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Financing the Enterprise: Debt and Equity

Introduction to the Legal and Economic Characteristics of Debt and Equity

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The finances of businesses not organized as separate legal entities are simple - they are indistinguishable from those of their owners. As businesses grow, their owners often seek to conduct their activities through separate legal entities such as corporations that provide limited liability, perpetual existence and transferability of ownership interests.[1]

There are numerous ways to finance a corporation's activities, each with different risk and reward profiles for the corporation and its investors. Here, we will briefly discuss the most common financing instruments and their legal implications under United States and similar legal systems. The choice of how to finance a business enterprise, sometimes referred to as its "capital structure", is complex and the subject of much analysis that is beyond the scope of this introduction.

Debt, Equity and Leverage

Typically, capital structures consist of a combination of equity (capital invested by owners) and debt (capital borrowed by the corporation). Initially, a decision must be made as to what extent the corporation will be financed with debt. Borrowing funds can enhance returns to equity investors - the owners

of the enterprise. Consider the following example: a business is financed entirely with equity capital in the amount of $100,000. In its first year of operation, its net income (revenues less expenses) is $10,000. The equity investors have received a 10% annual return on their investment. If instead the same business is financed 10% with equity capital and 90% with debt requiring an annual interest payment of 10% (referred to as the "coupon"), the equity investors' annual return would be 91% ($10,000 of annual return less $900 interest expense divided by the $10,000 equity investment). The ratio of debt to equity capital is referred to as "leverage". Leverage is used to enhance equity investor returns by increasing the portion of the enterprise's capital that is entitled only to a fixed return. This leaves more of the enterprise's earnings (after covering these fixed returns) for the equity investors.

So why don't all businesses operate with massive leverage? Considering the legal nature of debt and equity helps answer the question.

Debt is an enforceable contractual obligation. Failure of a borrower to make a required payment on a debt instrument could result in a legal judgment against the borrower that must be satisfied from its assets and, if such assets are insufficient, bankruptcy proceedings. Too much debt can wipe out the owners' investment - this is the downside risk of using leverage to grow a business. For this reason, emerging growth companies are typically financed mainly with equity. Companies with more predictable cash flow, such as public utilities, typically have higher leverage.

Legal Characteristics of Debt and Equity

As we noted, debt obligations are contractual and the borrower's obligations are set forth in the lending agreement. Debt may take the form of a loan from banks or other institutional lenders or a bond that is purchased by investors that may be traded in the secondary market[2]. In either case, however, the borrower's obligations are contractual and are set forth in the loan agreement, bond indenture[3] or similar agreement. Solvent debtors[4] owe no fiduciary duties to debt holders to consider their best interests and can take actions that benefit the owners to the detriment of the debt holders, such as paying dividends or undertaking acquisitions. To protect themselves against such actions, creditors will often insist on contractual provisions in the lending agreement to prevent or limit measures that could result in deterioration of the borrower's creditworthiness, such as incurrence of additional debt, encumbering its assets with liens, payment of dividends or equity repurchases. Violation of a provision of this type (known as a "covenant"), allows the debt holder to declare the debt immediately due and payable. In

extending credit through the purchase of debt obligations, investors are relying on the integrity of the governing legal system to enforce contracts and, in extreme cases, the bankruptcy process to which the borrower is subject.

Equity holders in public companies[5], on the other hand, typically have no such contractual rights. Rather, equity holders rely on the corporation's directors to manage the corporation in compliance with their fiduciary duties of loyalty and care. Directors of large corporations do not operate the business themselves on a day-to-day basis but engage and supervise managers to do so. These managers also owe equity holders these duties. Equity holders may enforce these fiduciary duties through legal proceedings for monetary damages or to enjoin pending transactions.

The duty of loyalty requires that directors and managers act in the best interest of the corporation and not put their personal interest before that of the corporation or its equity holders. A director entering into a transaction with the corporation (for example borrowing funds from the corporation), would violate the duty of loyalty unless ratified by a majority of disinterested directors or shareholders. Undertaking a business opportunity for the director's own account that could otherwise benefit the corporation could also violate the duty of loyalty.

The duty of care requires directors and managers to exercise reasonable prudence in operating the corporation and to be adequately informed before making business decisions. Notably, in evaluating compliance with the duty of care, courts ordinarily apply the "business judgment rule", which creates a presumption of validity for business decisions.

Equity holders thus rely on directors' and managers adherence to these fiduciary duties - and the existence of a robust legal system to enforce such adherence - to protect their investment. In addition, public corporations frequently include equity in the compensation of their managers, which is intended to create a degree of alignment of economic interests with passive investors.

