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Citation

Spence, R. A. (2017). Corporate Finance and the Role of Lawyers. *Edinburgh Student Law Review*, 3(2), 102-113. Retrieved from <https://hdl.handle.net/1887/70663>

Version: Not Applicable (or Unknown)

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Note: To cite this publication please use the final published version (if applicable).

CORPORATE FINANCE AND THE ROLE OF LAWYERS

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Edinburgh Student Law Review (2017) Volume III, Issue 2 at 102 - 113

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A. INTRODUCTION

The singular objective of corporate finance is profit maximisation. Key functions co-exist and operate in tandem within this system and play a crucial role for corporations to achieve their main purpose of maximising profit for shareholders. Performed correctly, the functions of corporate governance, capital budgeting, risk and capital structure ensure this aim is fulfilled. However, should a function falter, the whole central objective could collapse. Indeed, lawyers as “transaction cost engineers” aim to find the most economically efficient legal means to save or make a corporation money; they play a crucial role within these functions, but should they be lured into another Enron¹ or Wells Fargo² type scenario, it may also ruin their singular focus on efficiency.

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¹ R C Cramton, “Enron and the Corporate Lawyer: A Primer on Legal and Ethical Issues” (2002) 1049 Cornell Law Faculty Publication, available at:

<http://scholarship.law.cornell.edu/cgi/viewcontent.cgi?article=2223&context=facpub>.

² M Levine, “Wells Fargo Opened a Couple Million Fake Accounts” (*Bloomberg*, 9 September 2016) available at: <https://www.bloomberg.com/view/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts>.

B. WHAT IS CORPORATE FINANCE?

In essence, all financial activities of a business fall under the corporate finance remit.³ Although the definition of corporate finance is broad, the main focus is profit maximisation for shareholders,⁴ which is done through careful financial planning and investment.⁵ All day-to-day business relating to debt and finance within a corporation is passed through the corporate finance lens one way or another.⁶ To do this successfully, and lawfully, various key functions exist.

C. MANAGEMENT DECISIONS

(1) Corporate governance function

Corporate governance is of paramount importance because it dictates and regulates the practices, processes and rules by which the board of directors (BOD) “direct” and the management “control” a corporation.⁷ When executed effectively, corporate governance cannot only increase accountability, but also prevent major corporate catastrophes: the corporate fraud scandals of Enron and Wells Fargo being prime examples.⁸ Indeed, “a corporation without a system of corporate governance is like a body without a soul or conscience”.⁹ It is therefore unsurprising that corporate governance is the mechanism through which a corporation must adhere to ethical and transparent behaviour, while having regard to shareholder interests.¹⁰ Without such a function within a corporation, market participants would undoubtedly conduct their business elsewhere, which would, in turn, impair market efficiency and economic growth.¹¹

It is said that corporate governance controls are also in place to address potential conflicts of interest between the shareholders and the executive corporate directors. Managers, who have control of the company, often pursue their own best interests ahead of

³ A Damodaran, *Applied Corporate Finance* (2015) 1-3.

⁴ R Pike and B Neale, *Corporate Finance and Investment: Decisions and Strategies* (1993) 12-13.

⁵ P Moles, R Parrino and D Kidwell, *Corporate Finance* (2011) 4-7.

⁶ R Hutchinson, *Corporate Finance: Principles of Investment, Financing and Valuation* (1995) 1.

⁷ *The Report of the Committee on the Financial Aspects of Corporate Governance* (1992) (“Cadbury Report”) para 2.5.

⁸ L Lavelle, “Commentary: How Governance Rules Failed at Enron” (*Bloomberg*, 20 January 2002) available at: <http://www.bloomberg.com/bw/stories/2002-01-20/commentary-how-governance-rules-failed-at-enron>. See also, M Corkery, “Wells Fargo Struggling in Aftermath of Fraud Scandal” (*The New York Times*, 13 January 2017) available at: https://www.nytimes.com/2017/01/13/business/dealbook/wells-fargo-earnings-report.html?_r=0.

⁹ M D Madawaki, I Ahmed and A Usman, “Corporate governance: a key for creating a better Nigeria” (2014) 3(7) *International Journal of Business and Management Invention* 1 at 2.

¹⁰ J Loughrey, *Corporate Lawyers and Corporate Governance* (2011) 14-15. Moreover, in the Anglo-American tradition, the question of what duties are owed by corporate directors to non-shareholder constituencies is still very much a hotly debated moot point. In the strict legal sense, corporate directors do not owe anything to non-shareholder constituencies, even with the existence of the Companies Act 2006 s 172. See A Keay, “Tackling the issue of the Corporate Objective: An analysis of the UKs enlightened shareholder value approach” (2007) 29(4) *Sydney LR* 577 at 580-584.

