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Part 2 What is Corporate Finance?

- Taking into account the distinction between debt and equity

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Series Overview – 5 in total

- Part 1: What is Finance Law?
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* This series is a digest of my book "**Finance Law - Fundamentals of Finance Law and Essentials of Advanced Financial Transactions**" (Shoji-Homu, 2016). In the text, "the Book" refers to this book.

While the distinction between corporate finance, debt and equity was briefly explained in "**Part 1: What is Finance Law?**", a more in-depth explanation will be provided here.

1. What is Corporate Finance? - Addressed from a legal perspective

Corporate finance is a very frequently used yet polysemic concept.

1-1. Broad definition: Financial transactions in general from a corporate perspective

First, in economics, there is a field of study called corporate finance. **Corporate finance** in economics is a field that covers a wide range of topics, including not only (i) corporate financing methods, but also (ii) corporate investment theory (investment) and dividend policy, because it deals with all aspects of corporate financial activities. Specifically, **financing costs** (cost of capital), evaluation of **corporate value, optimal capital structure** (e.g., **MM theory** and **agency theory**, etc.) are discussed (for more details, see Chapter 4, Section 2 of the Book.)

1-2. Narrow definition: Financing based on the creditworthiness of a company

Next, financing based on the creditworthiness of a company may be referred to as corporate finance in a narrower sense, as opposed to financing based on the earning power of the assets themselves (asset finance). In this sense, corporate finance is used to **include both debt finance and equity finance**.

1-3. Narrowest definition: Debt finance that reserves enterprise-wide credit

Furthermore, the term “corporate finance” is sometimes explained to mean debt finance, that reserves enterprise-wide credit. Corporate finance in this sense is used **in the category of debt finance** in contrast to non-recourse finance, which is also included in debt finance.

Corporate finance in the narrow or narrowest sense is a traditional method of financing for companies, and from the investor's point of view, there exists the advantage of being able to draw on the entire gross assets of the fundraiser.

However, on the other hand, there is **information asymmetry** between fundraisers and investors, and information disclosure based on accounting to fill this gap is not complete. Therefore, (i) it is not always easy to investigate or judge whether all of the assets of a fundraiser have substantial economic value, and even when it is possible, it is costly and time-consuming (possibility and ease of investigating asset value), and (ii) Debt (other competing receivables) incurred by the fundraiser are not limited to those that can be confirmed on the balance sheet. The possibility of **contingent liabilities** arising from unexpected accidents or **off-balance sheet liabilities** cannot be ruled out, and even if such investigation is possible, it would be costly and time-consuming (possibility and ease of investigating the debt value). In addition, as (iii) it is common for there to be an unspecified number of creditors against the fundraiser, including general trade creditors, there is a competitive relationship with these creditors upon debt collection (competitive nature of debt collection).

Thus, in corporate finance, there are disadvantages or risks depending on individual circumstances. Finance methods such as asset finance, structured finance and non-recourse finance responding to investors' incentives to avoid these (details will be explained in Part 3 of this series).

2. Debt and Equity Finance

The distinction between debt and equity finance is the most fundamental and important concept in corporate finance, whether in the broad, narrow, or narrowest sense.

2-1. Significance of Debt and Equity

In general, **debt** means liabilities, which in this case generally means an obligation to repay the principal **under stipulated conditions.** On the other hand, equity is (i) in a **narrow sense**, used to mean the equity capital of a corporation (company) (referred to as **equity in a narrow sense** in the Book), (ii) in a **broad sense**, is not limited to this, and is generally used to include those that have the characteristics of capital contribution (money) without obligation to return the principal by a certain deadline (debt) (**equity in a broad sense** in the Book).

2-2. Difference in rights to cash flow

Debt has priority over equity in terms of **rights to cash flows** (rights to the cash, flow and payment of money, including the right to claim dividends and distribution of residual assets held by shareholders and the right to claim interest payments and redemption of principal held by bondholders). Therefore, there is a difference between debt and equity in terms of the credit risk of the fundraiser. In addition, in terms of debt, while the fundraiser is obligated to pay the principal and return of the investment at a fixed time, the return paid by the fundraiser to the investor is fixed at a certain limit. With equity, on the other hand, the fundraiser is not obligated to return the principal, but the return paid by the fundraiser to the investor extends to all investment income in excess of the principal (upside). It can be said that debt is a low-risk, low-return investment, while equity is a high-risk, high-return investment.

2-3. Relationship to the right to control

The distinction between debt and equity also has a difference in the content and scope of the investor's **right to control** the fundraiser (including not only shareholders' voting rights at shareholders meetings (especially the right to elect directors), but also the creditor's rights to vote in bankruptcy proceedings in the event of the debtor's bankruptcy). Equity investors, as investors, become owners of the fundraiser (corporation), and thus acquire organization law control over the fundraiser (referred to as the **right to control in the narrow sense** in the Book). On the other hand, debt investors are not owners of the fundraiser (legal entity) and therefore do not have control over the fundraiser under organization law. The right of control that debt investors can exercise over fund raisers (referred to as **the right to control in a broad sense** in the Book) are limited to those by through the use of covenants for investment recovery purposes.

