

THE SEPARATION OF OWNERSHIP AND CONTROL

The Evolution of Business

Consider the firm in its evolution. Most firms start out because an entrepreneur has an idea about a new product, or a way to make things cheaper, or a better way of organization production. The entrepreneur takes a chance and **receives profit in compensation**. Profit is revenues minus costs. Costs are the payments to the other resource suppliers (because the entrepreneur is also a resource) that the entrepreneur has contracted. The entrepreneur agrees to pay these suppliers no matter how business turns out. The entrepreneur gets what ever is left. If the venture is a flop, the entrepreneur is liable for the losses.

Some ventures are successful, some not. The ones that are not do not continue. The ones that are successful have the singular characteristic: The business expands. Most often, business expansion requires that the entrepreneur accumulate additional resources. Sometimes the entrepreneur's success allows the entrepreneur to expand using personal wealth. More often, however, the entrepreneur must raise financial capital from other investors. These invested capital suppliers must then work out an arrangement with the entrepreneur. All of the other kinds of business units that we see in the world, such as partnerships, corporations, joint ventures, franchises, mutual companies, are the result of working out the details between the entrepreneur and the financial capital suppliers. We can call these **expanded business units** because they are caused by the desire to expand and the necessity of acquiring outside financial capital.

The association between the entrepreneur and the financial capital suppliers **redefines the notion of profit**. Part or all of the profit of the business is now owned by the financial capital suppliers.

The arrangements can be elaborate: royalty structure for oil exploration and extraction, profit payouts for movie and other artistic productions, franchise fees and royalties, profit sharing among partners. Until the last two centuries, partnerships and especially family partnerships were the most common form of expanded business organization. Today the **stock corporation** is the type of business unit that accounts for the largest share of total output.

The stock corporation defines the relation among the financial capital suppliers to be one of fixed or residual claims. Debt holders have fixed claims; stock holders have residual claims. Stock holders own the profits. Debt holders get excess of revenues over costs after material suppliers and labor are paid. If this *operating income* is not sufficient to cover the fixed claims of the debt holders, company may go bankrupt.

The expanded business form necessarily separates ownership of profits from the control of the company. The owners of the profits are the investors of the financial capital. They must hire managers to control the business. The managers may still retain a large share of ownership in the enterprise (Bill Gates and Microsoft) or they may own virtually no stock in the company. At all events, the managers are no longer the owners of the firm by definition. Hence, there is a **separation of ownership and control**.

The same kind of separation is found in the other expanded business organizations. However, the problems of the separation of ownership and control are most severe in the corporation. The corporation is a flexible expanded business unit. Other expanded business units are much more narrowly focused. Movie production companies form to make one movie. Oil exploration consortia form to drill one well. Law partnerships form to provide legal services only

and usually only a very specific kind of these. On the other hand, corporations allow for on-going business across a limitless spectrum.

With this flexibility comes the **cost of managerial malfeasance**. Managers may not act in the interest of the stockholders. (Time, Inc., merges with Warner Communications forming Time-Warner as a way of stopping a takeover by Paramount, Inc.)

Separation of Ownership and Control

The three basic types of business organizations are 1) the sole proprietorship 2) the partnership and 3) the stock corporation. The publicly traded common stock corporation is the most dominant form of business organization in the U.S. economy and probably in the world. The characteristics of the common stock corporation are that 1) claims to the residual cash flows are owned by the common stock holders; 2) fixed claims to net cash flows may be owned by other groups like preferred stock holders, debt holders, and long term lease holders; 3) the control of the assets is vested in managers appointed by a board of directors elected by the stockholders.

The theory of management described by Alchian and Demsetz says that the best way to compensate managers is by making them the owners of the firm. That is, managers themselves shirk unless their pay is tied to their performance in organizing production. In the stock corporation, managers are definitionally divorced from at least part of the ownership. Stockholders are outside investors that provide capital to the firm and specialize in taking the risk of the uncertainty of the profitability of the enterprise.

Jensen & Meckling coin the term *Agency Cost*.¹ It is a good term to describe contracting problems. Agency is the case where one party, the principal, contracts with another, the agent, to act on the principal's behalf. Agency cost results from the fact that the agent will never act in perfect accord with the principal's interests.

The stock corporation creates the problem of the separation of ownership and control that creates agency costs. Definitionally, separation of residual claims to profits and managerial control of assets is separation of ownership and control. The top management of a corporation are the agents of the owners, the stockholders. In some matters the managers do not act in the interests of the stockholders.