¹¹ M Maher and T Andersson, *Corporate Governance: Effects on Firm Performance and Economic Growth* (1999) Organisation for Economic Co-Operation and Development 1 at 31.

those of the company.¹² Yet even with strong corporate governance procedures in place, it would appear that internal mechanics are often abused. Take, for example, the BOD. The function of the BOD is to “include setting the company’s strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship”.¹³ The BOD is supposed to be objective and independent; however, it is often the case that the BOD is comprised of subjective and partisan members. An excellent example of this was the “meek, handpicked”¹⁴ 1997 Disney Board, containing seventeen members, all of whom had ties to the chairman and CEO Michael Eisner;¹⁵ the conflict of interest could not have been greater.¹⁶ Given that self-interest is the dominant human paradigm,¹⁷ management do not always act in the interests of the company and its “members as a whole”,¹⁸ but instead, they act in their own personal interest.¹⁹

Management self-interest raises important questions about information asymmetries. Akerlof would argue that because we live in a “market for lemons”,²⁰ management have the ability to open the floodgates to abuse, corruption and selfish desires.²¹ The discretion management have as to the extent of the information disclosed ensures that there is potential for significant asymmetries between shareholders and management.²² In order to avoid such a problem, the author would argue that a rigorous corporate governance system is key; one which is designed to foster transparency by overcoming the information asymmetries correlated with business. A strong corporate governance regime, amongst other things,²³ is the mechanism by which such self-interest is kept in check.²⁴ Yet, since the collapse of Enron in 2001, unethical behaviour has become more prevalent.²⁵ One only has to look at the financial scandals within the last decade to conclude that such issues are still rife within corporate finance.²⁶ However, it would appear that most shareholders are willing to risk that

¹² This is the so-called “agency problem”. See, L A Bebchuk and J S Fried, *Executive Compensation as an Agency Problem* (2003) The National Bureau of Economic Research, available at: <http://www.nber.org/papers/w9813>.

¹³ Financial Reporting Council, *The UK Corporate Governance Code* (September 2014) 1, available at: <https://www.frc.org.uk/Our-Work/Publications/Corporate-Governance/UK-Corporate-Governance-Code-2014.pdf>.

¹⁴ C Hill and R W Painter “Comprised fiduciaries: conflicts of interest in government and business” (2011) 95 Minn LR 1637 at 1654.

¹⁵ Damodaran, *Applied Corporate Finance* (n 3) 19-21.

¹⁶ In the UK there is a duty to avoid conflicts of interest, see the Companies Act 2006, s 175(1).

¹⁷ B A Zikria, *One Home, One Family, One Future* (2010) 130.

¹⁸ Companies Act 2006, s 172(1), a director of a company in the UK has “to promote the success of the company for the benefit of its members as a whole”.

¹⁹ There are tactics which top management employ that identifies this self-interest. For example, “golden parachutes”, “greenmile” and “poison pills” to name but a few. Given the space constraint, these will not be discussed. There is also a duty to act within one’s power, see the Companies Act 2006, s 171(a) and (b).

²⁰ G A Akerlof, “The market for “lemons”: quality uncertainty and the market mechanism” (1970) 84(3) *The Quarterly Journal of Economics* 488-500.

²¹ C Cox and K Fogarty, “Basis of insider trading law” (1988) 49 *Ohio State Law Journal* 353 at 353, described as a “cancerous greed”.

²² E Avgouleas, *Governance of Global Financial Markets* (2012) 29.

²³ Financial Reporting Council, (n 13).

²⁴ *Ibid.*

²⁵ E Perrot, “An Ethical Diagnosis of the Enron Affair” in *Enron and World Finance: A Case Study in Ethics* (2006) 116.

²⁶ C Bryant and R Milne, “Boardroom Politics at heart of VW Scandal” (*Financial Times*, 2015) available at: <http://www.ft.com/cms/s/0/e816cf86-6815-11e5-a57f-21b88f7d973f.html#axzz3u2EosOAT>. See also, M Foster, “Toshiba scandal sheds harsh light on Japan’s corporate governance” (*The Guardian*, 2015) available at:

eventuality occurring because they are not best placed to commercially operate, in a day-to-day setting, the will of the corporation.

D. FINANCING DECISIONS

(1) Capital structure function

When a corporation requires capital to invest in new projects, it has to choose the most efficient and cost effective financing option. It is important to find the right capital structural mix of debt and equity to fund company operations.²⁷ Finding the right balance depends not only on what stage a corporation is in within its life cycle, but also on the corporation's strategy and future goals.²⁸ The challenge for management is "to identify the mix of securities... that minimises the cost of financing the firm's projects... [whilst maximising] the total value of those projects and, therefore, the overall value of the firm".²⁹ However, finding that optimal ratio "has proved to be something of a holy grail, highly desirable but illusory and difficult to grasp".³⁰

(a) *The debt and equity dichotomy*

Within corporate finance, the term "debt" means a corporation is reliant upon borrowed funds to be repaid with interest as an investment source in order to sustain continuing operations and prospective growth.³¹ The ratio of debt in the financing structure is a measure of the corporation's financial leverage; a higher ratio indicates a higher leverage and a lower ratio indicates a lower leverage.³² Debt finance is usually for a shorter period of time than that of equity, carrying a lower risk and lower return.³³ Debt can come from, amongst other things, bank loans, credit unions, pension funds³⁴ and corporate bonds. The main advantage of debt is that there is an "interest tax shield benefit"³⁵ – interest payments are tax deductible,³⁶ thereby reducing the cost of capital.³⁷ There is a level of certainty when budgeting in relation to interest payments due to the fixed payment dates and often prior knowledge of the interest sum. Another advantage is that the bank or lending institution has limited say in the running of the business; however, if the debtor corporation is highly leveraged, the loan agreement

<http://www.theguardian.com/business/2015/jul/21/toshiba-scandal-sheds-harsh-light-on-japans-corporate-governance>.

