1.10: Agency Relationships

An Agency Relationship exists any time one or more people (the principals) hire another person (the agent) to perform a service and then delegates decision-making authority to that person. The central issue with agency relationships is potential conflict of interest between the principal and the agent or between two or more groups of principals.

Agency problems can cause difficulties in maximizing firm value. The major agency conflict we will focus on is between managers and stockholders (owners). Stockholders hire managers under the goal of maximizing firm value as doing so will maximize the wealth of shareholders. However, the manager may operate under the goal of maximizing his happiness instead of firm value. This may take the shape of overspending on perks (office decorations, company jets, etc.) or on limiting risk in order to protect job security, even at the expense of favorable risk-adjusted return opportunities. There are many ways to try to control for agency costs, including:

The Threat of Firing

While most people understand the threat of being fired, this is not an overwhelming threat to most top managers (although it is more credible for other employees of the firm). Many Chief Executive Officers (CEOs) get rich compensation packages (Golden Parachutes) even if they are forced out of their position. Also, there are some instances where the Board of Directors (the people responsible for hiring and paying the CEO) may be "friendly" to the CEO. In many cases, the CEO is also the Chairperson of the Board of Directors.

The article, The Top 20 CEOs With Even Bigger Golden Parachutes than Marissa Mayer's, list the CEOs who hold the largest Golden Parachutes in the S&P 500.

The Threat of Takeover<\h3>

If a firm is purchased by another firm, the acquiring firm may replace upper management. One reason for a takeover is that the management team is not maximizing firm value. If others feel that they could run the firm in such a way as to make it more valuable, they may buy the firm with the intention of bringing out this additional value. However, takeovers are not cheap. Most acquiring firms pay premiums of 20% to 50% to complete a takeover. For example, if the stock price before the takeover is $50, the takeover offer may be $70 per share. This leaves a lot of room for mismanagement. If a firm's assets are worth $60 per share under optimal conditions, but under current management are only valued at $50, management is not maximizing firm value. However, it may not be bad enough to justify a takeover. Also, many firms use defenses (Poison Pills) that make takeovers harder to execute. For example, there may be a clause in the debt agreements that all debt becomes due in the event of a takeover.

Influence of Large Shareholders

This is a relatively new form of Corporate Governance that is gaining prominence. Activist investors may pressure management to run a more efficient operation. If a shareholder with a large stake in the firm creates enough pressure on management and the board of directors, changes to the firm's strategies and/or operations may occur.

Compensation Packages

The best way to make managers interested in maximizing value is to pay them based on their stock performance. This is often accomplished through payment with stock options (the right to purchase shares at a fixed price even if the stock goes higher). Also, many CEOs own significant amounts of stock in the company they work for. Caution must be exercised that compensation is based on maximizing value and not other factors. For example, compensation based on the size of the company's assets may create incentives to make investments that increase assets without adding value. Also, compensation based on meeting sales targets may get met by selling items for a loss (which reduces firm value). Finally, stock options may be the most popular way of trying to align the interests of shareholders and managers but they also have some serious flaws. Specifically, the way many options packages are granted they reward short-term fluctuation in the price of the stock more than long-term value creation. There have also been issues related to the timing of option compensation that has acted more as a wealth transfer to executives rather than an incentive. Compensation packages must be carefully designed to align the interest of management with the objective of creating shareholder wealth in order to minimize agency conflicts.

Another agency conflict arises between the two principals, the stockholders and bondholders. Because of the difference in the way stockholders and bondholders are compensated, their attitudes towards a "worthwhile" investment may be different. This can lead to conflicts between which projects to undertake. Generally, bondholders prefer low-risk investments (as their potential return is limited) and stockholder prefer higher risk investments (assuming the higher risk is compensated by higher return).

The better we can control these agency problems, the better our chances of maximizing firm value. The term corporate governance is used to describe the policies that firms have in place to better align agency issues. Two studies that address this are Gompers, et al, 2003 and Cuñat, et al, 2010). These studies provide evidence that improving corporate governance results in higher shareholder wealth.