Is the Agency Assumption Valid for Public Corporations?

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Friedman (1970) stated that CEOs of public corporations are the agents of shareholders, which we refer to as the 'agency assumption.' Jensen and Meckling (1976) modeled Friedman's agency assumption, popularizing it among academics. However, in the mid-1970s, the academic consensus was that the agency assumption had little predictive validity in that CEOs did not generally maximize profits for shareholders (Fama & Miller 1972; Jensen & Walkling 2010). Post-1990s the prescriptive validity of the agency assumption improved with the widespread adoption of executive stock option pay. The purpose of this paper is to determine whether the agency assumption is descriptively and prescriptively valid.

INTRODUCTION

Friedman (1970) stated that CEOs of public corporations are the agents of shareholders. We refer to this as the 'agency assumption.' The purpose of this paper is to determine whether the agency assumption is descriptively and predictively valid.

Jensen and Meckling (1976) modeled Friedman's agency assumption, popularizing it among academics. However, in the mid-1970s, the academic consensus, (including the authors), was that the agency assumption had little predictive validity in that CEOs did not generally maximize profits for shareholders (Fama & Miller 1972; Jensen & Walkling 2010). This view was supported when Jensen and Murphy (1990a) found inconsistent evidence for the prediction that CEOs were paid for increasing share price. The agency assumption had relatively low predictive validity until the early 1990s.

After the early 1990s, the predictive validity of the agency assumption improved when executive stock option pay skyrocketed. Incentivized with stock options, CEOs began running their public corporations to increase stock price, which improved the predictive validity of the agency assumption. Soon after the rise of executive equity pay, Hall and Liebman (1998) document that there is a, "strong relationship between firm performance and CEO compensation" (p. 654). Since then, the agency assumption has continued to appear predictively valid. The predictive validity of the agency assumption therefore changed in the early 1990s from low to high. Inconsistent evidence across time reduces confidence in the currently high predictive validity of the agency assumption and calls in to question the notion that the agency assumption will continue to be predictively valid.

In addition to assessing its' predictive validity, this paper also aims to determine whether the agency assumption is descriptively valid. Legal scholars argue that the agency assumption fails to describe the

relationship between CEOs and shareholders. Stout (2002), for example, refutes the descriptive validity of Friedman's agency assumption noting that, "…he obviously is not a lawyer. A lawyer would know that the shareholders do not, in fact, own the corporation. Rather, they own a type of corporate security commonly called 'stock.' As owners of stock, shareholders' rights are quite limited" (p. 1191). Thus, before the early 1990s, the agency assumption would seem to lack both descriptive validity and predictive validity.

By fundamentally examining the descriptive validity of the agency assumption as well as the origins of the changes in its' predictive validity, this paper aims to encourage further discussion of our continued reliance on the agency assumption in management policy and practice.

The next section of the paper provides a brief history of, and background to, corporate governance in light of the agency assumption. It also explains why legal scholars reject the descriptive validity of the agency assumption. The Analysis Section seeks to illustrate why the predictive validity of the agency assumption shifted from low to high in the early 1990s. The Discussion Section analyzes this shift and calls in to question the confidence researchers should place on the assumption's continued predictive validity. The final section contains our conclusions.

HISTORY AND BACKGROUND

Corporate Governance and the Agency Assumption

Businesses, such as guilds, banks and trading merchants have existed since the 16th century. The East India Company, formed by royal charter in 1600 has been described as the original example of the "too big to fail" corporate entity. The Tea Act of 1773 was, in essence, designed as a bailout mechanism for The East India Company which was in severe financial distress and was the catalyst for the infamous Boston Tea Party revolt. After the declaration of independence, the Founding Fathers called on citizens to remain vigilant against the power of moneyed interests (Hartmann, 2010). As a result, now-skeptical Americans demanded that states restrict each corporation with a charter.

In the early 1800s, corporate charters were granted for a limited time and could be revoked and ensured that corporate activities were restricted to the chartered purpose. Additionally, corporate law prohibited corporations from owning stock in other corporations, prohibited any political or charitable contributions, did not provide shareholders with limited liability; and provided no legal protections for management from lawsuits against corporate actions. Rather, in most cases, stockholders, often locals, behaved like owners and involved themselves in management of corporate affairs (Gomory & Sylla 2013).

