

# Role of Corporate Finance Law in Corporations.

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## **Abstract:**

*This paper has focused on the role of corporate finance law in corporations. Corporations, in Pakistan has been governed by the Companies Act, 2017, aims to maximize the profit by minimizing the risk, possesses a separate legal personality having rights and duties towards the outside world. As the word corpus means body; Companies enjoys separate legal personality from its shareholder, members and directors. British East India Company was the first business corporation that have earned profit for its members. A company is formed by due process of law and not otherwise. Company if is created by limited number of shareholders i.e two to fifty it is a private company and in other case it is a public company. A public company formulated by due process of law possesses separate corporate personality, the liability of its members is limited and also has many other distinct characteristics.*

*Corporate Finance Law is legal aspect of financial management of a public corporation and focuses to manage the finance of a company in legal ways. It governs the decision making process in the company and provide a six step process of financial decision making, it helps to reduce agency cost and transaction cost by tackling agency relations between different limbs of the company i.e shareholders, managers and third party. By all these means it objects to achieve the basic aim of a company i.e to earn profit and minimize the risk.*

**Key words:** Corporation, Agency, Financial Decision Making, Limited Liability, Separate Legal Entity, Risk, Profit

### **Introduction:**

If someone remarks that the modern world is world of corporations than it is a very true statement. Nearly whole of the business of the modern world is carried through the tool of a company. A company is a juristic person created by operation of domestic law in force in the concerned state i.e The Companies Act, 2017 in Pakistan.

Company is a separate legal entity from its members and possesses a corporate personality. It has a perpetual succession and a common seal. It can sue and be sued, possesses assets. The shareholder of the company has limited liability as to company because company has its own personality separated from personality of its members. Shareholder by their will delegates the managerial authority to directors who manages the affairs of the company.

It is not necessary that liability is always limited but in some special circumstances the virtual veil of incorporation vanishes and the person become liable for liability of the company.

Corporate Finance Law as identifiable from the term is simply the legal aspects of finance of the corporations. Corporate Finance is that area of the finance that deals with financing

the company and management of the company finance. It aims to maximize share and shareholder value by making effect plans. Corporate Finance Law is legal rules of financing and financial management.

### **Methodology:**

This paper is based on qualitative research based on physical and online library research. The online data sources i.e Jstor etc has been used to collect data on the topic of corporate finance, corporate finance law etc. Thus, the secondary data collected from research papers, books, websites etc has been used to analyze and conclude this paper. Online data sources and libraries mainly Central Library of International Islamic University, Islamabad has been used to carry the discussions.

### **Discussions:**

Authors, Lawyers, Jurists, philosophers and many others have defined law in their own ways from many aspects but if one is willing to extract the core idea than “the law” is simply a set of rules and principles governing a specific subject.

Law has certain specified purposes as to its subject. For instance, if we put Human beings as a subject of law than one can summarize

purpose of law as keeping the peace by maintaining status quo, preserving the rights of its subjects by promoting social justice and by providing order for social change.

Corporate law is law of corporations and their relation to the general world. It is also the law relating to matters which derive directly from the life-cycle of a corporation.<sup>1</sup> Corporate law can also be termed as Company Law, is a law which deals with all matters of the corporations i.e creation of company, regulation of its business and relation to outside world, its membership, management and winding up of the company simply all affairs of company from its corporate birth to its corporate death. Though Armour & Whincop<sup>2</sup> defined it into a narrower sense that *Corporate Law* is body of laws dealing with complex contracts of corporations and is an addition to *Law of Contract*.

Functions or purposes of corporate law are

more or less the same as are in the case of the law generally but this is to corporations only and not individual but in addition to all those purposes it also emphasis on formation and dissolution of the corporate entities.

### **1. Objectives of Corporate Finance Law:**

The corporate finance, corporate finance management and law are most important limbs of a corporate entity. The main objective of corporate finance and law of corporate finance is to serve with the purpose of corporation, these objectives are based upon the basic purpose of corporate entity.

