

TRUST AND INCENTIVES IN AGENCY¹

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I. INTRODUCTION

The demise of Enron, the largest bankruptcy in United States history, raised fundamental questions about the role of trust in agency relationships. The corporate collapse cast doubts on trust relationships between investors and corporate managers, between investors and investment advisors and accountants, between pension beneficiaries and trustees, and between employers and employees. The events surrounding Enron gave support to arguments that courts and legislators had eroded the role of trust in corporate fiduciary law.⁴

Legal scholars and the courts have tended to downplay trust in corporate control, instead emphasizing market penalties for management actions that depart from shareholder interests. Critics of corporations have gone so far as to argue that maximizing shareholder value is inconsistent with ethical behavior.⁵ Frank Easterbrook and Daniel Fischel conclude that because fiduciary duties vary from one type of agency relationship to another, “fiduciary duties are not a distinctive topic in law or economics.”⁶ Indeed, although the rhetoric of trust is fundamental to agency, there has been little discussion of trust in agency literature or in general legal scholarship.⁷

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⁴ Lawrence E. Mitchell, *Fairness and Trust in Corporate Law*, 43 DUKE L. J. 425, 425-26 (1993) (Mitchell observes that “Trust is the glue that binds corporate relationships” but argues that by replacing traditional fiduciary rules with the fairness test, “courts opened up the examination of self-dealing transactions to consider the fiduciary’s interest as well”).

⁵ See, e.g., Constance E. Bagley and Karen L. Page, *The Devil Made Me Do It: Replacing Corporate Directors’ Veil of Secrecy with the Mantle of Stewardship*, 36 SAN DIEGO L. R. 897 (1999).

⁶ Frank H. Easterbrook & Daniel R. Fischel, *Contract and Fiduciary Duty*, 36 J.L. & ECON. 425, 446 (1993).

⁷ See, e.g., Melvin A. Eisenberg, *Corporate Law and Social Norms*, 99 COLUM. L. REV. 1253, 1254 (1999) (In discussing recent attempts to examine social norms in legal literature, Eisenberg observes that the “neglect of the operation of social norms in the field of corporate law parallels the neglect of the operation of social norms in the law generally”); See also Mitchell, *supra* note 4; and Marleen A. O’Connor, *The Human Capital Era: Reconceptualizing Corporate Law to Facilitate Labor-Management Cooperation*, 78 CORNELL L. REV. 899 (1993).

Yet the public outcry and soul-searching that followed the Enron debacle suggest the continuing importance of trust in agency relationships. Although Enron's corporate managers were subject to contractual incentives to perform their duties, other governance mechanisms were activated after the fact. The force of social norms was felt in Congressional hearings, negative press, and public opprobrium. Market penalties for loss of trust swiftly led to the bankruptcy itself, as the company's clients and lenders withdrew from contracts.⁸ Shareholders and employees filed lawsuits against Enron executives. These events demonstrate how contractual incentives for trust are accompanied by social, legal, and market governance mechanisms.

In this article, we present a general framework for understanding the role of trust in agency relationships. We provide an operational definition of trust that clears up many conflicting interpretations and allows for treatment of diverse types of agency situations, including investor/corporate manager, trustee/beneficiary, attorney/client, and employer/sales agent. We also illustrate how different types of governance mechanisms work together to promote trust. Our analysis is of particular interest for corporate governance, since as Henry Hansmann and Reinier Kraakman point out, three generic agency problems arise in companies as reflected in potential conflicts (1) between owners and managers, (2) between majority and minority owners, and (3) between the firm itself and contracting parties (such as creditors, employees and customers).

What drives principals to rely on agents, and agents to act in the interest of principals? Some principal-agent relationships entail formal contracts that contain *explicit* incentives for performance, but other agency relationships involve contracts that do not specify performance incentives or are voluntary associations that do not require a formal contract.¹⁰ However, agency relationships generally are not formed in isolation: they are embedded in social relationships, which take place against the background of agency law, and they frequently occur within market networks.

⁸ *Financial Collapse of Enron Corporation*: The House Committee on Energy and Commerce, 107th Cong. (2002) (Prepared witness testimony of Jeffrey K. Skilling) (Former Enron CEO Jeffrey Skilling likened the company's failure to a "classic 'run on the bank:' a liquidity crisis spurred by a lack of confidence in the company...").

⁹ Henry Hansmann & Reinier Kraakman, *Agency Problems & Legal Strategies* (Feb. 25, 2004) (Research Paper no. 301, on file with The Center for Law, Economics & Public Policy, Yale Law School).

¹⁰ RESTATEMENT (THIRD) OF LAW OF AGENCY § 1.01 (Tentative Draft No. 2, 2001) ("Agency is the fiduciary relationship that arises when one person (a 'principal') manifests assent to another person (an 'agent') that the agent shall act on the principal's behalf and subject to the principal's control, and the agent manifests assent or otherwise consents so to act"). RESTATEMENT (SECOND) OF LAW OF AGENCY, § 1 (Comment b) (Agency can result from a voluntary association. Thus, a person may act as another's agent with the corresponding duties even though the agent expects no compensation, such as an individual who holds a power of attorney on behalf of a family member. A son who holds a mother's power of attorney is subject to fiduciary duties — e.g. not to make gifts of her property to himself without authority — even though the instrument that states his powers does not refer at all to fiduciary duties). We thank Deborah A. DeMott for this clarification.

These three types of forces provide implicit incentives for performance: *social norms*, *legal duties*, and *market standards*. These forces create a system of *trust* that motivates principals to place their trust in agents and in turn motivates agents to behave in a trustworthy fashion. A complete description of the principal-agent relationship cannot be based on explicit incentives alone, but must recognize implicit incentives for trust behavior that result from the social, legal and market contexts.¹¹ Thus, a more complete understanding of agency requires a unified framework that includes the implicit social, legal, and market contexts in addition to explicit contractual incentives.

Our discussion demonstrates a purpose for social norms, legal duties, and market standards that promote trust. We examine three main ways that implicit incentives create a context for agency contracts. First, we show that social norms, legal duties, and market standards *establish enforcement mechanisms* that enhance the contractual performance of agents by supplementing or replacing explicit contractual incentives. Second, we find that social norms, legal duties, and market standards *provide a system of trust* that is essential to giving agents the delegated authority and flexibility required to carry out intermediation. Finally, we demonstrate that social norms, legal duties, and market standards *reduce transaction costs* by avoiding the need to spell out fully contingent contracts and by allowing principals and agents who are not well acquainted with each other to form contracts. A system of trust can create incentives for agents to perform tasks and report truthfully even without explicit contractual incentives.