General incorporation laws, making the granting of charters more open, were introduced by most states in the mid-1800s and a developed and active market for corporate securities emerged in "[w]ith the development of a relatively sophisticated share market, shares became readily marketable, liquid commodities with a value of their own independent of (and often quite different from) the value of a company's concrete assets. (Ireland, 2001, p.6) By 1860, most states provided for limited liability for shareholders. Shareholders, "in exchange for limited liability (and an easy life), they had given up virtually all of the rights traditionally associated with ownership either of the corporation or its assets: the right to operate and manage; the right to sell, dispose, pledge, encumber, or hypothecate; the right to create lesser titles in interests, such as leases, licenses, easements of covenants; the right to bequeath." (Rona, 1989, p. 198).

During the early 20th century, the 'modern industrial corporation" as Chandler (1977) labeled it, grew dramatically in size and strength, and was "driven primarily by the relentless search for productive and organizational efficiency" (Gindis, 2013, p. 3). These corporate giants, run by professional managers in a bureaucratic manner, produced profits for the shareholder but more as a matter of incidence than design. It was in this economic context that Berle and Means (1932) argued that a separation of ownership from control was inevitable given the diffuse nature of share holdings. According to Berle and Means (1932), the status of shareholders shifted from "owner" to "bondholder" was because shareholders, "…by surrendering control and responsibility over the active property, have surrendered the right that the

corporation should be operated in their sole interest…" (pp. 355-6) Thus, shareholders voluntarily separated themselves of management responsibilities at the cost of reduced dividends. Keynes agrees that the shareholders of these large corporations "…are almost entirely dissociated from the management, with the result that the direct personal interest of the latter in the making of great profit becomes quite secondary. When this stage is reached, the general stability and reputation of the institution are the more considered by the management than the maximum of profit for the shareholders." (Keynes, 1926, pp. 42-43).

Accounting scholars also recognized that the removal of shareholders from management reduced the status of shareholders to that of bondholders. Paton and Littleton (1940, p. 8.) note that, "…it has become almost axiomatic that the business accounts and statements are those of the entity rather than those of the proprietor, partners, investors, or other parties or groups concerned." Relegating shareholders to the status of bondholders led some accountants, in the early 1900s, to categorize capital stock and surplus as liabilities (Kohler 1931, p. 201), while others, such as Patton and Littleton, prescribed listing the claims of shareholders and creditors as "equities." They suggested, therefore, that, "interest, taxes, and dividends, all should be reported as distributions (or expenses) of entity income." (Paton and Littleton, 1941, p. 43; Also, Paton 1922, p. 181) Stout (2013) also supports this notion stating that, "….directors viewed themselves not as shareholders servants, but as trustees for great institutions that should serve not only shareholders but other corporate stakeholders as well, including customers, creditors, employees, and the community" (p. 2).

Much attention was paid to corporate social responsibility in the mid-to-late 1950's with academics (such as Peter Drucker) and corporate critics (such as Ralph Nader) alike, arguing for a more socialized version of the American corporation. This sentiment continued throughout the 1960's. The term "stakeholder" was introduced in 1963 by the Stanford Research Institute and was defined as "those groups without whose support the organization would cease to exist." (*per* Freeman & Reed, 1983, p. 89). Therefore, it was in this context, and contrary to the conventional wisdom of the time, that Friedman (1970) argued the only "social responsibility of business is to increase its profits."

Until the late 1970s, "management was loyal to the corporation, not to the shareholder," where the primary objective of management, "…was not to maximize shareholder wealth, but to ensure the growth (or at least the stability) of the enterprise by 'balancing' the claims of all important corporate 'stakeholders'--employees, suppliers, and local communities, as well as shareholders." (Holmstrom & Kaplan 2003, p. 15) In treating shareholders like bondholders, boards declared dividends at fixed rates and intervals, similar to interest on bonds.

