Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure

Jensen and Meckling (1976)

Presentation by Emma Xu and Michael Farrell
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Overview

One of the most cited papers in Finance

Develops Agency Theory

Provides theory on why commonly held firms do not maximize value per se

Explains why debt is a source of capital even without tax advantages

Explains why lenders place restrictions on debt

Explains why issuers of stock/debt accept restrictions and monitoring

Agency Costs

Agency Relationship

Costs paid by the initial entrepreneur.

Agency costs: Monitoring Expenditures + Bonding Expenditures + Residual Loss

Corporation a specific case of the agency problem

J&M General Comments on the Firm

Legal Fiction

Nexus of contracts: makes little sense to think of insiders and outsiders

The firm is not an individual

Every individual is maximizing their own personal utility

“The behavior of the firms is like the behavior of a market.” p.311

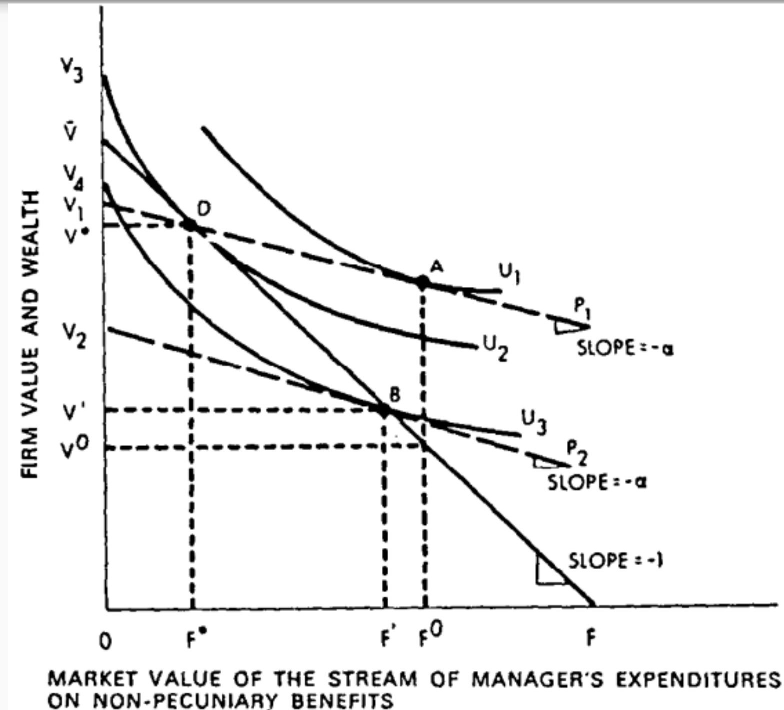
Agency Costs of Outside Equity

Compare behavior of manager who owns 100% vs manager who owns (1-a)*100%

Relative cost of pecuniary ($$) and nonpecuniary :-D costs changes

Lowers firm value

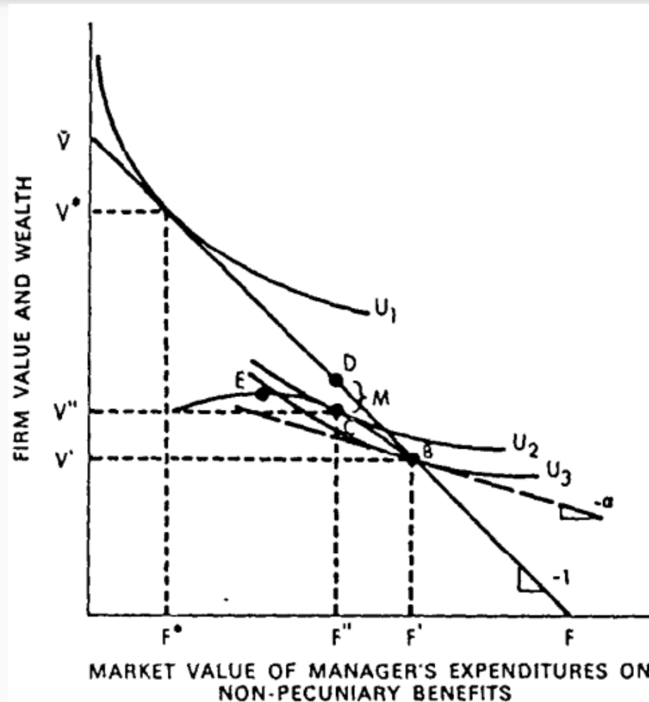
They also show that this lowers investment



Monitoring

Change incentives

Cost of monitoring: M



AC Equity

Tension between managers and outside shareholders

Monitoring/restraining manager from deviating from shareholder maximum

Costly

Benefits and Costs: sounds like we will have an equilibrium.

Agency Cost of Debt

Debt: fixed payments, possibility of default in cases of bankruptcy.

What incentives does borrowing introduce? Excessive risk-taking.

Insulates manager from the full impact of decisions -- limits losses in bad states of the world.

An Extreme Example: Risk shifting

Assume a firm has $10m debt due tomorrow

The total assets of the firm is worth $8m now

The firm can take the $8m to Las Vegas and play “double or nothing”

If doing nothing: $8 goes to debtholders, equity value=0

If playing gamble: winning-$10m to debtholders, equity value=$6m

losing-both debtholders and equityholders get nothing

Restrictions and Monitoring

Providers of capital are not stupid (or at least should not be!)

They will anticipate these types of incentives

Solution: structure loan contracts accordingly (in terms of price and covenants)

At the cost of equity holders

Equilibrium Ownership Structure

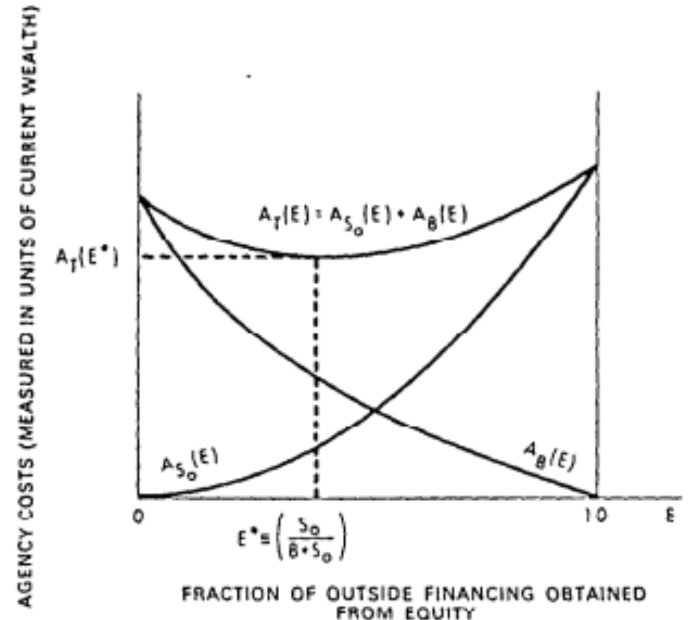
A theory on capital and ownership structure:

There is an optimal debt-equity mix that minimizes total agency costs.

So: Value of “outside” equity

B: Debt

A(E): Agency costs



Thank you!