USC Marshall

FBE 630. FUNDAMENTALS OF CORPORATE FINANCE

Professor John G. Matsusaka

Spring 2025

Tuesdays 1:00 pm – 3:50 pm

SYLLABUS

Overview

This course provides a rigorous introduction to fundamental concepts in corporate finance. The goal is to introduce students to central ideas underpinning research in corporate finance and develop an ability to frame phenomena in terms of existing theory. By the end of the course, students should have a working knowledge of the main tools of corporate finance research, and be equipped to begin independent research. The second class in the sequence, FBE 631, explores various applications to contemporary issues in the field. This class begins with the neoclassical and tradeoff models, moves to agency problems and asymmetric information, then financial contracting, and concludes with corporate governance.

Learning Objectives

- Become familiar with central theoretical ideas underpinning research in corporate finance.
- Become familiar with the scholarly papers that form the foundation of modern corporate finance.
- Become familiar with the main empirical findings in the literature.
- Understand the limitations as well as strengths of core concepts, and areas where our understanding is most tenuous.
- Develop the ability to formulate and solve mathematical models in the field.
- Develop the ability to interpret and critique empirical evidence in the field.
- Develop the skill to summarize and present research findings.

Course Methods

Class meetings are organized around lectures that develop models and discuss empirical results. Some papers will be presented by students as a way to develop presentation skills and create a participatory environment. There is a weekly homework assignment that focuses on modeling. Working through models develops a deeper understanding of the underlying theory, and prepares students for independent research. Understanding theory is especially important for empirical research.

Prerequisites

Students must have completed one semester of doctoral level microeconomics, ideally GSBA 602. Students should also have completed or be currently enrolled in a second-semester microeconomics class that covers game theory, information economics, and contracting, ideally GSBA 612.

Grades

Grades will be assigned on the following basis:

Homework	**30%**
Final exam (Mar. 4)	**50%**
In-class presentations and participation	**20%**

At times this class will follow a standard lecture format, but we will also approach learning in a variety of other ways. Your responsibilities are:

1. Attend class, learn the lecture material.
2. Read the assigned papers.
3. In-class presentations.
4. Complete homework assignments.
5. Attend the Finance Seminar when the paper is in the area of corporate finance, and be prepared to discuss the paper the following class.

Teaching Assistant

The teaching assistant is to be determined. The TA will grade homework and go over the solutions at a time to be arranged.

Contact Information

Please do not hesitate to contact me if you have questions about the class. Email is convenient: matsusak@usc.edu.

Class Notes Policy

Pursuant to the USC Student Handbook (www.usc.edu/scampus, Part B, 11.12), students may not record a university class without the express permission of the instructor and announcement to the class. In addition, students may not distribute or use notes or recordings based on University classes or lectures without the express permission of the instructor for purposes other than personal or class-related group study by individuals registered for the class. This restriction on unauthorized use applies to all information that is distributed or displayed for use in relationship to the class.

Academic Integrity

The University of Southern California is a learning community committed to developing successful scholars and researchers dedicated to the pursuit of knowledge and the dissemination of ideas. Academic misconduct, which includes any act of dishonesty in the production or submission of academic work, compromises the integrity of the person who commits the act and can impugn the perceived integrity of the entire university community. It stands in opposition to the university's mission to research, educate, and contribute productively to our community and the world.

All students are expected to submit assignments that represent their own original work, and that have been prepared specifically for the course or section for which they have been submitted. You may not submit work written by others or "recycle" work prepared for other courses without obtaining written permission from the instructor(s).

Other violations of academic integrity include, but are not limited to, cheating, plagiarism, fabrication (e.g., falsifying data), collusion, knowingly assisting others in acts of academic dishonesty, and any act that gains or is intended to gain an unfair academic advantage.

The impact of academic dishonesty is far-reaching and is considered a serious offense against the university. All incidences of academic misconduct will be reported to the Office of Academic Integrity and could result in outcomes such as failure on the assignment, failure in the course, suspension, or even expulsion from the university.

