A Transactional Studies Approach to Teaching Corporate Law

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Drawing on concepts articulated in Ron Gilson's article, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*,[1] transactional studies supplement the traditional approach to teaching corporate law by providing a conceptual framework for students to understand the legal and non-legal issues that confront business lawyers, learn how complex business arrangements are structured and, in the process, assess the role of lawyers in adding value to a transaction. Drafting and negotiation are not emphasized. Instead, a central theme is the management of transaction costs, drawing on law and economics scholarship to convey issues that often face deals lawyers – including information asymmetries, moral hazard, adverse selection, agency costs, and signaling, as well as the impact of legal "frictions" (such as tax) on structuring.

My experience in teaching transactional studies has primarily been the Deals course[2] and, more recently, a seminar at Cornell that builds on Deals concepts to explore the intersection between corporate governance and capital structure. The Deals approach provides a launching point for students to begin to bridge the gap between the theoretical solutions addressed in introductory classes and the real-world problems that appear – and which lawyers must address – in actual corporate transactions. The course investigates contracting patterns that have emerged with respect to different types of transactions, and considers whether more effective arrangements could be achieved. During the first part of the semester, students are introduced to concepts and tools that can be used to evaluate alternative deal structures. The second half applies those concepts and tools to "real world" deals. The class is divided into teams, each of which is assigned a different deal and given a set of documents (often 200-300 pages long). Each deal is considered over two classes. Prior to the first class, a student team prepares a draft of a substantial paper that analyzes their deal using tools from the first half of the course. The student team then presents its analysis of the transaction during the first class. In the second class, the lawyers and/or clients who actually participated in the transaction then present their deal to the students. Students are expected to take the opportunity to test how the classroom approach corresponds to the way those who "did the deal" understood it – through asking questions and highlighting aspects of the deal that may or may not fit within the classroom framework. The resulting give-and-take with seasoned practitioners is at a level many years ahead of what students would normally experience as starting lawyers.

The benefits can be substantial. The ABA Section of Business Law described the experience of one senior academic when he first started work at a large New York law firm. His first assignment was to mark up a stock purchase agreement. His response – "I'd be happy to do it, but I have two questions: What's a stock purchase agreement, and when you say mark it up, what do you mean?"[3] A Deals approach can begin to bridge

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[1] 94 YALE L.J. 239 (1984).

[2] An excellent description of the Deals course appears in Victor Fleischer, *Deals: Bringing Corporate Transactions into the Law School Classroom*, 2002 COLUM. BUS. L. REV. 475.

[3] Francesca Jarosz, *None of Your Business? No*, BUS. LAW TODAY, Sept./Oct. 2006, *available at* http://www.abanet.org/buslaw/blt/2006-09-10/jarosz.shtml.

that gap and, as importantly, provide a transactional framework within which students can assess corporate law.

Each deal, of course, has its own characteristics, depending on whether, for example, it involves selling (or buying) a company or asset, creating a joint venture, financing a movie, or entering into a long-term supply contract. However, as experienced transactional lawyers will tell you, at the core of most deals is a recurring set of issues that needs to be addressed no matter what is being transacted. The parties, for example, may assess risks differently or, based on their relative access, have more or less information on which to base an assessment. Alternatively, a party's actions may change once a contract is signed that shifts risks and benefits to someone else. The value of a business or asset, as well, may be uncertain, with the purchaser looking to bridge an information gap to assess value or potentially discounting value to reflect the uncertainty. As Gilson notes, lawyers play a pivotal role in engineering deals in order to minimize transaction costs, in many cases doing so through deal structure or contract language that creates value that can be shared among all parties (including the lawyers).

Suppose, for example, Ajax Corp. ("Ajax") plans to acquire Bravo Inc. ("Bravo") pursuant to a merger agreement that will close three months after the agreement is signed. During the period between signing and closing, Ajax and Bravo have potentially divergent interests – a moral hazard problem as Ajax looks to maximize the value of its investment, but without being able to directly oversee Bravo or verify its actions (since Bravo remains a separate company). Bravo's interests will have changed, after contractually transferring the risks and benefits of its business to Ajax, altering its managers' behavior potentially to Ajax's detriment. Law and economics scholarship regarding insurance addresses a similar moral hazard problem. Having bought a policy, a beneficiary may decide to increase her use of medical services or take less care of the covered asset. The structural response, in the case of insurance, includes a reliance on deductibles, co-payments, and limits and ceilings on coverage. In acquisitions, a principal response is the inclusion in the merger agreement of direct contractual limitations – covenants – that restrict Bravo's actions before the closing. Examples include Bravo's agreement to continue to conduct business in the ordinary course and to obtain the necessary consents in order to close the deal. The covenants typically must be complied with (in all material respects) as a condition to closing. Absent those protections, Ajax may not go forward with the deal or, reflecting the risk of Bravo's actions between signing and closing, do so only at a lower price.

