R/Sm Jensen, Michael C., “Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers,” in Smith’s book of readings.

Focus on the introduction and sections I and VI.

R/P Fuller, Joseph and Michael C. Jensen, “How Bigger Dividends Build Trust,” Financial Times, October 6, 2003.

NR/Sm Easterbrook, Frank H., “Two Agency Cost Explanations of Dividends,” in Smith’s book of readings.

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**MIDTERM EXAMINATION**  
**Midterm exam coverage will not extend beyond topic 6.**

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**7. Methods of Marketing Common Stock:**

**Public Offerings of Seasoned Stock**

R/Sm Smith, Clifford W., “Investment Banking and the Capital Acquisition Process,” in Smith’s book of readings.

Read only section 3.1 for now.

### **Private Placements of Common Stock**

NR/L Wruck, Karen H., "Equity Ownership Concentration and Firm Value: Evidence From Private Equity Financings," Journal of Financial Economics, 1989, pp. 3-28.

### **8. Initial Public Offerings**

R/P Ibbotson, Roger G., Jody L. Sindelar, and Jay R. Ritter, "Initial Public Offerings," Journal of Applied Corporate Finance, Summer 1988, pp. 37-45.

R/Sm Ritter, Jay R., "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings," in Smith's book of readings.

Focus on sections 1-3.

R/Sm Smith, Clifford W., "Investment Banking and the Capital Acquisition Process," in Smith's book of readings.

Read only section 4 for now.

NR/L Ritter, Jay R., "The Costs of Going Public," Journal of Financial Economics, December 1987, pp. 269-281.

Sections 1-4 and 6 and the cost data given in Table 4 are especially useful.

R/P Utal, Bro, "Inside the Deal that Made Bill Gates \$350,000,000," Fortune, July 21, 1986, pp. 23+.

NR/L Ritter, Jay R., "The Long Run Performance of Initial Public Offerings," Journal of Finance, March 1991, pp. 3-27.

### **9. Equity Carve-outs and Corporate Spinoffs**

NR/L Schipper, Katherine and Abbie J. Smith, "Equity Carve-Outs," in Corporate Restructuring and Executive Compensation, edited by Joel M. Stern, G. Bennett Stewart III, and Donald H. Chew), Ballinger Press Institutional Investor Series in Finance, 1989, Cambridge, Massachusetts.

NR/L Parrino, Robert, "Spinoffs and Wealth Transfers: The Marriott Case," Journal of Financial Economics, 1997, pp. 241-274.

### **10. The Role of Wall Street Analysts in the Marketing of Corporate Equity**

R/P Rynecki, David, "The Price of Being Right," Fortune, February 5, 2001, pp. 126+.



**11. Stock Market Manipulation and the Corporate Cost of Capital**

R/P Lewis, Michael, "His So-Called Life of Stock Fraud," New York Times Magazine, February 25, 2001, pp.26+.

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**Reminder: you are encouraged to start working early on Problem set 7 (which is due on the last class meeting date).**

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**12. Corporate Voting Rights: Alternative Arrangements and Ownership**

R/P DeAngelo, Harry and Linda DeAngelo, "Managerial Ownership of Voting Rights: A Study of Public Corporations with Dual Classes of Common Stock," Journal of Financial Economics, March 1985, pp. 33-69.

Focus on the discussions of (i) the motives for substantial vote ownership by managers (section 2), (ii) the motives for dual class structures (section 5), and (iii) the summaries introduction and conclusion (sections 1 and 7). Read the empirical material only to get an intuitive understanding of the nature or managerial ownership in firms with multiple classes of common stock.

R/P **Problem set 5**

**13. Proxy Contests**

R/P DeAngelo, Harry and Linda DeAngelo, "Proxy Contests and the Governance of Publicly Held Corporations," Journal of Financial Economics, June 1989, pp. 29-59.

**14. Large Block Stockholders and Managerial Monitoring**

R/P DeAngelo, Harry and Linda DeAngelo, "Controlling Stockholders and the Disciplinary Role of Corporate Payout Policy: A Study of the Times Mirror Company," Journal of Financial Economics, May 2000, 153-207.

R/P Anders, George, "The "Barbarians" in the Boardroom," Harvard Business Review, July-August 1992, pp. 79-87.

R/P Munk, Nina, "How Levi's Trashed a Great American Brand," Fortune, April 12, 1999, pp. 83-90.