For more information about academic integrity see the student handbook or the Office of Academic Integrity's website, and university policies on Research and Scholarship Misconduct.

Please ask your instructor if you are unsure what constitutes unauthorized assistance on an exam or assignment, or what information requires citation and/or attribution.

Students and Disability Accommodations

USC welcomes students with disabilities into all of the University's educational programs. The Office of Student Accessibility Services (OSAS) is responsible for the determination of appropriate accommodations for students who encounter disability-related barriers. Once a student has completed the OSAS process (registration, initial appointment, and submitted documentation) and accommodations are determined to be reasonable and appropriate, a Letter of Accommodation (LOA) will be available to generate for each course. The LOA must be given to each course instructor by the student and followed up with a discussion. This should be done as early in the semester as possible as accommodations are not retroactive. More information can be found at osas.usc.edu. You may contact OSAS at (213) 740-0776 or via email at osasfrontdesk@usc.edu.

Support Systems

- Counseling and Mental Health - (213) 740-9355 – 24/7 on call. Free and confidential mental health treatment for students, including short-term psychotherapy, group counseling, stress fitness workshops, and crisis intervention.
- 988 Suicide and Crisis Lifeline - 988 for both calls and text messages – 24/7 on call. The 988 Suicide and Crisis Lifeline (formerly known as the National Suicide Prevention Lifeline) provides free and confidential emotional support to people in suicidal crisis or emotional distress 24 hours a day, 7 days a week, across the United States. The Lifeline is comprised of a national network of over 200 local crisis centers, combining custom local care and resources with national standards and best practices. The new, shorter phone number makes it easier for people to remember and access mental health crisis services (though the previous 1 (800) 273-8255 number will continue to function indefinitely) and represents a continued commitment to those in crisis.
- Relationship and Sexual Violence Prevention Services (RSVP) - (213) 740-9355(WELL) – 24/7 on call. Free and confidential therapy services, workshops, and training for situations related to gender- and power-based harm (including sexual assault, intimate partner violence, and stalking).
- Office for Equity, Equal Opportunity, and Title IX (EEO-TIX) - (213) 740-5086. Information about how to get help or help someone affected by harassment or discrimination, rights of protected classes, reporting options, and additional resources for students, faculty, staff, visitors, and applicants.
  - Reporting Incidents of Bias or Harassment - (213) 740-5086 or (213) 821-8298. Avenue to report incidents of bias, hate crimes, and microaggressions to the Office for Equity, Equal Opportunity, and Title for appropriate investigation, supportive measures, and response.
  - The Office of Student Accessibility Services (OSAS) - (213) 740-0776. OSAS ensures equal access for students with disabilities through providing academic accommodations and auxiliary aids in accordance with federal laws and university policy.
  - USC Campus Support and Intervention - (213) 740-0411. Assists students and families in resolving complex personal, financial, and academic issues adversely affecting their success as a student.
  - Diversity, Equity and Inclusion - (213) 740-2101. Information on events, programs and training, the Provost's Diversity and Inclusion Council, Diversity Liaisons for each academic school, chronology, participation, and various resources for students.
  - USC Emergency - UPC: (213) 740-4321, HSC: (323) 442-1000 – 24/7 on call. Emergency assistance and avenue to report a crime. Latest updates regarding safety, including ways in which instruction will be continued if an officially declared emergency makes travel to campus infeasible.

- USC Department of Public Safety - UPC: (213) 740-6000, HSC: (323) 442-1200 – 24/7 on call. Non-emergency assistance or information.
- Office of the Ombuds - (213) 821-9556 (UPC) / (323-442-0382 (HSC) . A safe and confidential place to share your USC-related issues with a University Ombuds who will work with you to explore options or paths to manage your concern.
- Occupational Therapy Faculty Practice - (323) 442-2850 or otfp@med.usc.edu . Confidential Lifestyle Redesign services for USC students to support health promoting habits and routines that enhance quality of life and academic performance.

READINGS AND SCHEDULE

The following is provisional and may be modified as the semester progresses. Asterisks indicate readings to be discussed in class.

