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Teaching Corporate Finance

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With projections that the demand for legal services will remain relatively flat in the post-crisis period, legal service providers are placing greater emphasis on business and client development, and increasingly expect such efforts from their newest associates.³ As language and culture can be the bridge or barrier to communication, lawyers who can speak the language and understand the business of clients will be in the best position to meet such expectations.⁴ Here, we explore the role of corporate finance education in the law school curriculum in providing the requisite immersion and language instruction for corporate lawyers in training.

I. Corporate Finance in the Law School Curriculum

The broad outline of the corporate finance syllabus in the law school curriculum has remained relatively consistent since its introduction in the early 1940s.⁵ What have changed over time are the materials, methods and motivations relied on to teach the corporate finance topic.⁶ For example, Professor William Bratton suggested responding to new developments in corporate finance by taking an integrated approach by blending scholarly materials with cases and statutes;⁷ Professor William Carney's presents a finance-oriented approach to teaching the corporate finance topic, where students are first presented with the financial principles and then

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³ Julie Savarino, *What Works to Develop New Business for Law Firms in the "New Normal"?* BNA (November 4, 2013) <http://www.bna.com/what-works-to-develop-new-business-for-law-firms-in-the-new-normal/>.

⁴ See, e.g. Chambers Guide which ranks best law firms and lawyers by conducting in-depth telephone interviews with lawyers and clients. Banking & Finance clients praise firms for commercial awareness and commercial approach to matters. Nationwide: Banking & Finance, CHAMBERS AND PARTNERS (2014), <http://www.chambersandpartners.com/12788/6/Editorial/5/1>.

⁵ For example, Professors Adolf A. Berle, Jr. and Roswell Magill in their 1942 textbook, *Cases and Materials in the Law of Corporation Finance*, describe the subject as including such concepts as valuation, debt and equity financing, and capital structures (the area of finance covering capital budgeting and structuring decisions of corporations and constituents). ADOLF A. BERLE JR. & ROSWELL MAGILL, *CASES AND MATERIALS IN THE LAW OF CORPORATION FINANCE* (2ED. 1942). 70 years later, today's Corporate Finance textbooks largely follow this structure. Professor William Bratton's *Corporate Finance* (7th Edition, 2012) presents the corporate finance topic in five parts: valuation, debt financing, hybrid financing, equity financing and mergers and acquisition, WILLIAM BRATTON, *CORPORATE FINANCE* (2012); Professor Stephen Lubben's *Corporate Finance* (2013) is organized around the four basic units of valuation, finance, mergers and acquisitions, and financial distress, STEPHEN J. LUBBEN, *CORPORATE FINANCE* (2013).

⁶ Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 345-346 (2005); RONALD J. GILSON & BERNARD S. BLACK, *SOME OF THE ESSENTIALS OF FINANCE AND INVESTMENT* (1993).

⁷ William W. Bratton, Jr., *Corporate Finance in the Law School Curriculum*, 1985 DUKE L.J. 237, 252 (1985).

apply the finance to analyze and understand cases;⁸ Professor Richard Booth argued for a focus on finance and shareholder rights;⁹ and Professors Peter Huang and Michael Knoll placed special emphasis around the concept of capital structures and their possibility of creating value.¹⁰ Thus, apart from agreeing on the core concepts, educators have taken widely differing views of how the topic ought to be approached.

The place of corporate finance within the broader law school curriculum has also sometimes been a quandary due to its specialized and technical nature as well as its misfit with the traditional Socratic teaching method.¹¹ Professor Andrew Hicks argued that the dominant focus on Socratic methods in the first year of law school made it difficult for a student to engage within the varied methods of teaching necessitated by corporate law topics.¹² Professor Victor Fleischer echoed the concern that writing bench briefs and engaging in Socratic exercises did not equip students with the transactional skills required by modern corporate law practice.¹³ In response to this perceived disconnect, Professor Robert Thompson proposed pre-conditioning students to this area of law by introducing cases which address shareholder rights and other business relationships earlier in the law school curriculum.¹⁴

Amid drastic changes to both the finance and regulatory landscapes in the post-crisis period, now is an opportune moment to reevaluate the methods, materials and motivations used in teaching corporate finance to this generation of corporate lawyers. While training lawyers for a specific area of practice has traditionally been in the domain of the employers, a recent Harvard study by Professors John Coates, Jesse Fried and Kathryn Spier suggests that employers may be looking to students and schools to share some of this responsibility.¹⁵ The study reports that legal employers strongly advise students to take certain courses while in law school such as accounting and financial statement analysis and corporate finance,¹⁶ suggesting that graduates with such training can signal to employers' their interests and aptitude for this area of practice.¹⁷ Beyond this signaling effect, this brief article considers how we can connect corporate finance

⁸ WILLIAM J. CARNEY, *CORPORATE FINANCE: PRINCIPLES AND PRACTICE*, 3D (FORTHCOMING 2014).