We face a similar issue, but in a different context, when Ajax issues long-term bonds. Following their investment, Ajax's bondholders risk the loss of wealth in the face of management opportunism that potentially favors equity over debt. Ajax's managers, for example, may choose to invest in projects that benefit Ajax's shareholders, but whose risk is principally borne by the bondholders. The response, like in the acquisition context, is covenants that restrict Ajax's actions and potentially furnish control rights to bondholders in the event of breach. Absent those protections, bondholders may not be willing to invest capital or do so only at higher cost.

Recognizing their value, deals lawyers for both Ajax and Bravo will negotiate to include the necessary protections until their cost begins to exceed their utility. In some cases, such as in the Ajax acquisition, the most efficient way to manage the risk of

Bravo's moral hazard may be – instead of, or in addition to, covenants – to tie a portion of the price to be paid at closing to any interim change in Bravo's business. Or Ajax may simply commit to hire Bravo's managers after the deal is closed, conditioned on good behavior. The key – in both the acquisition and bond contexts – is to identify issues and create structural responses that, depending on the parties and the characteristics of the deal, address those issues at low cost.

A transactional analysis can also help illustrate issues that come up in the standard Corporations or Business Organizations course. Students, for example, are typically introduced to an array of mechanisms by which target boards can defend against a hostile acquisition or bulletproof an agreed deal. Poison pills, no-shops/no-talks, matching rights or rights of first refusal, and termination fees are typically included, often within the context of a court opinion that assesses those mechanisms in light of the target board's fiduciary duties. Analyzing them as part of a deal may help students gain a better feel for what the parties intended and provide further context for the court's decision.

Suppose, for example, Ajax insists that Bravo agree to a matching right and a termination fee. The matching right would give Ajax the ability to match any superior offer for Bravo made by a rival bidder, so long as it did so within three business days. Bravo would be obligated to pay Ajax a termination fee in the event the merger agreement was terminated or Bravo's shareholders failed to vote for the transaction.[4] Neither mechanism is *per se* invalid. But combined, a student may ask, what makes them an effective (even if permissible) deterrent against another offer?

We can start with the capital asset pricing model, which demonstrates that the free market will price assets accurately if certain assumptions are satisfied, namely that (i) all investors have a common time horizon, (ii) all investors have the same expectations about the future, (iii) there are no transaction costs, and (iv) information is costlessly available to all investors. Of course, none of those assumptions holds in the real world, providing a role for experienced deals lawyers to introduce protection devices as one means to enhance value.

Assume that Ajax and a subsequent bidder would value Bravo identically if they had the same information. The bidder, in that case, faces a real risk of incurring expense to evaluate Bravo, only to see Ajax match or top its bid in response. In fact, as between Ajax and the new bidder, Ajax is likely to have better information on Bravo (perhaps at lower cost) and so has an advantage in valuing the deal. The new bidder knows it will win only if its bid – for a company whose value will decline by the termination fee – is greater than Ajax's, but Ajax (with superior information) is likely to match the bid unless it is too high. Success, for the new bidder, means the risk of suffering the "winner's curse." Faced with that possibility, the bidder may decide not to bid at all. In return for the protection, Bravo would expect for Ajax to pay a higher deal price, reflecting Ajax's greater certainty of closing and the lower likelihood of a competing bid.

[4] *See, e.g., In re Toys "R" Us, Inc., Shareholder Litigation*, 877 A.2d 975 (Del. Ch. 2005).

There are, however, examples where matching rights and a termination fee did not deter a subsequent bidder. In the struggle for control of MCI, Qwest bid repeatedly to try to top Verizon, despite its possession of matching rights. What might cause a competing bid to be made? From a transactional cost perspective, Bravo may have a private value to the new bidder (perhaps due to synergies) over and above the common value shared with Ajax. A key is the size of the private value component. Using a simple auction model, we would expect the outside bidder to prevail over Ajax only if its private value exceeds (i) any private value held by Ajax plus (ii) the incremental cost to the outsider of acquiring common value and private value information. Stated differently, while the deal protection devices would deter a new bidder that stood substantially in Ajax's position, they would be unlikely to deter a synergistic bidder with substantial private gains that it would share with Bravo's shareholders through a higher bid price. Deal protections make small, margin-topping bids unattractive. A substantial increase in deal value, however, is still possible, and that value may benefit Bravo's shareholders.

There is an advantage, in transactional studies, to having some transactional experience, but it's not necessary. The law and economics scholarship provides an excellent framework within which to assess transactions. Pairing academics with adjunct practitioners is also a possibility. Even if they are not familiar with the scholarship, the concepts translate easily into how experienced deals lawyers think and work.