University of Paris-Dauphine

Advanced Corporate Finance Theory

Instructor: Gilles Chemla (HDR), gchemla@yahoo.com

1 Course Description

1.1 Course Objective:

The main objective of the course is to familiarize students with a number of important, recent results and subjects that have been added to the theory of corporate finance. A second, important objective is to provide an overview of some of the modelling issues faced and of the methods that are currently employed in the area of corporate finance.

1.2 Course Material

Attached is a course reading list. We will be discussing the starred items thoroughly, and you are expected to read them carefully *before* each class. You are encouraged to look at the other readings on your own. Some of them will also be briefly discussed. They are meant to develop your general knowledge of the topic and your modelling skills.

1.3 Evaluation:

- **Class presentations: Each (group of) student(s) will be asked to present either one paper or one chapter of the main textbook to the class (without the supplementary sections/Appendices unless they are perceived to be important to the understanding of the audience). The presentation, that is limited to 40 minutes, should provide an overview of the arguments and the model(s) developed in the paper/chapter, as well as a personal, well-documented opinion of the qualities and the shortfalls of the paper. A copy of the transparencies prepared for the presentation will be provided to the instructor by the beginning of the class that will provide a written basis for evaluation by the instructor.**
- **Class participation: You will be expected to raise questions and to comment on the papers/chapters presented by the instructor and by other students.**

2 Reading List

The 7 topics that will be covered in class can be categorized into three main areas. Topics 1 and 7 refer to capital structure, mostly viewed as debt versus equity. Topics 2 and 3 focus on issues associated with debt finance, while topics 4 to 6 take a close look at issues involved with equity financing, control, and convertible securities.

Students are expected to read the starred readings before class. They should be able to understand the economic intuitions and to solve the models in these readings. Other non-starred papers will sometimes be discussed more briefly by the instructor, and they can be read by the students that want to learn more about a specific topic or the students that specialize in corporate finance. Papers with a (s) are surveys and papers with a (e) are empirical papers that you can read to develop your knowledge of corporate finance.

The following books are recommended:

- Tirole, J., 2006, *The Theory of Corporate Finance*, Princeton University Press, main textbook (hereafter TCF).
- Grinblatt, M. and S. Titman, 2002, *Financial Markets and Corporate Strategy*, (2nd edition) McGraw Hill, focus on Chapters 1-3 and 14-20 (background finance reading).

2.1 Early Agency-Based Theories of Capital Structure

- * TCF Chapter 3.
- * S. Myers, 1977, "Determinants of corporate borrowing", *Journal of Financial Economics*, pp.147-175.
- * Jensen, M. and W. Meckling, 1976, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure", *Journal of Financial Economics*, 3, 305-60.
- Jensen M., 1986, "Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers", *American Economic Review*, 76, 323-29.
- Green R., 1984, "Investment Incentives, Debt and Warrants", *Journal of Financial Economics*.
- Grossman, S. and O. Hart, 1982, "Corporate Financial Structure and Managerial Incentives", in **The Economics of Information and Uncertainty**, J.J. McCall (ed.), University of Chicago Press, 107-40.
- S. Ross, 1977, "The determination of financial structure: The incentive-signalling approach," *Bell Journal*, pp. 23 - 40.
- Leland, H., and D. Pyle, 1977, "Informational Asymmetries, Financial Structure, and Financial Intermediation", *Journal of Finance*.
- S. Myers and N. Majluf, 1984, "Corporate financing and investment decisions when firmsave information that investors do not have", *Journal of Financial Economics*, pp. 187-221.

- Myers, S., 1984, “The Capital Structure Puzzle”, *Journal of Finance*, 39 (3), 575-92.
- Bolton, P., and X. Freixas, 2000, ”Equity, Bonds, and Bank Debt: Capital Structure and Financial Market Equilibrium under Asymmetric Information”, *Journal of Political Economy.*
- (s) M. Harris and R. Raviv, 1991, “The Theory of Capital Structure,” *Journal of Finance*, pp.297–355.
- (e) Graham, J. and C. Harvey, 2001, “The Theory and Practice of Corporate Finance: Evidence From the Field”, *Journal of Financial Economics.*