Jensen & Meckling begin their analysis of the firm by examining what happens when a sole proprietorship sells an equity interest to outside investors. Their story is that once the proprietor is a partial owner, work effort declines. If the proprietor sells $(1-\forall)$ interest, then shirking only costs the proprietor \forall cents on each dollar that the value of the firm declines. The proprietor will consume more leisure and more perks. (It is shirking just like in the Alchian & Demsetz problem.) A lot of analysis in Jensen and Meckling deals with expansion. Shares of the business will not sell equal to the value of the company based on managerial effort when the manager was full residual claimant. This is true with or without expansion. There is always a consequent reduction in managerial effort.

The outside investors try to monitor this, however, they cannot do so perfectly. The value of the firm declines because 1) monitoring costs real resources and 2) monitoring is not perfectly effective. On this basis alone the amount outside investors are willing to pay for their $(1-\forall)$ interest is much less than $(1-\forall)\%$ of the capitalized value of the cash flows available to the

¹ Michael Jensen and William Meckling, "Theory of the Firm: Managerial Behavior, Agency Cost and Ownership Structure," *Journal of Financial Economics*, 1976.

proprietor. Outside investors know the manager will shirk and there is no way to perfectly monitor or bond the manager's behavior.

If the firm has many new investment projects available, then the proprietor may be able to sell the firm for much more than its current cash flows. But this amount will still be less than the discounted value of the expected cash flows if the proprietor could fund the projects without outside equity interests.

Agency costs between owners and managers is one explanation of why stock issues sell for less than capitalized value of the cash flows if the manager were a 100% owner. Agency costs are also a possible explanation of why new stock issues result in a decline in the price of the existing stock. New stock issues are typically associated with a decrease in the amount of ownership claims held by management.

Debt v. Stock Ownership

The effect of partial equity ownership on the agency costs between stockholders and managers would seem to be remedied by converting the company to all-debt financing. Modigliani & Miller argue that there is no effect of financing in the choice between stock and bonds. Hence, why not choose all bonds, maximize the tax savings, and minimize the agency costs?

The answer is the *Collateral Problem*. What if there was 100% debt in a company with random cash flow? In some states of the world the company would go bankrupt. This limits the debt leverage a firm may use.

The Agency Costs of Debt

There are agency costs of debt. Jensen & Meckling outline three: 1) bankruptcy behavior (bet-the-ranch, asset substitution), 2) under investment, and 3) bankruptcy costs.

Bankruptcy behavior is the willingness of the residual claimant to engage in extremely high risk projects when there is no equity at stake. Examples include the recent debacle of the savings and loan industry. S&Ls faced with sharp competition in interest rates paid to savers as a result of deregulation of the banking industry in the late 70s and a large portfolio of low interest home loans dating back to the 50s became technically insolvent. With essentially no equity at risk, the managers gambled on high risk real estate projects. The debt holders (the savers in this case) were unconcerned because they were insured by the government. The result were a lot of spectacular failures. Note that the reason the whole industry went down is because S&Ls were all investing in the same asset—real estate. When prices of that asset declined most all of the institutions went into a tail spin. Banks on the other hand have not fared as badly facing similar circumstances because across the banking industry, different banks have invested recklessly in different assets. Some investments have paid off, some have failed.

Bankruptcy behavior often takes the form of asset substitution. Sometimes this involves out and out fraud as in the cases of Miniscribe and Crazy Eddie's. Crazy Eddie took his inventory and moved it around from store to store to pad his inventory that he reported. But it can just be the movement of *plastic* assets from one venture to another. For instance, a failing car dealer can roll over inventory from plain sedans into exotic sports cars in hopes of increasing margin and pulling out of financial distress.

Under-investment is another problem of high D/E. With little equity, a low return project even one that is riskless may be passed over by equity holders. This occurs because with little equity and a lot of debt all of the return from a low return project goes to guarantee the interest

payments on the debt. With nothing left for the equity holders they have no incentive to engage in the project. (This is called the Myers underinvestment problem.)

Bankruptcy costs are the explicit costs of filing bankruptcy—lawyers fees and the like. These costs are not as high as typically believed. They average around 5% of liquidation value. However, they are costs that the equity holders do not take into account when making decisions. Therefore, the collateral level must be at least as large as these costs to ensure that equity holders behave in a profit maximizing fashion. As a consequence of these, debtholders will not hold debt in an all debt company. They require there to be some collateral—some stock investment as well as debt.

In the Jensen & Meckling view, the optimal debt to equity ratio is a balancing of the agency costs of debt against the agency costs of equity where the agency costs of equity is the shirking induced by diluted ownership of the top manager. This view has fallen out of favor because in the stock corporation, the top manager rarely has a substantial share of outstanding equity. Nonetheless, empirical investigation of this suggests that in the range of average equity ownership of major corporations, increasing the holdings of top managers causes significantly more profitable decisions.