SUMMARY OF THE PAPER "THEORY OF THE FIRM: MANAGERIAL BEHAVIOR, AGENCY COSTS AND OWNERSHIP STRUCTURE" PUBLISHED IN *JOURNAL OF FINANCIAL ECONOMICS,* VOLUME 3 (1976), pp. 305-360.

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SUMMARY BY

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ABSTRACT

"This paper integrates elements from the theory of agency, the theory of property rights and the theory of finance to develop a theory of the ownership structure of the firm. We define the concept of agency costs, show its relationship to the 'separation and control' issue, investigate the nature of the agency costs generated by the existence of debt and outside equity, demonstrate who bears these costs and why, and investigate the Pareto optimality of their existence. We also provide a new definition of the firm, and show how our analysis of the factors influencing the creation and issuance of debt and equity claims is a special case of the supply side of the completeness of markets problem."

A quote from Adam Smith at the beginning of the paper:

> The directors of such (joint-stock) companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company.
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> Adam Smith, *The Wealth of Nations*, 1776, Cannan Edition. (Modern Library, NY 1937),p.700

SUMMARY OF THE PAPER

1.1 Motivation of the Paper

The authors draw on progress in the theory of (1) property rights, (2) agency, and (3) finance to develop a theory of ownership structure for the firm. In addition to tying together the elements of the theory of each of these three areas, the analysis casts new light on and has implications for a variety of issues in the professional and popular literature such as the definition of the firm, the "separation of ownership and control", the "social responsibility" of business, the definition of a "corporate objective function", the determination of an optimal capital structure, the specification of the content of credit agreements, the theory of organizations, and the supply side of the completeness of markets problem.

The Jensen and Meckling (1976, hereinafter JM) theory explains:

1) Why an entrepreneur or manager in a firm which has a mixed financial structure (containing both debt and outside equity claims) will choose a set of activities for the firm such that the total value of the firm is less than it would be if he were the sole owner and why this result is independent of whether the firm operates in monopolistic or competitive product or factor markets;
2) Why his failure to maximize the value of the firm is perfectly consistent with efficiency;
3) Why the sale of common stock is a viable source of capital even though managers do not literally maximize firm value;

4) Why debt was relied upon as a source of capital before debt financing offered any tax advantage relative to equity;
5) Why preferred stock would be issued;
6) Why accounting reports would be provided voluntarily to creditors and stockholders, and why independent auditors would be engaged by management to testify to the accuracy and correctness of such reports;
7) Why lenders often place restrictions on the activities of firms to whom they lend, and why firms would themselves be led to suggest the imposition of such restrictions;
8) Why some industries are characterized by owner-operated firms whose sole outside source of capital is borrowing;
9) Why highly regulated industries such as public utilities or banks will have higher debt equity ratios for equivalent levels of risk than the average non-regulated firm;
10) Why security analysis can be socially productive even if it does not increase portfolio returns to investors.

1.2 Theory of the Firm: An Empty Box?

JM argued that while the economics literature is replete with references to the "theory of the firm", the material generally subsumed under that heading is not a theory of the firm but actually a theory of markets in which firms are important actors. The firm is a "black box" operated so as to meet the relevant marginal conditions with respect to inputs and outputs, thereby maximizing profits, or more accurately, present value. Except for a few recent and tentative steps, however, we have no theory which explains how the conflicting objectives of the individual participants are brought into equilibrium so as to yield this result. The limitations of this black box view of the firm have been cited by Adam Smith and Alfred Marshall, among others. Professional debates over the social responsibility of corporations, the separation of ownership and control, and the rash of reviews of the literature on the "theory of the firm" have evidenced continuing concern with these issues.

A number of major attempts to reconstruct the theory of the firm tried to substitute other models for profit or value maximization with the result that value maximization was insufficient to explain managerial behavior in large corporations. Some of these reformulations rejected the fundamental principle of maximizing behavior as well as rejecting the more specific profit maximizing model [Williamson (1964, 1970,1975), Marris (1964), Baumol (1959), Penrose (1958), Cyert and March (1963), Machlup (1967)]. JM retained the notion of maximizing behavior on the part of all individuals in their analysis.

1.3 Property Rights

An independent stream of research with important implications for the theory of the firm was stimulated by the pioneering work of Ronald Coase and extended by Armen Alchian, Harold Demsetz and others. While the focus of this research has been "property rights",

the subject matter encompassed is far broader than that term suggests. What is important for the problem addressed in this paper is that specification of individual rights determines how costs and rewards will be allocated among the participants in any organization. Since the specification of rights is generally effected through contracting (implicit as well as explicit), individual behavior in organizations, including the behavior of managers, will depend upon the nature of these contracts.