Our analysis of the social, legal, and market contexts of agency provides a framework for understanding trust. We define trust as *equilibrium behavior*. This means that the principal's decision to trust the agent is the best response to what the principal expects the agent to do. In turn, the agent's decision to behave in a trustworthy fashion is the best response to what the agent expects the principal to do.¹²

Principals place their trust in agents by relying on their performance, while agents behave in a trustworthy fashion by performing their duties. The social, legal and market contexts provide motivations to trust that frame or complement explicit contracts. As part of the social context, we include not only social norms but also personal ethics and beliefs. Although we examine the sources of trust, we do not distinguish the types of trust

¹¹ Taking account of implicit incentives requires a reexamination of the foundations of agency that seems particularly appropriate in view of the preparation of the Third Restatement of the Law of Agency, herein "Restatement (Third)." A restatement refers to a treatise on law published by the American Law Institute. The restatements, while nonbinding on the courts, exert considerable influence on the development and discussion of a body of law. The first restatement of the law of agency was given in 1933, being completed by Warren A. Seavey after the late Floyd R. Mechem. The second restatement was published in 1958 also supervised by Warren A. Seavey, herein "Restatement (Second)." The reporter for Restatement (Third) is Deborah A. DeMott, whose presentation takes account of many substantial changes in the law. See also Deborah A. DeMott, *A Revised Prospectus for a Third Restatement of Agency*, 31 U.C. DAVIS L. REV. 1035 (1998).

¹² See John Nash, *Equilibrium Points in N-Person Games*, 36 PROC. OF THE NAT'L ACAD. OF SCI. OF THE U.S. 48, 48-49 (1950). See also John Nash, *Non-Cooperative Games*, 54 THE ANNALS OF MATHEMATICS 286 (1951). Our definition is sufficiently general as to allow the principal and the agent to move sequentially over time or to engage in repeated interaction.

that might result from different explicit or implicit incentives since the observed behavior may be indistinguishable.¹³ Moreover, we do not classify trust on the basis of the individual's frame of mind and whether or not the principal or agent would be disappointed by breach, since the decision process is not observable.¹⁴ We assume that individuals are rational and that trust behavior is the result of choices based on explicit and implicit incentives, and individual preferences, information, and beliefs about the actions of others.

We show that the fundamental nature of the agent as an intermediary between the principal and third parties creates the need for trust. Our analysis contrasts markedly with the standard economic model of agency. We explain that this is because the economic model is focused on the role of the agent as a worker choosing effort rather than as an intermediary. For this reason the role of trust has not been given much consideration in economics.¹⁵

The economic approach has generated controversy regarding the definition of agency in law. Robert Cooter and Bradley Freedman observe that "fiduciary relationships have occupied a significant body of Anglo-American law and jurisprudence for over 250 years, yet the precise nature of the fiduciary relationship remains a source of confusion and dispute."¹⁶ Some legal scholars have questioned whether the fiduciary nature of the agent should be part of the legal definition.¹⁷ Organization theorists view legal duties themselves as ineffective or even as destroying trust.¹⁸ This

¹³ See Jay B. Barney & Mark H. Hansen, *Trustworthiness as a Source of Competitive Advantage*, 15 STRATEGIC MGMT. J. 175 (1994) (Barney and Hansen distinguish several types of trust: strong-form, in which opportunistic behavior would violate values or standards of behavior; semi-strong form, in which the parties are protected by explicit contracts, and weak form in which there are legal constraints on conduct).

¹⁴ *But see* Diego Gambetta, *Can We Trust?*, in TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS 213, 217-35 (Diego Gambetta ed. 1988) (In contrast, Gambetta speaks of an individual's disposition toward conditional trust. Such a disposition is meant to indicate that individuals would place trust in others).

¹⁵ Indeed, Oliver Williamson characterizes trust as irrational. Oliver E. Williamson, *Calculativeness, Trust & Economic Organization*, 36 J. L. & ECON. 453, 458 (1993) (Williamson emphasizes two crucial assumptions about human behavior: that individuals are boundedly rational and that individuals are opportunistic, which he defines as self-interest seeking with guile). *But see* Partha Dasgupta, *Trust as a Commodity*, in GAMBETTA, *supra* note 14, at 49 (recognizing the effects of incentives on trust).

¹⁶ Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1045 (1991).

¹⁷ Agents are fiduciaries but the notion of a fiduciary is too broad to precisely define agency. Frank H. Easterbrook and Daniel R. Fischel point out that "The many agency relations that fall under the 'fiduciary' banner are so diverse that a single rule could not cover all without wreaking havoc." *See* Easterbrook and Fischel, *supra* note 6, at 425. Deborah A. DeMott finds that fiduciary obligation is one of the most elusive concepts in Anglo-American law, in *Beyond Metaphor: An Analysis of Fiduciary Obligation*, 37 DUKE L. J., 879, 879 (1988).

¹⁸ *See* Stewart Macaulay, *Non-contractual Relations in Business: A Preliminary Study*, 28 AM. SOC. REV. 55 (1963); MARGARET M. BLAIR & LYNN A. STOUT, TRUST, TRUSTWORTHINESS, AND THE BEHAVIORAL FOUNDATIONS OF CORPORATE LAW (Georgetown Univ. Law Center, Working Paper No. 24403, 2000); LARRY E. RIBSTEIN, LAW V. TRUST, (George Mason Univ. School of Law, Working Paper No. 00-38, 2000) (According to Ribstein, "Legal coercion of faithful behavior therefore reduces the opportunities for trust to develop").

sociological approach tends to emphasize the social context to the exclusion of legal rules and contract incentives.¹⁹

We present a comprehensive overview of trust and incentives in the principal-agent relationship. The framework is summarized in Table 1. We consider in turn the implicit incentives created by underlying social norms, legal duties, and market standards. We then examine economic models of explicit incentives in agency contracts and detail the historical development of the economic theory of agency. We explore the fundamental differences between legal and economic perspectives on agency, and we show that these two approaches can be fully reconciled only if the economic perspective is markedly adjusted to reflect the actual context of principal-agent relationships.

