Petri Mäntysaari

The Law of Corporate Finance: General Principles and EU Law

Volume III: Funding, Exit, Takeovers

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The Law of Corporate Finance: General Principles and EU Law

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1 Introduction

1.1 Cash Flow, Risk, Agency, Information, Investments

The first volume dealt with the management of: cash flow (and the exchange of goods and services); risk; agency relationships; and information. The firm manages these aspects by legal tools and practices in the context of all commercial transactions.

The second volume discussed investments. As voluntary contracts belong to the most important legal tools available to the firm, the second volume provided an introduction to the general legal aspects of generic investment contracts and payment obligations.

This volume discusses funding transactions, exit, and a particular category of decisions raising existential questions (business acquisitions). Transactions which can be regarded as funding transactions from the perspective of a firm raising the funding can be regarded as investment transactions from the perspective of an investor that provides the funding. Although the perspective chosen in this volume is that of a firm raising funding, this volume will simultaneously provide information about the legal aspects of many investment transactions.

1.2 Funding, Exit, Acquisitions

Funding transactions are obviously an important way to manage cash flow. All investments will have to be funded in some way or another. The firm's funding mix will also influence risk in many ways.

Funding. The most important way to raise funding is through retained profits and by using existing assets more efficiently. The firm can also borrow money from a bank, or issue debt, equity, or mezzanine securities to a small group of investors.

Securities can also be issued to the public. In this case, the management of information will play a central role. For example, the marketing of securities to the public is constrained by the mandatory provisions of securities markets laws, and there can be ongoing disclosure and other obligations for issuers.

Exit. The firm must manage exit-related questions in two contexts. First, the firm's own investors will want an exit at some point of time. There is a very wide range of exit forms depending on the investment. For example, an investor can sell his claims to another investor, the company can make payments to an investor

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who wants out, the company can merge with another company, or there can be an IPO. Exit can influence the firm's cash flow and create risks. Second, the firm will act as an investor itself. In this case, it must manage its own exit.

Business acquisitions (existential decisions). Business acquisitions belong to the largest investments that the firm will make. The acquisition must also be funded in some way or another. For example, the buyer might issue securities to the public, a small number of investors, or the sellers. Alternatively, it might borrow money from a bank.

For the target firm, business acquisitions can raise existential questions. For example, the target's board may have to decide whether the target should remain independent or accept a takeover proposal. In addition to business acquisitions, existential questions are normally raised by corporate insolvency (which will fall outside the scope of this book).

Business acquisitions are legally complicated, and they involve the use of most legal instruments discussed in Volumes I–II. Typically, there is a contract between the buyer and the seller. The management of information plays a major role in this context.

1.3 Financial Crisis

The financial market crisis that began in mid-2007 affected the funding of firms on a very large scale. There was a "Minsky moment". The legal aspects of funding and exit transactions nevertheless remain unchanged. The same legal tools and practices that were available before the crisis will be available even after the crisis.

On the other hand, the financial crisis increased risk-awareness. One can therefore assume that risks will be managed more carefully immediately after the crisis (before firms again become less risk averse and start reacting to the fear of negative things occurring rather than risk as such).

Before the crisis, there was a trend towards higher and higher leverage. During the crisis, it became more difficult for non-financial firms to raise debt funding. As a result, it became vital for firms to have enough equity on the balance sheet and to ensure liquidity by hoarding cash. After the crisis, firms may again have better access to debt funding.

One of the things that could change the funding mix of firms after the financial crisis is the choice of principal. The trend towards higher leverage was partly caused by the choice of shareholders as the most important principal in corporate governance. However, firms whose managers choose to further the long-term interests of the firm rather than the short-term interests of its shareholders are more likely to survive in the long term.

2 Funding: Introduction

2.1 General Remarks

The purpose of Chapters 2–7 is to discuss the legal aspects of the most important forms of funding from the perspective of a non-financial firm. There are various forms of external funding ranging from traditional debt and shareholders' capital to mezzanine capital. The firm can also release capital and retain earnings. The purpose of this chapter is to provide an overview.

