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Value Creation by Business Lawyers in the 21st Century

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TRANSCRIPT: VALUE CREATION BY BUSINESS LAWYERS IN THE 21ST CENTURY

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It's a delight to be here.[1] When I started working on *Value Creation by Business Lawyers*[2]— or when I was in law school — we could have held today's meeting in a telephone booth. There was nothing even remotely in the curriculum. Victor Brudney and Marvin Chirlestien's *Corporate Finance*[3] book was still in mimeograph form — note the dated technology reference. David Herwitz's *Business Planning*[4] book had been around for a while, but it was strictly legal. And that exhausted it. What I take the greatest pleasure from is the fact that a number of years later, enough to make me feel old, it still seems that I got the question right: how do business lawyers create value for their clients? The answer to that question is always going to be time and circumstance mediated but the question remains the same.

So, let me give you some sense of where the question came from, because it came from practice, not from the academy. When I left my firm, I traded a partnership for an untenured associate professorship. The associate professorship turned out to be wonderful for me, but at the time there were people who thought it was pretty dumb, including, importantly, my partners. I started thinking about the project from the time I started teaching, and probably had an early draft by 1982. As the timing suggests, this was the project that took me out of practice. I believed that what I was doing in practice was creating value, and in ways other than just negotiating legal rules and regulatory requirements. But I couldn't articulate it in a coherent way, which meant I couldn't train anybody very well.

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[1] This transcript is from the January 4, 2014, Section on Transactional Law and Skills of the American Association of Law Schools (AALS) conference. AALS devoted its annual section program to the 30th anniversary of Professor Ronald Gilson's seminal article, *Value Creation by Business Lawyers*.

[2] Ronald J. Gilson, *Value Creation by Business Lawyers: Legal Skills and Asset Pricing*, 94 YALE L.J. 239 (1984).

[3] *See* VICTOR BRUDNEY & MARVIN A. CHIRELSTEIN, CASES AND MATERIALS ON CORPORATE FINANCE (3rd ed. 1987).

[4] *See* DAVID R. HERWITZ, BUSINESS PLANNING: MATERIALS ON THE PLANNING OF CORPORATE TRANSACTIONS (1966).

So the project became: how do you address the question of how business lawyers create value? Of course if we don't create value, there is plenty of evidence that we lose the work. And that became a bigger problem, not a smaller problem, as time went on.

The way I began to answer the value creation question was to recognize that there was nothing in the traditionally legal literature that spoke to creating value. We simply did not have a theory of the relationship between legal structure and value. That means that the core of the project — the analytic framework to link what the lawyer does to what the value of the transaction is — has got to come from somewhere else in the university. Now, that doesn't mean that my partners from when I was practicing law didn't get it. Rather, they learned it in an experiential way that is very hard to communicate to students or young associates. Theory, on the other hand, is a very effective way of transmitting the link between the work of business lawyers and the value attained by their clients.

Where I started the search for these links was driven in part by the moment in which I was working. At the time there was an explosion in financial economics and particularly in asset pricing. It then was an easy move to say, "Well, if I can understand how the market goes about determining the value of a capital asset — lawyers facilitate the creation or the transfer of capital assets — then I'll begin to have some way to connect the particular things I did as a lawyer with the valuation outcome that gets refracted through the lens of the market." So it was easy. I started with the capital asset pricing model, which is theoretically elegant but turned out to be empirically unsound (but it did get Bill Sharp the Nobel Prize). What was particularly useful about it for my project was that its structure framed asset pricing in an interesting way. If all of its assumptions are right — as a short hand, think no transaction or information costs — then the model is tautologically true.

This analytic approach — showing how a question was answered in a perfect market — was common in finance and in other areas of economics. For law schools, it importantly included Coase's theorem that in the absence of transaction costs, the allocation of liability does not matter. Of course, it was precisely Coase's point that all of the interesting things appear when you let frictions back into the structure. And this step became the core of *Value Creation*.[5] A great deal of what business lawyers did — I used an acquisition agreement because I knew its structure well — addressed these frictions. We allowed clients to price transactions more closely to what CAPM would dictate in a frictionless world.