Table 1. Explicit and implicit incentives in agency

	Explicit and implicit incentives for performance		Trust	Transaction costs
Contract	Contract terms	<i>Contractual incentives:</i> Rewards and penalties based on performance	Strict reliance on contract terms assumes absence of trust	High transaction costs of writing and monitoring complete contracts
Social Context	Social norms	<i>Social pressures:</i> Violating norms affects social status and conscience	Trust established by social pressures and personal ethics	Transaction costs lowered by social norms. Incomplete contracts
Legal Context	Legal duties	<i>Legal remedies:</i> Penalties for breach of duty and breach of trust	Agent is fiduciary: law defines a trust relationship	Transaction costs lowered because of law of agency
Market Context	Market standards	<i>Market remedies:</i> Penalties based on reputation, future transactions, access to market networks	Trust established by reputation and informal market networks	Transaction costs lowered because of market standards. Implicit contracts

¹⁹ See, e.g., S. Sitkin & N. Roth, *Explaining the Limited Effectiveness of Legalistic 'Remedies' for Trust/Distrust*, 4 ORG. SCI. 367 (1993). But see Simon Deakin & Frank Wilkinson, *Contract Law and the Economics of Interorganizational Trust*, in TRUST WITHIN AND BETWEEN ORGANIZATIONS 146 (Christel Lane & Reinhard Bachmann eds., Oxford Univ. Press 1998) (suggesting that due to pervasive uncertainty, "normative rules, including the rules of the legal system, may provide an important mechanism for the reproduction of trust").

II. IMPLICIT INCENTIVES: THE SOCIAL CONTEXT

The social context of economic transactions fosters the appearance of *social norms* and *standards of ethical behavior* that, in turn, promote trust and confidence. Economic transactions take place in a social context because the parties to transactions are part of a system of interpersonal relationships. The social norms that govern these relationships affect agency by disciplining the behavior of agents, principals, and third parties. By fostering trusting and trustworthy behavior, social norms can result in superior economic performance in agency.²⁰

The system of trust nurtured by the social structure of economic exchange injects flexibility and efficiency to agency relationships. By constraining the parties' behavior in predictable ways, trust greatly simplifies the contracting process. Efficiency is enhanced in high-trust societies because individuals: spend less to protect themselves from opportunism, have less dependence on written contracts, can avoid forming complete contingent contracts, can reduce the costs and frequency of litigation, and benefit from innovative transactions. In addition, society is less dependent on formal institutions to enforce agreements, governmental policy announcements have greater credibility, people adopt more appropriate horizons in making investment decisions, and economic actors choose production technologies that are optimal over the long, rather than short, run. As a result, society has larger returns to accumulation of human capital, and overall economic performance is improved through political channels.²¹

A. SOCIAL NORMS, SOCIAL PRESSURES, AND AGENT PERFORMANCE

A social norm is a shared rule or guide to what types of behavior are appropriate or inappropriate.²² The norm prescribes regularity of behavior and encourages compliance or penalizes departures through social or external pressure. Regularity of behavior implies sufficient conformity without implying that all members of a social group necessarily conform or

²⁰ Kenneth J. Arrow, *Gifts and Exchanges*, 1 PHIL. & PUB. AFF. 343, 357 (1972) ("Virtually every commercial transaction has within itself an element of trust, certainly any transaction conducted over a period of time. It can be plausibly argued that much of the economic backwardness in the world can be explained by the lack of mutual confidence.")

²¹ See Stephen Knack & Philip Keefer, *Does Social Capital Have an Economic Payoff? A Cross-Country Investigation* Q. J. ECON. 1251, 1252-1254 (1997) (showing that trust and civic norms are stronger in nations with higher and more homogeneous incomes, with institutions that restrain predatory actions of chief executives, and with better-educated populations). See Rafael La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, & Robert W. Vishny, *Trust in Large Organizations*, 87(2) AM. ECON. ASS'N. 333 (1997) (showing that trust promotes cooperation in large organizations and that trust is lower in countries with dominant hierarchical religions).

²² See ROGER BROWN, SOCIAL PSYCHOLOGY 48 (The Free Press 1965); Richard H. McAdams, *Conventions and Norms (Philosophical Aspects)*, in INT'L ENCYCLOPEDIA OF THE SOC. & BEHAV. SCI. 2735 (Neil J. Smelser & Paul B. Baltes eds., Elsevier Science 2001) (McAdams defines a norm as a regularity of behavior for which most or all individuals approve conformity and disapprove nonconformity); ELIOT R. SMITH & DIANE M. MACKIE, SOCIAL PSYCHOLOGY 375 (Phila. Psychol. Press 2000) (defines social norms as "generally accepted ways of thinking, feeling, and behaving that people agree on and endorse as right and proper" thus, the way individuals make sense of words and expressions is in part based on social norms).

that those who conform do so at all times. Examples of social norms include loyalty, reciprocating favors and gifts, and abiding by the terms of unwritten agreements.²³ Transgressing norms can lead to social condemnation or ostracism or can trigger feelings of shame. To understand the role of trust in society and its effects on agency relationships, it is useful to ask how social norms arise and why individuals abide by social norms.

Many social norms have evolved through centuries of interaction between and within all kinds of social groups and populations. Social norms can emerge as informal means of facilitating coordination or enforcing adherence to mutually beneficial conventions. Social norms can reflect traditions arising from a social convention.²⁴ When a critical mass of people follows a pattern of behavior, a social convention can become self-enforcing by giving rise to social norms.²⁵ Social norms might also arise from patterns of approval and disapproval that reflect individual preferences about the behavior of others, such as aversion to noise.²⁶

Social norms can evolve as a response to specific events that are then refined through trial and error. Norms that yield outcomes that are successful from the point of the view of the social group, are more likely to survive, adapt, and supplant ineffective norms. Individuals who are less risk-averse tend to experiment and potentially generate improvements in existing social norms. Finally, social norms may emerge as convenient guides to behavior, reducing the costs of planning for and adjusting to different states of the world. Those types of social norms might be interpreted as a means of overcoming *bounded rationality*.²⁷

Individuals often have an incentive to obey social norms because noncompliance results in social pressure. Individuals also follow social norms to increase the chance of obtaining rewards such as success in education, employment, business endeavors, or politics.²⁸ Individuals may

²³ See Ramon Casadesus-Masanell, *Trust in Agency*, 13 J. ECON. & MGMT. STRATEGY 375, 384 (2004).

²⁴ See DAVID LEWIS, *CONVENTION: A PHILOSOPHICAL STUDY* 97-100 (Harvard Univ. Press 1969).