2.2 Separation of Investment and Funding Decisions?

There can be different views in financial economics and corporate finance law (as well as business practice) about whether investment and funding decisions are separate decisions.

Financial economics. In financial economics, funding and investment decisions are separate decisions. When the firm considers the acquisition of an asset, it should estimate the cash flows that are expected to arise from the ownership of the asset. These should then be discounted at a rate that reflects the risk associated with those cash flows. The asset should be acquired if the net present value (NPV) is positive. How the acquisition should be financed is another matter.[1]

According to the *separation theorem*, investment and financing decisions can be separated if there is an opportunity to borrow and lend money (the Fisher-Hirshleifer separation theorem first identified by Irving Fisher). Investment decisions and financing decisions should thus be made independently of one another.

The separation theorem has three important implications: First, the firm should invest in projects that make it wealthier. Second, the personal investment preferences of individual "owners" are irrelevant in making corporate investment decisions, because individual "owners" can maximise their personal preferences for themselves Third, the financing method does not affect the "owners'" wealth.

The separation theorem is complemented by the *unanimity proposition* according to which firms need not worry about making decisions which reconcile conflicting shareholder interests, because all shareholders are thought to share the same interests and should therefore support the same decisions.

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[1] See, for example, McLaney E, Business Finance. Sixth edition. Pearson Education, Harlow (2003) p 237.

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However, the unanimity proposition does not describe corporate reality very well. For example, because of private benefits of control, company decisions affect the interests of the controlling shareholder in ways other than through the decision's impact on the value of the company. In company groups, the business interests of the parent or the group as a whole normally affect decision-making in companies belonging to the group.[2]

In Volume I, it was argued that shareholders cannot be regarded as the firm's "owners" in the first place and that they do not share the same interests.

Corporate finance law. In corporate finance law, questions of funding and investment are, for four reasons, very often connected.

First, the providers of funding also provide ancillary services (section 2.3 below). Who holds the claim in general matters.[3] Some investments are not possible without the ancillary services of certain finance providers.

Second, the firm cannot acquire any asset without funding. (a) Very often the acquisition and funding are part of the same contractual framework. Such cases range from simple purchases of supplies or equipment (section 3.4.2) and simple financial leasing transactions (section 3.3.3) to asset-backed or structured finance (section 3.4.4), and generally to large transactions in which the availability of funding is a typical condition precedent to closing (Chapter 20). (b) Even where the acquisition and funding are not part of the same contract framework, the availability of external funding can influence the amount that the firm can invest or the price that it can pay. For example, the availability of debt funding can depend on whether potential lenders believe that the cash flows from the asset enable those debts to be repaid or whether the asset can be used as collateral. The structuring of the acquisition can therefore be influenced by the interests of the lenders and other investors and depend on the structuring of the funding transaction.

The connection between investment and funding decisions can be illustrated by the takeovers of Chrysler, an American car manufacturer, and ABN Amro, a Dutch bank.

Chrysler. In 2007, the suddenly tightening market for corporate debt and the high volatility of stock markets meant that many leveraged buyouts either collapsed or had to be re-negotiated because the banks that had agreed to lend money began to press for better terms. Cerberus Capital Management, which agreed to acquire the Chrysler Group from Daimler-Chrysler, had to re-negotiate its deal just before closing. Cerberus had to provide more equity, and the seller had to lend some of the money to Cerberus.

ABN Amro. In the ABN Amro case, there were two competing bids in 2007. Barclays Bank, an English bank, noticed that a consortium led by Royal Bank of Scotland, a Scottish Bank, had submitted a higher bid for ABN Amro. Barclays Bank then brought on board two strategic investors, China Development Bank, a state-owned bank, and Temasek, Singapore's government investment vehicle. They agreed to subscribe for shares in Barclays Bank. This enabled Barclays Bank to revise its offer.

