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Business Organization and Finance

Legal and Economic Principles

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William A. Klein, John C. Coffee, Jr., and Frank Partnoy

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BUSINESS ORGANIZATION AND FINANCE

LEGAL

AND

ECONOMIC PRINCIPLES

ELEVENTH EDITION

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PREFACE

The principal objective of this book is to explain, in simple terms but not simplistically, (a) the basic economic elements and legal principles, as well as the language, of business organization and finance; (b) the interrelationships between and among the economic elements and legal principles; and (c) the practical importance of a basic understanding of those elements, principles, and interrelationships. While we like to think that the book contains some sophisticated ideas, we have tried to make it understandable for a person with no background whatsoever in business, in accounting, in economics, or in law. As our audience, we have tried to keep in mind a bright young woman or man from a family of musicians, with a college major in English, now entering a law school or a graduate school of business—on the brink of discovering, with great surprise, that the study of business can be interesting and enjoyable, as well as profitable, and that it need not be intimidating. Another important goal was to humanize big business; to overcome a natural tendency to think of corporations, especially those big enough to have become household names, as bloodless entities; to show that the word "corporation" or a name such as "General Motors" is nothing more than a shorthand device for describing a complex set of relationships among people—people with all the human characteristics of the readers and their friends; and to demonstrate that an awareness of this reality is essential to understanding and learning how to deal with this kind of complex socioeconomic organization.

Because the book is intended for a bright but untutored audience, the order in which topics are considered reflects our intuitive sense of the order in which questions might occur to, and need to be answered for, such a reader. To that extent, we have abandoned a potentially more sophisticated logic that would have focused on such fundamental structural issues as control, risk and return, duration (including termination and withdrawal), conflicts of interest, and additional capital needs. We have also followed the traditional format of separating the law of proprietorship (agency), partnership, and corporations, resisting the temptation to demonstrate how each of these can best be seen as a set of legal rules resolving in different ways the underlying structural issues. We assume, however, that a thoughtful reader will ultimately be unable to avoid recognition and appreciation of that basic theme and its importance to an understanding of business organization.

The final three chapters are concerned with the field known as "corporate finance." At a superficial level, there is a break between these chapters and the three that precede them. Yet there is continuity as well. The various corporate securities (common stock, bonds, etc.) and market instruments (options, margin loans, etc.) that are discussed in Chapter 4 can perhaps best be understood as devices for allocating control, risk, and return and for resolving other issues that are the underlying focal points of the first three chapters. Thus, Chapter 4 represents an effort to provide an understanding not just of the formal characteristics of financial instruments but of their economic function as well. In Chapter 5 the inquiry turns to valuation and considers the question of what difference it might make in the valuation of an enterprise whether control, risk, etc., are allocated one way rather than another. Chapter 5 also reviews some of the recent literature on relationships between managers and shareholders and on financial theory and contains a description of the markets in which securities are issued and traded. Finally, Chapter 6 analyzes the complexities of modern financial markets, and how they affect both the allocation of control, risk, and return, as well as the tensions and conflicts that arise in business relationships. Chapter 6 includes an assessment of the recent financial crisis, as well as the challenges presented by new technologies, structured finance, and derivatives.

This edition of the book—its eleventh over the span of nearly three decades—will be the last to list William A. Klein as an author. Although Professor Klein will be retiring from the book as co-author with this edition, his indelible imprint will remain. This book was his brainchild and will remain committed to his goal that an introduction to finance could be presented in a simple, direct style that minimized jargon and maximized lucidity. The remaining authors will try and live up to the standard of cogency that he set.

JOHN C. COFFEE, JR.
FRANK PARTNOY

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INTRODUCTION

We begin with an overview describing briefly (a) the *people*, or *participants*, involved in business ventures, categorized according to their economic roles, (b) the business *issues* with which they should be concerned (the economic *elements* of their relationship) and the constraints on their ability to achieve their goals, and (c) the *legal rules and devices* that are used to achieve their organizational or contractual objectives.