²⁵ See THOMAS C. SCHELLING, *MICROMOTIVES AND MACROBEHAVIOR* 94-97 (W. W. Norton & Company 1978).

²⁶ See McAdams, *supra* note 22.

²⁷ See Herbert A. Simon, *Rational Decision Making in Business Organizations*, 69 AM. ECON. REV. 493 (1979). Bounded rationality refers to the inability to foresee and analyze all possible effects of every act available in every set of circumstances that agents may face, or the related difficulty in assigning probabilities to well-specified events. If individuals were perfectly rational and could perfectly foresee the consequences of each available action in every possible state of the world, individuals would just select the optimal course of action given the prevailing set of circumstances. Bounded rationality is another way of observing that this kind of perfect foresight and sophisticated computation is costly if not impossible. Boundedly rational individuals do not satisfy the axioms of rational decision making under uncertainty and, thus, are not expected utility maximizers. Instead, boundedly rational agents are "satisficers," they search for best decision rules in a social and economic landscape that they perceive as complex and when they achieve a sufficiently high utility level, the search process is halted. See also JOHN VON NEUMAN & OSCAR MORGENTERN, *THEORY OF GAMES AND ECONOMIC BEHAVIOR*, (Princeton Univ. Press 1967) (1944); F. J. Anscombe & R. J. Aumann, *A Definition of Subjective Probability*, 34 ANNALS OF MATHEMATICAL STAT. 199 (1963). See generally LEONARD J. SAVAGE, *THE FOUNDATIONS OF STATISTICS* (Dover 1972) (1954).

²⁸ Individuals who are capable of experiencing shame, guilt, and altruism may be more likely to be successful. If emotional reactions are guided by the genetic factors, in addition to education and other environmental influences, natural selection might also favor the reproduction of individuals who abide

be encouraged to follow social norms through formal education or informal guidance within social networks. Following social norms in a contractual relationship also reduces social penalties that would arise in the event of failure, thus minimizing regret.

A social relationship between the principal and the agent can exist prior to the formation of the contractual relationship. Deborah DeMott observes that when a relationship of trust and confidence precedes that of agency, the “fiduciary obligation applies to the agent-to-be prior to the onset of the agency relationship.”²⁹ Prior relationships between the agent and the principal were held to impose duties on the agent in *Martin v. Heinold Commodities, Inc.*³⁰ and *Vargas v. Esquire*.³¹

Various social norms correspond to the duties of agents. For example, social norms that encourage hard work, loyalty and honesty reinforce the duties of the agent to act in the interest of the principal and to report truthfully to the principal. The presence of such social norms has two main effects on economic performance in agency contracts. First, they ensure that parties have proper incentives to perform even in the absence of explicit incentives. Second, such social norms contribute to the efficiency of the relationship because a reduced reliance on explicit incentives, such as bonuses or commissions, reduces the risk that must be shifted to the agent. Less reliance on risky payoffs reduces the need to compensate risk-averse agents for bearing risk, thereby increasing the aggregate benefit from the relationship. These benefits can be shared between the principal, the agent, and the third party.³² Thus, norms enhance efficiency by allowing the principal-agent contract to use explicit contractual incentives that are low-powered rather than high-powered. For example, a contract consisting of a small fixed payment and 90 percent commission on sales provides high-powered incentives for an agent to increase sales effort. Conversely, a contract consisting of a large fixed payment and a 10 percent commission provides low-powered incentives to increase sales effort because sales have little effect on the total payment.³³ The presence of social norms coupled with emotions of pride, shame, or guilt provide incentives for agents to perform their duties, even though explicit monetary incentives are low-powered. Because social norms allow for such low-powered incentives, the agent bears less risk and at the same time feels compelled to work hard. As

by social norms. See CASADESUS-MASANELL, *supra* note 23, at 400-01; See also Julio Rotemberg, *Human Relations in the Workplace*, 102 J. POL. ECON. 684 (1994); R. H. Frank, *If Homo Economicus Could Choose His Own Utility Function, Would He Want One With a Conscience?*, 77 AM. ECON. REV. 593 (1987); W. Raub, *A General Game-Theoretic Model of Preference Adaptations in Problematic Social Situations*, 2 RATIONALITY & SOC'Y 67 (1990); Matthew Rabin, *Incorporating Fairness into Game Theory and Economics*, 83 AM. ECON. REV. 1281 (1993).

²⁹ See DeMott, *supra* note 11, at 1054.

³⁰ 643 N.E. 2d 734, 741 (Ill. 1994).

³¹ 166 F.2d 651 (7th Cir. 1948), *cert. denied*, 335 U.S. 813 (1948).

³² See Casadesus-Masanell, *supra* note 23, at 401.

³³ See, e.g., OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 140 (The Free Press 1985) (Explicit incentives are said to be “high-powered” when the wage is highly sensitive to some measurable and verifiable signal of agent performance, and “low-powered” when the wage does not depend much on performance).

a result, the total economic gains from the relationship are larger than in their absence.³⁴

There are many situations where explicit contractual incentives must be low-powered. *Multitask agency*, in which the agent must take several types of actions to accomplish the object of the agency, provides an important example of the need for low-powered incentives.³⁵ When the principal relies exclusively on contractual incentives, the principal is tempted to develop explicit performance measures for all of the agent's activities and to attach rewards based on the agent's performance in each of those activities. For example, universities seek to measure the various activities of faculty, including teaching effectiveness, research output and administrative service. Quantitative evaluations of teaching effectiveness are also multidimensional, giving numerical scores to quality of lectures, instructor enthusiasm, difficulty of homework, student learning, and other factors. Such quantitative measures may not be effective in assessing the quality of teaching and may result in faculty actions geared to the evaluation measure rather than a search for the best pedagogical approach.

