

# **Following Jensen's tracks: Integrity as a positive economic category**

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(Working Paper WP15-01E)

## Summary

*Jensen* together with other economists as co-authors made a huge contribution to the development of the Agency Cost Theory as part of the economic theory of the firm. His considerations during the last 40 years concerning optimization of agency costs of public corporations by using free market mechanisms contrary to government interventions left behind salient footprints in literature. Starting with „Separation of Ownership and Control“ he discussed market oriented mechanisms to optimize agency costs in order to achieve an optimal allocation of resources. „Market for Corporate Control“, „Agency Cost of Free Cash-Flow“, „Public Corporations Going Private“, „Failure of internal Control Systems“, „Role of Analysts“, „Manager Incentive Systems“, „Agency Cost of Overvalued Equities“, „Role of Gatekeeper“ are the stop-overs which in the end brought Jensen to „Integrity as a positive economic model“. Moreover, he currently went so far to require a change in paradigm in economic theory and to explicitly integrate integrity as a positive economic category into economic theory comparable to real capital, innovation, human capital, institutions, organizations etc.

## Following Jensen's tracks: Integrity as a positive economic category

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*Jensen* together with other economists as co-authors made a huge contribution to the development of the Agency Cost Theory as part of the economic theory of the firm. Basically, the Agency Cost Theory is able to leave the deadlock of the 'Modigliani-Miller-Theorem' by arguing that even with efficient capital markets the ownership structure of public corporations which is the other side of the coin 'Capital Structure' has a significant impact on the company's value.

### *Following Jensen's Tracks*

In their seminal paper „Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure“ *Jensen/Meckling* (1976) argued that the management of a public corporation chooses its optimal ownership structure to minimize agency costs given firm size and firm's investment decisions. The management produces agency costs by behaving opportunistically to pursue its own objectives which are not necessarily the objectives of its principals. Because an efficient capital market is able to evaluate these agency costs and give them a price tag in corporate finance, it is the firm and therefore the management who pays the price for agency costs and has an incentive to minimize these agency costs by choosing the optimal ownership structure. The decisive message of the study is that the benefit of externally financing the firm compared with internally financing must be considerably higher than existing agency costs. Only by this assumption it can be explained why the "Public Corporation" with its current degrees of firm size, capital structure and ownership structure was able to highly successfully survive in the hard battle of economic evolution.

The authors draw this conclusion of a successful economic evolutionary process. According to this conclusion public corporations are a fantastic social invention and innovation which appears so trustful to be able to get billions of dollars, Euros, Yen etc. from millions of individuals out of their private wealth based simply on contracts which regulate rights and duties in this relationship. The strong increase of the usage of the legal form of public corporations and the tremendously grown market values of these companies worldwide suggest that up to now creditors and investors at least were not yet so much disappointed so that they would have turned off from these legal forms of firms despite considerable agency costs which were inherent with this legal form of companies. According to the authors agency costs are as real as other firm costs of labor, materials or capital and are neither depending on interpretations of auditing rules nor an issue of virtual opportunity costs considerations. But the level of agency costs is depending on frame and scope of the specific company laws as well as on frame and scope of the general judicial systems on one side and on the inventiveness of those who invent and trade the contracts between management,

firm and external firm owner resp. financiers on the other side. Both the judicial system and the perfection and sophistication of the contracts which are necessary for the modern public corporations are the results of a development process in which there are strong incentives for all participants to minimize the agency costs. To call this a tautology and to undervalue the efficient relationship between the existence of agency costs and the individual incentives of the management of public corporations should not oversee that there were alternative organization principles available in this development process and that therefore the possibility to invent other legal and organizational forms of firms was not per se locked out. Whatever the weaknesses of the public corporations are this legal form of companies held in the markets against all other alternatives. So far the good news. The bad news is that it is a permanent and challenging task for the market participants to minimize the agency costs of public corporations. But how to manage it?

### *Separation of Ownership and Control*

The true cause of agency costs in public corporations led by employed managers and financed by external investors is the separation of ownership and control of the firm. In a seminal scientific paper „Separation of Ownership and Control“ *Fama and Jensen (1983)* show the high benefit of the separation of ownership and control of the firm. They perceive the benefit in the specialization of agents for the decision management on one side – managers make strategic and operative decisions - and for the risk bearing on the other side – owners bear the risks of the decisions of the managers. Therefore, in the metaphor of ‘separation of ownership and control’ the metaphor of ‘separation of decision making and risk bearing’ is placed into the foreground. Through a detailed analyses of the decision processes in a firm the authors show that the ‘separation of decision making and risk bearing’ leads to the separation of ‘initiation and implementation of decisions’ respectively ‘ratification and monitoring of decisions’. To understand the respective separation, the decision process has to be structured. The authors carry out that in the past when companies only knew ownership-entrepreneurs there existed only limited knowledge about the decision processes in an externally financed public corporation. However especially the partitioning and attaching the isolated tasks in the decision process to the agents of the public corporation, especially manager and owner, is able to explain the extraordinary survivability of the judicial form of the stock based public corporation.

Roughly speaking there are four steps in the decision process:

Initiation:	Generation of proposals for the strategic usage of available resp. acquirable resources and structuration of the related contracts.
Ratification:	Decision about the proposal to be implemented.
Implementation:	Execution of the ratified strategic proposal.

Control: Measuring the performance of the agents who are responsible for the initiation and implementation of the respective proposal and implementation of respective incentive systems.

In this picture it is almost compelling that the initiation of proposals and the implementation of the decision has to be concentrated within one agent. Both functions – initiation and implementation – can be summarized under the heading ‚Decision-Management‘. Accordingly, the heading ‚Decision-Control‘ summarizes ratification and control. Decision-Management and Decision-Control therefore in *Jensen’s* view present the main components with which the decision process in a firm-organization can be described.

What follows out of this seems to be natural. Only the separation of ownership and control of the company leads to the organizational separation of Decision-Management and Decision-Control and is able to explain today’s structures of public corporations: management, board resp. supervisory entities and shareholders. These structures contribute to the high benefits of the specialization of Decision-Management and Risk-Bearing, which is based on Decision-Control, and to the fact that the corresponding agency costs are limited.

