

# The Legal Meaning of Agency and its Implications for Finance Theory

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## Abstract

*Agency theory in the finance literature is based on the assumption that an "agency" relationship exists between a firm's managers, the agents, and its shareholders, the principals. This paper demonstrates that, in a legal sense, no formal agency relationship exists between managers and shareholders. Legal theory views managers as agents of the corporation rather than of shareholders, and the paper discusses the implications of these differences for finance theory.*

## I. Introduction

The first two parts of this paper describe two contrasting definitions of agency: the first discusses the legal definition, in which managers are viewed as agents of the corporation itself; the second discusses the commonly accepted finance definition in which managers are viewed as agents of shareholders.

The third part of the paper discusses whether the legal meaning of agency has, or should have, any bearing on the use of the term in finance. It concludes that finance theory draws on the specific, legal definition of agency to dictate the responsibility of the manager-agent to the assumed shareholder-principal, and therefore that logical consistency requires that finance theory consider the legal definition.

Part three also discusses whether the different definitions have empirical consequences. If the interests of shareholders and the corporate entity are the same, then the use of the legal definition of agency in finance would simply be a formality. However, if the interests of shareholders and those of the corporation diverge under certain conditions then the proper specification of the agent-principal relationship becomes critical.

The final part of the paper discusses the possible implications that the legal definition of agency may have for finance theory. It concludes that because the interests of the corporation and those of some shareholders may differ under

certain circumstances, especially in the widely held corporation, that it is important for finance theory to consider the issue of who is the principal.

## II. Legal Definition of Agency

Jensen [7, page 329] states the critical role of definitions in financial research:

*The choice of tautologies or definitions has a large impact on the success or failure of research efforts - a fact that often goes unrecognized. Discussion of new research efforts often meets with resistance on the grounds that the effort is purely definitional, or the propositions are tautological and devoid of empirical content. Yet thorough and careful attention to definitions and tautology is often extremely productive in the early stages of research, especially if the research is a radical departure from the past.*

The definition of an agent is well established in law, and its use with respect to managers of a corporation is unambiguous. In a legal context, contrary to the commonly assumed relationship in the finance literature, managers are agents of the corporation itself, not of shareholders.

Seavey [14] defines agency as follows:

*Agency is a consensual, fiduciary relation between two persons, created by law by which one, the principal, has a right to control the conduct of the*

*agent, and the agent has the power to affect the legal relations of the principal.*

The first part of Seavey's definition shows that shareholders cannot be principals of managers since they have no right to control the conduct of managers. To be sure, shareholders do have the right to elect and remove directors, who in turn have a right to control managers. But, as noted by Margotta [12] the requirement that shareholder interests be directed through the board of directors is an important control mechanism, not a mere technicality, because directors have legal responsibilities to the corporation itself, which shareholders do not have. Former SEC chairman Harold Williams [15] also cited these different responsibilities:

*It (the board of directors) has a responsibility for the existence and stability of the enterprise that goes beyond the financial interests of the those who happen to hold its shares at a particular moment.*

The second part of Seavey's definition shows that managers are not agents of shareholders, since they have no power to affect the legal relations of shareholders. In fact, one of the primary reasons for the existence of the corporate form of business organization is to free owners from the hazard of having their legal relations affected by hired managers.

Seavey's definition makes clear that managers are agents of the corporation itself and, as such, may legally bind the corporation, are subject to the corporation's control and, like all agents, are legally obligated to work in the best interests of the principal, the corporation. Of course, as a legal entity the corporation cannot itself control managers, so directors are elected by shareholders to perform that function.

Adolf Berle also addressed the legal view of agency on several occasions. In 1959 he wrote [2, page 70]:

*Directors when he (the owner) had elected them were not, and in law are not now, his "agents." They are at liberty to defy his instructions. Their judgment, not his, must govern until he replaces them.*

And, in 1965 [3, page 71],

*In all of them (corporations) management is theoretically distinct from ownership. The directors of the corporation are not the "owners"; they are not agents of the stockholders and are not obliged to follow their instructions.*

While managers are not agents of shareholders they do have fiduciary responsibilities to shareholders and their actions are judged by courts in light of those responsibilities (1).

