Corporate Finance and Governance

Cases, Materials, and Problems for an Advanced Course in Corporations

THIRD EDITION

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Carolina Academic Press
Durham, North Carolina
For Alex
L.E.M.

To the memory of my father
L.A.C.

For Peter (happy 3rd birthday!)
J.J.H.
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Preface to the Third Edition

The study of corporate finance by lawyers has exploded. At one time the subject was limited principally to an examination of the legal capital rules in a segment of the basic course on corporations. Today, a separate course in corporate finance is part of the business curriculum at most law schools, and the study ranges from the lawyer’s traditional world of legal capital to market-based methods of valuation once reserved to the business school curriculum.

There are a number of reasons for this development. One is the increasing complexity and sophistication of the American and world financial markets, with the proliferation of new financial instruments having uncertain legal characteristics. Another is the humble rise of securitization as a means of financing beginning in the 1970s and its evolution into a more than $6 trillion industry. Yet another is the effect of the takeover boom of the 1980s, not only on the development of financing techniques such as original issue junk bonds but on the rights of security holders in target corporations and the legal understanding of the nature of the corporate form. Of further importance has been the influence of law and economics, first on academic lawyers and, increasingly, on judges and legislators. The result of these factors has been a radical rethinking of the nature of the corporate form, basic principles of corporate governance, the rights of security holders and, correspondingly, the duties of corporate management.

There are a number of reasons for corporate lawyers to study corporate finance. The first, and most practical, is that finance is the essence of any corporate law practice. Private placements, public offerings, debt issuances, securitizations, stock issuances, leveraged transactions, mergers, recapitalizations and the like are all important financing techniques, and the lawyer who lacks at least a rudimentary understanding of the basic business principles involved will be inadequately prepared to draft contracts and financial instruments, let alone counsel her client. The legal consequences of these financing techniques are themselves a part of the cost/benefit analysis that goes into the decision to undertake them, so the lawyer, to have meaningful input into the decisionmaking process, must be equipped to assist in this evaluation. Finally, on a broader professional level, the theory and practice of corporate finance has significant societal consequences, both internal and external to the corporation, and an understanding and appreciation of these consequences is the responsibility of every business lawyer.

This book is centered around two organizing themes. The first is that none of the difficult questions of corporate law (including the scope of corporate law itself) can be resolved without an underlying theory of the corporation. We suspect that judges mostly assume a theory of the corporation in resolving disputes which rarely is explicit in the opinion (or even consciously acknowledged by the judge). The same is often true of corporate scholars, and appears particularly true of legislators. Finance theory also is influenced by, or influences, the theory of the corporate form. We thus begin by pre-
senting a variety of theories of the corporation, both of ancient (in terms of corporate law) and recent vintage, to serve as an organizing theme for the materials that follow.

The second organizing theme of this book is that most difficult corporate law questions revolve around the tension created between principles of fiduciary duty and contract upon which corporate law is based, and that judicial decisionmaking reveals a constant readjustment of these principles within the context of corporate law. The extent to which one predominates in a given case is often a reflection of the judge’s theory of the corporation, but again it rarely is acknowledged. A self-conscious analysis of this issue ought to bring greater understanding to corporate law problems and result in more coherent resolutions of those problems.

What has changed in the Third Edition?

In addition to updating the materials presented in the Second Edition, we have streamlined and reorganized those materials in order to make learning easier. In particular:

- **chapter 1** (The Corporate Form: Theories and Consequences) and **chapter 2** (Limited Liability—A Central Problem in Corporate Finance) have been reduced in length without, in our view, any meaningful reduction in the substance they convey.

- **chapter 3** (Valuation) has been reorganized and enhanced in recognition of the central role that valuation plays in corporate finance. We also added a section on behavioral finance and its impact on investor behavior.

- **chapter 4** (Managing Risk (Hedging) with Derivatives) is a new chapter that includes the derivative materials formerly found in chapter 3. In addition to reorganizing the materials, we provide enhanced coverage of the four building blocks of derivatives—options, forwards, futures and swaps. We also discuss derivatives as tools for both risk reduction and speculation. We finish by examining how the courts are adjudicating disputes involving derivatives.

- **chapter 5** (The Rights of Contract Claimants—Part 1: Holders of Debt Securities) has been completely reorganized. We lead with materials on the use of leverage and the characteristics of debt securities generally that had previously appeared in chapter 7. We then discuss the valuation of debt securities before launching into an extended section addressing the legal treatment of debt securities. We then added a section addressing other participants in debt offerings, to wit, underwriters, indenture trustees and rating agencies. We then provide materials on the bankruptcy rights of debtholders. We finish by focusing on advanced debt topics, including a new subsection on asset-backed securitization.

- **chapter 6** (The Rights of Contract Claimants—Part 2: Preferred Stock) has been significantly reorganized and expanded. Included at the chapter’s end is an excerpt from Larry Mitchell’s seminal article on preferred stock: “The Puzzling Paradox of Preferred Stock (And Why We Should Care About It),” 51 Bus. Law. 443 (1996). This excerpt thoughtfully ties together all of the themes presented earlier in this chapter.