The above cited scientific papers of *Jensen* and his co-authors show that in their respective models a theoretical optimum of agency costs is achieved which is in the common interests of all agents, managers and owners. But the problem of the theoretical derivation of the respective optimal model solution lies in the fact that it is the result of a one-period model with perfect information (in game theory a simple one-shot game). The introduction of multiple periods (in game theory a model with multiple games with open end) and therefore of possible moral hazard behavior of the agents (management, board) as well as of asymmetric information in the models causes the effect that the model optimum in form of a minimum of agency costs – which indeed can theoretically and according to efficient markets practically be achieved even in a multi-period model but only at the point of time of conclusion of the respective contracts (CEO contract, board contracts, equity/bond contracts) – cannot be kept alive over multiple periods. In lapse of time especially the incompleteness of contracts leads to a worsening of the agency costs to the debit of the principals which they cannot realize in real order (some kind of a veil of invisibility). Taking this view in account the theoretic model of *Jensen* is nonetheless able to recognize the problems of agency costs of public corporations even when at the same time appreciating the high efficiency of public corporations. These theoretical acknowledgments about potential high agency costs coincides with the upcoming of real agency cost problems in public corporations in the markets. So far the beginnings of the discussion of *Jensen* concerning the theory of public corporations in the 70ies.

## *Market for Corporate Control*

In the 70ies/80ies especially in the USA the existing agency costs problems on the markets for public corporations asked for and caused an answer – totally in the sense of auto poetic evolutionary dynamics – based on new instruments of external financing, the so-called junk bonds. The answer was the so-called ‚Market-for-Corporate-Control‘ which in form of hostile takeovers caused quite a stir of economists, business people, politicians and the participants on the capital markets. This market in its different forms – besides hostile takeover it offers friendly takeovers like merger, private equity, LBO, MBO - served different objectives: reduction of over-capacities, achieving of synergies, optimization of the ownership- or management-structures, achieving economies of scale and scope, improvement of R&D, but also the replacement of inefficient management and board members. Most interesting is the last mentioned reason for the Market-for-Corporate-Control. The Market-for-Corporate-Control as the perfect solution against high agency costs.

*Jensen* together with *Ruback* (1983) published in „The Market for Corporate Control: The Scientific Evidence“ an overview of scientific studies concerning the Market-for-Corporate-Control certifying a high efficiency to this market. Especially the popular argument that the only reason for this market was to give the buying companies monopolistic profits and monopolistic market power was refused by *Jensen/Ruback*. In addition, the evidences contradict the popular argument that the buying companies get rich on the debit of the target companies (locusts).

The authors show the idea of an efficient competition of different management teams. According to this, the Market-for-Corporate-Control, commonly designated as the takeover market, is a market on which management teams compete for the right to manage the resources of a firm. By this the takeover market offers an additional important component to the respective existing internal and external manager markets. This interpretation leads to a change of paradigm in the discussion of the value added by takeovers: commonly financiers and active investors - separately or in coordination – buy the control rights of a company in the stock markets and engage or fire managers to increase the efficiency of resources allocation of the company. In the idea of the competing management teams these teams are in contrary the driving forces in the Market-for-Corporate-Control and the respective financiers therein play only a minor but nevertheless important role. Arbitrageurs and takeover specialists therein act as information resp. financial intermediaries and support the transactions by their capabilities to evaluate the different offers of different management teams inclusive of the incumbent managers of the firm and/or to finance the transaction and therefore to bear parts of the risk of the transaction. It is assumed that the shareholders of the firm do not own a specific loyalty to the firm; they decide according to the highest prices which are offered by the external management teams on the Market-for-Corporate-Control what can involve that they just sell their shares to arbitrageurs

resp. takeover specialists with the highest price offer. From this point of view, the competition of the management teams limits the possibilities for the incumbent management to diverge considerably from their duty to maximize the wealth of the shareholders and offers a mechanism to seize all chances to realize economies of scale and other synergy effects through reorganizing the way the resources of the firm are allocated. The Market-for-Corporate-Control solves the problem of high agency costs in case of an incumbent management not willing or capable to fulfill its job to maximize the long lasting value of the firm by order of its shareholders – the principals.

According to the authors the Market-for-Corporate-Control is also efficient in the sense of the theory of efficient markets. The information that the best management team gains the competition to control the firm to optimize the efficiency of the firm will immediately be incorporated in the pricing of the takeover process in the market. By this, the shareholders of the target firm will gain the premium which results from the expected higher efficiency of the firm based on the takeover. This efficient market argument is the precondition for the proper functionality of the Market-for-Corporate-Control as a management team market and it is the main argument that a takeover transaction is attractive for the shareholder of the target firm so that takeover transaction will take place. This implies that the potential efficiency gains of the takeover will enter into the deal price of the target firm and therefore will be the advantage of the shareholder of the target firm. With regard to the takeover objective of „replacement of an inefficient management resp. reduction of high agency costs“ the shareholder of the target firm can internalize the net present value of the expected increase of efficiency resp. the expected reduction of high agency costs by cashing in the respective deal price premium. The takeover will happen and solves the principal-agent-problem of a firm with high agency costs caused by an inefficient management.

The conclusion is: The Market-for-Corporate-Control is an efficient solution of the principal-agent-problem and therefore excessive agency costs of public corporations. Inefficient management involve inefficient firm-performance which leads to an undervaluation of the firm. The management team which undertakes the takeover knows the true higher value of the firm, buys the firm at the undervalued price, pays a premium to the shareholder of the target firm and increases the efficiency of the management and the whole company. By selling the firm at a later date at a much higher price according to the new higher efficiency of the firm the takeover management team and their financiers realize the profit of the whole takeover transaction.

