THE NEW CORPORATE FINANCE
Where Theory Meets Practice
TABLE OF CONTENTS

PREFA CE

INTRODUCTION: FINANCIAL INNOVATION IN THE 1980s AND 1990s
by Donald H. Chew, Jr., Stern Stewart & Co.

I. MAN AND MARKETS
1. THE NATURE OF MAN ...........................................4
   by Michael C. Jensen, Harvard Business School, and William H. Meckling, University of Rochester
2. INCENTIVES, RATIONALITY, AND SOCIETY ...........................................20
   by Michael J. Brennan, University of California at Los Angeles
3. SELF-INTEREST, ALTRUISM, INCENTIVES, AND AGENCY THEORY .................29
   by Michael C. Jensen, Harvard Business School
4. THE THEORY OF STOCK MARKET EFFICIENCY: ACCOMPLISHMENTS AND LIMITATIONS .........35
   by Ray Ball, University of Rochester
5. MARKET MYTHS .........................................................................................49
   by G Bennett Stewart III, Stern Stewart & Co.
6. AN ANALYSIS OF TRADING PROFITS: HOW MOST TRADING ROOMS REALLY MAKE MONEY .... 67
   by Alberic Braas and Charles N. Bralver, Oliver, Wyman & Company
7. STERN STEWART ROUNDTABLE ON RELATIONSHIP INVESTING AND SHAREHOLDER COMMUNICATION .................................................................................................73

II. CORPORATE STRATEGY AND STRUCTURE
8. CORPORATE STRATEGY AND THE CAPITAL BUDGETING DECISION ......................................104
   by Alan C. Shapiro, University of California at Los Angeles
9. FINANCE THEORY AND FINANCIAL STRATEGY ...................................................................119
   by Stewart Myers, Massachusetts Institute of Technology
10. THE ECONOMICS OF ORGANIZATIONAL ARCHITECTURE ..............................................127
    by James Brickley, Clifford Smith, and Jerold Zimmerman, University of Rochester
11. THE EVA* FINANCIAL MANAGEMENT SYSTEM ..................................................................140
    by Joel M. Stern, G. Bennett Stewart III, and Donald H. Chew, Jr., Stern Stewart & Co.
12. TOTAL COMPENSATION STRATEGY ..............................................................................155
    by Stephen F. O'Byrne, Stern Stewart & Co.
13. STERN STEWART EVA® ROUNDTABLE ...........................................................................165
    Panelists: Carm Adimando, Pitney Bowes; Robert Butler, International Paper; Susan Malley, Citicorp Investment Services; S. Abraham Ravid, Rutgers University; Richard Shepro, Alex Brown Investment Management; R. Hutchings Vernon, Joseph Willett, Merrill Lynch & Co., Inc.; Jerold Zimmerman, University of Rochester. Moderated by Joel Stern and Bennett Stewart.

III. CAPITAL STRUCTURE AND PAYOUT POLICY
14. THE MODIGLIANI-MILLER PROPOSITIONS AFTER THIRTY YEARS ........................................192
    by Merton H. Miller, University of Chicago
15. THE SEARCH FOR OPTIMAL CAPITAL STRUCTURE .............................................. 205
   by Stewart C. Myers, Massachusetts Institute of Technology

16. THE DETERMINANTS OF CORPORATE LEVERAGE AND DIVIDEND POLICIES .... 214
   by Michael J. Barclay, Clifford W. Smith, and Ross L. Watts, University of Rochester

17. ON FINANCIAL ARCHITECTURE: LEVERAGE, MATURITY, AND PRIORITY ........ 230
   by Michael J. Barclay and Clifford W. Smith, Jr., University of Rochester

18. DUTCH AUCTION SHARE REPURCHASES: THEORY AND EVIDENCE ............... 244
   by Donald B. Hausch, University of Wisconsin-Madison, and Dennis E. Logue and
   James K. Seward, Dartmouth College

19. THE DIVIDEND CUT "HEARD 'ROUND THE WORLD": THE CASE OF FPL ............. 250
   by Dennis Soter, Stern Stewart & Co., Eugene Brigham, University of Florida, and
   Paul Evanson, Florida Power & Light Company

20. BANK OF AMERICA ROUNDTABLE ON THE LINK BETWEEN CAPITAL STRUCTURE AND
    SHAREHOLDER VALUE ............................................................................... 262
    Panelists: Jay Allen, Tosco Corporation; Cheryl Francis, R.R. Donnelley & Sons Co.;
    Michael Jensen, Harvard Business School; Michael O'Neill, Bank of America; and
    Dennis Soter, Stern Stewart & Co. Moderated by Bennett Stewart, Stern Stewart & Co.