- **chapter 7** (The Rights of Contract Claimants—Part 2: Convertible Securities) is a new chapter that brings all the materials on convertible securities together in one place. The chapter begins with an explanation of the economics of, and justifications for, convertible securities (both convertible debt and convertible pre-
ferred stock). It then provides and extended discussion of, and substantial materials covering, the obligation of an issuer to protect the conversion rights of its convertible securityholders.

- **chapter 8** (The Rights of Ownership Claimants—Part 1: General Concepts) begins with a discussion of the nature of fiduciary duty generally. It then provides extensive coverage of a variety of substantive topics: dividend policy and the legal rules affecting dividends; redemptions and repurchases of common stock; preemptive rights and dilution; and recapitalizations and restructurings. It finishes with materials addressing the intersection between fiduciary duty and corporate democracy.

- **chapter 9** (The Rights of Ownership Claimants—Part 2: Mergers and Acquisitions) is essentially a new chapter dedicated to legal issues arising in mergers and acquisitions. In this context, the duty of care and the business judgment rule are first explored. A board’s duty of loyalty is then examined in light of its decision to sell the company, adopt defensive strategies, and enter into transactions with controlling stockholders. The chapter finishes with a discussion of antitakeover legislation and the *de facto* merger doctrine.

Leading the charge on the *Third Edition* is our new co-author, Jeffrey J. Haas. Jeff brings a wealth of both real world and scholarly insights to the book. In addition to updating and reorganizing all of the materials, he was responsible for enhancing the chapters and materials on valuation, derivative instruments, asset-backed securitization, convertible securities and mergers and acquisitions.

At the same time, we wish to thank our former co-author, Lewis D. Solomon, who worked on the first two editions of this book. We wish Lew well with the exciting new projects he is pursuing.

L.E.M.
L.A.C.
J.J.H.
January 1, 2006
Acknowledgments

Each of the people and organizations listed below has helped to make this project a reality, and each of them is a part of this book.


The lion’s share of the work on the Third Edition took place during the Summer of 2005. It could not have happened without the Herculean efforts of the following New York Law School student research assistants: Matthew Rench (‘06), Antar P. Jones (‘06), Lucia Freda (‘07) and Patricia E. Cleary (‘06). In addition, sincere thanks go out to the New York Law School library staff, particularly Grace E. Lee. The financial support of New York Law School, and the personal support and encouragement of Dean Richard A. Matasar and Associate Dean Stephen J. Ellmann, are also gratefully acknowledged.


Special thanks are due to Pat Ryan, whose insightful comments and feedback based on his usage of the prior edition were very helpful to us in improving the book. Additional thanks are due in the second edition to Geoffrey Barrow whose research help was very valuable, and Ross Issacs whose formatting of the manuscript saved us weeks of work. Thanks are also due to Andrew Buck, who proofread parts of the manuscript, to students at the Benjamin N. Cardozo School of Law who helped test portions of the manuscript in class, and to former Cardozo Dean Frank J. Macchiarola, who also provided generous financial support. The financial support of Cardozo’s Samuel and Ronnie Heyman Center on Corporate Governance is also gratefully acknowledged.

First Edition (1992)

A number of people helped make this project a reality and are due our sincerest thanks. Alex Seita, of the Albany Law School faculty, was patient in helping us with aspects of bankruptcy law. Bob Tymann sat through the first course in which the materials were taught, and offered helpful insights on the teachability of the book. On the research assistant front (all of whom are or were students at Albany Law School during the progress of this book) Arete Konogiannis and Laurie Marsh helped get the book started. Mike Williams and Matt Walko did the lion’s share of work as consummate professionals and without either of them this project would have suffered, both professionally and in terms of enjoyment. Mike is equally responsible with us for the development and preparation of chapter 3, and it is fair to say that without his dedication and insight it would have been substantially harder to complete this book. Jim Barriere was helpful in putting together much of chapter 6 and in keeping us abreast of current developments in corporate theory. Russ Siddiqi kept us up to the minute on business developments and provided creative insight into much of the takeover materials. Renee Doyle provided important information on a variety of topics and was of tremendous help in producing the manuscript. Finally, Abbie Baynes, a student at the National Law Center of George Washington University, contributed her efforts to section 1 of chapter 7.
ACKNOWLEDGMENTS

The staff of the Schaffer Law Library at Albany Law School was very patient, and particular thanks are due Mary Wood, who promptly filled all our inter-library loan requests, and Bob Emery, who seems to know everything! Dean Martin H. Belsky of Albany Law School provided generous financial support.

Michelle Sasso continued to prove her infallibility in typing the manuscript and Theresa Colbert (who typed part of the manuscript) was helpful in her secretarial assistance and ability to keep us organized. Dave Foss contributed his efforts in pulling together the final product.
I resist any thing better than my own diversity….

Walt Whitman

*Song of Myself*