### **2. Objectives and Purposes of Corporation:**

There are a number of objectives of a corporation i.e Profit Objective,<sup>3</sup> Growth Objective,<sup>4</sup> Market Share Objective, Survival,<sup>5</sup> Employee Satisfaction,<sup>6</sup> Social & national Objective, image and reputation

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<sup>1</sup> Kraakman RH, Cools S and Goto G, *The Anatomy of Corporate Law: a Comparative and Functional Approach* (Oxford University Press 2017)

<sup>2</sup> Armour J and Whincop MJ, "The Proprietary Foundations of Corporate Law" (2007) 27 Oxford Journal of Legal Studies 429

<sup>3</sup> Aremu M, "Nature, Scope and Purpose of Business" in Gunu, U, Kasum, A. S. & Mustapha, I. Y. (ed), *Contemporary Entrepreneurship Development* (Technical and Entrepreneurship Center (TEC), University of Ilorin 2015)

<sup>4</sup> Boone LE and Kurtz DL, *Contemporary Business* (9th edn Dreden Press 2001)

<sup>5</sup> Aremu M, "Nature, Scope and Purpose of Business" in Gunu, U, Kasum, A. S. & Mustapha, I. Y. (ed), *Contemporary Entrepreneurship Development* (Technical and Entrepreneurship Center (TEC), University of Ilorin 2015)

<sup>6</sup> Fried Y and others, "The Mediating Effects of Job Satisfaction and Propensity to Leave on Role Stress-Job Performance Relationships: Combining Meta-Analysis and Structural Equation Modeling." (2008) 15 International Journal of Stress Management 305

building along with shareholder satisfaction.<sup>7</sup>

While one can refer purpose as intention to do something. Malloy<sup>8</sup> identified these purposes as

- Production,
- Marketing,
- Finance and
- Personal purposes of the corporation.

The tentative assessment of the discussion supra seems to be in line with shareholder theory of purpose of business given by Adam Smith in his *The wealth of Nations*<sup>9</sup> which declares following objective of a corporation to earn as profit as maxim.

### **3. Corporate Finance Law's Objectives:**

As enlisted supra maximizing profit and minimizing risk are ultimately the objectives of corporate finance and law of corporate finance.

#### **1. Maximizing the profit:**

Profit dictionary means to gain something financially and technically profit is what a person or earn from a business. Making profit is the main objective of a business entity or corporation.

#### **2. Minimizing the risk:**

Risk is the main competitor to the profit. Risk is uncertainty in the business. Financial Risk can be defined as the ratio of debt and equity finance. Corporate Finance Law focus on to minimize the risk in order to gain as much as possible profit for its members.

### **3. Tools to achieve the Objectives of Corporate Finance Law:**

#### **i. Financial Decision Making:**

The modern world is world governed by corporations and not by natural human beings. Decision making is central part of any management. The decision of a fast food stall owner and the decision of a manager or director of a corporation are different. Financial decision makers are mainly

<sup>7</sup> Aremu M, "Nature, Scope and Purpose of Business" in Gunu, U, Kasum, A. S. & Mustapha, I. Y. (ed), *Contemporary Entrepreneurship Development* (Technical and Entrepreneurship Center (TEC), University of Ilorin 2015)

<sup>8</sup> Malloy, D. C. (2003). Understanding the Nature of Ethics, Values, and Purposes of Business, Health Care and Law: Implications and

Applications for Community Sport, *The Sport We Want Symposium* organized by Canadian centre for ethic in sport, September 12 – 13. 2003. Accessed on 30/12/2014 at [www.cces.ca/files/pdfs/CCES-PAPER-Malloy-E.pdf](http://www.cces.ca/files/pdfs/CCES-PAPER-Malloy-E.pdf)

<sup>9</sup> Smith A, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Cosimo 2007)

concerned to positively achieve the very objective of corporation i.e to earn profit. In financial decision making there is a strong connection of risk and return.<sup>10</sup> One cannot have an effective decision unless he analysis the risk and return. It can be defined as “*the selection of a course of action from among alternatives.*”<sup>11</sup>

Decision making is the process of identifying a decision, gathering information and making choices and assessing alternative resolutions.<sup>12</sup> There are three elements of a decision i.e Information, preferences and alternatives.<sup>13</sup>

## 1. Alternatives:

A decision is taken when management has to cater solution for an issue. Alternatives enables management to take decisions. Alternatives provide uncertainty that which alternative is perfect for required decision.

## 2. Preference:

The other important elements in the decision making is to give preference to a good alternative to your issue. Preference shall be free from all interpersonal preferences rather it should be given to actually suitable alternative.

## 3. Information:

There is always sufficient information to cater a solution for every certainty. It is duty of management to gather such information. Without proper information no one can make an effective decision.

If all the relevant information is not available than the decision has to be made on the basis of available incomplete information.<sup>14</sup>

## Decision Making Process:

There are four popular approaches<sup>15</sup> to make a decision.

- i) Rational Theory<sup>16</sup>:
- ii) Bounded Rationality<sup>17</sup>:
- iii) The Political View<sup>18</sup>.