²⁷ There is also a third category called "hybrid securities". These include warrants, convertible bonds and preferred stock. Given the space limitation, hybrid securities will not be discussed.

²⁸ Damodaran, *Applied Corporate Finance* (n 3) 295-297.

²⁹ Moles et al, *Corporate Finance* (n 5) 620.

³⁰ Pike and Neale, *Corporate Finance* (n 4) 325. See also, S C Myers, "Capital Structure Puzzle" (1984) at 1, available at: <http://dspace.mit.edu/bitstream/handle/1721.1/2078/SWP-1548-15376697.pdf?sequence=1>. See too, J Bjorkholm and V Johansson, "Debt versus Equity: in a low interest rate environment" (2015) at 3-4, available at: <http://www.diva-portal.org/smash/get/diva2:840459/FULLTEXT01.pdf>; Pike and Neale, *Corporate Finance* (n 4) 325.

³¹ Moles et al, *Corporate Finance* (n 5) 8.

³² Moles et al, *Corporate Finance* (n 5) 620.

³³ Pike and Neale, *Corporate Finance* (n 4) 274.

³⁴ It must be noted that unlisted SMEs typically are the only sort of corporation that utilise credit unions and pension funds for financing.

³⁵ A Korteweg, "The Net Benefits of Leverage" (2010) 6 J Fin 2137 at 2140. See also, Moles et al, *Corporate Finance* (n 5) 631.

³⁶ Moles et al, *Corporate Finance* (n 5) 631.

³⁷ Pike and Neale, *Corporate Finance* (n 4) 275.

may contain prohibitions and financial covenants which require the debtor to operate in a certain manner. Nonetheless, the primary obligation is simply to pay the interest payments. Once the debt is paid off, the business relationship ends. There are however some significant disadvantages to debt financing. If a company mismanages its working capital, is too reliant on debt and enters a period of decline, then satisfying loan repayments may prove difficult, resulting in potential insolvency.³⁸ Also, carrying too much debt may be considered high risk, which in turn may limit the business's ability to raise capital in the future.³⁹

Equity, on the other hand, involves raising money by selling an ownership interest in the company. Equity financing is more long-term⁴⁰ than debt financing and carries greater risk but at the same time potentially achieves higher returns.⁴¹ Equity encompasses a broad range of sources including money raised from friends, family and venture capitalists to giant initial public offerings (IPO).⁴² A major advantage of equity financing is that the corporation is not contractually obliged to make payments to investors and can therefore manage working capital effectively in times of hardship. It can also allow access into the investors' network, which may add credibility and future financing opportunities to the business. In terms of business growth and diversification, this network may be crucial. Moreover, given that the majority of investors adopt a short-term view, they usually expect an immediate return.⁴³ However, there is no requirement for the corporation to pay back the investment if the business fails because risks and liabilities are shared.⁴⁴ A disadvantage of equity raising is that the investor will require some form of ownership in the corporation with a percentage of the profits, which may come in the form of dividends. It is also the case that before making any significant business decisions, management must consult investors with voting power for approval. In some scenarios, large investors will demand that they are represented on the BOD. It is also possible that returns made to shareholders over time, will exceed the rate of interest on the loan.⁴⁵

(b) Interplay with the financial markets

The financial markets play an important role in the capital raising process. In order to raise capital, the corporation issues debt instruments⁴⁶ and equity to investors operating in the financial markets. This results in cash flows from the capital markets to the corporation.⁴⁷

³⁸ See generally, R E Carpenter and B C Petersen, "Capital market imperfections, high-tech investment, and new equity financing" (2002) 112 *The Economic Journal* F54 at F55.

³⁹ P Peterson-Drake, "Advantage and disadvantages of the different capital budgeting techniques" (2015), available at: <http://educ.jmu.edu/~drakepp/principles/module6/advdistable.pdf>.

⁴⁰ It should be noted that shareholder time horizons are one of the most pernicious market problems of our generation. The average holding period on a share is less than a year.

⁴¹ Pike and Neale, *Corporate Finance* (n 4) 274.

⁴² R Geddes, *IPOs and Equity Offerings* (2003) 8-10.

⁴³ M Turner, "Here is the letter the world's largest investor, BlackRock CEO Larry Fink, just sent to CEOs everywhere" (2016), available at: <http://uk.businessinsider.com/blackrock-ceo-larry-fink-letter-to-sp-500-ceos-2016-2?r=US&IR=T>. See too M W Roberge, J C Flaherty, R M Almeida Jr and A C Boyd, *Lengthening the Investment Time Horizon* (2016) MFS White Paper Series, available at: https://www.mfs.com/wps/FileServerServlet?servletCommand=serveUnprotectedFileAsset&fileAssetPath=/files/documents/news/mfse_time_wp.pdf.

⁴⁴ Carpenter and Petersen (n 38) at F55.

⁴⁵ Peterson-Drake (n 39).

⁴⁶ For example, a corporate bond.

⁴⁷ Goldman Sachs, "Interactive Guide to Capital Markets" (February 2014) available at: <http://www.goldmansachs.com/s/interactive-guide-to-capital-markets/>.