After the poor stock market performance of 1973-74, free market academics were quick to blame managerial-style corporate governance which had focused on corporate stability rather than profitability. The investor capitalism which took hold in the following decades has been firmly attributed to the acceptance of Jensen and Meckling's Agency Theory. In their 1976 article, "Theory of the Firm: Managerial behavior, agency costs and ownership structure," Jensen and Meckling proposed a theory that was quickly adopted as the solution to the corporate failures of the day. Jensen and Meckling argued that firms could realize their potential by re-aligning the interests between shareholders ("agents") and company management ("principals"). Principals, it was argued would operate in their own self-interest rather than in the interests of the shareholders who, Jensen and Meckling characterized as the owners of the business. Proponents of the theory used it to discredit what they viewed as the inefficient diversification and expansion of American companies.

Legal Scholarship

Legal scholars are the experts in determining the extent to which a legal principal-agent relationship exists between the CEO and shareholders. Legal scholars are also experts in assessing an entity's contractual rights and duties to property. The consensus amongst legal scholars has, for some time, been that shareholders are not the residual claimants of the profit and, thus, CEOs are not the agents of shareholders (See Bainbridge, 2006, p. 442; Blair & Stout, 2006; Pottage, 1998, p. 338; Lee, 2005, p. 10; Frisch, 2004, p. 12; Allen, 1992).

The reason that CEOs are not agents of the shareholders is because shareholders have little legal ability to influence management decisions. Even if CEOs were to maximize profits, managers can legally use corporate the profit to, "…raise managers' salaries, start an on-site childcare center, improve customer service, beef up retirees' pensions, or make donations to charity." (Stout 2002, p. 1194)

Shareholders have 3 methods of recourse to force boards to distribute the free cash flows. They can (1) file a derivative lawsuit against the board, (2) oust board members, and (3) sell the shares. The ability of shareholders to successfully win a derivative lawsuit for not declaring dividends is negligible because board members are protected by the business judgment rule. The business judgment rule provides managers and corporate board members with substantial latitude to pursue any business strategy that does not result in 'reckless indifference' to the interests of the corporation as a whole (Dibadj, 2005, p. 485). As long as the board, at least purportedly, uses the assets underlying the undistributed profits for the long-run benefit of the corporation, shareholders have little recourse. Shareholders also face substantial legal barriers to removing board members solely for failing to maximize or distribute profits (Levitt, 2006; Bebchuk, 2007). The ability of shareholders to successfully oust board members is negligible as various rules make ousting a board member practically impossible. Between 1996 and 2004, insurgents won only twice with market capitalization over $200 million, outside of the takeover context (Bebchuck, 2007).

Recently, in an unprecedented move intended to disabuse business experts, the financial press, and economists who study the firm, of some widely-held but erroneous beliefs about corporations, 53 authors published The Modern Corporation Statement on Company Law (2016). These distinguished scholars (experts versed in a variety of national legal systems, including those of the U.S. and U.K. as well as the E.U.) reiterate (amongst other fundamentals of corporate law) that corporations are legal persons, that shareholders do not own corporations only shares of stock (bundles of intangible rights), and that corporate directors are not legally obligated to maximize shareholder profits.

The Statement declares that, "Corporations are universally treated by the legal system as "legal persons" that exist separately and independently of their directors, officers, shareholders, or other human persons with whom the legal entity interacts. Legal separateness or "personhood" is not a metaphor or fiction but a powerful legal reality" (p. 1).

It would perhaps be tempting for social scientists to dismiss legal scholarship as being only marginally relevant to their fields, however it is becoming increasingly apparent that this view on the relationship between shareholders and the corporation is not solely held by legal scholars. In 2017, The Harvard Business Review published "Managing for the Long-Term". This is a series of 4 articles on how corporate financial health could suffer if there is a continued focus on shareholder wealth maximization (which is predicated on the idea that shareholders own the corporation).

The first article, "The Error at the Heart of Corporate Leadership" by Bower and Paine, argues that the idea that shareholders own the corporation is faulty. They further posit that because of this error, the agency-based model of governance and management has the potential to weaken companies and could even be damaging to the broader economy.

"Attributing ownership of the corporation to shareholders sounds natural enough, but a closer look reveals that it is legally confused and, perhaps more important, involves a challenging problem of accountability. Keep in mind that shareholders have no legal duty to protect or serve the companies whose shares they own and are shielded by the doctrine of limited liability from legal responsibility for those companies' debts and misdeeds. Moreover, they may generally buy and sell shares without restriction and are required to disclose their identities only in certain circumstances. In addition, they tend to be physically and psychologically distant from the activities of the companies they invest in. That is to say, public company shareholders have few incentives to consider, and are not generally viewed as responsible for, the effects of the actions they favor on the corporation, other parties, or society more broadly. Agency theory has yet to grapple with the implications of the accountability vacuum that results from accepting its central—and in our view, faulty— premise that shareholders own the corporation." (Bower & Pain, (2017).