<sup>10</sup> McMenamin J, *Financial Management* (Routledge 2005)

<sup>11</sup> Weihrich H and Koontz H, *Management* (McGraw-Hill 1993)

<sup>12</sup> “7 Steps of effective decision making” <[https://www.umassd.edu/media/umassdartmouth/fy/cm/decision\\_making\\_process.pdf](https://www.umassd.edu/media/umassdartmouth/fy/cm/decision_making_process.pdf)> accessed November, 23<sup>rd</sup> 2019

<sup>13</sup> “WP1053 Decision Making - Mosaic Projects” <<https://mosaicprojects.com.au/WhitePapers/>

WP1053\_Decision\_Making.pdf> accessed November 23, 2019

<sup>14</sup> Pohl J, *Elements of Human Decision-Making*. (Baden-Baden 2006)

<sup>15</sup> Tiernan S, Morley M and Foley E, *Modern Management: Theory and Practice* (Gill & Macmillan 2013)

<sup>16</sup> Imparato N and Harari O, *Jumping the Curve: Innovation and Strategic Choice in an Age of Transition* (Jossey-Bass Publishers 1996)

<sup>17</sup> Turpin SM and Marais MA, “Decision-Making: Theory and Practice” (2004) 20 ORiON

<sup>18</sup> Pfeffer J, *Power in Organizations* (Pitman Publ Inc 1981)

iv) Escalation of Commitment.

Using a step-by-step decision-making approach can help you make more careful and thoughtful decisions by managing relevant information and options. This approach increases the likelihood that the individual will choose the most satisfactory option that will lead to an effective decision.

By evaluating different models following six steps can be concluded as essential steps of decision making.<sup>19</sup>

1. Identify and diagnose the problem.
2. Gather relevant information & Identify alternative solutions.
3. Evaluate alternatives.
4. Choose an alternative.
5. Implement the decision.
6. Evaluate the decision.

**1. Identify and diagnose the problem.**

The first step in the decision-making process is to identify what the purpose of the decision-making is, i.e. where the problem is

and how it will be solved: the course of action.

One problem is the difference between the current state of affairs and the desired state.<sup>20</sup> Until the problem is identified in a definite terms, possible solutions cannot be established. A comparison of organizational performance and historical performance can identify the problem using multiple data sources, including the current performance of other organizations or the expected performance in the future.

Identification of Problem shall be followed by a willingness to do something to cure the problem. Before taking action the situation needs accurate diagnosis of problem. Diagnosis includes assessment of the original root of the problem by careful selection of all relevant material and by discarding irrelevant information.

Sometimes decisions need to be made without problem: for example, a company must grow rapidly to take advantage of market opportunities and decide which path to take.

**2. Gathering Relent information**

<sup>19</sup> Tiernan S, Morley M and Foley E, *Modern Management: Theory and Practice* (Gill & Macmillan 2013)

<sup>20</sup>“Definition of Problem”  
<<https://quizlet.com/es/196307888/management-ch-3-flash-cards/>> accessed November, 23<sup>rd</sup> 2019



**and Identify alternative solutions:**

The 2<sup>nd</sup> step of decision making is collecting some pertinent information before making a decision: All the relevant information from all the relevant sources shall be collected before making a decision. This step involves both internal and external collection of information as discussed supra.

The major portion of 2<sup>nd</sup> step is to identify the alternative solution. After identification and diagnoses of the problem and selection of relevant information, the next step is to identify available alternatives to resolve the problem. One should broad possibilities and ways to resolve the problem by identifying as many alternatives as possible. In generating alternatives one may look toward ready-made solutions that have been in practice in alike situations.

**3. Evaluation of alternatives:**

The next step is to look at and explore alternatives. Considering the pros and cons as well as the costs and benefits associated with each option. Suggesting alternatives, it raises the positive impact of the decision.<sup>21</sup>

In evaluating alternatives, one will look at the potential impact of the alternative under a variety of conditions, in order to develop potential plans that can be used with future conditions in mind. When you consider the range of options available to an organization to handle growth, a number of different methods can be used. The organization will consider the costs associated with each option and the time taken to complete the alternative. The potential for success of each of these options will also need to be considered, as well as the impact of any decision on staff, training and culture.

**4. Choice of alternative:**

The next step is to choose the most appropriate one. If, for some reason, none of these options are considered appropriate, the manager should repeat the process over and over again. When there are alternatives and the steps outlined above are handled more efficiently, choosing alternatives can be a daunting task. Other methods may vary greatly from purpose i.e. problem solving.