Week	Topic	Due
Jan. 14	Neoclassical model + Firm objective	
Jan. 21	Tradeoff theory: taxes & bankruptcy	HW 1
Jan. 28	Agency and asymmetric information: theory	HW 2; presentations
Feb. 4	Agency and asymmetric information: evidence	HW 3; presentations
Feb. 11	Financial contracting: cash flow	HW 4
Feb. 18	Financial contracting: control rights	HW 5
Feb. 25	Corporate governance I	HW 6
Mar. 4	FINAL	

Part I. Capital Structure: Debt versus Equity

1. Neoclassical Model

* Fama, Eugene F. & Merton H. Miller, *The Theory of Finance*, Dryden Press, 1972, Chapters 1, 2. Out of print but downloadable at http://faculty.chicagobooth.edu/eugene.fama/research/.

* Matsusaka, John G., *Neoclassical Model of Finance: Certainty*, class notes, 2015. [Available on Blackboard]

* Friedman, Milton, "The Social Responsibility of Business is to Increase Its Profits," New York Times, September 13, 1970. [Well-known argument for value maximization]

Milton Friedman 50 Years Later, edited by L. Zingales, J. Kasperkevic, and A. Schechter, Stigler Center at the University of Chicago Booth School of Business, eBook, 2020: https://promarket.org/2020/11/17/ebook-milton-friedman-50-years-later/.

Rajan, Raghuram G. and Luigi Zingales, "What Do We Know About Capital Structure? Some Evidence from International Data," *JF*, Dec. 1995. [Stylized facts.]

Modigliani, Franco and Merton H. Miller, "The Cost of Capital, Corporation Finance, and the Theory of Investment," *AER*, June 1958. [Classic article.]

Modigliani, Franco and Merton H. Miller, "Reply to Heins and Sprenkle," *AER*, Sep. 1969. [Simpler proof using the risk-class method.]

Hart, Oliver and Luigi Zingales, "Companies Should Maximize Shareholder Welfare Not Market Value," *Journal of Law, Finance, and Accounting*, 2017. [Against value maximization]

2. Tradeoff Theory

* Miller, Merton H., "Debt and Taxes," *JF*, May 1977. [Fundamental article.]

* Andrade, Gregor & Steven N. Kaplan, "How Costly is Financial (not Economic) Distress?," *JF*, October 1998.

* Graham, John R., "How Big Are the Tax Benefits of Debt?," *JF*, 2000.

* Faccio, Mara and Jin Xu, "Taxes and Capital Structure," *JFQA*, 2015.

Almeida, Heitor & Thomas Philippon, "The Risk-Adjusted Cost of Financial Distress," *JF*, December 2007. [Risk-adjusted estimates.]

Blouin, Jennifer L., John E. Core, and Wayne R. Guay, "Have the Tax Benefits of Debt Been Overestimated?," *JFE*, 2010. [Improved simulations; earnings mean reverting.]

Elkamhi, Redouane, Jan Ericcson, and Christopher A. Parsons, "The Cost and Timing of Financial Distress," *JFE*, 2012. [Broader conception of bankruptcy cost.]

Maksimovic, Vojislav and Josef Zechner, "Debt, Agency Costs, and Industry Equilibrium," *JF*, 1990. [Industry equilibrium model.]

Korteweg, Arthur, "The Net Benefits to Leverage," *JF*, 2010.

3. Security Choice: Agency Problems & Asymmetric Information

* Jensen, Michael C. and William H. Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *JFE* 1976. [Asset substitution.]

* Myers, Stewart C., "Determinants of Corporate Borrowing," *JFE* 1977. [Debt overhang/underinvestment.]

* Myers, Stewart C. and Nicholas S. Majluf, "Corporate Financing and Investment Decisions When Firms Have Information that Investors Do Not Have," *JFE* 1984. [Asymmetric information/adverse selection.]

Ross, Stephen A., "The Determinants of Financial Structure: The Incentive Signalling Approach," *Bell Journal of Economics* 1977. [Signaling.]