### *Agency Costs of Free Cash Flow*

In a series of papers *Jensen* (1986, 1987, 1988) developed the economic category of the so-called ‚Free-Cash-Flow‘ which became a constituent part of the economic Corporate Finance Theory. By this he extended the category of high agency costs from ‚inefficient management leading to low firm value‘ to the category ‚misallocation of Free-Cash-Flow‘. The basic idea is that there is a conflict between the manage-

ment and the shareholder of a public corporation about the question whether the Free-Cash-Flow should be given to the shareholder or not. The interests of the management are i) keeping the size of the company high through a high Free-Cash-Flow (great power as a function of firm size), ii) avoiding capital markets to finance new real investments (avoidance of the monitoring role of the capital market in case of financing of investments), iii) getting cheap refinancing (investment decisions based on low capital costs) and iv) realizing absolute independency in the usage of the free financial assets (i.e., so-called Empire-Building). The interests of the shareholder in contrary are i) to make their own decisions about the usage of the free financial assets, ii) to strictly control and monitor the management in their financing and investment decisions and iii) to reach a more efficient allocation of the free financial assets by finding other and better investments inclusive better risk diversification.

The strong problem of Free-Cash-Flows occurred in the USA in the 80ies especially in matured industries which still showed high profit margins but according to their decreasing market demands could not yet find profitable areas to invest and to grow. But instead of distributing the Free-Cash-Flow to their shareholder and possibly divest and shut down specific parts of the business these firms aggregated huge free cash flows as a reaction on the missing growth opportunities and invested them in additional business area diversifications. Very often these firms used their free cash flows by investing in large acquisitions. But in these transactions the firms payed a much to high price for their target firms. Based on these empirical phenomena *Jensen* outlined the theory of the so-called 'Takeover-Waves' which were mostly motivated by high Free-Cash-Flows. Consequences of Free-Cash-Flows were considerable reductions of a formerly high firm performance because the investment decisions based on the Free-Cash-Flow were highly inefficient.

A remedy for the misuse of free cash flow was seen by *Jensen* in the firm takeover through so-called raider which financed the takeover transaction using a high leverage ratio (junk bonds) which had to be internalized by the firm. By this a raider with limited financial assets could realize huge takeover transactions. *Jensen* was convinced that a high debt ratio of the firm after the takeover transaction could be an efficient mean to reduce existing high free cash flows respectively to avoid the building-up of high free cash flows.

Therefore, in the context of high agency costs through the misuse of high free cash flows *Jensen* recognized that the Market-for-Corporate-Control could be an efficient means to fight high agency costs of public corporations. But already in the 80ies *Jensen* stated that the Market-for-Corporate-Control suffered increasing regulatory and political restrictions in the USA which led unavoidably to the fact that the Market-for-Corporate-Control lost its efficiency. But if the Market-for-Corporate-Control lost its efficiency and its basic functionality the agency costs of the public corporations had to increase again. But following this, what could be the efficient market-oriented remedy to "save" the up-to-date highly efficient model of the public corporation?

### *Criticized ,Market for Corporate Control ‘*

For the development of *Jensen's* argumentations, it is probably valuable to listen to *Jensen* when he complains the way different society's groups and society's institutions in the USA fought against the Market-for-Corporate-Control. *Jensen* indeed showed some understanding for the criticizing the Market-for-Corporate-Control when he ascertained that regardless of the high advantages of this market for firm's shareholder, the firms itself and the society as whole this market could create a multitude of inconveniences for the firm's top level management. And manager rattled in such a manner exerted pressure on the different levels of the legislative and judicial institutions of a country, i.e., the USA, to impose restrictions on this market. Plenty of new laws restricted the liberty of actions of the market participants were established in the years 1985, 1986 and 1987. *Jensen* stated nearly depressed that after all it is possibly just the democratic system that these kinds of political decisions are taken to protect the interests of top level managers and other groups which could be victims of the functionality and efficiency of the Market-for-Corporate-Control without having regard for the fact that by deciding in this way public corporations as an efficient business organization type could be damaged considerably at least by the reduction of its efficiency and by an increase of its agency costs.

### *Public Corporations Going Private*

*Jensen*, as it could be assumed, desperate and disillusioned about the lost efficiency of the Market-for-Corporate-Control as a promising solution against high agency costs of public corporations, looked for other market-oriented solutions and stroke gold. If and when the Market-for-Corporate-Control breaks down as a solution for the huge agency cost problem of public corporations and when therefore the agency costs would remain counterproductively high then the public corporation as a specific organizational form of firms had to leave the market which would be the logical consequence in a theory of the evolution of efficient firm structures. In his article from 1989 „Eclipse of Public Corporation“ *Jensen* reached the conclusion that there was the theoretically compelling and empirically observable phenomenon that the public corporations were threatened to vanish from the market. Provocatively he forecasted that until the year 2003 the last shares of public corporations would be traded in open stock markets if the current trend of public firms going private would go on.

In this phase *Jensen* observed the golden age of the „Wall Street Smart Guys“ (KKR and others) overtaking firms, financing their transactions with junk bonds issued by their target firms and managing the firm as a private corporation. In view of the failing of the Market-for-Corporate-Control *Jensen* seemed to recognize that going private could be a surrogate solution for the agency cost problem of public corporations because there was in his view a strong need to find a solution for the conflict between manager and owner of a public firm. The basic idea accordingly was that the privati-

zation of the public firm could lead out of the dilemma of the separation of ownership and control. In a private corporation the owner of the firm controls the firm which means that the interests of the owner are identical to the interests of the manager. Agency costs then disappeared.

Whether the privatization through LBO (Leveraged Buy Out) was indeed the effective solution for the agency cost dilemma of business firms of the economy *Jensen* himself was not absolutely sure. Especially the question of maximal vs. optimal firm sizes which public companies should choose to be successful in the competitive markets turned out to be an open question for *Jensen* even with regard to the astonishing efficiency of private business organizations which *Jensen* adjudged to the so-called LBO-partnerships. Consequently, *Jensen's* privatization arguments ended up in a deadlock by contradicting his former statements in relation to the high efficiency of public corporations. According to his former arguments public corporations especially use the separation of firm's ownership and control to put the important risk bearing function on a broader basis which meant that the public corporation could work efficiently on a much bigger size than private corporations. If all public corporations would be transferred into private corporations all public corporations had to adapt their firm size according to the optimal but lower firm size of private corporations. If these newly established private firms did not adapt to the lower firm sizes they would become considerably inefficient because of the lack of specialization in the complex decision processes on the one side or they would develop comparable structures of differentiation between owner and manager which on the other side would again incorporate high agency costs in private corporations. So nothing would have been gained. In contrary: With private companies there would have been lost the stock market technology needed for a Market-for-Corporate-Control which could counteract high agency costs because without stock trading there is no Market-for-Corporate-Control for private corporations. The result of the privatization of the corporations would not be better than public corporations. It would even be worst.

