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Agency Costs of Free Cash Flow, Corporate Finance, and Takeovers

By MICHAEL C. JENSEN*

Corporate managers are the agents of shareholders, a relationship fraught with conflicting interests. Agency theory, the analysis of such conflicts, is now a major part of the economics literature. The payout of cash to shareholders creates major conflicts that have received little attention.[1] Payouts to shareholders reduce the resources under managers' control, thereby reducing managers' power, and making it more likely they will incur the monitoring of the capital markets which occurs when the firm must obtain new capital (see M. Rozeff, 1982; F. H. Easterbrook, 1984). Financing projects internally avoids this monitoring and the possibility the funds will be unavailable or available only at high explicit prices.

Managers have incentives to cause their firms to grow beyond the optimal size. Growth increases managers' power by increasing the resources under their control. It is also associated with increases in managers' compensation, because changes in compensation are positively related to the growth in sales (see Kevin Murphy, 1985). The tendency of firms to reward middle managers through promotion rather than year-to-year bonuses also creates a strong organizational bias toward growth to supply the new positions that such promotion-based reward systems require (see George Baker, 1986).

Competition in the product and factor markets tends to drive prices towards minimum average cost in an activity. Managers must therefore motivate their organizations to increase efficiency to enhance the probability of survival. However, product and factor market disciplinary forces are often weaker in new activities and activities that involve substantial economic rents or quasi rents.[2] In these cases, monitoring by the firm's internal control system and the market for corporate control are more important. Activities generating substantial economic rents or quasi rents are the types of activities that generate substantial amounts of free cash flow.

Free cash flow is cash flow in excess of that required to fund all projects that have positive net present values when discounted at the relevant cost of capital. Conflicts of interest between shareholders and managers over payout policies are especially severe when the organization generates substantial free cash flow. The problem is how to motivate managers to disgorge the cash rather than investing it at below the cost of capital or wasting it on organization inefficiencies.

The theory developed here explains 1) the benefits of debt in reducing agency costs of free cash flows, 2) how debt can substitute

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[1]Gordon Donaldson (1984) in his study of 12 large *Fortune* 500 firms concludes that managers of these firms were not driven by maximization of the value of the firm, but rather by the maximization of "corporate wealth," defined as "*the aggregate purchasing power available to management for strategic purposes during any*