* Jensen, Michael C., "Agency Costs of Free Cash Flow, Corporate Finance and Takeovers," *AER*, May 1986. [Free cash flow problem.]

Stulz, Rene M., "Managerial Discretion and Optimal Financing Policies," *JFE* 1990. [Attempt to formalize FCF idea.]

* Baker, Malcolm and Jeffrey Wurgler, "Market Timing and Capital Structure," *JF* 2002. [Behavior theory of capital structure]

4. Evidence

*I. Shyam-Sunder and S. C. Myers, "Testing Static Tradeoff Against Pecking Order Models of Capital Structure," *JFE*, 1999. [Tradeoff versus pecking order theory.]

*E. F. Fama & K. R. French, "Financing Decisions: Who Issues Stock?," *JFE*, June 2005. [Evidence against the "pecking order" theory.]

M. T. Leary & M. R. Roberts, "Do Firms Rebalance Their Capital Structures?," *Journal of Finance*, 2005. [Evidence for tradeoff model with adjustment costs.]

J. Graham & C. Harvey, "The Theory and Practice of Corporate Finance: Evidence from the Field," *JFE*, 2001. [What managers say they do.]

*I. Welch, "Capital Structure and Stock Returns," *Journal of Political Economy*, 2004. [Capital structure changes driven by stock price changes.]

I. Strebulaev, "Do Tests of Capital Structure Theory Mean What They Say?," *JF*, 2007.

I. Strebulaev & B. Yang, "The Mystery of Zero-Leverage Firms," *JFE*, 2013.

Part II. Financial Contracting

5. Assigning Cash Flow

Townsend, Robert M., "Optimal Contracts and Competitive Markets with Costly State Verification," *Journal of Economic Theory* 1979. [First CSV paper.]

* Gale, Douglas and Martin Hellwig, "Incentive-Compatible Debt Contracts: The One-Period Problem," *RES* 1985. [Easier to understand than Townsend.]

* Bolton, Patrick and David S. Scharfstein, "Optimal Debt Structure and the Number of Creditors," *JPE* 1996.

DeMarzo, Peter M. and Yuliy Sannikov, "A Continuous-Time Agency Model of Optimal Contracting and Capital Structure," *JF* 2006. [Dynamic security design.]

Tirole, Jean, *The Theory of Corporate Finance*, 2006. [Chapter 3 gives abbreviated versions of key models]

Donaldson, Jason R., Denis Gromb, and Giorgia Piacentino, "Conflicting Priorities: A Theory of Covenants and Collateral," working paper, 2022. [Develops a theory of debt structure, collateral, covenants]

6. Assigning Control Rights

Grossman, Sanford J. and Oliver Hart, “The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration,” *JPE* 1986. [Introduces ‘residual rights of control’.]

Hart, Oliver and John Moore, “Property Rights and the Nature of the Firm,” *JPE* 1990. [The other foundational paper.]

* Aghion, Philippe and Patrick Bolton, “An ‘Incomplete Contracts’ Approach to Financial Contracting,” *RES* 992. [Application of control rights to security choice.]

Hart, Oliver and John Moore, “A Theory of Debt Based on the Inalienability of Human Capital,” *QJE* 1994.

Dewatripont, Mathias and Jean Tirole, “A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence,” *QJE* 1994.

Hart, Oliver, “A Theory of Debt Based on the Inalienability of Human Capital,” *QJE* 1994.

Part III. Corporate Governance

Shleifer, Andrei and Robert W. Vishny, “A Survey of Corporate Governance,” *JF* 1997.

Hart, Oliver and Luigi Zingales, “New Corporate Governance,” WP, 2022.

Jensen, Michael C. and Kevn J. Murphy, “Performance Pay and Top-Management Incentives,” *JPE* 1990.

Burkhart, M., D. Gromb, and F. Panunzi, “Large Shareholders, Monitoring, and the Value of the Firm,” *QJE* 1997. [Monitoring by shareholders can hurt value if it disincentivizes managers from investing.]