**5. Implement the decision:**

When a decision is made it needs to be

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<sup>21</sup> Tiernan S, Morley M and Foley E, *Modern Management: Theory and Practice* (Gill & Macmillan 2013)

implemented. This phase of the process is critical to the success of the decision and is the key to successful decision-making. Some of the best is useless if not used properly. In order to implement the decision effectively, one must ensure that the initiators will know why the decision was made, and the reason for its implementation.<sup>22</sup>

Decisions often fail at the implementation stage due to lack of rationality and commitment towards implementation.

#### 6. Evaluation of Decision:

Evaluation of decision made and implemented in is the final step of decision making process. In this step results of the implemented decisions are evaluated that whether the decision has served the purpose for which it was intended. If the decision has not cater the solution of intended problem, all steps of decision making shall be repeated to

make a new effective decision.<sup>23</sup> Evaluation of the achievement of a new business will be measured on the success and effectiveness of the project.

#### i. Risk Management:

Traditionally risk is viewed as a 'negative'. Webster's dictionary has defined risk as "exposing to danger or hazard."<sup>24</sup> Risk is the probability or threat of damage, injury, liability, loss, or any other negative occurrence that is caused by external or internal vulnerabilities. Risk is the chance of loss.<sup>25</sup> It can in pure corporate terms be referred as the difference between the actual return and expected return from.<sup>26</sup> Risk is based upon uncertainty.

#### Risk is either General or Specific:

General risk can be referred a risk that a business faces as a whole. General market risk refers to the risk exposure of the portfolio against the market as a whole.<sup>27</sup> While

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<sup>22</sup> Tiernan S, Morley M and Foley E, *Modern Management: Theory and Practice* (Gill & Macmillan 2013)

<sup>23</sup> "7 Steps of effective decision making" <[https://www.umassd.edu/media/umassdartmouth/fy/cm/decision\\_making\\_process.pdf](https://www.umassd.edu/media/umassdartmouth/fy/cm/decision_making_process.pdf)> accessed November, 23<sup>rd</sup> 2019

<sup>24</sup> Damodaran A, *Applied Corporate Finance* (4th edn Willey 2014)

<sup>25</sup> Senthilnathan S, "Risk, Return and Portfolio Theory A Contextual Note" (2016) 5 International Journal of Science and Research (IJSR). 705

<sup>26</sup> "Return & Risk" <<https://www.slideshare.net/saadiakh/risk-and-return-14615477>> accessed November, 24<sup>th</sup> 2019

<sup>27</sup> Platen E and Stahl G, "A Structure for General and Specific Market Risk" <<http://citeseerx.ist.psu.edu/viewdoc/download>



contrary specific risk is risk to some particular aspect of business. Specific risk can't be converted into general risk.<sup>28</sup>

In corporate sector there is a lot of risk involve in agency relation. An agent is a person who represent another in certain transaction or act. Corporate sector is build up in the agent principal relation i.e Directors acts as agents of shareholders of the company. The most risk is involved in agency costs in control transactions. The cost of agency relation is cost of transaction.

#### **Agency Relationship:**

Corporate finance law focuses on the legal strategies for addressing the principal/agent problems which arise when a person attempts, through offers to the company's shareholders, to acquire sufficient voting shares in a company to give it control of that company.

Agency is a contract under which one or more persons i.e the principal engage another person i.e the agent to perform some service on their behalf which involves delegating some decision-making authority to the

agent.<sup>29</sup> The agency relationship is in most of the cases is a two-way process. Once the agent acts in good faith and works in the interest of the principal by providing information the principal returns some favor to the agent.

#### **Agency Cost:**

The principal incurs cost through various means such as monitoring to order limit the aberrant activities of the agent. Agency cost is sum of monitoring cost, bonding cost and residuary loss.<sup>30</sup>

Monitoring costs are costs incurred by the head designed to keep the agent in line with the interests of the head. It will be important for the agent to find out the cost of compiling the costs in certain circumstances to ensure that the principal does not take steps that could harm the principal or compensate if he or she does so. Although the principal and the agent will incur the costs, however, it is not possible to ensure that the agent's actions will be in full harmony with the principal's interests. The residual costs are equal to the amount spent from reducing the welfare of

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d?doi=10.1.1.13.7104&rep=rep1&type=pdf.>  
accessed November 24, 2019

<sup>28</sup> Ibid.

<sup>29</sup> Oteng A, *Agency* (GIMPA 2016)

<sup>30</sup> Jensen MC and Meckling WH, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *Journal of Financial Economics* 305

the principal due to the difference between the decisions of the attorney and the decisions that may enhance the welfare of the principal.