Economic analysis shows that with exclusive reliance on contractual incentives, the agent will devote attention only to the particular action that provides the greatest reward net of effort costs. That is, when a principal relies only on explicit monetary incentives, agents might be expected to

³⁴ High-powered incentives may be desirable when measurable and verifiable signals for all of the dimensions to the agent's effort or attention are available. There are two countervailing effects associated to high-powered incentives. First, the agent is compelled to work harder. Because the agent will realize a large total payment if the values of the verifiable signals are large and the likelihood of them being large is positively correlated to his effort, he will be likely to exert large effort or attention. As the agent increases his effort, there will be more surplus created. For example, if the agent is a salesman, the more effort he devotes to looking for and persuading customers, the larger will be the expected sales and total gains to the relationship. On the other hand, under high-powered incentives the agent will be bearing a substantial amount of risk because even if he works hard, there is some probability that the signals upon which his salary is based will turn out to be low. For example, the salesman may be unlucky and even if he tries very hard, low sales may accrue. In this case, if the salesman's full compensation comes from commission, he will end up with no wage at all. Thus, high-powered incentives expose the agent to substantial risk. As the agent's risk-bearing increases, there is less surplus created and the agent needs to be compensated by a proportionally high fixed payment in order to be persuaded to enter the relationship.

³⁵ Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991) (The study of trust in a multitasking setting is of great relevance because it is in multitasking environments that the principal's ability to provide extrinsic incentives is most hampered. Under mild assumptions Holmstrom and Milgrom show that in multitasking situations the optimal contract may be a fixed lump-sum payment even when some dimensions of effort can effectively be measured and thus stimulated through a commission rate. In their model, the agent's effort or attention is two-dimensional. One of the dimensions is imperfectly observable, and the other cannot be observed at all. Holmstrom and Milgrom assume that attention is a homogeneous input in the agent's cost function and that both dimensions of attention are important to the principal (the principal derives strictly positive gross benefit only if the agent puts effort in both dimensions). In this setting, providing incentives on the dimension of effort that is imperfectly observable results in the agent exerting no effort on the other dimension. Thus, the best the principal can do is to offer a fixed payment. Of course, for such a contract to be mutually beneficial, Holmstrom and Milgrom need to assume trustworthiness on the part of the agent. To illustrate their theory, Holmstrom and Milgrom provide the example of a home remodeling contractor. While attention put forth to ensure timely completion is (imperfectly) measurable, other dimensions of attention such as courtesy, attention to detail, or helpful advice are not measurable. If incentives are provided for the observable dimension, then the contractor devotes most of his attention to finish the job on time and very little to provide useful advice. If the unobservable tasks are sufficiently important to the home-owner then providing explicit incentives will be detrimental).

shirk those tasks where effort is more difficult to observe.³⁶ The result can be inefficient outcomes, such as when employee effort affects both the quantity and quality of output, resulting in a high output of poor quality or a low output with high quality.³⁷ Intermediaries must accomplish multiple tasks associated with completing a transaction for the principal, particularly when the terms of the transaction with a third party has many dimensions. For example, sales agents make decisions that affect offers to customers including price, products sold, and accompanying services and guaranties. It is difficult if not impossible to design explicit contractual incentives that will create the right balance of choices made by the sales agent.

Another type of multitask agency occurs when agents serve multiple principals, as occurs for example with attorneys, real estate agents, brokers, and independent sales agents. It may be desirable for an agent to serve multiple principals when there are economies of scale. Exclusive reliance on explicit incentives would cause agents to respond to any differences in compensation across principals. This suggests that an agent who deals with multiple principals will receive the same compensation arrangement from each principal.³⁸ However, even if compensation arrangements are similar, the tasks required to serve multiple principals are likely to differ or their interests may compete, so that agents may not act in the interests of all of the principals. This makes it difficult to design explicit incentives that adequately address the varying interests in such multi-principal contexts.

General social norms that induce agents to work in the interest of the principal or to report accurately would help to resolve problems of contract design in common multitasking situations. Social norms that lead agents to act in the general interest of a principal can resolve the problem of balancing multiple tasks for a single principal or serving the interests of multiple principals. Thus, where they result in trust behavior, social norms would contribute to the efficiency of the agency in multitask principal-

³⁶ For example, management consultants devote attention to two distinct sets of activities: providing useful advice and writing up ideas and judgments in a well-crafted report. The problem is that while it is easy to evaluate whether attention was dedicated to writing up an attractive report, it is more difficult to assess whether or not attention was devoted to coming up with insightful recommendations. If consultants were paid as a function of the number of pages in the report, most of their attention would be devoted to making long reports and very little to provide quality advice. As a result, consultants are generally paid fixed fees (low-powered incentives). In these circumstances, clients willing to enter the relationship are actually relying on social norms and ethical standards. Such norms are enforced through internal emotional processes as well as future material rewards and punishments (reputation or future business prospects).

³⁷ A example involves using incentive pay for teachers based on their students' test scores. Such explicit incentives on teachers may have the effect of hindering the development of creative thinking and favor memorization over reasoning. Furthermore, they may promote cheating on the part of the teacher. In 1989 a ninth-grade teacher in Greenville, South Carolina was caught distributing statewide basic skills tests answers to students to improve her performance rating. Gary Putka, *Classroom Scandal: Cheaters in Schools May Not Be Students, But Teachers*, Wall St. J., Nov. 2, 1989, at 1. See also Holmstrom & Milgrom, *supra* note 33, at 25.

³⁸ See Saul Levmore, *Commissions and Conflicts in Agency Arrangements: Lawyers, Real Estate Brokers, Underwriters and Other Agents' Rewards*, 36 J.L. & ECON. 503 (1993) (arguing that avoiding conflicts between multiple principals explains why real estate agents use fixed-percentage commission arrangements rather than graduated commission schedules. Similarly, lawyers use fixed-percentage contingency fees).

agent relationships. This may explain why fiduciary duties are present for providers of certain types of services such as realtors or brokers.

Likewise, social norms that promote accurate disclosure of information or work effort would help to resolve certain types of market failure. Exclusive reliance on explicit incentives could potentially cause markets to fail, as illustrated by the classic problem of the market for lemons.³⁹ The lemons problem is an illustration of the general adverse selection problem familiar to the insurance industry. First identified by Nobel-prize winning economist George Akerlof, the lemons problem arises when the quality of used cars is unobservable. Since customers cannot verify the quality of the car, their willingness to pay for a car reflects only the average quality of cars, which is not sufficient to attract sellers of good cars. Thus, as in Gresham's law of money, bad cars drive out good cars from the market. However, if a social norm were to operate that induced a sufficient number of individuals owning bad cars to accurately disclose quality, individuals would be willing to pay more for cars that are represented as being of high quality. The greater the level of trust, the more chance there is that the willingness to pay for good cars would be sufficiently great to attract sellers of good cars to the market, resolving the market failure.