The papers above illustrate that at a fundamental level, the agency assumption lacks descriptive validity. It seems clear that from a legal, and hence one could argue, practical, perspective that

shareholders do not own the corporation and as a result CEOs are not agents of the shareholders. They are instead agents of the corporation, a separate legal person.

ANALYSIS

According to Friedman (1953), the assumptions of descriptive theories do not need to be descriptive themselves. The only requirement for an assumption to be considered valid is its predictive ability. At the same time, the fluctuation in predictive validity implies that less confidence ought to be placed on the predictions; that is, fluctuations in predictive validity jeopardize predictive validity. As such, we believe it is instructive to understand the circumstances which led to the sudden increase in predictive validity in the early 1990s. This will lend confidence to the predictions of future research, particularly related to prescriptive research.

We rely here on media and academic articles, to illustrate how the predictive validity of the agency assumption rose in the early 1990s, paying particular attention to relevant regulations, since regulations often contribute to changes in management behavior (Murphy, 2012). In addition to identifying relevant regulations, we also examine the underlying academic arguments made to justify the regulations and their implementation. Understanding the reasoning behind the regulations that would incentivize CEOs to maximize shareholder value will hopefully help researchers assess the stability of the predictive validity of the agency assumption. That is, if the predictive validity of the agency assumption rose in the early 1990s, unless we understand the impetus of the change, who's to say it will not revert back?

Relevant Regulations

In the early 1980s, hostile takeovers exploded, pressuring CEOs to increase share prices. (Jensen, Murphy, & Wruck, 2004, p. 27). By 1990, due to successful lobbying efforts by the Business Roundtable, states passed restrictions making hostile takeovers impracticable (Tirole, 2006, p. 44). "The late 1980s brought sweeping changes in both US financial markets and global geopolitics. Court decisions and legislation in the US brought the hostile takeover market to a virtual halt." (Jensen, Murphy & Wruck, 2004, p. 23) As a result of these efforts, "[t]otal M&A transactions fell 56% from a peak of $247 billion in 1988 to $108 billion in 1990; and this decline has accelerated through the first six months of 1991." (Jensen, 1991, p. 15) Soon after the "…decline in takeover activity in the late 1980s … activists – including many of the largest state pension funds – demanded increased links between CEO pay and shareholder returns. The activists were joined by academics such as Jensen and Murphy (1990b), who famously (or infamously) argued 'It's not *how much* you pay, but *how* that matters.'…" (Murphy, 2012, p. 74).

After the demise of hostile takeovers in the early 1990s, two regulations were passed relevant to executive equity pay. First, in 1991, the SEC dropped the holding period requirements under Section 16(b) of the Securities Exchange Act of 1934, enabling senior executives to exercise the option and sell the stock on the same day, as long as the stock option had already been held for six months or longer. Prior to 1991, a senior executive of a publicly held company who exercised a stock option would be required to then hold the underlying share for six months in order to satisfy the holding requirements of Section 16(b) or possibly face surrendering any gain to the corporation as a "short swing" profit. Second, in 1993, "Section 162(m) of the U.S. Internal Revenue Code was passed into law. The intent of this law was to rein in outsized executive compensation by eliminating the tax-deductibility of executive compensation above $1 million unless the excess compensation was performance-based" (Stout 2012, p. 20). Ferris and Wallace (2009) explains that, from 1993 to 2003, Section 162(m) resulted in an approximately ten-fold increase in executive stock option pay.

Academic Origins

The consensus among pundits and academics is that the agency assumption provided the ideology for institutional investors and academics to argue for regulations favorable to hostile takeovers and executive equity pay. An article in the *Economist* links Jensen and Murphy (1990b) (henceforth JM90b) to the

growth of stock options through the changes made to Section 162(m) of the U.S. Internal Revenue Code in 1993. (Economist May 6th, 1999) A New Yorker article explains that Jensen and Meckling (1976) (henceforth JM76) and JM90b "provided an intellectual rationale, of sorts, for the controversial explosion in C.E.O. pay that began in the nineteen-eighties; and it justified the widespread adoption of executive stock options." (Cassidy, 2002, p.64) Paul Krugman (2006) also blames JM90b for the growth in stock options and related accounting scandals of the early 2000s.