### **General Agency Problems:**

There are three general problems of agency relationship.<sup>31</sup>

#### **1. Directors act as agent of the Shareholders:**

The owners of the firm i.e shareholder and the managers and directors are contracted to run the company. The problem is that director must be able to assure that they will act in the benefits of the shareholder rather than pursuing their own interest.

#### **2. Majority shareholder controlling the company:**

The minority shareholders as principal and the majority shareholder that practically controls the company. The issue lies in ensuring that majority shareholder acts in the best benefit of the company and for their own benefit.

#### **3. Company as agent of shareholder.**

The company while carrying on business to the outside world acts as agent its own shareholders. The problem is that company does not act in positive manner such as by expropriating creditors, exploiting workers, or misleading consumers.

### **Problem Resolution:**

It is not necessary that no profit is earned due to above listed problems. For instance managers are highly skilled officials equipped with high technical knowledge and ability to work for the benefit of the company. On the other hand shareholders have better control over the management of the company and can manage directors and creditors etc. Similarly, customers and employee also works for their own benefit. These problems can be resolved in various ways. There are many managerial (market oriented strategies)<sup>32</sup> and legal strategies to resolve these problems. Corporate Finance Law looks into the legal strategies of problem resolution.

These problems can be resolved by applying legal framework, by making and applying

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<sup>31</sup> Kraakman RH, Cools S and Goto G, *The Anatomy of Corporate Law: a Comparative and Functional Approach* (Oxford University Press 2017)

<sup>32</sup> Richter, T. (2002). The voucher privatization and its impacts on the management and financing of the joint stock company Options. In *The voucher privatization and its impacts on the management and financing of the joint stock, company Options*. Masaryk University, Brno.

rules and regulations. There are two type of strategies i.e Regulatory and Governance. Strategies can be subdivided on the basis of time of implementation i.e Ex- Ante and Ex-Post.

Regulatory strategies are said to be inherently strong in commanding active words that control the content of head-to-agent relationships or their construction or termination.

In contrast, governance strategies, which are based on relationships, benefit principals indirectly by improving their control over the company or by building incentives for their agents.

Ex-Ante are those strategies that are applied before or at the time of creation of relationship of agency while ex-post are those which are implemented at the time of end or termination agency relationship or at time of arousal of some issue.

Ex-Ante strategies focuses on making clear cut rules and regulations to be followed by the agents. These rules aims to empower the shareholders i.e principals. On the other hand, ex-post strategies are framed in order to cater with the problems arising out of the ex-

ante strategies implementation. These are aimed to nullify the negative effect of ex-ante strategies. Ex-post rules are generally applied by courts of law.<sup>33</sup>

### **Advantage of Legal Strategies:**

The chief positive consequence of legal strategies (with respect to corporate law) is in its capability to curtail the agency cost and transaction cost of the company. Rules and procedures that develop disclosure by agents or facilitate enforcement actions brought by principals against dishonest or negligent agents helps to minimize cost of agency and cost of transaction.

In some cases legal efforts to protect principals may also result in benefits to agents even more than principals. This is because the principal will be willing to pay extra money to the agent where he will ensure that the agent's performance is not only reliable but also of good quality. Lenders operate in much the same way as the aforementioned market process. Both principals and agents can benefit when the legal and enforcement system can effectively penalize corporate business activities, lenders can borrow money at low interest rates and enjoy a low rate of fraud.

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<sup>33</sup> Ibid

### **Legal Objective of Corporate Finance Law:**

There are four legal objective of corporate finance law which are enlisted as below:

1. Objective of decision making
2. Identification of possible approaches
3. Cash flow
4. To manage risk.

### **Conclusion:**

Corporate finance is most important limb of a corporation. Business Corporation cannot operate without capital and finance. Corporate finance focuses to manage and distribute the finance and capital of the corporation in right way in order to benefit the company and shareholders. The main object of a business corporation is to earn profit and to enhance its value in general public. The corporate finance law focuses to help the corporation to achieve its object.

Corporate Finance Law help managers to take effective decision by providing systematic decision making by identifying problems and identifying best possible variable alternatives, implementing and evaluating the decision made in the light of problems and alternative solutions thereof.

Corporations are run by way of principal and

agent relation. Sometimes shareholders becomes agents and on the other hand sometimes managers and sometime corporation itself act as agent. Shareholders invest their capital in the corporation in order to attain some good return in form of profits. Corporate finance law aims to resolve problems that are faced to stakeholders due to agency relation among the corporations by implementing a number of strategies to resolve these problems.

In the end we can conclude that corporate finance law focuses to serve with the purpose of earning profit and minimizing risk by managing cash flow, agency relationship and financial decision making by applying different legal rules and standards.

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