Westminster House **2315 College Avenue** **Berkeley, California**

ABSTRACTS OF PAPERS

Jesse Fried
Professor, Boalt Hall School of Law, University of California, Berkeley, Co-Director BCLBE
Brian Broughman
University of California, Berkeley

"Deviations from Contractual Priority in the Sale of VC - Backed Firms"

Financial contracting theory generally assumes cash flow rights are fully respected. Researchers have identified one setting in which they are not: equity holders' holdup power in bankruptcy enables them to undermine creditors' priority rights. This paper documents deviations from contractual priority in another important context: sales of VC-backed firms. Using a hand-collected dataset, we find common shareholders sometimes receive payment before VCs' liquidation preferences are satisfied. We show that these carve-outs are larger when governance arrangements give common shareholders more power to impede the sale. The study provides further evidence that cash flow rights do not perfectly predict ex post payouts.

Christine Parlour
Professor, Haas School of Business, University of California, Berkeley
Andrew Winton
Professor, Carlson School of Management, University of Minnesota

"Credit Risk Transfer and Bank Lending"

This paper studies how banks and lending institutions would optimally choose to allocate and/or sell off business risks implicit in their own loan portfolios. In particular, it develops a theoretical framework and model in which financial institutions who loan to entrepreneurs can decide to reallocate risk by either selling loans to third parties or alternatively insuring against risks through the credit default swap (CDS) market. Although these two approaches for laying off risk might appear to be substitutes for one another on first blush, there can be conditions under which the bank would strictly prefer one vehicle to the other. Our analysis characterizes many of these conditions, which in turn generate empirical predictions on prices in the loan and CDS markets.

David Aboody
Professor, Anderson School of Management, University of California, Los Angeles
Ron Kasznik
Professor, Graduate School of Business, Stanford University

"Executive Stock-Based Compensation and Firms' Cash Payout: The Role of the Shareholder"

This study investigates the extent to which the structure of executive stock-based compensation helps to align managers' cash payout choices with shareholders' tax-related payout preferences. Specifically, shareholders' preferences between dividends, which are taxed as ordinary income, and stock repurchases, which can result in gains taxed as long-term capital gains, can depend on the relative magnitudes of their tax consequences. Similarly, to the extent that executives make payout choices that increase their compensation, stock options, which are not dividend-protected, can induce managers to favor repurchases over dividends as a form of payout. In contrast, compensation in the form of restricted stock, which is dividend-protected, is more likely to induce the use of dividends. To test our hypothesis that the structure of executive stock-based compensation aligns managers' payout choices with shareholders' payout preferences, we investigate whether exogenous changes in shareholders' tax-related payout preferences following the recent dividend tax rate reduction result in predictable shifts in executive stock-based compensation and in managers' payout choices. Consistent with our predictions, we find that, for firms with a greater percentage ownership by individual investors, firms with stronger shareholder rights, and firms with lower financial reporting costs associated with substituting restricted stock for stock options, there is a significantly positive relation between changes in the use of restricted stock in executive compensation and changes in the use of dividends in firms' payout. The findings for changes in the use of stock options are consistent with, albeit somewhat weaker than, the findings for changes in the use of restricted stock. Our hypothesis and empirical findings that shareholders' tax-related payout preferences play a role in the design of executive stock-based compensation extend the prior literature that has largely focused on the role of incentive contracts in inducing managerial effort and retention.

Steven Bochner
Partner, Wilson Sonsini Goodrich & Rosati
Joseph Grundfest
Professor, Stanford Law School, Stanford University

"Fixing 404"

While debate persists as to whether the costs of Sarbanes- Oxley's Section 404 regulations exceed their benefits, there is far broader consensus that the rule's first year implementation was inefficient. In the words of the PCAOB's former chairman, "the first round of internal control audits cost too much." Second year Section 404 costs appear to have declined.

"Fixing 404" continued

Significant dispute remains, however, over the magnitude of the decline, and concern persists that Section 404 continues to impose inefficient costs. This article discusses numerous factors that contribute to Section 404's cost-inefficiency. Substantively, the terms "material weakness" and "significant deficiency" are still too open-ended to provide significant guidance. To the extent that auditors have, in fact, looked to these core definitional terms to drive their control audit practices, it is not difficult to understand how and why the process is inefficient. Moreover, economic and political environments in which Section 404 rules are implemented generate a powerful tropism for inefficient hyper-enforcement, and auditors have little incentive to dampen it. To address these concerns, the SEC and PCAOB should move forward with their recently stated intention to amend Auditing Standard No. 2 to incorporate many of the observations found in their later policy statements and reports, and to redefine the objective of the internal controls audit process so as to eliminate the need to examine controls that are unlikely to have a material effect. The PCAOB should also act on its recently stated intent to focus on cost-inefficient Section 404 practices in its audit firm inspection process.