### III. Finance Definition of Agency

Jensen and Meckling [9, page 308] define agency as follows:

*We define an agency relationship as 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.*

This definition is consistent with the legal definition, but leaves out the critical criteria for determining who is an agent and who is a principal. The authors assume that managers are agents of shareholders, as shown in the following (at 309):

*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 modern diffuse ownership corporations are intimately associated with the general problem of agency.*

The assumption that managers are agents of shareholders seems to derive from equating ownership with being a principal. In many cases, of course, owners are principals. The widely held corporation, however, presents a different, almost philosophical, problem with regard to ownership and property rights, which Berle and Means [4, page 297] recognized as early as 1932:

*Must we not, therefore, recognize that we are no longer dealing with property in the old sense? Does the traditional logic of property still apply? Because an owner who also exercises control over his wealth is protected in the full receipt of the advantages derived from it, must it necessarily*

*follow that an owner who has surrendered control of his wealth should likewise be protected to the full? May not this surrender have so essentially changed his relation to his wealth as to have changed the logic applicable to his interest in that wealth?*

As shown here, the legal and finance definitions of agency are identical in describing the responsibilities of agent to principal. They are also identical in specifying the manager as the agent. They differ, however, in their specification of the principal; legal theory defines the corporation as the principal, while finance theory specifies the shareholder as the principal.

#### IV. Significance of Definitional Differences

Given these differences, the important question is whether they matter - and on this there is significant disagreement. To be sure, in the great majority of decisions faced by managers it does not matter whether managers are agents of shareholders or of the corporation, since decisions which benefit the corporation almost invariably benefit individual shareholders, as well as shareholders collectively. Nor does it matter in closely held corporations, where the interests of the corporation and those of its relatively few shareholders are likely to be the same.

However, it is an important question in some decisions faced by directors of widely held corporations, as again demonstrated by Berle and Means [4, page 197]:

*The three main rules of conduct (for directors) which the law has developed are: (1) a decent amount of attention to the business; (2) fidelity to the interests of the corporation; (3) at least reasonable business prudence. In applying these rules a distinction must be taken which invariably irritates the layman and is today, for the first time, giving some pause for thought for lawyers. This is the ancient metaphysical squabble between loyalty to the "corporation" and loyalty to the stockholders... Since the corporation is a distinct legal identity, separate and apart from shareholders, it may become necessary to determine whether a director can be honest and faithful with regard to the whole corporation at the same time that he is taking a hostile position towards an individual shareholder.*

Manne [10, page 259] has also recognized the important distinctions that must be made in analyzing the widely held and the closely held corporation, reasoning that "the legal-historical developments and the economic functions of these two systems [i.e. of the small, closely held corporation, and of the large, widely held corporation] are quite different, and meaningful legal or economic analysis must begin by recognizing this fact."

For the large, widely held, corporation the definition of who the agent is held legally accountable to is important because it affects one's perspective on the hierarchies of corporate constituencies, and that perspective becomes critical when, in some instances, directors must choose between their perception of corporate interests and current shareholder interests, as measured by current stock prices.

For example, since finance theory assumes that the manager is the agent of the shareholder, the shareholder is assigned the paramount place in the hierarchy of constituencies. Jensen [8, page 110] states this point as follows:

*Stockholders are commonly portrayed as one group in a set of equal constituencies, or 'stakeholders', of the company. In fact, stockholders are not equal with these other groups because they are the ultimate holders of the rights to organizational control and therefore must be the focal point for any discussion concerning it.*

Jensen expands on the preeminence of the shareholders when he describes their right to control the corporation [8, page 111]: "Stockholders... hold the right to control of the corporation, although they delegate much of this control to a board of directors..."