2.2 Theories of Debt

- * TCF Chapters 3 to 5.
- * Gale, D. and M. Hellwig, 1985, “Incentive-Compatible Debt Contracts: the One-Period Problem”, *Review of Economic Studies.*
- R. Townsend, 1979, “Optimal contracts and competitive markets with costly state verification”, *Journal of Economic Theory*, pp.265-293.
- D. Diamond, 1984, “Financial intermediation and delegated monitoring”, *Review of Economic Studies.*
- (s) Hart O., 1995, *Firms, Contracts and Financial Structure*, Clarendon Lectures in Economics, Oxford Univesity Press, ch. 5-.
- * Bolton, P. and D. Scharfstein, 1990, “A Theory of Predation Based on Agency Problems in Financial Contracting”, *American Economic Review*, 80, 93-106.
- Hart, O. and J. Moore, 1998, “Debt, Default and Renegotiation”, *Quarterly Journal of Economics.*
- Hart, O. and J. Moore, 1994, “A Theory of Debt Based on the Inalienability of Human Capital”, *Quarterly Journal of Economics*, November.
- Bolton, P. and D. Scharfstein, 1996, “Optimal Debt Structure with Multiple Creditors”, *Journal of Political Economy.*
- Rajan R., 1992, ”Insiders and Outsiders: The Choice between Informed and Arm’s-Length Debt”, *Journal of Finance*, 47(4), 1367-400.
- D. Diamond, 1989, “Debt Maturity Structure and Liquidity Risk”, *Quarterly Journal of Economics*, 106, 709-37.
- D. Diamond, 1991, “Monitoring and Reputation: The Choice between Bank Loans and Directly Placed Debt”, *Journal of Political Economy*, 99, 689-721.

2.3 Interactions Between Debt Financing and Input/Output Markets

- * TCF Chapter 7.
- Brander, J. A. and T. R. Lewis,1986, “Oligopoly and Financial Structure: The Limited Liability Effect”, *American Economic Review*, 76, 956-70.
- Bolton, P. and D. Scharfstein, 1990, “A Theory of Predation Based on Agency Problems in Financial Contracting”, *American Economic Review*, 80, 93-106.
- Bhattacharya, S., and G. Chiesa, 1995, “Proprietary Information, Financial Intermediation and Research Incentives”, *Journal of Financial Intermediation.*
- Shleifer, A., and R. Vishny, 1992, ”Liquidation Values and Debt Capacity: A Market Equilibrium Approach”, *Journal of Finance*, 47(4), 1343-66.
- Titman S., 1984, “The Effect of Capital Structure on a Firm’s Liquidation Decision”, *Journal of Financial Economics*, 13, 137-51.
- Maksimovic, V. and S. Titman, 1991, “Financial Policy and a Firm’s Reputation for Product Quality”, *Review of Financial Studies.*
- Chemla, G. and A. Faure-Grimaud, 2001, “Dynamic Adverse Selection and Debt”, *European Economic Review.*
- * Perotti, E. C. and K. E. Spier, 1993, “Capital Structure as a Bargaining Tool: The Role of Leverage in Contract Renegotiation”, *American Economic Review*, 83 (December).
- * Holmstrom, B., and J. Tirole, 1997, ”Financial Intermediation, Loanable Funds, and the Real Sector”, *Quarterly Journal of Economics*, 112(3), 663-91.
- R. Gertner and D. Scharfstein, 1991, “A theory of workouts and the effects of reorganization law,” *Journal of Finance*, pp. 1189-1222.
- Aghion, P., O. Hart and J. Moore, 1992, “The Economics of Bankruptcy Reform”, *Journal of Law Economics and Organization.*

2.4 Equity Structure, Control Rights and Corporate Governance

- * TCF Chapters 9 and 10.
- * Burkart, M., D. Gromb and F. Panunzi, 1997, “Large Shareholders, Monitoring and the Value of the Firm”, *Quarterly Journal of Economics.*
- Myers, S., 2000, ”Outside Equity”, *Journal of Finance*, 55(3), 1005-37.
- Bolton, P., and E.-L. von Thadden, 1998, “Blocks, Liquidity, and Corporate Control.” *Journal of Finance* 53(1), pages 1-25.
- * Admati, A., P. Pfleiderer, and J. Zechner, 1994, “Large Shareholder Activism, Risk Sharing, and Financial Market Equilibrium.” *Journal of Political Economy*, 102(6), 1097-1130.

- Hermalin, B., and M. Weisbach, 1998, "Endogenously Chosen Boards of Directors and Their Monitoring of the CEO ", *American Economic Review*, pp. 96-118.
- Almazan, A., and J. Suarez, 2004, "Entrenchment and Severance Pay in Optimal Governance Structures", Journal of Finance.
- Roe, M., 1994, *Strong Managers and Weak Owners: The Political Roots of American Corporate Finance*, Princeton University Press.
- Aghion, P. and P. Bolton, 1992, "An Incomplete Contracts Approach to Financial Contracting", *Review of Economic Studies*, 59, 473-494
- Dewatripont, M., and J. Tirole, 1994, "A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence", *Quarterly Journal of Economics*, 109(4), pp. 1027-54.
- M. Harris and A. Raviv, 1989, "The design of securities", *Journal of Financial Economics*, pp. 255-287.
- Fluck, Z., 1998, "Optimal Financial Contracting: Debt versus Outside Equity", *Review of Financial Studies*, 11(2), pp. 383-418.