Types of Debt and Equity

Debt and equity investments each come in different types, offering differing risk and return profiles for investors. The simplest type of debt obligation is unsecured debt, where the lender has a claim on all the borrower's unencumbered assets for satisfaction, on a ratable basis with other unsecured liabilities such as obligations to suppliers. For added protection, lenders may require a lien or encumbrance on specific assets of the borrower, such as real

estate, intellectual property or accounts receivable. These assets are reserved to satisfy claims of these lenders (known as "secured creditors") and are not available to unsecured lenders or creditors until the secured creditors' claims are fully satisfied. Lenders willing to assume additional risk in exchange for enhanced returns can agree to "subordinate" their claims to other creditors, meaning they agree that they won't be paid until the unsubordinated creditors are paid in full.[6]

Equity can be divided into common and preferred stock. Common stock is entitled to all the value of the corporation after more senior claims have been satisfied. The amount of common stock that may be issued is limited to the amount authorized by the corporation's charter or certificate of incorporation. The charter will also establish a "par value" per share of the common stock in jurisdictions where par value is required. This amount, which may be extremely low (such as $.01 per share), is recorded as the "common stock" of the corporation on its balance sheet. Proceeds of sales of common stock in excess of the par value are recorded as "additional paid in capital".

Preferred stock is entitled to payment of a specified dividend and preference over common stock on receiving proceeds from the corporation's liquidation. These provisions make preferred stock more "debt like" but the failure to pay a required dividend does not give rise to an enforceable claim for payment. Rather, during such a failure, payment of dividends to common stock will be prohibited. Corporations may issue multiple series of preferred stock, the terms of which are set forth in the corporation's charter or certificate of incorporation, although many jurisdictions allow for corporations to provide for "blank check" preferred stock, where the board of directors is authorized to determine the terms of classes of preferred stock without going through the formalities of a shareholder vote to amend the charter.

A corporation may also issue "convertible" debt or preferred stock, which offer investors a contractual return but also allow them to participate in the upside if the value of the common stock rises significantly. These instruments pay interest and dividends like typical debt or preferred stock but are convertible at the option of the holder into common stock at a price (the "conversion" or "strike" price) specified at the outset of the transaction (typically at a significant premium to the current market price of the common stock). If the price of the common stock rises above the conversion price, holders may convert the debt into common stock and realize a profit. In effect, the corporation has sold a call option on its common stock together with the debt or preferred stock, the value of which is reflected in a lower interest or dividend rate than would be available with typical unsecured borrowing.

Conclusion

Corporate financial managers have numerous financing tools available to optimize their financing costs while investors can choose instruments that meet their risk and return objectives. The legal system provides the framework for these instruments, by ensuring their enforceability and allowing for sufficient flexibility to create instruments that meet the needs of both corporations and investors.

This introduction barely scratches the surface of several very complicated issues. There is much useful literature on corporate finance, debtor-creditor law and the fiduciary duties of corporate officers and directors that will be of interest to those seeking more information. A helpful compilation of finance terminology can be found at the following link: https://corporatefinanceinstitute.com/resources/knowledge/dictionary/.

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[1] There are other entities that may be used for business activities (such as partnerships and limited liability companies) but our discussion is limited to corporations. For a useful introduction to forms of business organizations, see https://horizontecubano.law.columbia.edu/content/legal-structures-non-state-sector-according-type-and-scale-activity.

[2] For information on the operation of the primary and secondary markets, see https://horizontecubano.law.columbia.edu/content/social-functions-stock-market.

[3] Indentures are instruments that allow bonds to be publicly traded without the need to enter into a new contract each time a bond is purchased by a new investor.

[4] Insolvent debtors may owe fiduciary duties to creditors, who effectively own the enterprise if the equity has no value.

[5] Companies whose securities are publicly traded (for example, with stock traded on a stock exchange) are referred to as "public companies". Public companies in the United States are subject to additional obligations (including periodic disclosure) under the federal securities laws. See https://horizontecubano.law.columbia.edu/content/social-functions-stock-market.

[6] Corporations can also obtain financing by selling assets to a special purpose vehicle (i.e., an entity that conducts no activities other than holding these assets) in a true sale transaction. The special purpose vehicle simultaneously borrows from investors to fund the purchase of these assets. This process, known as "securitization" gives creditors exposure to the specified assets without taking the general credit risk of the corporation, which can often result in lower credit risk and therefore lower financing costs to the corporation.

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