2-4. Degree of liability in equity: limited vs. unlimited liability

In equity, in terms of the **debt owed by the fundraiser to the debt investor**, there are two types of liability: (i) **limited liability** where the equity investor is liable only to the extent of the damage to the principal invested and not beyond this amount and (ii) **unlimited liability** where the equity investor is liable not only for damage to the investment principal but also beyond this.

2-5. Summary

Based on the above,【Figure 2-1】summarizes the distinction between debt and equity.

【Figure 2-1: Distinction between debt and equity】

<table>
<tr><th></th><th>Legal basis</th><th>Credit risk</th><th>Return</th><th>Control</th><th colspan="2">Limited/Unlimited liability</th></tr>
<tr><td>Debt</td><td>Contract</td><td>Priority over equity
(low risk)</td><td>Fixed amount
(low return)</td><td>No control</td><td colspan="2">(Limited Liability)</td></tr>
<tr><td rowspan="2">Equity</td><td rowspan="2">Organization law</td><td rowspan="2">Subordinate to Debt
(high risk)</td><td rowspan="2">Full upside amount
(high return)</td><td rowspan="2">Has control</td><td>(i)</td><td>In the case of limited liability</td></tr>
<tr><td>(ii)</td><td>In the case of unlimited liability</td></tr>
</table>

(Source: Created independently by the author based on a figure in Chieko Matsuda, "Theory and Practice of Finance: Diversified Corporate Financing and New Financing Business" (Kinzai Institute for Financial Affairs, 2007)).

2-6. Theory of Securities Design

In contrast, focusing on the allocation of the two elements of securities of (i) the right to cash flow and (ii) the right to control, for example, there is debate about what type of (financial) contract is optimal for raising funds in the presence of information asymmetry (**Theory of Securities design**).

3. Hybrid Securities and Mezzanine Finance

3-1. Hybrid Securities

A concept related to debt (liability) and equity (capital) is hybrid securities. Hybrid securities are securities that have intermediate characteristics that combine various debt (liability) and equity (equity) characteristics. The following types and specific examples of hybrid securities are under debate. Note that from the theory of securities design, hybrid securities are organized as a matter of combining the right to cash flow and the right to control.

(1) Derived from equity

Equity (capital) in the narrow sense of the term, but with rights to cash flow that take precedence over ordinary equity (such as common stock) (e.g., preferred stock) or without rights to control (e.g., non-voting stock, etc.)

(2) Derived from debt

Debt (liabilities) with rights to cash flows that are subordinated to those of ordinary debt (e.g. straight bonds).

(3) Option type

The main attribute is debt, but with an option to acquire equity in the narrow sense or to convert it into equity in the narrow sense (e.g., bonds with stock acquisition rights, convertible bonds, etc.)