## 15. Corporate Growth, Contraction, and Value

R/P Jensen, Michael C., "The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems," Journal of Finance, July 1993, pp. 831-880. [Excerpts in packet.]

This article is very thought provoking, but too long to cover in totality in this course. The packet contains excerpts that are relevant for our discussion. Emphasize sections IV and V in your reading.

R/P Dreazen, Vochi, "Wildly Optimistic Data Drove Telecoms to Build Fiber Glut," Wall Street Journal, September 26, 2002.

## 16. Junk Bonds

R/P Rabinowitz, Dorothy, "Mr. Giuliani and Mr. Milken," Wall Street Journal, December 26, 2000, p. A 10.

NR/L Asquith, Paul, Mullins, David W., Jr., and Eric D. Wolff, "Original Issue High Yield Bonds: Aging Analysis of Defaults, Exchanges, and Calls," Journal of Finance, September 1989, pp. 923-952.

## 17. Derivatives and Corporate Financial Policy

R/P Loomis, Carol J., "Cracking the Derivatives Case," Fortune, March 20, 1995, pp. 50+.

R/P Buffett, Warren, "Avoiding a Mega-Catastrophe: Derivatives Are Financial Weapons of Mass Destruction," Fortune, March 3, 2003

## 18. Enron and Its Aftermath: Reputation, Trust, and Access to the Capital Markets

R/P McLean, Bethany., "Why Enron Went Bust," Fortune, December 24, 2001, pp. 58+.

## 19. Common Stock Repurchases

R/Sm Dann, Larry Y., "Common Stock Repurchases: An Analysis of Returns to Bondholders and Stockholders," in Smith's book of readings.

In reading this article, emphasize (i) the institutional details of stock repurchase methods, (ii) the suggested motivations for repurchase, and (iii) the broad-brush empirical findings summarized in Table 2 and Figure 1.

R/P **Problem set 6**

## 20. Management Buyouts

- R/P DeAngelo, Harry and Linda DeAngelo, "Management Buyouts of Publicly Traded Corporations," Financial Analysts Journal, May-June 1987, pp. 38-49.
- R/P Kravis, Henry R., Keynote Speech Delivered at the Private Equity Analyst Conference in New York City on September 22, 2004, unpublished manuscript.

## 21. Corporate Restructuring, Takeovers, and Economic Efficiency

- R/P Jensen, Michael C., "Eclipse of the Public Corporation," Harvard Business Review, September-October 1989, pp. 61-74.
- R/P "High Leverage and Stock Market Pressures on Corporate Management," Transcript of Roundtable Discussion, Journal of Applied Corporate Finance, Summer 1990.
- R/Sm Jensen, Michael C. and Richard S. Ruback, "The Market for Corporate Control: The Scientific Evidence," in Smith's book of readings.
- Focus on sections 1, 4.1, and 4.3-4.6. Read the other sections if you are interested in learning more about the wealth effects of takeover activity. Be careful not to get bogged down in the empirical details. This article contains an incredibly large amount of evidence which you should not try to memorize.
- R/P Moeller, Sara B., Schlingemann, Frederick P., and Rene M. Stulz, "Wealth Destruction on a Massive Scale? A Study of Acquiring-Firm Returns in the Recent Merger Wave," Journal of Finance, April 2005, pp. 757-782. [Excerpts in packet.]
- NR/Sm Jarrell, Gregg A., Brickley, James A. and Jeffrey M. Netter, "The Market for Corporate Control: The Empirical Evidence Since 1980," in Smith's book of readings.

## 22. Takeover Defenses

- NR/L Dann, Larry Y. and Harry DeAngelo, "Corporate Financial Policy and Corporate Control: A Study of Defensive Adjustments in Asset and Ownership Structure," Journal of Financial Economics, April 1988, pp. 87-127.
- Focus on sections 4 and 5. Read the appendix only to the extent that you are interested in learning more about particular cases.

## 23. Private Versus Social Consequences of Corporate Investment Policy

- R/P McCoy, Charles, "For Takeover Baron, Redwood Forests Are Just One More Deal," The Wall Street Journal, August 6, 1993, pp. A1+.
- R/P Walters, Mark, "California's Chain-Saw Massacre," Reader's Digest, November 1989, p. 144+.

R/P DeAngelo, Harry and Linda DeAngelo, "Ancient Redwoods and the Politics of Finance: A Study of the Hostile Takeover of the Pacific Lumber Company," Journal of Financial Economics, January 1998, pp. 3-53.

R/P **Problem set 7**

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**FINAL EXAMINATION**

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