Today we know that in the year 2003 the public corporations did not disappear which means that we have to deal again and again with agency costs of public corporations. The privatization does not solve the agency cost problem neither basically theoretically nor practically. Today we know that going private, i.e., through Private Equity firms, can be and often is very efficient and value increasing depending on the specific circumstances of a respective firm. But we also know that the public corporation which is listed on the stock market is not and will not be obsolete.

### *The failing of internal monitoring systems*

In another article in 1993 „The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems“ *Jensen* criticizes the internal monitoring systems of the public corporations. In this time *Jensen* realized a long-term trend in respective industries of western industrialized countries. Technological progress and the outsourc-

ing of production capacities into developing and former communist countries led to over-capacities in the western industrialized countries. The companies and their management had to adapt the structures to the new requirements and had to decide and realize exits from specific production capacities. This involved that firms and their management after a long time period of permanent growth had to adapt their business and management philosophy from growth to reduction and shrinking.

*Jensen* describes the firms' problems drastically. Accordingly, the exit problem was serious especially for firms which experienced high growth, strong market positions and high cash flows respective high profits over a long time. Internal firm culture and mentality of management in this situation made it extremely hard for the firm to adapt in time so that with ongoing time the problem grew from 'difficult to solve' to 'unsolvable'. Fundamentally there had to be acknowledged an asymmetry in the live cycle of the firms between growth phases and shrinking phases. All participants had not thought enough about how to organize a shrinking phase respectively how to design growth phases which did not imply the seed of an upcoming shrinking. In one after another industry with over-capacities the management was not able to recognize that their firms had to shrink and reduce capacities; instead they left the exiting to other firms while expanding and investing themselves. But if all firms behaved in this way the necessary cutback of capacities in the stricken industries would have been postponed with high substantial costs for the respective economies.

Indeed, *Jensen* ascribed an important potential role to the Market-for-Corporate-Control in organizing the firm's exit if the management was not able to do so. But he had to admit that the tight political restrictions put upon the Market-for-Corporate-Control started to work. Therefore, this mechanism failed to take place as a broad solution approach. Accordingly, *Jensen* asked the question whether the internal monitoring systems were responsible to initiate and organize the capacity exit in time. Suddenly, no more the firm's management but the firm's board as a further agent of the shareholder as the principal lied in the focus on agency cost problems. Result: The firms' boards did not play their part in the Decision-Control-Area accordingly. *Jensen* enumerated a number of aspects which constitute the efficiency and capability of the board to play the exit role as decision-controller:

- The internal culture of boards whereupon politeness and kindness is more important than truth and openness in the boardroom.
- Information problems limit the efficiency of board member.
- Statutory duties imply that risk minimization lies over value maximization.
- Deficiency of outside board members with substantial long term firm's equity ownership.
- Board size too high.
- CEO as chairman of the board.
- Reactivation of active investors.

It is obvious that *Jensen* did not only care about the Decision-Monitoring-Function but especially about the Decision-Ratification-Function of the Board as he demanded 1983. He recognized that the boards in the existing public corporations did not fulfill their duties. His claiming that the Market-for-Corporate-Control should play the respective role fell on deaf ears because of the tight political restrictions.

### *Intermediate results*

Public corporations show agency costs. Moral hazard, incomplete contracts and asymmetric information cause the real agency costs to go beyond the theoretically possible optimum. The Market-for-Corporate-Control as an almost perfect solution is almost destroyed by the top manager class. Even the boards of public corporations in their monitoring function are neutralized by the top manager. By this a self-complacent management of public corporations becomes absolutely independent in the safeguarding of its personal interests at the cost of their principals which are the firm's owners. Practically the agency costs are no more optimal in the sense of the theory of separation of ownership and control respectively the separation of Decision-Management and Decision-Control. The public corporation so far contains a constructional fault for which firms' principals in special and the society as a whole in general had to pay for extensively. At the end of the 80ies resp. the beginning of the 90ies *Jensen* had to have this point of view concerning the questionable advantages of public corporations. *Jensen* must have heavily suffered from these depressing findings especially in connection with the fact that driven by technological progresses and by deregulations the capital markets and therefore the public corporations gained substantially importance in the economies worldwide. But instead of ringing the mourning bells for the public corporations *Jensen* had to celebrate their revivals. And how could this go well in the long term if the control mechanisms of the markets against too high agency costs did not yet and no more work? Presumably this did not paralyze *Jensen* on his way to search for other solutions, probably this situation incited him.

### *The role of analysts*

In the 90ies and at the beginning of the new century *Jensen* draw his attentions to a specific group of capital market participants which in contrary to the LBO-stars, i.e., KKR, did not act in the capital markets as buyer or seller of assets but which could through their specific activities influence the decisions of the main capital market participants. We talk about stock market analysts. From *Jensen's* point of view in searching for solutions against high agency costs this could be characterized as follows: If and when the Market-for-Corporate-Control, the privatization of public corporations and the firms' internal monitoring systems all together failed to force the firm's management to represent their principals' interests and to minimize agency costs then the question is valid whether independent analysts by critically analyzing the firm and its management could contribute to optimize agency costs.

In his article as co-author with *Fuller* (*Fuller/Jensen, 2002*), „Just say no to Wall Street“, *Jensen* puts the question about the role of analysts. In this question *Jensen* was guided by the high values of technology stocks, dot.com stocks and telecommunication stocks in this time which led in some cases to enormous fraud cases, i.e., Enron. But instead of communicating the true situations of the firms to lead the market to evaluate the firms according to their true intrinsic values analysts with their recommendations caused the markets to wrongly evaluate and over-evaluate the firms with all negative respective consequences, so the view of the authors.