Others who blame JM90b for the rise of stock option pay in the early 1990s and stock option pay for the accounting scandals of early 2000 include Stout (2012), Martin (2011), Dobbin and Zorn (2005), Blair (NYT September 26, 2007) and, Denning (2013), The Economist (Nov 16, 2002, p. 86). Both Michael Jensen (Deutsch, 2005, NYT) and Kevin Murphy (Grimein, Lavelle & Barrett, 2006, Businessweek) agree that JM90b contributed to the growth of executive stock option pay in the early 1990s and the scandals in the early 2000s. (See also Murphy, 2012, p. 74)

The theoretical foundation for JM90b is JM76 and the foundation of JM76 is found in Friedman (1970). Friedman (1970) envisions CEOs as the agents of shareholders who should therefore always seek to maximize profit.

> The whole justification for permitting the corporate executive to be selected by the stockholders is that the executive is an agent serving the interests of his principal…[where]…there is one and only one social responsibility of business–to use its resources and engage in activities designed to increase its profits…(p. 122)

As indicated previously, in 1970, this view was not the consensus and academics generally viewed shareholders as stakeholders more akin to bondholders than to the principal or owner of the corporation. Friedman (1970) notes that, at the time, public opinion was rife with "wide spread aversion to 'capitalism,' 'profits,' the 'soulless corporation'" and that many businessmen advocated "…for wage and price guidelines or controls or income policies" (p. 123).

Shortly after its publication, Karl Brunner invited Michael C. Jensen and Karl Meckling to one of his famous Interlaken conferences to present a paper that modeled Friedman (1970) for the purpose of discussion (Jensen & Walkling, 2010; Fox, 2009; Forecade & Khurana, 2011). JM76 model Friedman's vision of CEOs as agents of shareholders, noting that the "divergence between the agent's decisions and those decisions which would maximize the welfare of the principal" lowers profits for shareholders. They identified equity pay and the threat of hostile takeovers as methods to motivate CEOs to maximize shareholder value.

Thus, if CEOs are the agents of shareholders, JM76 predicts that we should observe executive equity pay and/or the threat of hostile takeovers, which combined would be substantial enough to motivate CEOs to maximize profit. But JM76 had a problem with the descriptive validity of the agency assumption. In the early 1970s, executive equity pay was insignificant and hostile takeovers had only begun. As echoed in the previous section, Jensen admits that Meckling and he, "…could not say that what business firms actually did was maximize profits." (Jensen & Walkling, 2010, p. 3)

As a result, according to Jensen, their paper "turned out to be very controversial" and the attendees at Brunner's Interlaken conference were not receptive. Jensen explains in an interview, (Jensen & Walkling, 2010) that when Meckling and he presented their paper at the University of Chicago, "…colleagues and friends were in the audience and they ran us out of the room on a rail. They were furious at us. I remember to this day, walking out of that room in the face of this antagonism, this almost hatred" (p.3). Their paper received "an equally riotous reception" at a University of Chicago finance workshop (p. 3). (Also, New Yorker 2002) Not only did attendees at these conferences and workshops reject the paper, no one would publish it. Oliver Williamson editor of the *Bell Journal of Economics* rejected it at the desk and was "…incensed that anybody would even dare to submit a paper like this to the Bell Journal" (p. 3).

After these rejections, Jensen explains that along with Gene Fama, Merton Miller, he, co-founded the *Journal of Finance and Econ*omics in 1974 (p. 3). In 1976, when they were all co-editors, Eugene Fama gave JM76 an "unsolicited acceptance" (p. 3). After receiving Fama's Letter of Acceptance, Jensen states that he exercised his "rights as Editor to make it the lead article" (p. 3). In July 1, 1976, Jensen published JM76 in the *Journal of Financial Economics*. Even years after the publication, Jensen explains, co-editor

Merton Miller continued to believe that the there was no value in the paper (p. 3). Furthermore, Eugene Fama did not agree that shareholders would act like a "principal" because, "…portfolio theory tells us that risk bearers are likely to spread their wealth across many firms and so not be interested in directly controlling the management of any individual firm" (Fama, 1980, p. 295).