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2 See also Gilson RJ, Controlling Shareholders and Corporate Governance: Complicating the Comparative Taxonomy, Harv L R 119 (2006) p 1665.

3 Tirole J, The Theory of Corporate Finance. Princeton U P, Princeton and Oxford (2006) p 75.

Third, when choosing the funding mix, part of the firm's risk management is to take into account the assets being financed. Firms that are safe, produce steady cash flows, and have easily redeployable assets that they can pledge as collateral can afford high debt-to-equity ratios. In contrast, risky firms, firms with little current cash flows, and firms with intangible assets, tend to have low leverage. Companies whose value consists largely of intangible growth options have significantly lower leverage ratios than companies whose value is represented primarily by tangible assets.[4]

The fate of Northern Rock, a British mortgage bank, is an example of the relationship between the assets being financed and funding. Northern Rock relied largely on short-term borrowing from the capital market to fund its mortgage lending practices and to offer more attractive mortgage rates than its conservative competitors. When the interbank market was temporarily disrupted, Northern Rock faced a liquidity crisis and anxious customers queued up wanting to take their money out. In 2007, Northern Rock became the first British lender in 30 years to be granted a bailout by the Bank of England. The problems of Northern Rock were largely caused by its business model.

Fourth, a funding transaction can be someone else's investment transaction, and the legal framework of the transaction must address the concerns of both parties.

2.3 Forms of Funding, Funding Mix, Ancillary Services

All investments must be funded in one way or another. In addition to other investments, the firm will need to hoard reserves as part of its overall liquidity and risk management in order to mitigate the risk of liquidity shortages.[5]

Funding mix, ancillary services. From the firm's perspective, the typical forms of funding are: retained earnings; capital released by the firm; debt; shareholders' capital (equity); and mezzanine. There can be even other forms of funding ranging from the investments of asset investors (sections 3.3.1 and 9.2) to state aids (see Volume II).

The firm will thus choose a *funding mix* by weighing up the financial, commercial, and legal advantages and disadvantages of different sources of funding. The funding mix depends on: the availability and cost of capital; corporate risk management and the management of agency relationships between the firm as principal and investors as agents (Volume I); the ancillary services provided by the investors; and other things.

Providers of external funding can provide *ancillary services* such as signalling services, monitoring services, management services, access to markets, access to technology, and so forth. For example, shareholders' company law rights partly

4 Tirole J, *op cit*, pp 99–100. See also Ferran E, Principles of Corporate Finance Law. OUP, Oxford (2008) p 63, citing Myers SC, Capital Structure, J Econ Persp 15 (2001) pp 81–102 at pp 82–84.

5 Tirole J, *op cit*, pp 199–200. See also Desperately seeking a cash cure, The Economist, November 2008.

facilitate the provision of ancillary services (Volume I). The provision of ancillary services is sometimes based on particular contract terms (joint-venture agreements, venture capital, project finance, shareholders' agreements, and so forth). The scope of ancillary services depends on the form of funding, the investor, the firm's needs, and other things.

For example, shareholders have particular functions in a limited-liability company (Volume I). In a large listed company with dispersed share ownership and mainly short-term shareholders, few shareholders have actually provided funding by subscribing for new shares. However, many shareholders have a pricing and monitoring role. In an industrial firm, block-ownership can facilitate an industrial partnership. In a venture capital transaction, an equity investment is often combined with the provision of management services.

The Second Company Law Directive provides that the subscribed capital may be formed only of assets capable of economic assessment and that an undertaking to perform work or supply services may not form part of these assets.[6]

The *overall cost* of funding is not limited to the direct costs of capital. The overall cost of funding depends also on the value and cost of ancillary services. The firm's choices can reflect the *relative weight* of different parties as providers of funding and ancillary services.

For example, a listed company's share buyback programme can decrease the value of its publicly-traded bonds and lower its credit rating. Its choices can therefore reflect the relative weight of bondholders and shareholders as providers of funding and ancillary services. Before the financial crisis that began in 2007, share buyback programmes were used as a takeover defence designed to increase the share price and the cost of a takeover. During the crisis, it became important to hoard liquidity. Share buyback programmes were not necessary, because the hostile bidders would have been unable to finance their bids.[7]

Furthermore, *corporate risk management* plays a very important role, because the firm's funding mix influences its risk profile (Volume I).

