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1. The Agency theory

Theory used to explain the relationships between business principals and their agents, especially those between owners and managers.

1.1. Key concepts

- **Agency and contracts:** although the notions of contract and agency are closely linked, some scholars note two major types of differences. First, agents are usually not selected for a particular job or for a set of discrete tasks, but are hired for a broad range of activities, which can change over time and are compatible with the principal's fundamental objectives and interests. In this case, the principals involved must be, to some extent, interested in the personality of the agent, in its profile, and in other characteristics that are generally not an issue in contractual agreements. The principal will put an emphasis on the achievement of global objectives rather than specific tasks. Second, in an agency relationship, there is generally significantly less independence between the agency and the principal than between contracting parties. In practical terms, this means that the principal-agent relationship is more hierarchical and impulsive than a contractual relationship, and that the principal is more at liberty to reward, punish and control the agent. A conventional view would even want the agency to be a specific application of the contract theory. However, some may argue that the opposite is also true: a contract is a formalized, structured and limited version of the agency, but the agency itself is not based on any contract.

- **Agency relationship:** Jensen and Meckling (1976) define an agency relationship as a contract by which one or more persons (the principal) hire another person (the agent) to perform some service on their behalf, giving the agent some of their decision-making power. By its nature, the agency relationship is problematic if the principal and the agent's personal interests are divergent.
- **Agency costs:** as it is impossible for the principal to make sure, at no cost, that the agent makes the best decisions for him. Both the principal and the agent will have to assume monitoring and obligation costs. Agency costs occur when suspicion arises between the two parties. According to Jensen and Meckling (1976), these costs can be grouped in three categories:

• Monitoring costs borne by the principal to limit the opportunistic behaviour of the agent and incentive costs (incentive systems) incurred by the principal to orient the agent's behaviour.

• The obligation or commitment costs that may have been incurred by the agent to win the principal's trust (motivation cost).

• The third type of cost is an opportunity cost referred to as "residual loss" which equates to the loss of utility suffered by the principal following a divergence of interest with the agent, such as the cost sustained by the principal following the unfavourable management of the principal's interests by the agent

1.2. Understanding the Agency Theory

An agency refers to a relationship comprising two parties, where one party, called the agent, represents the other party, called the principal. An agent is usually hired by the principal to perform an act or service on his behalf. By implication, the agent doesn't only use the principal's resources, but also makes decisions with the resulting risks to be borne by the principal alone.

This makes agency relationships complicated as disputes, disagreements and conflicts of interests do arise. When the aspirations of the principal and the agent don't align, we have a principal-agent problem. This informs the need for a concept like agency theory to regulate how an agency works.

The agency theory explains how to best organize agency relationships so as to prevent conflicts and other issues that arise between agents and principals. There are two key assumptions underlying the agency theory, and they are:

- Individuals are generally egoists who act in their own self-interests. In short, both the principal and agent are out for their own benefits.
- Agents have access to more information and are usually in a decision-making capacity.

1.3. Origin and development

1.3.1. The Adam Smith's premise:

Adam Smith's book An Inquiry into the Nature and Causes of the Wealth of Nations, (1776) and, particularly, his thoughts on the ineffectiveness of companies whose management was entrusted to a non-owner agent, is undoubtedly one of the most relevant reference for the study of problems related to the agency relationship. « The directors of such companies, however, being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honour, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company. »

1.3.2. The experts at the wheel, the decline of family businesses

As Kitsou (2013) explains, the 20th century marked the beginning of the decline of the family business. The size of a company increased the complexity of management and an opening of capital became necessary, sometimes blurring the line between private wealth and business assets. As a result, the general decline of the family as a reference of social structure started and since the 1920s, we witnessed a general crisis of genealogy, inheritance and transmission as guarantors of social order.

The distinction between owners and managers was permanently settled with the Great Depression of the 1930s, during which we witnessed the emergence of a new class; the "managers». Schools and networks saw them as the new elite, devoted to the management of large enterprises. Technical expertise was preferred to the "right of blood" in a political context that demanded more and more to see one's competence to govern based on managerial knowledge as opposed to heredity. This inclination seen within the political sphere started to extend to big businesses. In general, the separation between management and ownership was inscribed in practice and in law.

1.3.3. The assertion of the agency theory

In order to make the new forms of government compatible with the theory of private property rights, the development of corporate governance was associated with an aspect of theorization. This is how the agency theory progressively asserted itself. The question was not to define a principal-agent theory (as it already existed since Adam Smith), but to make the theory of private property rights, established in a previous period with a theory on the distinction of management power and property, compatible. In other words, it was about defining an exercise of power that was not the product of the owners, while maintaining the need for private ownership of the means of production.

Jensen and Meckling, (1976), Fama and Jensen, (1983b) tried to show that the role of shareholders consists in exerting an essential counterweight to avoid that managers' discretional power becomes limitless and therefore potentially counterproductive. The functions of each party were therefore redefined. If the manager exercises power in a sovereign manner, with decisions informed by his managerial competence, he remains an agent designated by the principal (shareholders) and as such, he must sufficiently inform the market in a way that allows the shareholders to know and endorse the results.

1.3.4. Mass shareholding

The agency theory faced a short-term glory; just as it was establishing itself, mass shareholding changed the rules of the game of corporate governance and made the definition of a manager’s sovereign power increasingly ambiguous.

If shareholding was of little importance in the period that established the primacy of the manager, the situation changed radically in the 80s with the development of pension financing by the markets, the privatizations undertaken in various countries, and employee ownership. During two decades, shareholding grew at exponential rates, to the point that at the end of the 1990s, it was clear that capitalism no longer resembled the one Marx had witnessed. The largest portion of shares of the world's largest companies were then in the hands of the public. The debate on the private ownership of means of production had reached a new dimension. From then on, social exclusion as a result of privatization was not only the only issue. The inclusion of a large group players in the game of business ownership needed to also be taken into account, because it was creating new social and political consequences. Therefore, the recent Enron, WorldCom or Eurotunnel scandals not only concerned business strategies and venture capitalists, but could also jeopardize the savings and financing system on which depended the prosperity of our economies. Big business became a public space because its ownership was diluted in the public.

1.4. Agency Theory Examples

Below are some examples of how agency theory works in business relationships.

- **Company Management and Shareholders**: There's no doubt that the shareholders of a company are the owners of that company. But for sake of efficiency and the need for experienced hands, the shareholders cannot all run the business at the same time. So they delegate this responsibility to an appointed manager. Here the shareholders are the principals, and the company management are agents.
- **Investors and Fund Managers**: Another agency theory example is seen in investor-manager’s relationship.

Investors in a fund are the principals while the fund managers act as the agents.

The fund managers might pursue personal interests, such as large commissions, while sacrificing investor interests.

Agency theory is applied here, requiring that the fund managers act as much as possible, in the best interest of the investors, while there is adequate reward for the fund managers.

- **Employers and Employees**: quite similar to all of the above is the employer-employee relationship. Employees are to act in the best interest of employers while the employers are to ensure that they are sufficiently compensated.