This capital is then invested back into the firm for the purpose of growth and profit.⁴⁸ Raising capital is done through the primary market by issuing debt instruments or equity, which is usually underwritten by an investment banking syndicate.⁴⁹ Primary markets are crucial to raising capital, and secondary markets play an equally important role by allowing investors to buy or sell previously owned shares as they wish.⁵⁰ A strong secondary market often means investors are willing to pay a higher share price in the primary market.⁵¹

Financial markets also affect the economy and its performance by playing a significant role in contributing to its health, growth and efficiency:⁵²

Financial markets help to efficiently direct the flow of savings and investments in the economy in ways that facilitate the accumulation of capital and the production of goods and services. The combination of well developed financial markets and institutions, as well as a diverse array of financial products and instruments suits the needs of borrowers and lenders and therefore the overall economy.⁵³

Indeed, in a perfect marketplace that effectively allocates capital, corporate finance will be maximised because markets are healthy, constantly growing and highly efficient. Yet without a robust financial system, it would be very difficult to boost efficiency and growth, and thus corporate finance. For example, a financial system encompasses financial institutions and markets, who “provide a framework for carrying out economic transactions and monetary policy, and help to efficiently channel savings into investment, thereby supporting economic growth”⁵⁴ and efficiency. However, problems within the financial system can be catastrophic and, due to globalisation, can easily trigger a domino-like chain of events. The Global Financial Crisis of 2007 (GFC) is a case in point. According to the International Monetary Fund, rapid growth in the supply of credit coupled with sustained asset prices led to an accumulation of risk within the financial markets.⁵⁵ A low interest rate environment underpinned by loosely regulated monetary policies not only ensured that credit was relatively cheap; it also encouraged a search for yield that led investors to continually invest in riskier investments.⁵⁶ The GFC, which started as a monetary and interbank market liquidity seizure, quickly morphed into a global economic catastrophe, argued to be the worst since the Great Depression.⁵⁷ In order to avoid such a chain of events, it is crucial to have

⁴⁸ T S Maness, *Introduction to Corporate Finance* (1988) 10-12, also available at: <http://www.mheducation.co.uk/he/chapters/9780077121150.pdf>.

⁴⁹ Banking syndicates are in place to deal with large, complex and risky transactions.

⁵⁰ D C Mauer and L W Senbet, “The Effect of the Secondary Market on the Pricing of Initial Public Offerings: Theory and Evidence” (1992) 27(1) *Journal of Financial and Quantitative Analysis* 55 at 57.

⁵¹ Moles et al, *Corporate Finance* (n 5) 46.

⁵² D Econ, “The Federal Reserve Bank of San Francisco” (2005) available at: <http://www.frbsf.org/education/publications/doctor-econ/2005/january/financial-markets-economic-performance>.

⁵³ *Ibid.*

⁵⁴ International Monetary Fund, “Financial System Soundness” (2015) available at: <http://www.imf.org/external/np/exr/facts/banking.htm>.

⁵⁵ O Blanchard, J Caruana and R Moghadam, “Initial Lessons of the Crisis” (2009) *International Monetary Fund*, available at: <https://www.imf.org/external/np/pp/eng/2009/020609.pdf>.

⁵⁶ The Economist, “Six Years of Low Interest Rates in Search of Some Growth” (*The Economist*, 6 April 2013) available at: <http://www.economist.com/news/briefing/21575773-central-banks-have-cushioned-developed-worlds-economy-difficult-period-they-have-yet>.

⁵⁷ P Lysandrou and A Nesvetailova, *The Shadow Banking System and the Financial Crisis* (2015) Financialisation, Economy, Society and Sustainable Development Working Paper 1 at 3. See also, Y Nersisyan and L Randall-Wray, *The Global Financial Crisis and The Shift to Shadow Banking* (2010) 587 The Levy Economics Institute Working Paper 1 at 3.

well-supervised and well-regulated financial systems, not only to foster economic growth and stability, but also to maximise corporate finance.⁵⁸ Indeed, the purpose of an efficient financial system is to “create financial liquidity for those important projects that promise the highest profitability and that maximise collective utility”.⁵⁹

E. INVESTMENT DECISIONS

(1) Capital budgeting function

Capital budgeting is also a crucial function of corporate finance because its purpose is to select investments that will increase the value of the firm.⁶⁰ As long as the projected returns exceed costs⁶¹ and overcome the cost of capital⁶² hurdle rate and risk related issues, companies should strive to pursue capital investment opportunities that generate the highest profits.⁶³ The firm’s strategic plan will aid the decision-making process of deciding which capital investments should be pursued.⁶⁴ This is a crucial business decision because, for better or worse, capital investments generate the firm’s revenue.⁶⁵ However, most companies have funding constraints thus rendering their availability to expend capital limited.⁶⁶ It is therefore important for management to ration capital⁶⁷ and utilise specific capital budgeting techniques to ascertain which project will yield the greatest return.⁶⁸ Indeed, recent research shows that the net present value (NPV) and payback rule (PR) are the prevailing techniques adopted by most companies.⁶⁹

The NPV method is a widely used concept. It is a relatively basic concept that evaluates the difference between future cash flows and the present value of cost. The first stage is to establish the project’s cost by identifying and totalling expenses. The second is to estimate the future cash flows of the project. It is also important to bear in mind the risk of the project and the appropriate cost of capital. Consequently, the NPV allows management to make a balanced decision on whether or not to accept or reject a project based on this cost benefit analysis.⁷⁰

⁵⁸ *Ibid.*

⁵⁹ P Vernimmen, P Quiry, M Dallochio, Y Le Fur and A Salvi, *Corporate Finance: Theory and Practice* (2005) 268.