In this paper *Jensen* talks about the so-called expectations game according to which the firms' information policy to the markets on one hand exert influence on the expectations of stock analysts. On the other hand, by publishing their earnings forecasts and their target prices the latter place the future growth expectations of the firms quite high, not least because of the information they get from firms and their respective management. The capital market evaluates the high future expectations which are expressed by the analysts with increasing stock prices. But during the earnings season, the question comes up whether the firms really can reach the analysts' high earnings forecasts. If not, firms and their management have important decisions to make whether to accept considerable stock price decreases or to undertake measurements, i.e., through the so-called earnings management, to fulfil or to slightly over-fulfill the earnings forecasts in order to keep the stock price on the high level or even to improve it.

*Jensen* leaves open whether the analysts are forcing the earnings and expectations game because of own personal interests or whether it lies in the hands of the firms' management to get out of the vicious circle of excessive earnings forecasts and the respective fulfillment through earnings management. From his experiences concerning firm management's dealing with Wall Street it can be derived that in the end the responsibility lies with the management because the management knows best the true situation of the firm. The reversal conclusion from this must be that the securities analysts cannot play the role of the omnipotent external monitoring agency to limit high agency costs in public corporations.

### *Manager-Incentive-Systems*

Besides the Market-for-Corporate-Control, privatization of public corporations through LBO/MBO and firm-internal monitoring mechanisms the group of securities analysts also fails to act as problem solver in relation to high agency costs of public corporations. Therefore, only incentives for the management remain to solve the problem of high agency costs in public corporations. Based on the ongoing real life experiences of economics, economists and businesses in these times this conclusion became common sense in economics and business. In the following decade especially in the USA there consistently aroused a strong development in the area of firm-internal

management incentive systems based on the perception that to combat the problem of high agency costs in public corporations only the right design of internal management incentive systems could be successful.

Therefore, in two articles (*Jensen, 2003; Jensen, 2004*) *Jensen* dealt with firm-internal incentive systems. In the 2003-article *Jensen* showed that the incentive to „lie“ was not inherent in the psychology of persons but it was inherent in the respective systems of incentives. Incentive systems with non-linearity force the management not to tell the truth. Incentive systems with non-linearity lead to the effect that higher risks are taken because the rewards are fixed downstream and that in case of high budget over-fulfillments the firm performance is stretched into the future quasi as a buffer for rainy days or that the management totally abstains from ongoing efforts to increase the firm's performance. In both cases the incentive system leads to the result that the management does not maximize the value of the firm by order of its principals. Even in the zone between 'very bad' and 'extraordinary good' performances the respective incentive systems lead to the effect that the numbers concerning the performance of the firm are likely to be turned out too high in order to increase the performance-oriented partition of the management rewards.

In the article from 2004 *Jensen/Murphy (2004)* go deeply down into the economics of the incentive and reward systems of public corporations. Their analysis comes to the conclusion that the existing reward systems for the top management does not serve the maximization of the firm's value, not without pointing out that firm value is not identical with the firm's short term share price. The authors even go a step further in pointing out that the respective incentive systems lead to value destroying decisions. Plenty of system improvements especially the linearity of reward systems was proposed by the authors. But even based on these improvements the authors came to the conclusion that it is impossible to design incentive systems which bring the interests of the management in correspondence with the interests of the management's principals. The respective improvements in the best case could indeed but only partly limit the disincentives of the system and therefore only partly limit the damages of the wrongly designed incentive systems. And only by combining incentive systems with the idea of the strategic value accountability of the management, the respective incentive design improvements in the authors' proposal could get attractiveness. But the responsibility for the strategic value of the firm has to be delegated to the management and it has to be monitored. This is shown in the proposal R-36 of the authors:

„R-36. The remuneration committee should take the lead in seeing that Strategic Value Accountability is clearly assigned to those who have the unique combination of business judgment, financial knowledge, wisdom, and willingness to take on the critical task of managing the interface between the operating organization and the capital markets so as to create value.

Let us be clear that the assignment of the decision rights for managing relations with the capital markets is much more than simply talking to investors and institutions to assess their interests, opinions, desires and advice. It goes to the core of what it means to direct the organization so that choices are made that will maximize the chance of competitive success and the efficient use of society's scarce resources (human, capital, technological and material) entrusted to the organization. Remuneration committees must confront these issues. The committee must see to it that this talent and capacity is recruited into the organization and retained. They must see to it that those who have accepted the Strategic Value Accountability task are held to the value consequences even when they turn out poorly." (S. 86)

### *Strategic Value Accountability*

With that, the authors open a door which leads away from purely mechanistically models of incentive systems to the question of the integrity of management and board. Mostly, incentive systems are wrongly designed and fail therefore to offer solutions for the agency cost problem. But even optimal incentive systems do not represent a sufficient condition for optimal agency costs. Thus for the first time in *Jensen's* work 'integrity of management and board' emerge as economic categories without it no solution for the agency cost problem were possible. Incentive systems represent therefore just a complement but definitely not a substitute for integrity and not for external approaches like Market-for-Corporate-Control, privatization or monitoring through securities analysts.

### *Agency Cost of Overvalued Equities*

According to *Jensen* (2004a, 2004b) the importance of the integrity of management and board becomes relevant especially in these cases in which the firm's shares are strongly overvalued. Temporarily congruent with the dot.com-bubble in the western stock markets *Jensen* turned his attention to the question of overvaluation of public corporations. The agency costs of overvalued equity accordingly are that none of the above discussed instruments to limit agency costs like Market-for-Corporate-Control, Going Private, internal monitoring mechanisms or external securities analysts could efficiently work in case of overvaluation. All known instruments failed even theoretically to limit overvaluation let alone their total inefficiency in practice. This result dashed to the ground but corresponds with the experiences in the past decades and can even be used to explain the still running financial crises which started with the US-subprime-crisis which was also a crisis of overvaluation.