From Jensen's own admission, JM76 did not follow the scientific method to publication, as it was not independently, blindly review by peer academics. The peer review process helps to avoid bias and inaccuracy caused by cronyism among authors and editors. Scholars understand that "the reason we trust journal quality rests on the process by which manuscripts are evaluated before publication; that is, the peer review system" (Campanario, 1998).

In this way, Friedman's naked assertion that CEOs are the agents of shareholders was given legitimacy in a top academic journal. JM76 went on to become the most cited papers in social science in the past 40 years and the "cornerstone of the corporate governance field, not only in terms of its impact on the literature but also in terms of policy and practice." (Per Lan & Heracleous, 2010, p. 294, citing Daily, Dalton, & Cannella, 2003; Dalton, Daily, Ellstrand, & Johnson, 1998; Shleifer & Vishny, 1997). (Also, Fourcade & Khurana 2011)

While academics did not share Friedman's vision of CEOs as agents of the shareholders, they had not formally provided the evidence necessary to reject the theory. JM76 reasoned that if CEOs are agents of shareholders, evidence should manifest in the form of executive equity pay. Michael C. Jensen and Kevin J. Murphy empirically test this expectation, predicting a positive relationship between stock prices (i.e., performance, shareholder value) and CEO pay in Jensen and Murphy (1990a) (henceforth, JM90a).

The conflict of interest between shareholders of publicly owned corporations and the corporation's chief executive officer (CEO) is a classic example of a principal-agent problem…In these situations, agency theory predicts that compensation policy will be designed to give the manager incentives to select and implement actions that increase shareholder wealth (p. 225-6).

They sample salaries and bonuses from 1974 through 1988 for 2,505 CEOs in 1,400 publicly held companies. They find the relationship between CEO pay and stock price "inconsistent with the implications of formal agency models of optimal contracting" (JM90a, p. 227). "The largest CEO performance incentives come from ownership of their firms' stock, but such holdings are small and declining…boards of directors do not vary the pay-performance sensitivity for CEOs with widely different inside stockholdings" (JM90a, p. 261). In sum, JM90a assumes that CEOs are agents of shareholders to predict that CEO pay will vary positively with stock price, a prediction for which they find inconsistent evidence.

In the same year, Professors Jensen and Murphy published an article in the *Harvard Business Review*, prescribing that the board of directors "…create incentives that make it in the CEO's best interest to do what's in the shareholders' best interests…" [where] "…the best incentives are determined primarily by large CEO stockholdings." (Jensen & Murphy 1990b) (henceforth, JM90b) Thus, the authors in JM90b are making a prescription based on a theory for which they themselves found inconsistent evidence in JM90a.

DISCUSSION

In investigating the origin of the change in predictive validity, we find that Jensen and Murphy (1990b) advocated for executive equity pay, despite the fact that Jensen and Murphy (1990a) found evidence inconsistent with the agency assumption. Typically, when scientists find evidence inconsistent with their theory, they question the assumptions of the theory. In this case, JM90a&b should have questioned whether CEOs are descriptively the legal agents of shareholders. Instead, JM90b continue to assume that CEOs are agents of shareholders in order to prescribe that boards pay executives in equity.

Michael Jensen understands that prescriptive research without an accepted descriptive theory is "unscientific." (Jensen, 1976; Friedman, 1966) The accepted view of free-market economists at the time was described by the Fama and Miller (1972) who ask: "[W]hat right have we now to [tell executives to] put aside their own utility functions and maximize instead the market value of the owners' equity in the

firm?" They believed that they had no right to prescribe profit-maximizing goals. The fact that Michael Jensen made prescriptions without a proper descriptive theory appears to be a classic case of scientists influencing the data to fit the theory they espouse (Ghoshal, 2005). How can researchers place confidence in the predictive validity of the agency assumption in this situation?

The evidence suggests that the academics that proposed the agency assumption were not happy that CEOs were failing to maximize profits for shareholders. They first used the agency assumption to prescribe regulations favorable to hostile takeovers and when that failed they prescribed executive equity pay. Today, CEOs paid in equity pay generally seek to maximize shareholder value. However it seems reasonable to suggest that we must question our confidence in the agency assumption when its predictive validity was contrived in such a way.