I have one anecdote that proves the fact that really good lawyers intuitively understand how to create value even if they are unable to articulate it in a helpful way. I had the occasion in connection with a consulting project to

[5] Gilson, *supra*, note 1.

look at a set of acquisition agreements that documented transactions done in the late nineteenth century. This was the period in which local utilities got rolled up into regional utilities. In my case, the transactions reflected the creation of Pacific Gas & Electric — the San Francisco Bay Area public utility. The acquisition agreements were perfectly familiar and understandable. Any current M&A lawyer who looked at these documents would be astonished by two things: The first is that the nineteenth-century lawyers were doing the same thing that current M&A lawyers are doing and they were using familiar techniques. The second is that the work was handwritten. It was done by scribes rather than by typewriter or word processing machine — and the "T" at the beginning of a paragraph looked like it was written by an Irish monk.

But enough history. Now, where do you go with the value creation enterprise? As I said earlier, this question remains right, but part of its ambition is the notion that it has something to say about how we train lawyers. So the subject shifts to what are we now doing pedagogically. Here I want to stress a point that comes not from the original article, but from trying to implement the insight for some 30 years: teaching how to create value is not just a clinical exercise. It is important to be able to tie the clinical portion of a transactions-based course to a set of theories that connect those techniques to where we think the sources of value are.

Of course, we can tell stories, which are important in setting the context and making the problem visible. But we need something to extract from the anecdotes we tell that people then can use in more ways than just the particular transaction that gave rise to the anecdote. The anecdote may be an M&A story but we may want to be able to take the core of techniques that are used in M&A and translate them into real estate deals or joint ventures, or doing a deal that no one has quite seen before. Can we give our students a set of theories that allow them to ask the right questions when they don't have a form from a prior deal? If we can do this for our students, then it seems to me that we can do something really important for our clients.

When I started practice, I was the fourteenth lawyer in the firm. I still have a copy of the letterhead because with just fourteen lawyers everyone's names were still listed on it. I was at the very bottom. There were only two places on the letterhead that people noticed: the very top and the very bottom. I captured one immediately. So, for theory to matter it has to be integrated into the practical side of what we are telling students about lawyers. A second point is that this theory that we use is going to continue to evolve. The capital asset pricing model turned out to be a nice heuristic. In contrast, option pricing — which I spend more time on of late — turns out to be enormously important and useful.

For law schools, teaching option pricing is not using it to actually quantitatively value something, but rather using it in a way that helps us recognize that the structure of most transactions included embedded options, what

the financial economists call "real" options. Once the students can see the embedded options, option pricing will tell you what factors determine the value of that option and hence what the other side is likely to do to you. This then depends on whether your client is writing the option or will be the holder of it. For example, it allows a partner to ask an associate: "Write a memo for me. I want to know every option that's created by the agreement and what the party is likely to do with it and how you are going to constrain that or price that into your option." More importantly, perhaps, it lets the associate write that memo even if the partner did not frame the question in option language.

There are a number of useful analytic techniques that have been developed since *Value Creation*[6] was written that need to be built into a transactions course. Negotiation theory strikes me as being critically important in ways that don't get addressed as much as they should. I'll focus this morning on what I think of as "the simultaneity problem." The sunny side of negotiation theory — the win-win, we can cooperate and increase the size of the pie side — is clearly right, at least in the abstract. But in most business transactions, cooperative bargaining takes place at precisely the same time as distributive bargaining takes place — how to create value and how that value is split between the parties occur simultaneously. The problem is that the techniques you use to create value — sharing information, identifying who values what elements in the transaction in what ways, and what's important to each side — can bias the distributive bargaining. The two run into each other. One subject that warrants our efforts is teaching about the set of techniques that to some extent can acoustically separate the value creation and value distribution elements even if they do take place simultaneously. This seems to me an important skill for our students, but they're going to need some theory to motivate the exercise, particularly if it is going to generalize across transactional forms.

At this point, I should note that I remain skeptical about behavioral economics, at least in larger business settings. The evidence on whether in repeated circumstances you can learn your way out of particular biases is at best mixed with respect to how effective it is. It is a very different issue than how it operates in a consumer setting, but as of yet I still do not see a lot of payoff in the large business setting.

So, how do you tie together the theory and practice? That is, how do you take the theory that illuminates where the value is coming from to the transactional techniques that allow a business lawyer to capture that value? Again, you should notice that I didn't specify the kind of theory. The techniques are continually changing. But how do you tie that pedagogically to what's really going on in practice? Here — I can just do it and then I'll sit down — I can provide a capsulized account of 25 years of what I think of is the "Deals course"

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[6] Gilson, *supra*, note 1.

that was developed with Vic Goldberg and Dan Raff at Columbia. This course was then further evolved by the Law School and Wharton at Pennsylvania, and especially by Mike Klausner at Stanford Law School.