The reason for *Jensen* to put the question of overvaluation in the center of his reflections was the observation that Corporate Finance and Corporate Governance were in a miserable condition considering the total disasters of Enron, WorldCom and Xerox at that time. The theory as well as the practice of Corporate Finance and Corporate Governance were not able to recognize the respective developments of these and

other firms at time and were not able to induce market-oriented measurements to avoid the disasters or at least to considerably reduce the caused damages.

*Jensen* locates the faulty incentive systems described above to be the main reason for the overvaluation, intensified by the expectations game between management and analysts. Honest managers are captivated by an incentive system which brings them step by step away from the truth about the true value of the firm, „that honest people can, little by little, be led to make decisions that at some point cross the border between legitimate management decisions in the grey areas of accounting and outright fraud.“ (2004b, S. 551) When overvaluation has already started, so *Jensen*, it is within the scope of the existing monitoring and incentive systems almost impossible to stop the respective process of overvaluation not to mention to reverse it. And the different measurements of the management to keep up the numbers with the high and increasing evaluation lead at the end to the destruction of the values of the respective assets. *Jensen* characterizes this process as „Managerial Heroin“: At the beginning all participants feel comfortable with the overvaluation. The board has no reasons to proceed against the management. The capital market and with it the securities analysts see themselves confirmed and abstain from giving critical commentaries. The managers are completely at peace with themselves because on one hand it is their respective job to maximize the values for their principals and on the other hand they are massively profiting from the overvaluation based on their stock-based compensations. In addition, cheap refinancing in the markets allows interesting investment possibilities up to voluminous takeovers (stocks as currency). The Market-for-Corporate-Control cannot come into action because the firm is too expensive for a takeover, not mentioning the question whether the market could recognize the overvaluation. You cannot make profits by buying overpriced firms and selling the firms at the fair and lower price.

But with the statement that in the market no solutions were available to overcome overvaluation the story was not yet at its end. The overvaluation drama was just starting with the unavoidable process of the correction of the overvaluation. The management at the beginning of the correction sees the almost unsolvable task to justify the high valuation of the firm with the help of the real firm performance numbers. *Jensen* describes it in the following: „I have advised clients that they are highly unlikely to win this game. They did not believe me. Once one gets drawn into the overvaluation game, it is a matter of pure luck if one ever gets back in balance. In the end, it is not whether you are going to lose the game, but when you are going to lose it, and then the costs are enormous. Reputations will be lost and people will begin receiving serious prison sentences.“ (2004b, S. 553)

### *Role of gatekeeper*

This firm-internal aspect of the problem which had to be tackled by the management was going to be intensified by an important firm-external aspect. It's about the role of

the gatekeeper in relation to the overvaluation of firms. *Jensen* describes it in the following way (2004b, S. 553): “Investment banks exploited the trust of their brokerage clients by using their analysts to tout the stocks of their investment banking clients (or firms they would like to have as banking clients). Investment bankers commonly used the threat of unfavorable reviews or denial of coverage by their analysts, to browbeat firms into becoming (or remaining) clients. During the boom years much of this activity got covered up. It appears that all major US investment banks were involved in these activities. The very analysts who were touting the stocks to naive public investors were highly critical of these same stocks in private communications among themselves: an absolute loss of integrity in the system. Why? There were big fees involved. For example, Enron alone, in the years between 1998 and 2000, handed out over \$125 million in investment banking fees to various Wall Street firms. That is a lot of money sloshing around, and it turns out to have been more than enough to corrupt the system.

Law firms, commercial banks, and auditors all fell prey to the temptations to bet their reputations by engaging in practices aimed at capitalizing on the short-term profits that could be earned by helping overvalued firms prolong and capitalize (in the short run) on their overvaluation.“

The agency costs of the overvalued firms were enormous. The companies collected too much capital which they were not able to efficiently allocate. Bad investments and waste were the consequences. Instead of creating value using the available capital values were destroyed. If the overvalued shares of the firm acted as collaterals somewhere in the financial system to create additional debt respective to collect financings for the firm these collaterals were put under devaluation pressure. „And when that excessive valuation diminishes and we begin to see the result of this reflected in our debt structure, we find we are not able to manage the debt. That is what a lot of organizations are faced with now.” (2004b, S. 555) The destruction of values in the overvalued firm led to additional destructions of values in other areas of the economy because the overpricing of the firm’s stocks triggered plenty of otherwise wrong strategic decisions according to the role of the information-functionality of prices in *Hayeks* spontaneous order.

In his considerations *Jensen* basically had to keep the question open how to deal with the agency cost problem. He went so far to subdued state that never before in his scientific live he was unable to find a basic solution for an existing economic problem in theory or practice. But concerning the agency cost problem of the overvaluation of public corporations he admits not having a solution and he urged his colleges in the economic sciences worldwide to think about solutions. This cry for help he admitted with a high urgency because from his point of view agency costs based on firm’s overvaluation were much more serious compared to agency costs based on management’s underperformance and undervaluation. Nevertheless, *Jensen* (Work-

ing Paper) himself mentioned one possible approach for solving the agency cost problem in public corporations. It is the integrity of management and board.

### *Results*

With that, the considerations along the path on the footprints of *Jensen* have reached their destination, the introduction of the positive economic category „Integrity“.

Market-for-Corporate-Control, privatizations, internal monitoring mechanisms, monitoring through the capital market as well as incentives for the management and the board are important mechanisms to limit agency costs of public corporations. But these instruments are only efficient when they are based on high integrity of management and board. This theoretically derived result is immediately highly evident in practice. It becomes particularly clear considering the damages caused by the burst dot.com-bubble, the damages through the big fraud cases like Enron, WorldCom, Parmalat and other public corporations as well as the gigantic damages caused by the bursting of the real estate bubbles in many countries which basically were initiated by the subprime crises in the USA. In all these cases the firm-internal governance systems and the firm-external monitoring systems failed. It is true, *Jensen* assumes a positive effectiveness through stronger and better regulations for specific situations, but in his opinion these measures were often not efficient because they were wrongly designed so that occasionally led to higher damages than before.

It is also the great crises of the gatekeeper (Underwriter, Equity Analysts, Rating Agencies, Auditor etc.) which altogether also failed in these criminal cases without any exceptions. According to *Jensen* there are no substitutes for the integrity of management and board as agents of their principals to cure the public corporations and to keep the high value added of this judicial form of corporation for the benefit of the whole society.