⁹ Richard A. Booth, *A Minimalist Approach to Corporation Law*, 34 GA. L. REV. 431, 446 (2000).

¹⁰ Peter H. Huang & Michael S. Knoll, *Corporate Finance, Corporate Law and Finance Theory*, 74 S. CAL. L. REV. 175, 191-192 (2000).

¹¹ J. G. Deutsch, *The Teaching of Corporate Law: A Socratic Investigation of Law and Bureaucracy*, 97 YALE L.J. 96, 114 (1987).

¹² Andrew Hicks, *Teaching Modern Company Law — The Pint Pot*, 26 L. TEACHER 4, 4 (1992) available at <http://dx.doi.org/10.1080/03069400.1992.9992824>.

¹³ Victor Fleischer, *Deals: Bringing Corporate Transactions into the Law School Classroom*, 2002 COLUM. BUS. L. REV. 475, 478 (2002).

¹⁴ Robert B. Thompson, *Teaching Business Associations: Norms, Economics and Cognitive Learning*, 34 GA. L. REV. 997, 997-999 (2000).

¹⁵ John C. Coates IV, Jesse M. Fried & Kathryn E. Spier, *What Courses Should Law Students Take? Harvard's Largest Employers Weigh In*, 3 (February 17, 2014) (HLS Program on the Legal Prof., Research Paper No. 2014-12), available at SSRN: <http://ssrn.com/abstract=2397317>.

¹⁶ *Id.*

¹⁷ *Id.*; Thompson, *supra* note 14, at 997-999.

theory taught in the classroom with the practical skills demanded of corporate finance lawyers today.

II. Bridging Theories and Practice in the Classroom

In this Part we offer examples of how basic concepts in the corporate finance syllabus such as time value of money, appraisals and hedging can be used as a basis to develop the skills that are immediately applicable to corporate finance law practice. The guiding principle is to bridge the *law* or *legal skill* with *finance* concepts. Depending on the context, the *law* or *legal skill* may involve for example covenant review and drafting exercises, statute interpretation, due diligence, or correspondence with colleagues, clients or opposing counsel.

a. Time Value of Money

Money has time value, where a dollar today is worth more than a dollar paid in the future. By how much more depends on how far away in the future and the applicable discount rate. To place this basic finance concept into the legal context, we present to our students a debt prepayment option. We describe a situation where a client with \$100 million in loans outstanding would like to negotiate with its lender an option to prepay at any time any amounts without penalty or premium. The relevant prepayment clause reads:

“The Borrower shall have the right to prepay at any time and from time to time without penalty or premium all or any part of the principal due. Each prepayment shall be applied to the principal installments _____.”

We ask students to consider the following three options with which to fill in the blank: (a) in the order of maturity, (b) in the inverse order of maturity, or (c) *pro rata*. Which option would our client prefer?

The takeaway from the time value concept of money is that our client, the borrower, would prefer that the prepayment be applied in the order of maturity – i.e., to amounts due earlier rather than later in time – since a dollar paid down today is worth more than that same dollar paid down tomorrow. On the other hand, lenders will tend to prefer to reduce the average life of loan and thus would rather apply prepayments in the inverse order of maturity. One compromise would be to meet each other halfway and agree to apply the prepayment *pro rata* across all remaining installments. Often, lenders and borrowers will agree to vary the order of application depending on the source or amount of funds being used to prepay the debt. By situating the finance topic within a legal context in this way, we have found that students become more active participants in grappling with the concept being taught and can also gain an immediate appreciation of its application to practice.

b. Appraisal Remedy

Valuation is the keystone topic of the corporate finance syllabus. Both legal and financial valuations of assets go to determining fundamental value. When legal and financial valuations diverge, this gap may suggest that the market or financial models under- or over-represent value to which the law attaches consequences. For example, the sales price of a firm represents the

price at which the requisite percentage (e.g. *majority*) of owners are willing to sell, and may deviate significantly from the value placed on the same share by a *minority* shareholder who is opposed to a pending merger. In the latter case, market determined measures of value will systematically underestimate the valuation of the minority shareholder's investment. Legal rights can be relied upon to make up this gap, and the appraisal remedy is such a mechanism.