The basic course structure is that the first two-thirds of the course, with problem sets and documents and things like that, is theory. These classes teach the analytic techniques that link deal structure and value creation. The last third of the course gives the students the opportunity to test what we've told them by applying those techniques to real transactions. We divide the students into five teams. Each team gets a real complex transaction with the full documentation included. Consistent with the claim that the techniques generalize across types of transactions, we try to make each transaction as different from the other as possible. For example, in one year we may do a movie financing, a small biotech-large pharmaceutical joint venture, and a privatization like that of the Chicago Skyway.

From all of our selfish perspectives, the deals are the hardest part of the class because you have to whine and beg for people to give you their documents. Each deal is given two classes. The student team will write a serious paper on their deal, a draft of which is due before the students present the deal in a class they conduct. In the second class, the people, the lawyers, and sometimes the clients who did the deal show up. They present their way of thinking about the deal, which gives the students a chance to find out all the things that you need to know for writing a paper that you can't get off of the web or through the archaeology of the documents. And importantly, it is a check on what we are telling them. The hypothesis at the core of the course is that our approach will allow them to figure out these deals faster because of what we did in the first two-thirds of the course. And if they don't, they ought to tell us, because then our course — and our belief about how the world works — in fact is not working.

At Columbia we've been through probably over 125 different transactions. Professionals present the deals in radically different fashions. One transaction involved Blackstone's acquisition of a Florida theme park. Steve Schwarzman came in and spoke for five minutes and asked the class, "What do you want to know?" Other presenters take a different tack. Another transaction reflected the combination of steps by which GE restructured the global heavy gas turbine market. The head of GE's acquisition team presented the full sound and light show that was presented to the GE board. Somewhere in the middle of this scale fell a presentation by the lawyer who oversaw the United Nations' development of a weather derivative for Ethiopian farmers so they could self-insure against droughts.

In the end, the process comes down to this: there are a set of analytical techniques associated with value creation and the kind of documentation that lawyers use to overcome problems that get in the way of value creation. The way to think about them comes from an ever-changing body of theory that grows as

work elsewhere in the university grows. Most of that doesn't have anything to do with law. For example, if you think about a transaction as a Christmas tree, the legal rules hang like ornaments. You have got to hang them, and you have got to do them right. It's easy, it's routine, but if you mess it up it can be a significant problem. So you've got to hang the ornament so it doesn't drop on one of the little kids sitting near the Christmas tree. But the only time the ornament itself is important is if it comes at one of those decision tree nodes where solving it allows something else to happen — where the frictions are too costly to morph the transaction around it.

If we can teach our students to create value, when they find themselves in a law firm they are going to meet what seems to me the current test for associate career success: does the person for whom they worked conclude, "Hey, that person was helpful!" And, unlike when I was in practice, when I could do stupid things and I'd be forgiven and then taught by a mentor how to do it right, my sense is that it's a very unforgiving world now. Therefore we have to give students tools that will let them be helpful without having to watch and learn first.

QUESTION SEGMENT

Audience Question

Something that characterized what I think all of the papers touch on, which is what I'll deem to be an overly facile debate that is going on in the blogosphere about experiential education, either yes or no. As if it's a zero-to-one toggle. And it strikes me wrong that one of the great things about your article and about really the work of the chair today is it's rich with this isn't a zero-to-one toggle and you don't do theory without policy, without doctrine, without applied skills. I just wondered if any of you have a view on that, or if your papers are going to get rid of [that notion]. I think this is a non-debate that we are having.

Moderator

I wonder how much the Deals class tries to do that in some ways.

Professor Gilson

Well, here's the question that I have for the state commissions, and it's a genuine fact question. What I observed at Stanford, but more generally, is a dissipation of simulation models in favor of client representation. That both skews the subject matter — we can talk about small businesses having complicated problems but they don't have the same problems as large businesses and in general they are not as complicated. I think [your question] is right in the notion that there is a sharp line between experiential learning and classroom learning. If there is, it's a bind that we put ourselves in, and there's no particular reason for it. It seems to me that the push toward experiential learning is also a

push towards client representation to the exclusion of simulation models, which have the capacity of providing some things in a mix with client representation that the client representation model alone can't do. So if that is the direction business clinical are moving, I am left with the intuition that it works in some settings but does little for those of our students who are going into a big firm practice.