However, from a legal perspective, shareholders do not hold the right to control the corporation, nor can they delegate control to directors. Legal theory holds that a director's powers to control the corporation derive from the state, not from shareholders, and shareholders can neither delegate nor revoke those powers (although they can replace directors). These are important considerations in developing a theory of the widely held firm, and were emphasized in the frequently cited case of *Manson vs. Curtis* [11]:

*In corporate bodies, the powers of the board of*

*directors are, in a very important sense, original and undelegated. The stockholders do not confer, nor can they revoke those powers. They are derivative only in the sense of being received from the state in the act of incorporation. The directors convened as a board are the primary possessors of all the powers which the charter confers, and like private principals they may delegate to agents of their own appointment the performance of any acts which they themselves can perform. The recognition of this principle is absolutely necessary in the affairs of every corporation whose powers are vested in a board of directors.*

Aside from affecting our perspective on the hierarchy of corporate constituencies, there are important situations when the precise definition of the agency relationship is important. Bankruptcy, for example, presents one of the clearest theoretical conflicts between the two definitions of agency. Fischel [16, page 1442] illustrates the theoretical finance view as follows:

*The bankruptcy of an airline, for example, might be a disaster for its employees and managers who lose jobs but a matter of indifference to its investors who own shares in other airline companies that obtain the bankrupt company's routes.*

However, the bankruptcy of a principal is never a matter of indifference to the principal's agent, and any indication of indifference to such a traumatic event might subject managers to substantial liabilities. But if managers consider themselves agents of diversified shareholders and accept Fischel's view, they will leverage a company as highly as possible to gain maximum tax and other benefits (2). As long as current stock prices increase in response to higher debt, the managers may be acting in the interests of diversified shareholders. However, because such owners have diversified away most of the unsystematic risk associated with bankruptcy, they can tolerate higher levels of debt than can any non-diversified individual company, or any non-diversified shareholder in that company. Therefore, by acting in the interests of the diversified shareholder by taking on large amounts of debt, the manager may be acting contrary to the interests of the non-diversified corporate entity by exposing it to a higher risk of bankruptcy.

Corporate control issues pose the most interesting and most difficult conflicts arising from the

different interpretations of agency. In such cases, managers are sometimes faced with decisions which weigh the survival of the organization against immediate shareholder gains.

For example, Thornton Bradshaw faced such a decision as president of Atlantic Richfield Company. In response to a security analyst's criticism that Atlantic Richfield could have purchased 20 million shares of its own stock instead of acquiring Anaconda Copper Co., he said [5], "You know which road management will take if it comes to a reasonable choice between perpetuating an organization such as ours or beginning the liquidation process. Besides, if our shareholders disagree with our judgment, they can always sell their shares and invest elsewhere." The analyst, David Norr [13], subsequently commented that "management often seems dedicated to perpetuating the corporation's economic life - sometimes at the expense of shareholders.

Finance theory would generally agree with Norr in viewing this exchange as an example of a typical agency problem -- managers attempting to perpetuate the life of the corporation, and thereby their own jobs, at the expense of shareholders, their assumed principals (3). However, the managers' own interests are difficult to disentangle from those of the corporate entity, since their interests are frequently so similar. Managers working in a profitable company returning adequate returns to shareholders are less likely to be working under the crisis conditions brought on by losses, and less likely to be discharged by the board.

Given this conflict between corporate survival and the interests of current shareholders, how should the manager decide? Finance theory is unambiguous on the question. It not only states that managers should decide in favor of current shareholder interests, but also specifies the type of current shareholder whose interests should be considered (the well-diversified shareholder), and the criterion by which those interests should be judged (current share prices).

Managers, on the other hand, tend to equate corporate interests with shareholder interests (and probably with their own interests), and therefore tend to decide in favor of the corporate entity if they believe that current operating strategies will yield greater shareholder value in the future. The differences in these views is subtle: finance theory

says that what is good for the current shareholder, as measured by current stock prices, is good for the corporation, while managers seem to say that what is good for the corporation, as measured by the standards of their business judgment as to the future value of the corporation, is good for shareholders (4).

The legal literature is somewhat ambiguous on this point. While it is clear in addressing conflicts of interest between managers and shareholders, it seems not as clear in addressing possible conflicts between shareholder interests and the interests of the corporation itself. For example, American Jurisprudence [1, page 299] says that directors are required "to exercise the powers conferred solely in the interest of the corporation or the stockholders as a body or corporate entity, and not for their own personal interests." This reference does not allow that there can be a difference between the "interests of the corporation" and the interests of the stockholder. But, as has been illustrated, those differences can exist, especially in the widely held corporation.