2.5 Private Equity and Venture Capital

- * Chemla, G., M. Habib, and A. Ljungqvist, 2005, "An Analysis of Shareholder Agreements", mimeo.
- Dessein, W., 2003, Information and control in ventures and alliances, working paper, University of Chicago.
- Hauswald, R. and U. Hege, 2005, Ownership and control in joint ventures: theory and evidence, working paper, University of Maryland and HEC Paris.
- Hermalin, B. and A. Schwartz, 1996, Buyouts in large companies, *Journal of Legal Studies* 25, 351-370.
- * Cornelli, F. and O. Yosha, 2003, Stage financing and the role of convertible securities, *Review of Economic Studies* 70, 1-32.
- Gompers, P.A., 1995, Optimal investment, monitoring, and the staging of venture capital, *Journal of Finance* 50, 1461-1490.
- Neher, D.V., 1999, Staged financing: an agency perspective, *Review of Economic Studies* 66, 255-274.
- Schmidt, K., 2003, "Convertible Securities and Venture Capital Finance", *Journal of Finance*.
- * Cassamatta C., 2003, "Financing and Advising: Optimal Financial Contracts with Venture Capitalists", Journal of Finance, 58, 2059-86.

- de Bettignies J., 2004, "Financing the Entrepreneurial Venture", mimeo UBC.
- de Bettignies, J., and G. Chemla, 2005, "Corporate Venture Capital, Allocation of Talent, and Competition for Star Managers"; mimeo.
- Berglöf, E., 1994, A control theory of venture capital finance, *Journal of Law, Economics, and Organization* 10, 247-267.
- Hellmann, T., 1998, The allocation of control rights in venture capital contracts, *Rand Journal of Economics* 29, 57-76.
- Kirilenko, Andrei, 2001, Valuation and control in venture finance, *Journal of Finance* 56, 565-587.

2.6 The Market for Corporate Control

- * TCF Chapter 11.
- S. Grossman and O. Hart, 1980, "Takeover bids, the free-rider problem, and the theory of the corporation", *Bell Journal of Economics*, pp. 42-64.
- A. Shleifer and R. Vishny, 1986, "Large Shareholders and Corporate Control", *Journal of Political Economy*, pp. 461-488.
- Burkart, M., 1995, "Initial Shareholdings and Overbidding in Takeover Contests", *Journal of Finance*, 50(5), 1491-1515.
- Burkart, M., D. Gromb and F. Panunzi, 1998, "Why Higher Takeover Premia Protect Minority Shareholders? Tender Offers when Dilution is Endogenous", *Journal of Political Economy.*
- * Burkart, M., D. Gromb, and F. Panunzi, 2000, "Agency Conflicts in Public and Negotiated Transfers of Corporate Control", *Journal of Finance*, 55(2), 647-77.
- D. Hirshleifer and S. Titman, 1990, "Share tendering strategies and the success of hostile takeover bids", *Journal of Political Economy*, pp. 295-324.
- Grossman, S. and O. Hart, 1988, "One Share-One Vote and the Market for Corporate Control", *Journal of Financial Economics*, 20, 175-202.
- Gromb D., 1993, "Is One-Share/One Vote Optimal", *LSE Financial Markets Group Discussion Paper no. 177.*
- * Maksimovic, V., and G. Phillips, 2002, "Do Conglomerate Firms Allocate Resources Inefficiently across Industries? Theory and Evidence", *Journal of Finance*, 57(2), 721-67 (theory part only).
- Chemla G., 2004, "Takeovers and the Dynamics of Information Flows", *International Journal of Industrial Organization*, 22, 575-90.

- Shleifer, A. and L. Summers, 1988, “Breach of Trust in Hostile Takeovers”, in *Corporate Takeovers: Causes and Consequences*, Edited by Alan J. Auerbach, University of Chicago press.

- Chemla G., 2005, “Hold-up, Stakeholders and Takeover Threats”, *Journal of Financial Intermediation.*

- Chemla G., 2003, ”Downstream Competition, Foreclosure, and Vertical Integration”, *Journal of Economics and Management Strategy*, 12(2), 261-89.

2.7 Dynamic Capital Structure

- E. Fischer, R. Heinkel and J. Zechner, 1989, “Dynamic Capital Structure Choice: Theory and Tests,” *Journal of Finance*, pp. 19–40.

- H. Leland and K. Toft, 1996, “ Optimal capital structure, endogenous bankruptcy and the term structure of credit spreads,” *Journal of Finance*, pp. 987-1019.

- H. Leland, 1998, “Agency Costs, Risk Management, and Capital Structure,” *Journal of Finance*, pp. 1213-43.

- D. Mauer and A. Triantis, 1994, “Interactions of corporate financing and investment decisions: A dynamic framework,” *Journal of Finance*, pp. 1253-1278.

- * Hennessy, C., and T. Whited, 2005, ”Debt Dynamics”, *Journal of Finance.*

- Titman, S., and A. Tsyplakov, 2003, ”A Model of Dynamic Capital Structure”, mimeo University of Texas-Austin.

- * Chemla G., 2005, ”The Dynamic Trade-Off Theory with Real Investment”, mimeo.

- * Moyen N., 2005, ”Investment-Cash Flow Sensitivities: Constrained vs Unconstrained Firms”, *Journal of Finance.*