D. F. Larcker, G. Ormazabal, and D. J. Taylor, “The Market Reaction to Corporate Governance Regulation,” *JFE*, 2011.

R. Morck, A. Shleifer, and R. W. Vishny, “Management Ownership and Market Valuation: An Empirical Analysis,” *JFE*, 1988.

P. A. Gompers, J. L. Ishii, and A. Metrick, “Corporate Governance and Equity Prices,” *QJE*, 2003.

7. Boards

Adams, Reneé and Daniel Ferreira, “A Theory of Friendly Boards,” *JF* 2007.

Duchin, Ran, John G. Matsusaka, and Oguzhan Ozbas, “When Are Outside Directors Effective?,” *JFE* 2010.

Ferreira, Daniel, Miguel A. Ferreira, and Clara C. Raposo, “Board Structure and Price Informativeness,” *JFE* 2011.

Nguyen, Bang Dang and Kasper Meisner Nielsen, “The Value of Independent Directors: Evidence from Sudden Deaths,” *JFE* 2010.

Bebchuk, Lucien and Alma Cohen, “The Costs of Entrenched Boards,” *JFE* 2005.

Cremers, K. J. Martijn, Lubomir P. Litov, and Simone M. Sepe, “Staggered Boards and Long-Term Firm Value, Revisited,” *JFE* 2017.

Bebchuk, Lucien, “Giving Shareholders a Voice,” New York Times, April 19, 2012.

Cremers, K. J. Martijn and Simone M. Sepe, “Board Declassification Activism: The Financial Value of the Shareholder Rights Project,” working paper 2017.

Bebchuk, Lucien and Alma Cohen, “Recent Board Declassifications: A Response to Cremers and Sepe,” working paper 2017. [Response to critique]

8. Activism

* Brav, Alon, Wei Jiang, Frank Partnoy, and Randall Thomas,” Hedge Fund Activism, Corporate Governance, and Firm Performance,” *JF* 2008.

Brav, Alon, Wei Jiang, Hyunseob Kim, “The Real Effects of Hedge Fund Activism: Productivity, Asset Allocation, and Labor Outcomes,” *RFS* 2015.

K. J. M. Cremers, E. Giambona, S. M. Sepe, and Y. Wang, “Hedge Fund Activists: Value Creators or Good Stock Pickers?,” WP, 2020. [Critique of hedge fund evidence]

9. Shareholder Proposals and Voting

Denes, Matthew, Jonthan M. Karpoff, and Victoria McWilliams, “Thirty Years of Shareholder Activism: A Survey of Empirical Results,” *Journal of Corporate Finance* 2017.

Matsusaka, John G. and Oguzhan Ozbas, “A Theory of Shareholder and Approval Rights,” *Journal of Law, Economics, and Organization* 2017. [A theoretical framework, optional reading]

* Cuñat, Vicente, Mireia Gine, and Maria Guadalupe, “The Vote Is Cast: The Effect of Corporate Governance on Shareholder Value,” *JF* 2012.

Matsusaka, John G., Oguzhan Ozbas, and Irene Yi, “Why Do Managers Fight Shareholder Proposals? Evidence from No-Actin Letter Decisions,” *Journal of Law and Economics* 2021.

10. Interested Investors

* Matsusaka, John G., Oguzhan Ozbas, and Irene Yi, “Opportunistic Proposals by Union Shareholders,” *RFS* 2019.

* Min, Geeyoung and Hye Young You, “Active Firms and Active Shareholders: Corporate Political Activity and Shareholder Proposals,” *Journal of Legal Studies* 2019.

Riedl, Arno and Paul Smeets, "Why Do Investors Hold Socially Responsible Mutual Funds?," *JF* 2017.

Bolton, Patrick, Tao Li, Enrichetta Ravina, and Howard Rosenthal, "Investor Ideology," *JFE* 2020.

11. Passive Investors and Proxy Advice

Appel, Ian R., Todd A. Gormley, and Donald B. Keim, "Passive Investors, Not Passive Owners," *JFE* 2016.

