

AGENCY PROBLEMS AND LEGAL STRATEGIES

1) The 3 main AGENCY PROBLEMS

LAW



establishes structure and internal rules

controls conflicts among stakeholders

The need is to motivate the agent to act in the principal's interest rather in the agent's own interest

1) The 3 main AGENCY PROBLEMS

Issues arising from any agency relationship:

- a) agent has better information than principal
- b) agent can act opportunistically
- c) principal must monitor agent (agency costs)

3 agency conflicts:

- firm's owners v. managers
- majority v. minority shareholders
- firm v. outside stakeholders

1) The 3 main AGENCY PROBLEMS

The third agency conflict is broader: it concerns conflicts between the firm and 'outsiders' such as creditors, employees, and customers. These conflicts often arise in distress situations, where shareholders may prefer strategies that shift value from creditors to equity holders.

Agency costs are higher whenever there are multiple principals! (information & coordination costs)

Coordination problems among multiple owners make it harder for dispersed shareholders to monitor managers. This explains why owners-managers conflicts are most serious in firms with dispersed ownership.

1) The 3 main AGENCY PROBLEMS

Law can play an important role in reducing agency costs:

- a) Imposing disclosure for the benefit of creditors or minority
- b) Providing legal constraints on power of majority to expropriate minority
- c) Sanctioning insider trading

Regulating insider trading and restricting self-dealing greatly reduce corporate managerial incentives to misuse confidential information or divert value.

Legal solutions to agency problems maximize aggregate welfare of the parties involved in the corporate relationships: this is the goal of the corporate law!

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

The legal strategies (i.e., the instrumental use of the law):

Mandatory v. Default rules

and

a) regulatory strategies (agent constraint): are prescriptive, constrain the agent directly, rely on external authorities (courts, regulators) to ensure compliance with rules and standards. Their effectiveness presupposes strong enforcement institutions.

v.

b) governance strategies (principal empowered). corporate governance strategies: facilitate principal's , but when principals are numerous and dispersed, governance strategies — which depend on shareholders' ability to act collectively — become less effective, making regulatory strategies comparatively more attractive.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

Legal Strategies for Protecting Principals

| | Agent Constraints | Affiliation Terms | Incentive Alignment | Appointment Rights | Decision Rights |
|----------------|------------------------------|------------------------------|--------------------------------|-------------------------------|----------------------------|
| EX ANTE | RULES | ENTRY | TRUSTEESHIP | SELECTION | INITIATION |
| EX POST | STANDARDS | EXIT | REWARD | REMOVAL | VETO |

Ex ante strategies prevent misconduct (rules, entry, trusteeship), whereas ex post strategies allow evaluation and sanction (standards, exit, removal, veto). Both sets complement each other.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.1. RULES AND STANDARDS

- **RULES** prescribe specific behaviors *ex ante* (dividend restrictions, minimum capitalization requirements, etc) used mainly for protection of creditors etc.

Examples include dividend restrictions, minimum capitalization rules, and detailed disclosure obligations to protect creditors and public investors.

- **STANDARDS** leave discretion for an *ex post* evaluation used for internal affairs (good faith, reasonable care, fairness, at arms length etc.).

Standards require courts and regulators to evaluate conduct *ex post* according to principles like 'fairness', 'good faith', or 'reasonable judgment'. Their flexibility is valuable but demands sophisticated adjudication.

The importance of rules and standards relies on an efficient enforcement.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.2. ENTRY AND EXIT STRATEGIES

- **Entry strategies**= systematic disclosure for the benefit of potential principals (capital markets). Entry strategies ensure an adequate supply of information before investment. Examples include prospectus requirements and rules mandating minimum financial sophistication for certain securities.

- **Exit strategies** = ▪ appraisal (withdrawal) rights, ▪ right of transfer the shares. Exit strategies protect investors against opportunistic actions. Appraisal rights compensate dissenting shareholders who object to major transactions, allowing them to exit at a fair value.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.3. TRUSTEESHIP AND REWARD

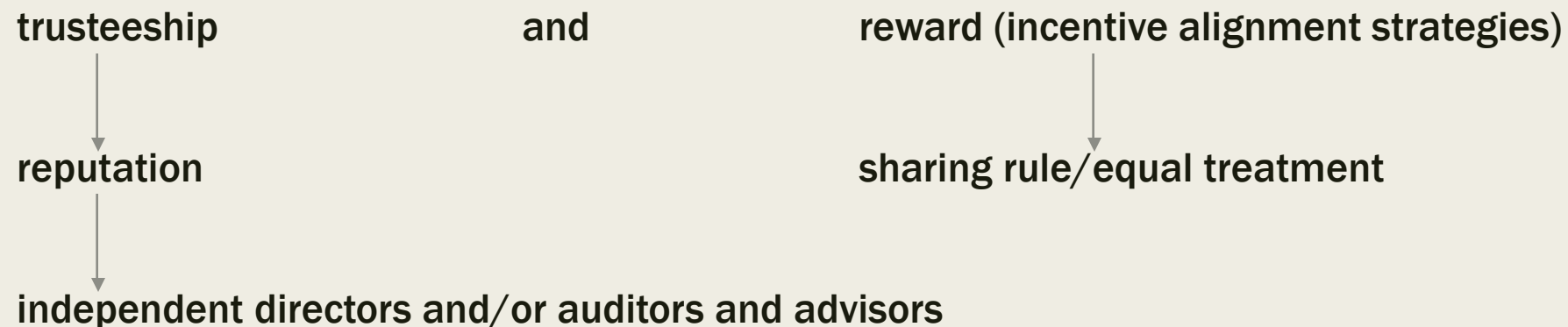
The trusteeship strategy restrains agents from seeking personal benefits by placing them under the supervision of trustees (independent directors, auditors, state officials) whose role is to ensure compliance.

The reward strategy aligns interests by tying the agent's monetary returns to those of the principal. The most common form is the equal-treatment rule on dividends, ensuring minority shareholders receive a proportionate share.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.3. TRUSTEESHIP AND REWARD

High-powered incentives vs. Low-powered incentives



2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.4. SELECTION AND REMOVAL

The right of the principals to appoint and remove directors and top officers.

Appointment rights are among the most important governance tools, as they allow principals to influence corporate direction and discipline managers.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.5. INITIATION AND RATIFICATION

The right of the principals to initiate or ratify certain fundamental corporate decisions.

Decision rights allow principals to intervene directly in major actions such as mergers, liquidation, amendments to the charter or large asset transactions.

2) LEGAL STRATEGIES FOR REDUCING Agency Costs

2.6. *EX POST AND EX ANTE STRATEGIES*

Let explain the differences

Ex ante strategies set the conditions and constraints before conduct occurs (rules, entry, trusteeship).

Ex post strategies evaluate conduct afterward (standards, exit, removal, veto) and allow sanctions or corrections.

3) DISCLOSURE

- important role in controlling corporate agency costs
- differences of disclosure with regard to regulatory strategies and governance strategies
- types of disclosures
 - periodic disclosures (known unknowns)
 - ad hoc* disclosures (unknown unknowns)

For periodic disclosures, the challenge is not whether disclosure occurs but its quality. Enforcement institutions — auditors, regulators — are essential to assure accuracy.

For *ad hoc* disclosures, strong legal enforcement is needed because principals cannot anticipate when relevant information will arise.