This has also been recognised by the Bank for International Settlements: "A bank's ability to withstand uncertain market conditions is bolstered by maintaining a strong capital position that accounts for potential changes in the bank's strategy and volatility in market conditions over time. Banks should focus on effective and efficient capital planning, as well as long-term capital maintenance."[8]

Different forms of funding have different *legal and commercial characteristics*. There are differences relating to both funding aspects and the typical ancillary services. (a) For example, borrowing is flexible, but the firm must repay its debts and

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6 Article 7 of Directive 77/91/EEC (Second Company Law Directive). See also Articles 10, 10a, and 10b on consideration other than in cash.

7 Knop C, Koch B, Köhn R, Frühauf M, Psotta M, Preuß S, Das Ende der Aktienrückkauf-Programme, FAZ, 26 March 2009 p 15.

8 BIS, Basel Committee on Banking Supervision, Proposed enhancements to the Basel II framework. Consultative Document (January 2009), Supplemental Pillar 2 Guidance, paragraph 10.

pay interest.[9] (b) In contrast, the repayment of shareholders' capital is subject to restrictions, but shareholders typically demand a higher return because of the equity nature of their claims. Furthermore, shareholders may increase the cost of shareholders' capital by using their legal and de facto powers. For example, they may be able to force the company to distribute more funds to shareholders in the short term. In addition, the issuing of shares can change the share ownership structure of the company and vest shareholders' rights in the subscribers of the new shares. (c) The cost of debt and shareholders' capital is normally influenced by tax laws.

As a result, some forms of funding are more popular than others. *Tirole* has summarised the result of several studies as follows: "In all [studied] countries, internal financing (retained earnings) constitutes the dominant source of finance. Bank loans usually provide the bulk of external financing, well ahead of new equity issues, which account for a small fraction of new financing in all major OECD countries."[10]

Corporate finance has not succeeded in explaining the capital structure of firms. In two papers, published in 1958 and 1963, Franco Modigliani and Merton Miller argued that a firm's financial structure made no difference to its total value and was therefore irrelevant. According to them, managers and owners should therefore devote themselves to maximising the value of their firms and waste no time thinking about gearing and dividends.

However, the Modigliani-Miller theorem does not hold in a world with agency costs, asymmetric information, and other market imperfections. The choice of the financial structure of the firm can affect its value. The irrelevance theory is true only in circumstances so rare that they are the exception rather than the rule.[11]

There is no universal theory of the debt-equity choice. There are several conditional theories. The three major competing theories of capital structure are the trade-off theory, the pecking-order theory, and the free cash flow theory.[12]

Shareholders' capital. In perfect capital markets, shareholders' capital is the most expensive form of funding for the firm. Shareholders should require a higher return because of legal constraints on repayment and on distributions to shareholders.

On the other hand, the firm needs some amount of shareholders' capital as equity. Equity increases the survival chances of the firm in hard times, and shareholders' capital makes it easier for the firm to raise debt capital, because it decreases risk for debt investors. The rights of shareholders are part of the price that the firm has to pay for investor lock-up.[13]

Too much shareholders' capital can nevertheless be bad for the firm for corporate governance reasons (see Volume I). For example, the lack of debt removes an

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9 For the optimal amount of debt, see Smith CW, Warner JB, On Financial Contracting. An Analysis of Bond Covenants, J Fin Econ 7 (1979) pp 117–161 at p 154.

10 Tirole J, *op cit*, p 96.

11 Generally, see Tirole J, *op cit*.

12 Myers SC, Capital Structure, J Econ Persp 15 (2001) p 81.

13 See Hansmann H, Kraakman R, Squire R, Law and the Rise of the Firm, Harv L R 119 (2006) p 1343.