Appel, Ian R., Todd A. Gormley, and Donald B. Keim, "Standing on the Shoulders of Giants: The Effect of Passive Investors on Activism," *RFS* 2019.

Schmidt, Cornelius and Ruediger Fahlenbrach, "Do Exogenous Changes in Passive Institutional Ownership Affect Corporate Governance and Firm Value?," *JFE* 2017.

Iliev, Peter and Michelle Lowry, "Are Mutual Funds Active Voters?," *RFS* 2015.

Ertimur, Yonca, Fabrizio Ferri, and David Oesch, "Shareholder Votes and Proxy Advisors: Evidence from Say on Pay," *Journal of Accounting Research* 2013.

Malenko, Nadya and Yao Shen, "The Role of Proxy Advisory Firms: Evidence from a Regression-Discontinuity Design," *RFS* 2016.

Li, Tao, "Outsourcing Corporate Governance: Conflicts of Interest within the Proxy Advisory Industry," *Management Science* 2018.

D. Larcker, A. L. McCall, and G. Ormazabal, "Outsourcing Shareholder Voting to Proxy Advisory Firms," *Journal of Law and Economics* 2015.

Heath, Davidson, Daniele Macciocchi, Roni Michaely, and Matthew C. Ringgenberg, "Do Index Funds Monitor?," *RFS* 2021.

Malenko, Andrey and Nadya Malenko, "Proxy Advisory Firms: The Economics of Selling Information to Voters," *Journal of Finance*, 2019.

Camara, Odilon, John G. Matsusaka, and Chong Shu, "Shareholder Democracy and the Market for Voting Advice," working paper, 2024.

Matsusaka, John G. and Chong Shu, "Does Proxy Advice Lead to Informed Voting?," working paper 2021.

Shu, Chong, "The Proxy Advisory Industry: Influencing and Being Influenced," *Journal of Financial Economics*, 2024.

Instructor Profile
John G. Matsusaka

Education

B.A. Economics, University of Washington
M.A., Ph.D. Economics, University of Chicago

Professional

Charles F. Sexton Chair in American Enterprise, 2009-
Professor of Finance and Business Economics, USC Marshall School, 1991-
Professor of Business and Law, USC Gould School or Law, 2004-
Professor of Political Science and International Relations, USC, 2005-
Executive Director, Initiative & Referendum Institute at USC, 2004-
Interim Vice Provost for Faculty Affairs, USC, 2019-2020
Vice Dean for Faculty and Academic Affairs, USC Marshall School, 2007-2013
Visiting Scholar, Booth School of Business, University of Chicago, 2017
John M. Olin Visiting Professor of Economics, GSB, University of Chicago, 2001
Visiting Associate in Economics, California Institute of Technology, 2000
National Fellow, Hoover Institution, Stanford University, 1994-1995

Other Professional

Consultant on corporate governance, Council of Economic Advisors, Executive Office of the President, Washington D.C., 2002

Research in Finance and Governance

"Is Direct Democracy Good or Bad for Corporations and Unions?," Journal of Law and Economics, 2023.

"Can Shareholder Proposals Hurt Shareholders? Evidence from SEC No-Action Letters," with O. Ozbas and I. Yi, *Journal of Law and Economics*, 2021.

"Opportunistic Proposals by Union Shareholders," with O. Ozbas and I. Yi, *Review of Financial Studies*, 2019.

"A Theory of Shareholder Approval and Proposal Rights," with O. Ozbas, *Journal of Law, Economics, and Organization*, 2017.

"When Are Outside Directors Effective?," with R. Duchin and O. Ozbas, *Journal of Financial Economics*, 2010.

"From Families to Formal Contracts: An Approach to Development," with K. Kumar, *Journal of Development Economics*, 2009.

"Decision Processes, Agency Problems, and Incomplete Information: An Economic Analysis of Capital Budgeting," with A. M. Marino, *Review of Financial Studies*, 2005.

"Corporate Diversification, Value Maximization, and Organizational Capabilities," *Journal of Business*, 2001 [Merton Miller Prize for "most significant paper."]