1.4 Agency Costs

Agency relationship is a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf which involves delegating some decision making authority to the agent. If both parties are utility maximizers, there is good reason to believe that the agent will not always act in the best interests of the principal. The principal can limit divergences from his interest by establishing appropriate incentives for the agent and by incurring monitoring costs designed to limit the aberrant activities of the agent. In addition, in some situations it will pay the agent to expend resources (bonding costs) to guarantee that he will not take certain actions which would harm the principal or to ensure that the principal will be compensated if he does take such actions. Agency costs refer to the sum of

a) The monitoring expenditures by the principal,
b) The bonding expenditures by the agent,
c) The residual loss, resulting from the divergence between the agent's decisions and those decisions which would maximize the principal's welfare.

Since the relationship between the stockholders and manager of a corporation fit the definition of a pure agency relationship, it should be no surprise to discover that the issues associated with the "separation of ownership and control" in the modern diffuse ownership corporation are intimately associated with the general problem of agency. The agency costs generated by the corporate form leads to a theory of the ownership (or capital) structure of the firm.

JM approach to the agency problem differs from most of the existing literature. That literature focuses almost exclusively on the normative aspects of the agency relationship; that is how to structure the contractual relation (including compensation incentives) between the principal and agent to provide appropriate incentives for the agent to make choices which will maximize the principal's welfare given that uncertainty and imperfect monitoring exist. JM's approach is a positivist type to the theory. That is, JM assumed individuals solve these normative problems and given that only stocks and bonds can be issued as claims, they investigated the incentives faced by each of the parties and the elements entering into the determination of the equilibrium contractual form characterizing the relationship between the manager (i.e. agent) of the firm and the outside equity and debt holders (i.e. principals).

1.5 Comments on the Definition of the Firm

The 1991 Nobel Economics Prize recipient, Ronald Coase, in his seminal paper on "The Nature of the Firm" (1937) pointed out that economics had no positive theory to determine the bounds of the firm. He characterized the bounds of the firm as that range of exchanges over which the market system was suppressed and resource allocation was accomplished instead by authority and direction. He focused on the cost of using markets to effect contracts and exchanges and argued that activities would be included within the firm whenever the costs of using markets were greater than the costs of using direct authority. Alchian and Demsetz (1972) object to the notion that activities within the firm are governed by authority, and emphasize the role of contracts as a vehicle for voluntary exchange. They emphasize the role of monitoring in situations in which there is joint input or team production.

Contractual relations are the essence of the firm, not only with employees but with suppliers, customers, creditors, etc. The problem of agency costs and monitoring exists for all of these contracts, independent of whether there is joint production in their sense; i.e., joint production can explain only a small fraction of the behavior of individuals associated with a firm.

It is important to recognize that most organizations are simply *legal fictions which serve as a nexus for a set of contractual relationships amongst disparate individuals*.

Viewing the firm as a nexus of contracting relationships amongst individuals also serves to clarify that the personalization of the firm implied by asking questions such as "what should be the objective function of the firm", or "does the firm have social responsibility" is seriously misleading. *The firm is not an individual*. It is a legal fiction which serves as a focus for a complex process in which the conflicting objectives of individuals (some of whom may represent other organizations) are brought into equilibrium within a framework of contractual relations.

In this sense, the "behavior" of the firm is like the behavior of a market; i.e. the outcome of complex equilibrium process.

1.6 An Overview of the Paper

The theory is developed in stages. The paper is divided into seven sections with the first being introduction and summary of the theory. Sections two and four provide analyses of the agency costs of equity and debt respectively. These form the major foundation of the theory. Section three poses some unanswered questions regarding the existence of the corporate form of organization and examines the role of limited liability. Section five provides a synthesis of the basic concepts derived in sections two-four into a theory of the corporate ownership structure which takes account of the trade-offs available to the entrepreneur-manager between inside and outside equity and debt. Some qualifications

and extensions of the analysis are discussed in section six, and section seven contains a brief summary and conclusions.

2.0 Conclusions

JM has demonstrated that the publicly held business corporation is an awesome social invention. Millions of individuals voluntarily entrust billions of dollars, francs, pesos, etc., of personal wealth to the care of managers on the basis of a complex set of contractual relationships which delineate the rights of the parties involved. The growth in the use of the corporate form as well as the growth in market value of established corporations suggests that at least, up to the present, creditors and investors have by and large not been disappointed with the results, despite the agency costs inherent in the corporate form.

Agency costs are as real as any other costs. The level of agency costs depends among other things on statutory and common law and human ingenuity in devising contracts. Both the law and the sophistication of contracts relevant to the modern corporation are the products of a historical process in which there were strong incentives for individuals to minimize agency costs. Moreover, there were alternative organizational forms available, and opportunities to invent new ones. Whatever its shortcomings, the corporation has thus far survived the market test against potential alternatives.

REFERENCES

Jensen, M. C and W.H. Meckling (1976) "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure," *Journal of Financial Economics*, Vol. 3, pp. 305-360.

Other references cited in Jensen and Meckling (1976)