### *Integrity of Management*

Immediately after the respective scientific papers concerning the high agency costs of the overvaluations of public corporations *Jensen* with other authors talks about the issue ‘integrity’. A suspicion arises from the timely coherence between his resigned findings that there was no cure for the overvaluations and the resulting serious consequences yet and his considerations about integrity: “*Jensen* despairingly looked for a way out.” Or ironically said: “*Jensen* couldn’t think of anything better than integrity.” Is this irony justified?

If *Jensen* understood integrity as a normative category of „good vs. bad or right vs. wrong“ the irony could be justified. With other words: Regulation doesn’t help and the markets do not provide solutions. To shift the problem to the ethical level and therefore implicitly to the society level and the respective educational institutions like par-

ents, schools, churches, religions, politics etc. to solve the problem could have been a solution for *Jensen* as a person like you and me but not for *Jensen* as an economist. And *Jensen* wouldn't be an extraordinary economist if he argued not as an economist. For him integrity is a positive economic category which is accessible to critical testing according to *Popper*. As a positive economic category integrity is connected with economic interdependencies according to which economic thesis can be formulated and empirically tested. But if integrity is connected with highly relevant economic cause and economic consequences than it must be recognized that this positive economic category can be used to solve of the agency costs problem of public corporations. In that light it makes sense to connect the 'overvaluation'-depression of *Jensen* with the 'integrity'-euphoria of *Jensen*. According to „eureka-I got it“ *Jensen* realized that the solution had to lie herein. Based on this it all depends on the definition of integrity as a positive economic category in order to open the door for theoretical and empirical analyses of the causes of high agency costs on one side and approaches based on integrity to solve the agency cost problem on the other side.

#### *Integrity as positive economic model*

The most extensive information about the positive concept of integrity is given by an article of *Erhard/Jensen/Zaffron* (2009). The authors differentiate between the integrity of persons and the integrity of objects, systems, groups of individuals and organizations. But, they basically do not see any differences in integrity whether it is related to subjects or to objects. *Jensen* (Research Paper No. 07-01, Research Paper No. 10-042) defines positive integrity as follows:

Definition: *Webster's New World Dictionary*.

1. the quality or state of being complete; unbroken condition; wholeness; entirety.
2. the quality or state of being unimpaired; perfect condition; soundness.

An individual is complete and whole if its word is complete and whole. And its word is complete and whole if the individual honors its word. Individuals can honor their word in two ways: Firstly, by keeping their word at the time they promised to do so; secondly, as soon as they recognized that they could not keep their word they had to inform everybody who is concerned about this fact and they had in addition to repair all the damages they have caused by not keeping their word. Behaving in this way an individual honoring its word can keep integrity even in the case that he does not keep its word given.

A serious person with integrity will conscientiously verify the whole situation before she is going to give its word and she will never give its word concerning circumstances which are in itself contradictory. Naturally most people consider keeping the given

word to be of highest importance; but it is much more important to keep integrity by honoring the given word if it is impossible to keep the given word; because if you take all things in live seriously giving your word it can happen that you cannot keep your word. But as a person with integrity you have to honor your word in order to keep integrity.

Integrity is quite important for single persons, groups of persons, organizations and parts of the society because integrity produces a high workability. Without integrity the workability of an object, a system, a person, a group or an organization diminish; and if workability diminish the possibilities for a high performance diminish. Therefore, integrity is a necessary condition for a maximal performance. And as an additional benefit out of its „honoring one’s word“ the person with integrity gets high trust from the viewpoint of others. (Research Paper No. 10-042)

Decisive for the positive view on integrity is that there is a direct link between the integrity of a person resp. subject and its performance. The relevant catchword in this respect is according to *Jensen* ‚Workability‘. „In short we assert the following simple, general rule: As integrity declines, workability declines, and when workability declines the opportunity for performance (the opportunity set) declines.“ (*Erhard/Jensen / Zaffron*, 2009, S. 40f)

Integrity does not only refer to persons but also to institutions and to systems. But especially with regard to institutions and systems integrity has to be interpreted in a broader sense. It does not depends only on the integrity of the corresponding persons resp. components of the system and their interrelationship within the system but also on the integrity of the system’s design and the system’s application and usage. „... the available opportunity set for performance of a system is conditional on the integrity of the components and relationship between components necessary to the designed standard of performance, and the integrity-of-design, and the integrity-of-use.“ (*Erhard/Jensen/Zaffron*, 2009, S. 44)

For organizations specific issues are valid concerning their integrity. “While a group or entity has a word, we must take care not to anthropomorphize groups or organizations. They do not have brains. They have behavior, but that behavior is the equilibrium behavior of a complex system made up of human beings, each of whom has their own word.

The word of an organization is that which is given by the persons authorized to do so by the organization, for example, its officers, board of directors, etc. for formally organized entities like corporations, partnerships, non-profits. For groups there will often be a formal or informally appointed “spokesperson”. As with the word of an individual, an organization’s word is also given by its actions (that is, the speaking of those actions), and by its agreements, its formal contracts, and its communications through annual reports, policies, slogans, advertising, and the interaction of its per-

sonnel with customers, employees, suppliers of all types (including materials, parts, services, and capital). If an organization is to behave with integrity it must take care to monitor and control all those who are authorized to speak for the organization (give its word), and to ensure that its word is honored." (*Erhard/Jensen/Zaffron*, 2009, S. 58f)

### *The Veil of Invisibility*

The problem with the manager's integrity is according to *Erhard/Jensen/Zaffron* (2009) that the common sense believes that a high integrity causes costs in the short term whereas only in the long run could bring some benefits to the manager. Therefore, it is very difficult to introduce the idea of 'integrity' as a production factor into the manager's world view. *Jensen* contradicts this believe and explains the lack of integrity by using the so-called 'Veil of Invisibility'. This veil of invisibility prevents that the obvious benefit of integrity can be seen immediately.