3-2. Mezzanine Finance

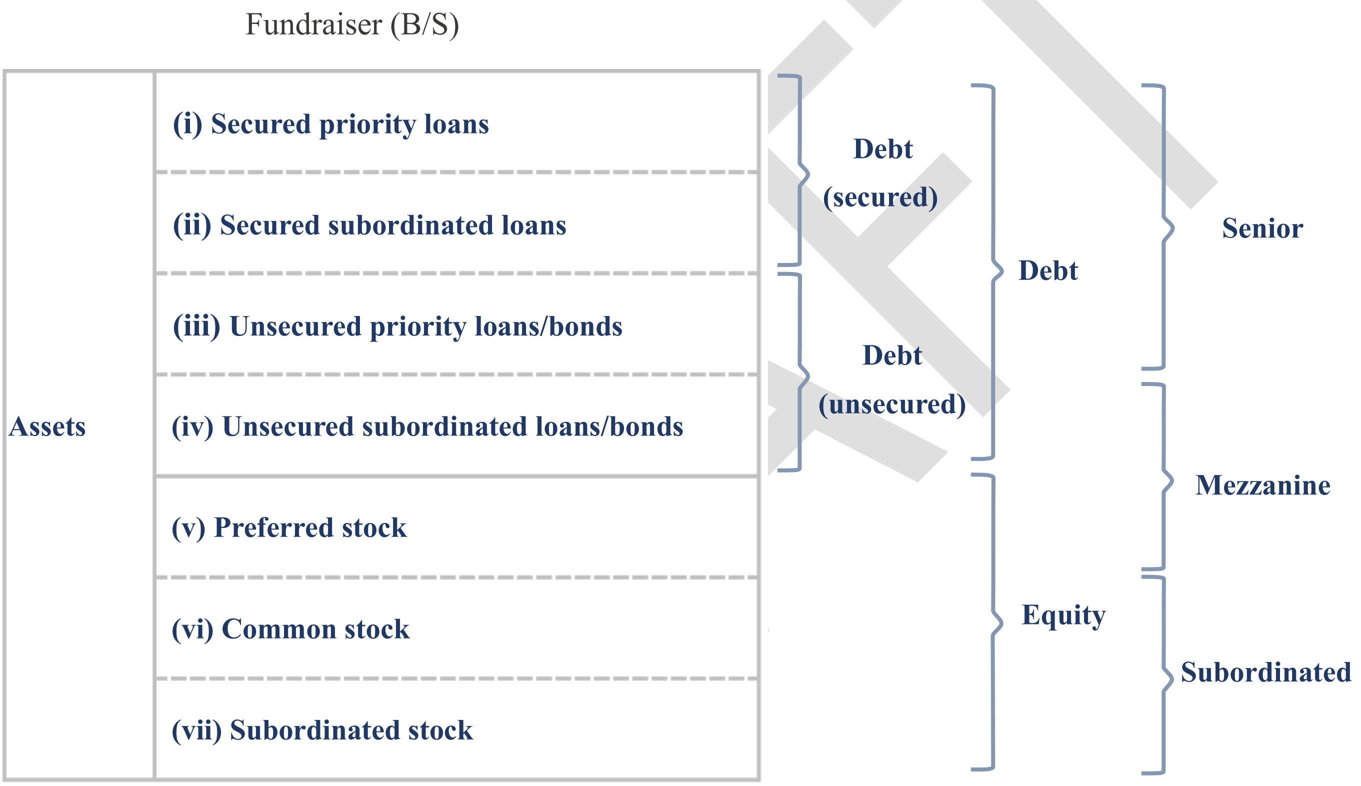
In finance, **mezzanine** refers that which due to the seniority-subordination structure (**4** below) is subordinate to higher-layer senior debt, but has priority over lower-tier common stock. Finance using mezzanine is referred to as **mezzanine finance**. Mezzanine has a combination of debt and equity characteristics, and representative examples include **preferred stock, subordinated bonds, and subordinated loans.** Hybrid securities and mezzanine have much in common in that they have characteristics intermediate between debt and equity, but subordinated loans, for example, are understood to be included in mezzanine but not in hybrid securities, which cover only securities.

4. Preferred/Subordinated Structure and Capital Structure

The order of priority with respect to the investor's rights to the fundraiser itself and/or its recovery is referred to as a **preferred/subordinated** structure or preferred/subordinated relationship. A typical preferred/subordinated structure is a debt-equity relationship. The existence of a preferred/subordinated structure creates a hierarchy among investors, each of which is referred to as a **tranche**. The preferred-subordinated structure is also referred to as a **capital structure**, as it corresponds in many respects to the order of capital structure on the balance sheet.

The Companies Act stipulates that there is a preferred/subordinated relationship between general creditors (debt) and common stock (equity), but in other situations, the rights among multiple general creditors or multiple common shareholders are in principle of equal rank. However, in finance transaction practice, the preferred/subordinated structure is further subdivided in order to provide various intermediate risks and returns (middle risk/middle return) in response to the balance of risk and return required by various investors. The **preferred subordinate structure** can be subdivided into two types: (a) that which is explicitly provided for in law and (b) that which is created by agreement of the parties (e.g. **subordination clause**). In the case of joint-stock companies, those that have a clear legal system are divided into (a) those that have a system under organization law under the Company Law (**corporate bonds, common stock, preferred stock, subordinated stock,** etc.) and (b) those that utilize contract types under the Civil and Commercial Code (**loans, voluntary arrangements, silent partnerships,** etc.). **【Figure 2-2】** shows an example of the capital structure of a stock company.

【Figure 2-2: Example of capital structure for a stock company】



5. Debt Finance - Loans and Bonds

Debt financing is provided through various types of loans and corporate bonds (for details, see Chapter 5, Sections 1 and 2 of the Book). Loans and corporate bond financing (investment) are used not only as part of traditional corporate financing by companies (corporate finance), but also as part of structured finance such as LBOs and real estate securitization (see Part 3 of this series for details).

6. Collateral

Closely related to the preferred-subordinate structure is the securing of priority rights through security interests (see Chapter 5, Section 3 of the Book for details). When the debt investor's security interest in a portion of the liability property held by the fundraiser has been established, there is a preferential right of recovery over the collateralized object in question. In this case, the investor who is the security interest holder is located in a higher tranche than the unsecured creditor.

The above has explained corporate finance. In the following part, **Structured Finance/Asset Finance** will be discussed.