⁶⁰ D R Harrington, *Corporate Finance Analysis: Decisions in a Global Environment* (1993) 123-125. See too, Moles et al, *Corporate Finance* (n 5) 364-365.

⁶¹ D Allen, *Strategic Financial Decisions* (1994) 112.

⁶² The cost of capital is the rate of return that a capital investment must generate, on this see Moles et al, *Corporate Finance* (n 5) 367.

⁶³ Moles et al, *Corporate Finance* (n 5) 6 and 365.

⁶⁴ Moles et al, *Corporate Finance* (n 5) 364.

⁶⁵ *Ibid.*

⁶⁶ The term “expend capital” means “capital expenditure”, which means funds used to acquire or upgrade assets. Hereafter it will be CAPEX.

⁶⁷ Moles et al, *Corporate Finance* (n 5) 368.

⁶⁸ Harrington, *Corporate Finance Analysis* (n 60) 123.

⁶⁹ R J Lunkes, V Ripoli-Feliu, A Giner-Fillol and F Silva da Rosa, “Capital budgeting practices: a comparative study” (2015) 7(3) *Journal of Public Administration and Policy Research* 39 at 46. Other techniques are the accounting rate of return (ARR) and internal rate of return (IRR) – due to constraint on space, these techniques will not be discussed.

⁷⁰ S A Ross, “Uses, Abuses, and Alternatives to the Net-Present-Value Rule” (1995) 24(3) *FM* 96 at 97.

However, there are problems with this analysis. Estimating future cash flows is fraught with difficulties. Industry trends may hamper analyses, despite the corporation's potential expertise in a particular area which allows them to estimate all variables. One example is the transport industry's reliance upon fuel and thus crude oil.⁷¹ In July 2014 crude oil was over US\$105 per barrel as opposed to today where it is sitting at US\$49.77.⁷² Unpredictable industry trends such as these will undoubtedly have a positive or negative affect on cash flows. The problem with trying to predict future events is that the outcome will almost always be wrong.⁷³ Yet, to mitigate against such an outcome, companies take advantage of hedging techniques.⁷⁴ Indeed, business is all about dealing with uncertainty and making decisions on potential risk and future events.⁷⁵

The PR is the simplest technique and is based on the notion that a project that pays back its initial investment quickly is a good idea. To apply the PR, one must first calculate the amount of time it takes to pay back the initial investment, called the payback period. If the payback period is less than a pre-specified length of time, then one can accept the project. However, it has been argued by some commentators that the PR is not reliable because it ignores the issue of profitability, the time value of money and does not depend on the cost of capital.⁷⁶ There is also no economic rationale that connects the PR with maximising shareholder profit.⁷⁷ Yet it is still a widely used technique, probably due to its ease and simplicity.⁷⁸

(a) Risk function

One very important corporate finance function when considering investment decisions is risk. Risk is often attributed in a negative form, however, in terms of corporate finance, a better analysis would be that risk is both a danger and an opportunity.⁷⁹ Given that risk is inherent in any business, the crucial question is not how to avoid it, but how best to manage it. Considering the implications of risk, and the impact it has on financial performance, will help to determine whether the investment will produce a viable return. There are various components to consider when measuring risk: firstly, market or systemic risk, which relates to the economy, interest rates and inflation; secondly, project risk, which is factor specific; thirdly, competitive risks, which are unforeseen cash flow issues due to competitor actions; fourthly, industry specific risk, which takes into account changes in technology, the law and commodity prices; and finally, international risk, relevant because of exchange rates and

⁷¹ EUROPIA, *EUROPIA White Paper on Fuelling EU Transport: A contribution from the EU refining industry to the debate on the future of transport* (2011) 5 and 12, available at:

https://www.fuelseurope.eu/uploads/Modules/Resources/europa-whitepaper_2011_lowres_corr_secured_20042011-2011-01251-01-e-2.pdf.

⁷² As at 25 May 2017 at 5pm BST. See the NASDAQ crude oil prices, available at:

<http://www.nasdaq.com/markets/crude-oil.aspx>.

⁷³ The Economist, "Does the past predict the future?" (*The Economist*, 23 September 2009) available at:

http://www.economist.com/blogs/freeexchange/2009/09/does_the_past_predict_the_futu. See also, Peterson-Drake (n 39).

⁷⁴ The Economist, "Gambles that haven't paid off" (*The Economist*, 19 January 2015), available at:

<http://www.economist.com/blogs/gulliver/2015/01/fuel-hedging-and-airlines>.

⁷⁵ Moles, *et al*, *Corporate Finance* (n 5) 376.

⁷⁶ S A Ross, R W Westerfield and B D Jordan, *Fundamentals of Corporate Finance* (2000) 249-252. See too, Moles *et al*, *Corporate Finance* (n 5) 381.