Social norms that promote work effort potentially resolve market failure problems that arise as a consequence of low-powered incentives. The problem of moral hazard, identified in the insurance industry, is said to occur when explicit incentives are not tied to performance. For example, individuals who purchase car insurance will have an incentive to drive more recklessly than individuals without insurance because insurance reduces the expected losses from accidents. Social norms that encourage safe driving or that penalize unsafe driving may partially offset the moral hazard effects of insurance. This explains public interest campaigns that exhort people to drive carefully, to wear seatbelts, or to rely on a designated driver when drinking. Similarly, social norms that promote work effort encourage efforts by employees and agents, offsetting the use of low-powered incentives such as wages. By increasing the gains from trade in such employment or contractual relationships, such social norms can reduce potential failure in the market for contracts.⁴⁰

B. TRUST IN SOCIETY AND DELEGATION TO AGENTS

Some types of social norms may result in trustworthy behavior of principals, agents, and third parties. Sociologist Mark Granovetter points out that in modern industrial society, economic action is embedded in structures of social relations and that social relations are responsible for trust in economic life.⁴¹ Because of the social relationships between parties

³⁹ See George Akerlof, *The Market for Lemons: Quality Uncertainty and the Market Mechanism*, 84 Q. J. ECON. 488 (1970) (observing that the lemons problem arises in the absence of trust).

⁴⁰ See Casadesus-Masanell, *Trust and the Market for Contracts*, (Working paper, on file with Harvard Business School 1999).

⁴¹ Mark Granovetter, *Economic Action and Social Structure: The Problem of Embeddedness*, 91 AM. J. SOC. 481, 491 (1985). See KARL POLANYI, *THE GREAT TRANSFORMATION* (Beacon Press 1964) (1957)

to economic exchange, social norms influence incentives for performance and affect the form of agency contracts.⁴²

In societies with high levels of trust there are greater opportunities for mutually beneficial economic transactions.⁴³ A society without trust approximates Thomas Hobbes's depiction of the world prior to the social contract.⁴⁴ Without trust, economic exchange becomes difficult: only spot transactions for goods with easily ascertainable quality would be possible. Individuals would be forced to barter because they lacked confidence in the monetary system, payment instruments or credit. With expectations of free riding, social division of labor would not be possible. Individuals would be reluctant to purchase goods whose quality was difficult to verify before consumption, people would never eat at a restaurant or buy food at a grocery store for fear of food-poisoning. Accordingly, individuals would rely on self-production of many types of goods and services. Niklas Luhmann summarizes the role of trust: "Without trust only very simple forms of human cooperation which can be transacted on the spot are possible, and even individual action is much too sensitive to disruption to be capable of being planned, without trust, beyond the immediately assured

(for a discussion of how economic transactions are embedded in social relationships). See also JAMES S. COLEMAN, FOUNDATIONS OF SOCIAL THEORY 302 (Belknap Press of Harvard Univ. Press) (1990). Brian Uzzi, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect*, 61 AM. SOC. REV. 674, 674 (1996) (defines *embeddedness* as: "the process by which social relations shape economic action in ways that some mainstream economic schemes overlook or mis-specify when they assume that social ties affect economic behavior only minimally or, in some stringent accounts, reduce the efficiency of the price system"). See also Brian Uzzi, *Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness*, 42 ADMIN. SCI. Q. 35 (1997); Brian Uzzi, *Embeddedness in the Making of Financial Capital: How Social Relations and Networks Benefit Firms Seeking Financing*, 64 AM. SOC. REV. 481 (1999).

⁴² See also ROBERT D. PUTNAM, MAKING DEMOCRACY WORK (Princeton Univ. Press 1993) (separates personal trust, which emerges in small, close-knit communities and is based on intimate familiarity with the particular individual, from trust that based on broader social norms of reciprocity and networks of civic engagement); FRANCIS FUKUYAMA, TRUST: THE SOCIAL VIRTUES AND THE CREATION OF PROSPERITY 26 (The Free Press 1995) (defining trust as "the expectation that arises within a community of regular, honest, and cooperative behavior, based on commonly shared norms, on the part of other members of that community" [emphasis added]). Other widely accepted definitions of trust include: Mark Granovetter, *Coase Encounters and Formal Models: Taking Gibbons Seriously*, 44 ADMIN. SCI. Q. 158, 160 (1999) ("The most common definition of 'trust' is precisely the confidence that another will not take advantage of you despite clear incentives to do so, even in 'end-game'"); GAMBETTA, *supra* note 14, at 217 ("When we say we trust someone or that someone is trustworthy, we implicitly mean that the probability that he will perform an action that is beneficial or at least not detrimental to us is high enough for us to consider engaging in some form of cooperation with him"). See COLEMAN, *supra* note 39, at 91 ("situations involving trust constitute a subclass of those involving risk. They are situations in which the risk one takes depends on the performance of another actor").

⁴³ See Akerlof, *supra* note 37; Casadesus-Masanell, *supra* note 38. Kenneth Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AM. ECON. REV. 537 (1968) ("Because of the moral hazard, complete reliance on economic incentives does not lead to an optimal allocation of resources in general. In most societies alternative relationships are built up which to some extent serve to permit cooperation and risk sharing. The principal-agent relationship is very pervasive in all economies and specially in modern ones; by definition the agent has been selected for his specialized knowledge and therefore the principal can never hope completely to check the agent's performance. You cannot therefore easily take out insurance against the failure of the agent to perform well. One of the characteristics of a successful economic system is that the relations of trust and confidence between principal and agent are sufficiently strong so that the agent will not cheat even though it may be 'rational economic behavior' to do so. The lack of such confidence has certainly been adduced by many writers as one cause of economic backwardness") (emphasis added). See also KENNETH ARROW, THE LIMITS OF ORGANIZATION 23 (1974).

⁴⁴ THOMAS HOBBS, LEVIATHAN (C. B. Macpherson ed., Penguin Classics: London 1986) (1651).

moment.⁴⁵ Moreover, without social norms that promote trust, there would be greater demands on the legal system, even though the system of courts and law enforcement itself relies on social norms.⁴⁶

In the absence of implicit incentives for trust, many types of agency relationships would be impossible since principals would constantly be suspicious of the performance and skill of their agents and agents would be wary of principals not abiding by the terms of the contract. Contracting could not occur in markets where moral hazard and adverse selection problems could not be effectively mitigated by explicit incentives. Contracts might not form where principals required costly monitoring of agent performance or reporting of information. However, the need to control agents through contracts and monitoring would negate many of the advantages of employing an agent. Agents act with substantial autonomy and delegated authority to transact on the principal's behalf with third parties. The time that the principal saved by employing the agent would be offset by time spent monitoring.