We study Delaware's version of the appraisal remedy which is contained in Section 262 of the Delaware General Corporation Law (DGCL). DGCL Section 262 provides appraisal rights to shareholders objecting to a merger and requires the court to determine "the fair value of the shares exclusive of any element of value arising from the accomplishment or expectation of the merger or consolidation."¹⁸ In such determination the court "shall take into account all relevant factors."¹⁹ We review the case law in this area to probe various components of Section 262, including fair value, expectation of the merger and relevance. By combing through the factors that the court and appraiser consider in their determination of value such as the nature of the enterprise, leverage, management, earnings and dividends, expenses of operation, and tax situation, students become familiar with how legal remedies rest on core concepts of finance.

To "bringdown" the appraisal discussion to current practice, we discuss the recent trend in appraisal litigation where professional money managers are buying the stock of target companies in anticipation of a deal (or after a deal is announced but before the deal is completed) for the primary purpose of acquiring the option to exercise appraisal rights.²⁰ There are investment funds that have been formed for this specific purpose, where the explicit investment strategy of the fund is to identify opportunities where it can capitalize on premiums that may be earned from an appraisal proceeding. Against the backdrop of the expansive wording of Section 262 of DGCL, we round out the topic by discussing whether the identity or motivations of the dissenting shareholder exercising the appraisal right should be one of the factors that the court takes into account in its determination of fair value. This discussion provides students with an opportunity to become familiar with current topics in corporate finance as well as understanding the motivations and business of prospective clients.

c. Hedging

Most companies have a certain level of hedging (and in some cases, failure to hedge may constitute a breach of directors' duties²¹) that takes into consideration the costs required to administer the hedge netted against its expected returns. We found that for this topic it is effective to first discuss the legal and regulatory concerns of hedging before relating it back to the financial mechanics and underlying instruments used to hedge risks. To do so, our focus is on the motivations behind those selling and buying the risks via the hedge and whether or not such risk shifting has societal value, and if so, the role of laws and regulations in ensuring that

¹⁸ 8 Del. C. § 262.

¹⁹ *Id.*

²⁰ See e.g. Wilson Sonsini Goodrich & Rosati, The Growth of Appraisal Litigation in Delaware (November 2013) available at <http://www.wsgr.com/publications/PDFSearch/wsgralert-delaware-appraisal-litigation.pdf>.

²¹ *Brane v. Roth*, 590 N.E.2d 587 (Ind. Ct. App. 1992).

such value is realized. What emerges from these discussions are the problematic aspects of regulation and practice which tend to detach the incentives to engage in due diligence from those who are in the best position to do so, as was evident from the rise of the originate-to-distribute model in the arranging of the mortgage-backed securities that were at the center of the recent financial crises. This leads to a discussion of the proper role of lawyers, when the boundary lines between legal and business diligence can become blurred at the initial structuring stages of corporate finance transactions.

Reviewing sections of the Dodd-Frank Wall Street Reform and Consumer Protection Act which bring swaps under federal regulation to increase transparency and minimize default risks²² and prohibit banks' and other "systemically important financial companies" proprietary trading and certain relationships with hedge funds and private equity funds²³ is useful for students considering or decided in pursuing a career in the compliance area or interested in bank regulation.

Conclusion

Increased competition for jobs among recent law graduates means that students interested in a specific field are seeking additional skills and means of specialization to signal and solidify their interests in a particular area of law.²⁴ In this brief article, we highlight some ways in which core corporate finance concepts can be presented to students interested in a career in corporate law to provide them with the practical skills demanded by them as well as employers.

In our conversations with students and recent graduates enrolled in our Corporate Finance class, we find that students were most receptive to the classes where covenant interpretation and hands-on financial analysis were covered.²⁵ In terms of course materials, students were unanimously in favor of a teaching approach which brings together academic literature, law firm client memoranda and case law for each topic. These methods and materials have the dual benefits of not only offering a lens with which problems can be addressed but also exposing students to specific examples which clearly highlights the business and legal motivations of parties and offers a glimpse into the creative counseling, negotiating and drafting strategies of corporate finance lawyers.

²² Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

²³ Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (also known as Volcker Rule).

²⁴ Notes of conversations held on May 1, 2014 are kept on record with authors; the related conversation and feedback were recorded with permission from participating students and is kept on record by Aaron Birk.

²⁵ *Id.*