⁷⁷ Moles *et al*, *Corporate Finance* (n 5) 377.

⁷⁸ J Berk and P DeMarzo, *Corporate Finance* (2007) 151-152. See too, Peterson-Drake (n 39).

⁷⁹ Damodaran, *Applied Corporate Finance* (n 3) 52-53.

political risk in international markets.⁸⁰ Risk is defined by what will happen in the future; there is no risk in the past. Unfortunately, there is no way to tell which risk-related issue may arise. The only protective mechanism is to hedge against risk through diversification and insurance in an attempt to mitigate loss as much as possible.⁸¹

F. LEGAL DECISIONS

(1) Role of the lawyer

The importance of lawyers within the world of corporate finance is significant. Lawyers have the ability to minimise clients' costs as much as possible due to their superior legal knowledge about the legal mechanics correlated with both capital raising and capital investing.⁸² In doing so, lawyers are able to act as a guide by manoeuvring their client through the complex legal framework, dealing with any unique or unusually prominent features along the way, and aiding them to their ultimate destination of profit maximisation.⁸³ Yet the role of the lawyer is not only about providing legal advice, "they are [also]... a wonderful resource of business advice"⁸⁴ too. It is therefore unsurprising that the role of the lawyer has shifted from being a "hired gun"⁸⁵ to a "value creating transaction cost engineer".⁸⁶ Indeed, some commentators have gone so far as to state that lawyers have "gatekeeping"⁸⁷ "guardian-like responsibilities".⁸⁸ However, these gatekeeping abilities have been challenged in recent years due to the role lawyers played in the Enron crisis.⁸⁹ Nevertheless, there are different aspects to a lawyers' role in the capital raising and capital investing processes; each will be discussed in turn.

(2) Lawyers' role in capital raising

The interplay with the financial markets is a key linchpin for many law firms because it is now a central area of business activity.⁹⁰ Lawyers are essentially viewed as an essential component in underpinning the capital raising process due to their expert advice on debt and equity financing. Lawyers work tirelessly performing their role as gatekeeper of the capital markets and they also perform a separate function as transaction cost engineers by finding the most economically efficient legal route that maximises profit for the corporation.⁹¹

⁸⁰ *Ibid* 58-60; Pike and Neale, *Corporate* (n 4) 178.

⁸¹ M N Baily and D J Elliott, *The Role of Finance in the Economy: Implications for Structural Reform of the Financial Sector* (2013) The Brookings Institution 1 at 14, available at: <https://www.brookings.edu/wp-content/uploads/2016/06/11-finance-role-in-economy-baily-elliott.pdf>.

⁸² L Bernstein, "The Silicon Valley lawyer as transaction cost engineer" (1995) 74 *Oregon LR* 239 at 246.

⁸³ *Ibid*.

⁸⁴ *Ibid* at 252.

⁸⁵ M C Suchman and M L Cahill, "The hired gun as facilitator: lawyers and the suppression of business disputes in Silicon Valley" (1996) 21(3) *Law & Social Inquiry* 679 at 681.

⁸⁶ R Gilson, "Value creation by business lawyers: legal skills and asset pricing" (1984) 94 *Yale LJ* 239 at 243. See too, Bernstein (n 82) at 241.

⁸⁷ M C Suchman, "Translation costs: a comment on sociology and economics" 74 *Oregon LR* 257 at 261-263.

⁸⁸ J C Coffee Jr, "The attorney as gatekeeper: an agenda for the SEC (2003) 103(5) *Columbia LR* 1293 at 1295.

⁸⁹ J C Coffee Jr, "Understanding Enron: it's about the gatekeepers stupid" (2002) 57(4) *The Business Lawyer* 1403-1420. See also, W H Dorton, "Corporate gatekeepers: an examination of the transactional lawyer's role (2010-2011) 99 *Kentucky LJ* 555 at 555.

⁹⁰ M Avery, M Zhu and J Cai, *China's Emerging Financial Markets: Challenges and Global Impact* (2009) 532.

⁹¹ C Pippel, "The lawyer as gatekeeper" (2004) 16(2) *Bond LR* 96 at 98.

(a) Equity

Lawyers provide an important advisory role to corporations on regulatory and legal affairs in relation to equity finance. Take, for example, an IPO,⁹² where the lawyers' role is to ensure and verify that the corporation has followed the rigorous procedures that the listing process entails.⁹³ Given that IPOs can often be very complex, and of an international nature, the role of the lawyer is particularly important. For example, say that a corporation, based in Russia and listed in the EU, wants to commence with an IPO. Offerings on the IPO are extended to other jurisdictions, such as Australia and the USA. Such complexity ensures that it is not uncommon for law firms, who have the technical expertise, to take the lead role in IPOs; this allows them to oversee the process from start to finish and beyond.⁹⁴

A lawyers' role in preparing a corporation for listing involves a vast array of functions and responsibilities. It is the lawyer who advises and manages the process of drafting and verifying the presentation materials⁹⁵ for the corporation to take to the market and raise equity. Lawyers are also responsible for drafting the prospectus, including its format and content, and managing the verification procedure whilst preparing regulatory announcements to be released in relation to the offering.⁹⁶ Legal due diligence is a key part of not only the prospectus, but also the IPO process as a whole.⁹⁷ Indeed, once submitted, the prospectus becomes a legally binding document, where the lawyers, amongst others, can be personally liable.⁹⁸ It is therefore not surprising that the whole IPO process is heavily scrutinised. Lawyers will also draft the articles of association, prepare letters of appointment for the directors and negotiate contracts and agreements for the corporation to enter into.⁹⁹

(b) Debt

The lawyer's role in underpinning the corporations' ability to raise debt will be examined by reference to a bond issuance. A bond is essentially a promise by the corporation to repay the

⁹² An IPO is not the only way for a corporation to raise equity. Non-exhaustive examples include a rights issue; share buybacks and venture capitalists to name but a few.