IV. RAISING CAPITAL

21. RAISING CAPITAL: THEORY AND EVIDENCE ............................................... 310
    by Clifford W. Smith, Jr., University of Rochester

22. AN OVERVIEW OF CORPORATE SECURITIES INNOVATION ........................... 311
    by John D. Finnerty, Fordham University and McFarland Dewey & Co.

23. INITIAL PUBLIC OFFERINGS ................................................................. 328
    by Roger G. Ibbotson and Jody L. Sindelar, Yale University, and
    Jay R. Ritter, University of Michigan

24. ARE BANKS LOANS DIFFERENT?: SOME EVIDENCE FROM THE STOCK MARKET .. 337
    by Christopher James and Peggy Wier, University of Oregon

25. THE CASE FOR PRIVATE PLACEMENTS: HOW SOPHISTICATED INVESTORS ADD VALUE TO CORPORATE DEBT ISSUERS ........................................... 346
    by Dennis Emerick and William White, Continental Bank

26. THE GROWING ROLE OF JUNK BONDS IN CORPORATE FINANCE ............... 355
    by Robert Taggart, Boston University, and Kevin Perry, Baring Asset Management

27. SOME NEW EVIDENCE ON WHY COMPANIES USE CONVERTIBLE BONDS ....... 364
    by Frank C. Jen, State University of New York at Buffalo, Dosounh Choi,
    Seoul National University, and Seong-Hyo Lee, Myongji University

28. PERCS, DECS, AND OTHER MANDATORY CONVERTIBLES ............................. 374
    by Enrique R. Arzac, Columbia University

29. THE ORIGIN OF LYONS: A CASE STUDY IN FINANCIAL INNOVATION .............. 384
    by John J. McConnell, Purdue University, and Eduardo S. Schwartz, University of California
    at Los Angeles

30. THE USES OF HYBRID DEBT IN MANAGING CORPORATE RISK .................... 392
    by Charles W. Smithson, Chase Manhattan Bank, and Donald H. Chew, Jr., Stern Stewart & Co.

31. SECURITIZATION: A LOW-COST SWEETENER FOR LEMONS ......................... 403
    by Claire A. Hill, George Mason University School of Law