Finance theory's view that a manager's only duty is to maximize the current wealth of his principal, the diversified shareholder, creates a simple and rigorous framework for analyzing numerous issues raised in financial research. But it risks over-simplifying and thereby missing other important issues faced by American corporations (5). Some of these are most dramatically seen in the struggles being waged over issues of corporate control. For example, the Marshall Field case illustrates that other considerations exist outside the simple model of finance theory (6):

*Plaintiffs appear to believe that large companies like Field are developed for takeovers; and that seeing to shareholder opportunities for sale of their shares at a premium is the most important duty of directors who manage publicly owned*

*corporations. Plaintiffs are mistaken; for if they were not, public equity ownership in corporations would be a form of entrepreneurial hazard that few corporations could survive.*

Recognizing that managers are agents of the corporation would be one step in an effort to broaden the scope of issues covered by finance theory, and would help unify legal and finance theories when those two disciplines overlap.

## V. Conclusion

This paper has attempted to show that the conventional finance view of the shareholder as the principal of the manager is not consistent with the legal view. Legal and finance theory agree in specifying managers as agents. The important disagreement is over who the principal is. Legal theory specifies the corporation as the principal, while finance theory specifies the shareholder.

This inconsistency may lead to conflicting views on what the proper behavior of managers should be in those situations where the interests of current shareholders, as measured by current stock prices, differ from the interests of the corporate entity, as determined by the board of directors.

In many areas of corporate management and financial research the differences in the meaning of agency discussed here have little impact. However, in some areas the correct specification of the agent-principal relationship seems more important; bankruptcy and corporate control decisions were discussed as examples.

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Footnotes

- 1 For example, see *Smith vs. Van Gorkom*, Del.Supr., 488 A.2d 858 (1985).
- 2 Other benefits include earnings leverage. Another benefit is management discipline, as described by Sanford Grossman and Oliver Hart. "Corporate Financial Structure and Managerial Incentives." In J. McCall (ed.), *The Economics of Information and Uncertainty*. Chicago: University of Chicago Press, 1982, 107-37, and Michael Jensen. "Agency Costs of Free Cash Flow." *American Economic Review* 76 (May 1986), 323-29.
- 3 In subsequent correspondence between the author and Mr. Bradshaw he explained that he and his board viewed the continued existence of the corporation in accordance with their strategic plan would yield greater returns to shareholders than would an immediate stock buyback.
- 4 Critical decisions involving corporate control, however, are typically not made by managers, but by directors, and usually by a committee of outside directors to minimize the potential conflicts of interests inherent in such decisions. Such decisions are closely scrutinized by shareholders, potential acquirors, and the courts. See, e.g. *Unocal Corp. v. Mesa Petroleum Co.*, 493 A.2d 946 (Del. 1985).
- 5 It is also critical to recognize that finance theory's view rests entirely on the validity of the efficient market hypothesis (EMH) as applied to managers. And while the EMH has found substantial support in the finance literature, it has also been criticized broadly (Lawrence H. Summers, "Does The Stock Market Rationally Reflect Fundamental Values?" *Journal of Finance*, Vol. XLI, No. 3, July 1986.), as well as in its specific applicability to corporate control decisions (Donald G. Margotta, "Finance Theory: Its Relevance in Corporate Control," *Akron Business and Economic Review*, Volume 18, Winter, 1987).
- 6 *Panter V. Marshall Field & Co.*, 486 F. Supp. 1168 (N.D. Ill. 1980), appeal docketed, No. 80-1375 (7th Cir. Mar. 21, 1980). The quote, cited in this case, was from the case of *Treadway Companies v. Care Corporation*, Fed. Sec. L. Rep. (CHH), paragraph 97,188 (S.D.N.Y. 1979).

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- 14 Seavey, William A., *The Law of Agency*, St. Paul: West Publishing Co. (1964).
- 15 Williams, Harold M., *The Corporation as a Continuing Enterprise*, an address before the Securities Regulation Institute, San Diego, Ca., Jan. 22, 1981.