⁹³ Practical Law, "Listing requirements and the prospectus" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/4-107-3994#>. See also, Practical Law, "Listing rules" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/7-107-6774>.

⁹⁴ J Cash, "Clifford Chance and Simpson Thacher take the lead on Auto Trader IPO" (*Legal Week*, 15 March 2015) available at: <http://www.legalweek.com/legal-week/news/2399068/clifford-chance-and-simpson-thacher-take-the-lead-on-auto-trader-ipo>.

⁹⁵ Practical Law, "Preparing a company for an initial public offering (IPO)" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/7-107-3997#>. See also, Practical Law, "Listing requirements and the prospectus" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/4-107-3994#>.

⁹⁶ T Lott, D Loosvelt, M Phillips-Sandy and R Roberts, *Vault Career Guide to Investment Banking* (2013) 55.

⁹⁷ R de R Barondes and G C Stranger, *Lawyer Experience and IPO Pricing* (2000) 5-8.

⁹⁸ Financial Services and Markets Act 2000 s 90. See also, Clifford Chance, "Initial Public Offers: a guide to the UK regime" (2015) 69, available at: http://financialmarketstoolkit.cliffordchance.com/content/micro-facm/en/financial-markets-resources/resources-by-type/guides/a-guide-to-the-uk-listing-regime/jcr_content/parsys/download/file.res.

⁹⁹ Practical Law, "List of documents: IPO" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/6-503-0273>. It must be stressed that the IPO process explained is in no way deemed to be a complete comprehensive picture. Given the limited space, it is submitted that it would not be possible to do so. This is merely one example.

money with interest.¹⁰⁰ In this case, the lawyers' role is to draft the documents and attest that the issue is valid and legal.¹⁰¹ This also ensures that lawyers will scrutinise wording ambiguities and negotiate terms, ensuring the corporations' interests are preserved.¹⁰²

There are various documents that a lawyer must draft for a bond issue. These include, non-exhaustively, the prospectus, subscription agreement, trust deed, agreement amongst managers, legal opinion and the signing and closing memorandum.¹⁰³ Another crucial role is due diligence. The lawyer of the issuer must provide "a legal opinion on the capacity of the issuer to issue the bonds... [and the lead manager's lawyer must establish whether or not] the issuer is creditworthy".¹⁰⁴ Once the bond issue is complete, there are still significant duties that a lawyer must perform. For example, the original documents must be signed as soon as possible, the listing document must be sent to the appropriate authority¹⁰⁵ and the transaction bible¹⁰⁶ completed.

(3) Lawyers' role in capital investing

In order to invest capital in new projects, there needs to be sufficient capital raised, through either debt or equity, to provide funding.¹⁰⁷ Capital investing by a corporation is the money spent on corporeal¹⁰⁸ and incorporeal¹⁰⁹ assets in order to increase the corporations' growth, profitability and effectiveness.¹¹⁰ Underpinning these capital investments is the lawyer, whose role is not only to provide legal advice, but also pragmatic business advice.¹¹¹ Generally speaking, the role of the lawyer ultimately ensures that the capital investment is protected from unexpected liabilities. Legal advice is important because it ensures certainty, in that the agreement reflects what is being invested in. Having strong legal procedures in place from the outset will minimise unnecessary commercial risks. In order to be more specific, it is helpful to identify the various steps required from a lawyer in the capital investing process. The example that will be used is the acquisition and purchase of an existing working factory.¹¹²

¹⁰⁰ Practical Law, "Bond issues: overview" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/4-201-8058#>. See also, London Stock Exchange, "How to issue debt" (2015) available at: <http://www.londonstockexchange.com/specialist-issuers/debts-bonds/how-to-issue/how-to-issue.htm>.

¹⁰¹ Practical Law, "Bond issues: the parties" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/9-620-0507>.

¹⁰² P Mantysaari, *The Law of Corporate Finance: General Principles and EU Law – Volume III: Funding, Exit, Takeovers* (2010) 83-116.

¹⁰³ Practical Law, "Chronology of a bond issue" (2015) available at: <http://uk.practicallaw.com.ezproxy.is.ed.ac.uk/1-505-0428>.

¹⁰⁴ *Ibid.*

¹⁰⁵ The "appropriate authority" is dependent upon the related jurisdiction.

¹⁰⁶ *Ibid.* A "transaction bible" is the set of main documents signed in a deal which are grouped together for ease of reference.

¹⁰⁷ Mantysaari, *The Law of Corporate Finance* (n 102) 1-6.

¹⁰⁸ An example could be the purchase of a building.