I. PARTICIPANTS

The central figures in business organization are the owners and managerial employees, but lenders may also play an important role (for example, by imposing limitations on an owner's freedom to hire or fire a manager or to expand the business), and often it is important to consider relationships with suppliers, customers, franchisees, and other people who may affect the way the business operates.

An *owner* has what is called an *equity* or *residual* interest in the business. Consider, by analogy, a person, Pamela, who buys a house, for use as her personal residence, using $25,000 of her own money, plus $75,000 borrowed from a bank, to pay the total purchase price of $100,000. The bank has a *fixed claim* for periodic interest payments and for ultimate repayment of the $75,000. The bank is sometimes said to hold the debt interest or debt claim in the house and Pamela the equity. Pamela's equity gives her a residual claim because when the house is sold and the debt must be paid (or assumed by the new buyer), Pamela receives whatever is left of the total sale price. For example, if the house is sold for $90,000, then, assuming none of the $75,000 debt has previously been paid off, Pamela will wind up with $15,000; if the house is sold for $120,000, she will wind up with $45,000. If Pamela were to rent the house to a tenant, she would receive the rent payments (barring misfortune) and would retain whatever is left of these amounts after paying the loan interest, taxes, and other expenses; that is, she would retain the residual. The holder of a residual claim is subject to greater risk of gain or loss than is the holder of a fixed claim. (These ideas are examined more fully in Chapter 1, Sec. II(F).)

Like the owner of a house, the owner of a business has a residual claim in the cash flows that it generates. The owner of a business will also have *control*—that is, the right to decide how the business is operated. The control of an owner may, however, be limited by agreement with a lender or other participant or by the practical necessity of delegating decision-making power to managerial employees.

There may, of course, be more than one owner of a business. Indeed, much of what is interesting and important about business organization is the set of relationships among owners.

The categories of owner, employee, and lender are useful ideal types, but one of the goals of this book is to show how they may merge with one another—how they form the ends of a spectrum along which one can move by varying the terms of the agreements among them. Thus, an ideal-type owner has the full residual claim and full control. An ideal-type employee has a fixed claim, to a salary, and is obligated to follow the directions (accede to the control) of the owner. But part or all of the employee's compensation may be a bonus based on profits, which is a residual-type claim that moves the employee along the spectrum in the direction of ownership. An employee with this kind of residual claim may bargain for the right to hire and fire all subordinate employees, thereby gaining a degree of control that moves her or him even closer to the status of an owner. Similarly, a lender may bargain for the right not only to fixed interest payments but also to some portion of any gain on the sale of the business and may have the right to veto the selection of key managerial employees. Moreover, the greater the amount of the debt in relationship to the total value of the business, the greater the risk to the lender and the further the lender moves along the spectrum from lender to owner.

II. BARGAIN ELEMENTS AND CONSTRAINTS

A. Bargain Elements

In business relationships, the fundamental bargain elements, which people in business may refer to as the basic "deal points," can be described by four general concepts or terms: (a) risk of loss, (b) return, (c) control, and (d) duration. These elements are interrelated, so the person with the greatest risk of loss generally will have control, the importance of control increases as duration increases, etc. (See Chapter 1, Sec. XII.)

Risk of loss refers to the allocation among the participants of losses from the investment in or operation of the business. If the business fails, who pays, or bears the burden of, debts, who is entitled to what portion of any remaining assets, etc.?

Return refers to salaries, interest, and other fixed claims, and to shares of the residual (the profit). Division of the residual presents some of the most interesting possibilities. For example, partners A and B might agree to split profits equally or they might agree that A will receive the first $10,000, that they will split the next $30,000 equally, and that B will receive 75 percent and A will receive 25 percent of all profits above $40,000. They might agree to pay some share of profits to a manager. They might grant to a lender an option to convert its fixed claim into some share of the residual (with, perhaps, a corresponding