Social norms and standards of ethical behavior enhance the value of the agency relationship if they can overcome some of the inherent asymmetry of information between principal and agent. Because the principal relies on the agent's autonomy and expertise, the principal is likely to have difficulty in observing the agent's action and determining whether or not the agent is acting in the principal's interest. The same problems of observability may limit any loss of market reputation for those agents that fail to perform their duties. Yet, actions that are not observable or understood by the principal might still be observed by the third party or the agent's coworkers. Here, social norms of behavior provide incentives for performance that are not feasible through explicit contractual incentives. Suppose that the agent's actions are observable but not verifiable in the legal sense. The applicability of formal contracts or legal sanctions might be limited, but pressures to conform to social norms — as well as market reputation effects — might affect the agent's behavior.⁴⁷

Even if no one can observe the agent's behavior, the agent may still be guided by standards of ethical behavior. Ramon Casadesus-Masanell shows that agency promotes the surfacing of emotions that motivate the agent to conform to prevailing social norms and standards of ethical behavior. These emotions cause the principal to trust the agent. Working within the bounds of a model of rational choice, Casadesus-Masanell shows that rational agents will develop emotions that prompt them to abide by social norms. If agents could choose their own preferences they would be strictly better off

⁴⁵ NIKLAS LUHMANN, *TRUST AND POWER* 88 (Chichester: Wiley 1979).

⁴⁶ ROBERT BRUCE SHAW, *TRUST IN THE BALANCE* (Jossey-Bass Inc. 1997).

⁴⁷ When actions are both observable and verifiable by the legal system, social norms still play a role on the maintenance of trust, but in this case there are other mechanisms in play such as the law enforcement and market reputation. Thus, if the agent is contractually obligated to keep certain documents as records of transactions, the threat of legal action will be sufficient to induce the agent to perform on this duty. Non-verifiable yet observable actions are useful to build a reputations for honesty. A willingness to develop a reputation as someone worthy of doing business with can result in trustworthy behavior. In the next two sections we discuss the role of the law and market standards in building and maintaining trust.

by developing personalities that felt some shame and guilt when deviating from social norms and standards of ethical behavior.⁴⁸ In other words, Casadesus-Masanell introduces *ethical standards* to the model of agency.⁴⁹ Although similar to social norms in that both act as benchmarks for evaluating behavior, the pressure to abide by an ethical standard is internal rather than societal. For example, there is an ethical standard not to take advantage of the weak: a store clerk will most likely not cheat a blind customer in a sale transaction, even if no one — not even the customer — will ever learn of the deception. Such cheating is most likely to generate feelings of guilt.

Casadesus-Masanell also shows that altruism may also result in trust. Altruistic individuals derive well-being from the happiness of others and thus have a willingness to act somewhat in the best interest of others. The significance of altruism for the analysis of economic behavior was first pointed out by Adam Smith: “How selfish soever man may be supposed, there are evidently some principles in his nature, which interest him in the fortune of others, and render their happiness necessary to him, though he derives nothing from it except the pleasure of seeing it.”⁵⁰

C. SOCIAL NORMS REDUCE TRANSACTION COSTS OF CONTRACTING

Social norms reduce the transaction costs of forming agency relationships by specifying standards of behavior. Social norms can substitute for contractual specification of duties and allow the formation of relationships without formal contracts, as in the case of a person who holds a power of attorney for a relative. Effective social norms also allow for simplification of formal contracts in agency relationships, as occurs when individuals perform complex agency tasks for a fixed wage with only a basic specification of duties. Many forms of employment involve only a general job title that is understood in a social context, without detailed job descriptions.

It can be prohibitively costly to write complete contracts that specify the duties and liabilities of each participant in every possible contingency.⁵¹ Moreover, it is costly to monitor the agent’s activities and such monitoring conflicts with the purpose of the agent as a decision maker acting under delegated authority. Incomplete contracts allow agents discretion because the duties and liabilities of the parties are left unspecified for some states of

⁴⁸ Ramon Casadesus-Masanell, *Trust in Agency*, 13 J. ECON. & MGMT. STRATEGY 375 (2004). See also Julio Rotemberg, *Altruism, Cooperation, and Reciprocity in the Workplace*, in HANDBOOK ON THE ECONOMICS OF GIVING, RECIPROCITY, AND ALTRUISM (Louis-Andre Gerard-Varet, Serge-Christophe Kolm, & Jean Mercier Ythier eds., 2002). See Frank, *supra* note 28 (pioneering work on the notion of rational shame).

⁴⁹ Casadesus-Masanell, *supra* note 46. See also Ralph Chami & Connel Fullenkamp, *Trust and Efficiency* (Int’l Monetary Fund, Working paper No. 02/33, 2002).

⁵⁰ ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS* 3 (Prometheus Books 2000) (1759).

⁵¹ See Easterbrook & Fischel, *supra* note 6 (pointing out that fiduciary duties are the consequence of contractual incompleteness and that the nature of the fiduciary duty depends on the economics of the relationship).

the world.⁵² The parties fill in contractual gaps by interpreting the spirit of the contract in light of the law and the social and market contexts. Besides the costs of writing contract contingencies, parties benefit from *strategic incompleteness*. One party may withhold information in order to increase his private gains from contracting. Also, the implicit portion of a contract may work better under contractual incompleteness because the written part of the contract affects the set of feasible, self-enforcing implicit agreements.⁵³

Social norms facilitate negotiation of contract terms and monitoring performance. They have evolved through hundreds of years of social and economic interactions. Agency contracts are embedded in these same social systems. As a consequence, the contract between principal and agent does not need to spell out the social and legal obligations of each participant to the relationship and define terms, because those are either spelled out by the law of agency or are implicitly understood given the prevailing social norms. The contract needs only specify a few housekeeping matters, fill in a few gaps specific to the contracting situation. The transaction costs of writing principal-agent contracts are thus dramatically lowered by the presence of social norms.