CONCLUSION

This paper seeks to determine whether the agency assumption—the belief that CEOs are agents of shareholders—is descriptively and predictively valid. No doubt other factors beyond JM76 and JM90b influenced the passage of the Internal Revenue Code Section 162(m), and ultimately the rise in executive equity pay in the early 1990s. However, research has yet to determine the contributions made by other academics, institutional investors, and pay consultants who used the agency literature to promote executive equity pay.

Section 2 shows that historically, academics viewed shareholders more as bondholders than the principal of public corporations, and the academic consensus agreed that CEOs did not, and, in fact, should not maximize profit. It also shows that legal scholars strongly reject the agency assumption that CEOs are the agents of shareholders on the grounds that the shareholder's ability to sue or vote out board members is negligible. Thus, CEOs are not legally the agents of shareholders and they have not historically acted like agents; that is, the predictive validity of the agency assumption was historically low.

In the early 1990s, the regulation tax code Section 162(m) combined with the agency assumption to influence a rise in executive equity pay. Friedman (1970) first asserted the agency assumption when its descriptive and predictive validity were weak. JM76 modeled the agency assumption and, against overwhelming opposition to its publication, it became the cornerstone of corporate governance. JM90a found inconsistent evidence for the agency assumption, suggesting its predictive validity was weak. JM90b, then, prescribed executive equity pay based on the agency assumption. Pundits attribute the passage of Section 162(m) of the tax code in 1993 to JM90b.

The purpose of this paper is to illustrate that the descriptive and "the core ideas of agency theory were not derived from inductive observation and practical experience, but instead, through the theoretical musings of a newly revitalized neoclassical economic theory" (Fourcade & Khurana, 2013, p. 28).

Today, in part because of academics prescribing executive equity pay when the agency assumption was not descriptively valid, the predictive validity of the assumption is strong. The degree to which academics influenced change in predictive validity is difficult to quantify; however, according to the consensus, JM76 and JM90b contributed to the explosion of executive stock option pay in the early 1990s and beyond. The predictive validity of the agency assumption appears to have increased, in part, because of academic influence, and ultimately for regulatory reasons. It seems that the political and regulatory climate must be factored into agency theory before relying on its' predictive value. Accordingly, we advise researchers and practitioners alike to use caution when making prescriptions based on the agency assumption.

ENDNOTES

1. In 1837, Connecticut adopted a general corporation statute that allowed for the incorporation of any corporation engaged in any lawful business. Delaware did not enact its first corporation law until 1883.
2. This view is consistent with that of Berle and Means (1932, p. 312) who suggest that "… balancing a variety of claims by various groups in the community and assigning to each a portion of the income stream on the basis of public policy rather than private cupidity."
3. Securities Exchange Act Release No. 34-28869 (Feb. 8, 1991) which revised Rule 16b-3(d) to permit senior executives to sell shares when the options are exercised.
4. "Congress as part of the Omnibus Budget Reconciliation Act of 1993, Section 162(m) of the tax code applies only to public firms and not to privately held firms, and applies only to compensation paid to the CEO and the four highest-paid executive officers as disclosed in annual proxy statements (compensation for all others in the firm is fully deductible, even if in excess of the million-dollar limit). More importantly, Section 162(m) does not apply to compensation considered performance-based for the CEO and the four highest-paid people in the firm." (Murphy 2011)
5. "Others have referred to editorial board members and external referees as the "gatekeepers of science" (Beyer 1978; Crane 1967; Glogoff 1988; Pipke 1984; Zsindely, Shubert, and Braun 1982)." (Campanario 1998)
6. As of May 19, 2013, SSRN shows it as the most cited of all SSRN articles and most cited in the management literature (Martin 2012, p. 11). This paper was named a Citation Classic by the Institute for Scientific Information in 1984 for being the most cited in its field.
7. Academics have long understood the role of managerial incentives (e.g. Burnham 1941, Cyert and March 1960, Fama and Miller 1972)
8. Despite this, Fama and Miller (1970) argued that their neo-classical models were useful, "...it has yet been demonstrated that the market value rule leads to predictions that are not widely at variance with observed management behavior."

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