¹⁰⁹ An example is the recent purchase of Lucasfilm by Disney, which contained the intellectual property rights for "Star Wars". On this see R Hawkes, "Star Wars lawsuits: who has Lucasfilm sued and why?" (*The Telegraph*, October 2016) available at: <http://www.telegraph.co.uk/film/star-wars-the-force-awakens/lucasfilm-trademarks-patents-copyright-lawsuits/>.

¹¹⁰ Mantysaari, *The Law of Corporate Finance* (n 102) 549.

¹¹¹ EUROPIA (n 71) para 6.1. This may include issues such as undertaking a thorough market research analysis to ensure that the investment will create value or any geographical constraints to name but a few.

¹¹² Indeed, there are many examples like investing in equipment, purchasing intellectual property rights or software.

The role of a lawyer in this process starts with the recitals, which is a non-binding agreement between the parties.¹¹³ Essentially this is a skeletal outline that sets out the key points of the deal. This will include, non-exhaustively, purchase price, intellectual property rights, timings and method of payment, what is included and excluded, warranties and indemnities and employees.¹¹⁴ A prudent lawyer would also draft an exclusivity clause, which prevents other parties from trying to compete for a certain period.¹¹⁵

According to Lee Buchheit, the recitals are important because they give the lawyer the framework for performing appropriate due diligence, along with providing a detailed questionnaire for the seller to flush out any actual or possible legal issues they may have.¹¹⁶ This process allows the potential capital investment to be scrutinised to identify any significant issues that may affect the corporation. It also assures that the corporation will receive exactly what they have contracted for. The due diligence process should not be commenced until the recitals are signed as it is economically inefficient to perform due diligence on issues not under the contract.¹¹⁷

The purchase of a working factory highlights many items relating to due diligence. With regard to property, the due diligence process requires investigation of planning consents, surveys, environmental issues and any lease agreements in place. Essentially, due diligence enables the lawyer to review the title documents to ensure that ownership is correctly represented by the seller. The lawyer will also perform due diligence checks on customer and supplier contracts, any finance agreements in place, company employees, intellectual property and any actual or potential litigation.¹¹⁸ The point of all this scrutiny and background checking is to highlight and determine any issues or unaccounted for points that may affect the corporation's growth and value.¹¹⁹

Provided the due diligence process is completed, the final role of the lawyer is to prepare the asset purchase agreement (APA); this contains warranties and indemnities intended to protect the buyer. Essentially the APA is a legal document containing all items intended for purchase.¹²⁰ For the purpose of the factory example, the APA will include plant and machinery, inventory, goodwill, stock, contracts, premises and intellectual property. The role of the lawyer is to draft the APA in clear and unambiguous terms as to what is actually being purchased so that a court will respect the deal (or more specifically the position of the client) if litigation arises.¹²¹ Once all the contracts are signed, and provided the covenants have not been breached or there are no defaulting events, the issue can be said to be complete.¹²²

¹¹³ Some have argued, however, that the recitals are not important for a lawyer (see C Maughn, M Maughn, M Keppel-Parmer and A Boon, *Lawyers' Skills* (2015) 64) but according to Professor Lee Buchheit, they are crucial – L Buchheit, “Architecture of a financial contract” (4 December 2015) Lecture given at Lecture Theatre 183, Old College, The University of Edinburgh.

¹¹⁴ Professor Lee Buchheit refers to these as the “operative clauses” – Buchheit (n 113).

¹¹⁵ B Hanotiau, *Complex Arbitrations: Multi-party, Multi-contract, Multi-issue and Class Actions* (2005) 149.

¹¹⁶ Buchheit (n 113).

¹¹⁷ *Ibid.*

¹¹⁸ Reuters, “Buying a business: due diligence checklist” (2009) available at: <http://www.reuters.com/article/businesspropicks-us-findlaw-buying-a-bus-idUSTRE52P6KP20090326#vCIYfMY6kszgSecC.97>.

¹¹⁹ N Lubbock, “Steeles Law Solicitors: a guide to buying and selling a business” (2015) available at: <http://www.steeleslaw.co.uk/publications/Guide%20to%20Buying%20or%20Selling%20a%20Business.pdf>.

¹²⁰ Practical Law, “Asset purchase agreement” (2015) available at: <http://uk.practicallaw.com/2-107-3546>.

¹²¹ M J Sandretto, *Cases in Financial Reporting* (2012) 345.

¹²² Lubbock (n 119).

G. CONCLUSION

To conclude, in order to maximise profits through corporate finance, the effective operation of the key functions within that context is crucial. A strong corporate governance regime ensures that corporate directors' conduct is kept in check while also monitoring the corporations' strategic decisions. The optimal mix of debt and equity within the capital structure regime is difficult, so finding the right balance is important for the future growth of the company. Investing in the most profitable investments is also an important function despite the issues stemming from the cost benefit analysis. It is important to weigh up the risk and opportunity and evaluate the potential for profit maximisation while protecting the corporation's interests as a whole. Given that everything within the rubric of corporate finance is connected, it is also clear as to why lawyers are so important. By minimising costs, thereby adding value to the transaction, their role in underpinning the capital raising and capital investing functions are crucial. However, one must remain wary, even with these functions in place, of the potential future corporate scandals lurking in the shadows.