By introducing the veil of invisibility the authors make recourse to an image of *Rawls* who uses the „veil of ignorance“ to come to his respective results in his theory of justice. In the context of integrity, the authors are confronted with the so-called 'Integrity-Performance Paradox'. It says that managers believe that they should do without integrity in order to increase the performance of the firm but in contrary give up performance by giving up integrity. According to this, integrity does not cause costs but the abstention of integrity does cause costs, i.e., agency costs, through a lower performance. It is the blindness of those responsible vis-à-vis the impact of integrity on performance. To be fair, this argument could be contradicted in a way that the model of the Integrity-Performance-Paradox couldn't be valid: because, how can it be explained that so many performance-oriented persons and organizations in the economy sacrifices the high performance potential of integrity without being forced to do so? The answer is: The injudiciousness concerning the costs of non-integrity behavior results from the fact that it is not even understood what a non-integrity behavior is.

Therefore, it is very interesting to look at a list of Out-of-Integrity behavior cited from the article of *Erhard/Jensen/Zaffron* (2009).

„As individuals we regularly:

- make promises and commitments we do not keep,
- show up late and/or not prepared for meetings, or don't show up at all,
- surreptitiously read documents, answer emails, work on other matters while in meetings,
- fail to return telephone calls when promised,
- violate or play games with negotiated agreements,

- lie to others including our spouses, children, partners, friends, organizations (including not being straight when it is merely uncomfortable to do so),
- cheat on spouses,
- cheat on taxes,
- steal (e.g., keep the excess change mistakenly given at the checkout counter, or padding expense reports),
- fail to return found items even when the identity of the owner is clear,
- using the web for personal reasons while working, including shopping on line,
- and on and on.“ (S. 71ff)

According to this, persons and organizations sacrifice integrity in the name of increasing performance but truly sacrifice thereby performance. The authors show in the footnotes on pages 71ff of the respective article how huge the losses of performance in case of non-integrity can be. It is not only about 2-3 percent losses of performance but instead it is about 100% - 500% performance increases. With integrity of a firm the performance of the firm could be doubled or even more than doubled. In relation to the value of the firm in the stock market this could mean a considerable and effective share price increase. Therefore, integrity in and of a public corporation could be a value driver which investors should focus on. But the veil of invisibility makes it so hard for management and external investors to understand and to recognize the respective interdependencies between integrity and performance and to act accordingly. This shows that methods and procedures to evaluate integrity of firms and their management could be able to repair the low extent of respective knowledge. To recognize Out-of-Integrity-behavior would be valuable not only for firm's principals - say investors – but also for firm's agents – say management and board member.

What integrity as positive economic category and efficient production factor stands for can be summarized citing the authors: „In a sentence, you have done what you said you would do, what you know to do, and what others expect you to do, or you have said you are not doing it, and you have cleaned up the mess you have caused by not doing it on time or not doing it at all. And if you are not going to obey the rules of the game you are playing in you have informed all others playing with you of that fact. You have nothing hidden; you are truthful, forthright, straight, and honest.” (S. 106f)

According to these explanations it is obvious that integrity is also able to improve the efficiency of the above discussed instruments against high agency costs of public corporations and in addition that the overvaluation problem can be overcome by

management and board itself without external forces' influence. It is also obvious that integrity is not just something like a nice-to-have virtue to increase the performance by about 1-2 percent but in contrary is a production factor like technology, valuable assets, know-how, innovations etc. which can enhance the productivity and performance of a firm by 100% and considerably more. The paradox that such a valuable production factor is neglected depends on the veil of invisibility of integrity and therefore the respective blindness of those who concern. Therefore, it depends on the revelation of the veil of invisibility. At this point economics as the relevant science has to be addressed and challenged.

### *Change of paradigm in economics?*

*Jensen* and his coauthors recognizably recognized that integrity „does not grow on the trees“ but that despite the veil of invisibility integrity has to go into the thinking and the acting of those who own decision competences and power, i.e., management and board of companies, market participants, administrations, institutions and political entities. The consequences which *Jensen* and his coauthors drew at their time were from today's point of view consequent, accurate and farsighted. They organized seminars and do this up to now which show and convince the respective participants that integrity leads to better trust, higher productivity and a much higher value creation, to be seen in his publication (*Jensen*, 2009) „A New Model of Integrity: An Actionable Pathway to Trust, Productivity and Value“.

A series of publications which accompanied their seminars followed with a new focus on „New Leadership“ based on the integrity concept (*Erhard/Jensen*, 2007) (*Scherr/Jensen*, 2007) (*Erhard/ Jensen/Granger*, 2013) (*Erhard/ Jensen/Zaffron/ Granger*, 2014). Applying theoretical knowledge into the practical economy and making the invisible integrity operative, before economics took note of this, were and still are the merit of *Jensen* and his fellow campaigners.

To give his request a broader basis *Jensen* felt forced to ask a change of paradigm in economic theory according to *Kuhn* (*Erhard/Jensen*, 2014) by requiring it with *Erhard* in: „Putting Integrity into Finance: A Purely Positive Approach“. This change of paradigm was indispensable, so *Jensen*, because if people in their day to day business could not see integrity by reason of its invisibility then scientific economics had to make integrity explicitly visible in its theories. Only by this many real economic phenomena could be theoretically explained and efficient political measurements could practically be developed to improve the real economic systems locally, nationally or globally in the senses of *Rawls*, *Buchanan*, *Eucken*, *Hayek* and *Popper* which today can be regarded as a highly actual matter.

A time line of the development of knowledge of *Jensen* and his coauthors beginning with „Managerial Behavior“ in 1976 up to „Integrity as a new paradigm“ in 2014 is shown in the following graph.

## Jensen's Biography



1976	Managerial Behavior, Agency Costs
1983	Separation of Ownership and Control Market for Corporate Control
1987	Agency Costs of Free Cash Flow
1989	Eclipse of Public Corporation
1993	Failures of Internal Control Systems
2002	Just say no to Wall Street
2003	Paying People to Lie
2004	Agency Costs of Overvalued Equities
2007	Integrity: Where Leadership begins
2009	Integrity: A Positive Model
2013	Integrity: Creating Leaders
2014	Integrity: A New Paradigm

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