32. USING PROJECT FINANCE TO FUND INFRASTRUCTURE INVESTMENTS ............ 411
    by Richard A. Brealey, Ian A. Cooper, and Michel A. Habib, London Business School
<table>
<thead>
<tr>
<th>Section</th>
<th>Author</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>V. RISK MANAGEMENT</td>
<td></td>
<td></td>
</tr>
<tr>
<td>33. FINANCIAL INNOVATION: ACHIEVEMENTS AND PROSPECTS</td>
<td>Merton H. Miller, University of Chicago</td>
<td>429</td>
</tr>
<tr>
<td>34. THE EVOLUTION OF RISK MANAGEMENT PRODUCTS</td>
<td>S. Waite Rawls III and Charles W. Smithson, Continental Bank</td>
<td>437</td>
</tr>
<tr>
<td>35. RISK AND REGULATION IN DERIVATIVES MARKETS</td>
<td>Ludger Hentschel and Clifford W. Smith, Jr., University of Rochester</td>
<td>446</td>
</tr>
<tr>
<td>36. STRATEGIC RISK MANAGEMENT</td>
<td>Charles Smithson, Chase Manhattan Bank, and Clifford W. Smith, Jr., University of Rochester</td>
<td>460</td>
</tr>
<tr>
<td>37. IDENTIFYING, MEASURING, AND HEDGING CURRENCY RISK AT MERCK</td>
<td>Judy C. Lewent and A. John Kearney, Merck &amp; Co., Inc.</td>
<td>478</td>
</tr>
<tr>
<td>38. RETHINKING RISK MANAGEMENT</td>
<td>Rene M. Stulz, The Ohio State University</td>
<td>488</td>
</tr>
<tr>
<td>40. CORPORATE INSURANCE STRATEGY: THE CASE OF BRITISH PETROLEUM</td>
<td>Neil A. Doherty, University of Pennsylvania, and Clifford W. Smith, Jr., University of Rochester</td>
<td>522</td>
</tr>
<tr>
<td>41. THE ARITHMETIC OF FINANCIAL ENGINEERING</td>
<td>Donald J. Smith, Boston University</td>
<td>534</td>
</tr>
<tr>
<td>42. HOW TO USE THE HOLES IN BLACK-SCHOLES</td>
<td>Fischer Black, Goldman, Sachs &amp; Co.</td>
<td>544</td>
</tr>
<tr>
<td>43. BANK OF AMERICA ROUNDTABLE ON DERIVATIVES AND CORPORATE RISK MANAGEMENT</td>
<td>Thomas Jones, Union Carbide Corporation; Lynn Lane, R.J. Reynolds Tobacco Company; Jonelle St. John, MCI Communications Corp.; and John van Roden, Lukens, Inc. Moderated by Robert McKnew, Bank of America</td>
<td>551</td>
</tr>
<tr>
<td>VI. CORPORATE RESTRUCTURING AND CORPORATE GOVERNANCE</td>
<td></td>
<td></td>
</tr>
<tr>
<td>44. THE MODERN INDUSTRIAL REVOLUTION, EXIT, AND THE FAILURE OF INTERNAL CONTROL SYSTEMS</td>
<td>Michael C. Jensen, Harvard Business School</td>
<td>573</td>
</tr>
<tr>
<td>45. RAIDERS, TARGETS, AND POLITICS: THE HISTORY AND FUTURE OF AMERICAN CORPORATE CONTROL</td>
<td>John Pound, Harvard University</td>
<td>593</td>
</tr>
<tr>
<td>47. THE MOTIVES AND METHODS OF CORPORATE RESTRUCTURING: PART I</td>
<td>G. Bennett Stewart III and David M. Glassman, Stern Stewart &amp; Co.</td>
<td>621</td>
</tr>
<tr>
<td>48. THE MOTIVES AND METHODS OF CORPORATE RESTRUCTURING: PART II</td>
<td>G. Bennett Stewart III and David M. Glassman, Stern Stewart &amp; Co.</td>
<td>636</td>
</tr>
<tr>
<td>49. REVERSING CORPORATE DIVERSIFICATION</td>
<td>Amar Bhide, Harvard Business School</td>
<td>646</td>
</tr>
<tr>
<td>51. LEVERAGED RECAPS AND THE CURBING OF CORPORATE OVERINVESTMENT</td>
<td>David J. Denis and Diane K. Denis, Virginia Tech</td>
<td>671</td>
</tr>
</tbody>
</table>

TABLE OF CONTENTS • ix
52. SOME NEW EVIDENCE THAT SPINOFFS CREATE VALUE, ................................................................. 683
   by Patrick Cusatis, Lehman Brothers, and James A. Miles and J. Randall Woolridge, 
   Penn State University

53. THE EVOLUTION OF BUYOUT PRICING AND FINANCIAL STRUCTURE 
   (OR, WHAT WENT WRONG) IN THE 1980s ................................................................................... 691
   by Steven N. Kaplan, University of Chicago, and Jeremy C. Stein, Massachusetts Institute 
   of Technology

54. LBOS—THE EVOLUTION OF FINANCIAL STRUCTURES AND STRATEGIES ......................... 708
   by Jay Allen, Bank of America

55. CONTINENTAL BANK ROUNDTABLE ON THE ROLE OF CORPORATE BOARDS IN THE 1990s, ... 720
   Panelists: James Birle, The Blackstone Group; Wade Cable, The Presley Companies; 
   Michael Jensen, Harvard Business School; Roger Lee, Caesars World; John Roach, 
   Fibreboard Corporation; William Roper, Science Applications International Corporation; 
   Fred Simmons, Freeman Spogli; and John Teets, The Dial Corp. Moderated by 
   Bennett Stewart, Stern Stewart & Co.