Agency Costs of Equity

In the previous section, agency problems and associated costs of debt were described. They occur between bondholders and stockholders. Agency problems of equity occur between managers and stockholders. Stockholders delegate decision-making authority to professional managers. The primary goal of managers serving the stockholders is supposed to maximize firm value. However, as you are probably aware, managers may not always maximize firm value. Instead, managers may engage in perquisite consumption such as frequent expense account meals, luxurious company cars, elegant office suites and more. The cost of these perquisites reduces firm value. Or managers may invest in projects that do not create value for shareholders in order to make the firm larger and gain power and prestige for themselves. A third type of agency problem of equity is shirking. Managers may not work as hard for the firm as they would if they owned 100% of the equity.

Jensen (1986, American Economic Review) presented the **free cash flow hypothesis**. According to this hypothesis, managers of firms with large amounts of free cash flow have more opportunities to waste this cash flow on pursuing their own best interests that are in conflict with the interests of stockholders. Free cash flow is defined as cash flow remaining after funding positive net present value projects. Cash payouts via common stock dividends and more effectively interest and principal payments reduce the cash available to managers to waste, according to Jensen's hypothesis. The implication for capital structure is that high debt levels reduce agency problems between stockholders and managers.

A great example of increasing debt to reduce agency problems of equity due to excess free cash flow is Sealed Air Corporation. In 1989, Sealed Air borrowed close to $137 million and used the borrowed cash to pay a special dividend to shareholders. This radical move increased Sealed Air's debt to total assets ratio from 13% to 135.8%. Interest coverage decreased from 14.7 times to 2.13 times. This huge increase in debt "created a crisis in the organization that lead to improved cash flow and increased operating efficiency." (Karen Hopper Wruck, "Financial policy, internal control, and performance: Sealed Air Corporation's leveraged special dividend," *Journal of Financial Economics*, Vol. 36, October 1994)

According to Sealed Air's CEO, Dermot Dunphy, the firm's product markets were becoming more competitive and the firm needed to operate more efficiently. However, in the absence of immediate pressing product market pressure, management found it almost impossible to convince people to work toward a more efficient organization. Along with the dramatic debt increase, Sealed Air changed the organizational rules of the game. Specifically, decision rights were moved to lower levels and a revised performance compensation system was introduced. The results of this leveraged recapitalization were fantastic. The average annual stock return for Sealed Air between the end of 1988 and the end of 1991 was 62.8% while the annual return for the S&P 500 Index was 10.8% for this same period.