In the course of the agency relationship, unanticipated contingencies will often arise.⁵⁴ The agent, by the authority conferred by the principal, has

⁵² There are many references to incomplete contracts in the legal literature. See generally Stewart Macaulay, *supra*, note 8; Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); Charles J. Goetz & Robert E. Scott, *Principles of Relational Contracts*, 67 VA. L. REV. 1089 (1981); Timothy J. Muris, *Opportunistic Behavior and the Law of Contracts*, 65 MINN. L. REV. 521 (1981). There is a vast economic literature on incomplete contracts. See, e.g., Sanford J. Grossman & Oliver Hart, *The Costs and Benefits of Ownership: A Theory of Vertical and Lateral Integration*, 94 J. POL. ECON. 691 (1986); Oliver Hart & John Moore, *Property Rights and the Nature of the Firm*, 98 J. POL. ECON. 1119 (1990); Oliver Hart & John Moore, *Incomplete Contracts and Renegotiation*, 56 ECONOMETRICA 755 (1988); Georg Nöldeke & Klaus M. Schmidt, *Option Contracts and Renegotiation: A Solution to the Hold-Up Problem*, 26 RAND J. ECON. 163, 1995; Phillipe Aghion & Jean Tirole, *Formal and Real Authority in Organizations*, 105 J. POL. ECON. 1 (1995); Dewatripont & Tirole, *A Theory of Debt and Equity: Diversity of Securities and Manager-Shareholder Congruence*, 109 Q. J. ECON. 1027 (1994); Lars A. Stole & Jeffrey Zwiebel, *Intra-Firm Bargaining under Non-Binding Contracts*, 63 REV. ECON. STUD. 375 (1996); David Kreps, *Corporate Culture and Economic Theory*, in POSITIVE PERSPECTIVES ON POLITICAL ECONOMY, (James E. Alt & Kenneth A. Shepsle eds., Cambridge Univ. Press 1990); David Kreps, *Static Choice in the Presence of Unforeseen Contingencies*, in ECONOMIC ANALYSIS OF MARKETS AND GAMES (P. Dasgupta, D. Gale, O. Hart, & E. Maskin eds., MIT Press 1992); Jean Tirole, *Incomplete Contracts: Where do We Stand?*, 67 ECONOMETRICA 741 (1999); Bengt Holmstrom & Paul Milgrom, *supra* note 33; Phillipe Aghion, Mathias Dewatripont, & Patrick Rey, *On Renegotiation Design*, 34 EUR. ECON. REV. 322 (1990); Tai-Yeung Chung, *Incomplete Contracts, Specific Investments and Risk Sharing*, 58 REV. OF ECON. STUD. 1031 (1991); Phillipe Aghion, Mathias Dewatripont, & Patrick Rey, *Renegotiation Design with Unverifiable Information*, 62 ECONOMETRICA 257 (1994); Franklin Allen & Douglas Maxwell Gale, *Measurement Distortions and Missing Contingencies in Optimal Contracts*, 2 ECON. THEORY 1 (1992); Ilya Segal, *Complexity and Renegotiation: A Foundation for Incomplete Contracts*, 66 REV. ECON. STUD. 57 (1999).

⁵³ The outcomes are the set of Nash equilibria. See Ian Ayres & Robert Gertner, *Filling Gaps in Incomplete Contracts: An Economic Theory of Default Rules*, 99 YALE L.J. 87 (1989); B. D. Bernheim & Michael Whinston, *Incomplete Contracts and Strategic Ambiguity*, 88(4) AM. ECON. REV. 902 (1998).

⁵⁴ There is a growing economic literature on unforeseen contingencies. See David Kreps, *supra* note 50; David Kreps, *A Representation Theorem for 'Preference for Flexibility'*, 47 ECONOMETRICA 565-576 (1979); Eddie Dekel, Bart Lipman, & Aldo Rustichini, *A Unique Subjective State Space for Unforeseen Contingencies*, (1997) CMS-EMS discussion paper 1202, Northwestern University; Emre Ozdenoren, *Preference for Flexibility in an Anscombe-Aumann Framework*, J. ECON. THEORY (forthcoming 2001).

the right to decide on a course of action. He also decides whether or not the unforeseen contingency should be reported to the principal for her to decide what to do. The principal's trust in the agent *completes* the agency contract. The prevailing social norms inform the agent on an appropriate course of action when contingencies not expressly addressed in the contract take place or in the absence of a formal contract.⁵⁵

Other transaction costs are also lowered by the embeddedness of the agency relation in a social system. Search costs are lessened because information sources are more reliable and thus less resources need be depleted in gathering information. Haggling and negotiating are also likely to be cut down because trust fosters agreement on fairness standards. Trust also facilitates communication, as parties will more likely agree on a common language. Fewer resources will be used to monitor contracts since social norms and ethical standards drive behavior. Finally, enforcing mechanisms such as penalties for breach of duty will be used less often since the intrinsic motivation will generally be sufficient to enforce performance. By specifying standards and relying on trust, the principal and agent lower transaction costs and increase the value of the relationship.

An important way that social norms can reduce transaction costs is when the agent serves the principal and third party as a *trust intermediary*. Suppose that a principal and third party do not trust each other but both place trust in an agent. The principal and third party may be reluctant to engage in direct economic exchange because of potential moral hazard and adverse selection problems. The principal and third party may come from different social groups or may even reside in different countries so that there would be weak social incentives for trust. For example, an export marketing company represents a manufacturer that wishes to sell its products abroad. If the export marketing company is trusted both by the manufacturer it represents and by the potential foreign buyer, a mutually beneficial transaction can be achieved even though the manufacturer and the buyer do not know each other.

The principal's and third party's trust in the agent may derive from social relationships with the agent. If the agent's social background incorporated sufficiently many features of both the principal's and the third party's systems of social norms and standards of ethical behavior, then there would be incentives for the development of trust between the three actors, making intermediated transactions feasible. Thus, social relationships between the principal and the agent and between the agent and the third party create an indirect relationship between the principal and the third party which substitutes for any direct social relationship. For example, suppose that the principal and the third party are in different countries, but the agent has social relationships in both countries that involve the principal and the third party. In Figure 1, the solid lines represent existing trust prior to the agency relationship and the dotted lines

⁵⁵ For the role of the law, see Section IV, *infra*.

represent the trust created by the agent in his function as a trust intermediary.

When the agent serves as a trust intermediary, the agency relationship will only be initiated if the system of trust is complete. Thus, for any two nodes there must be two arrows, one in each direction. The need for mutual, symmetric trust reinforces the incentives of each party not to defect on his or her duties. As James Coleman points out, when both parties to a trust relationship need to trust each other, there is an additional cost for any one party to break the trust in him, the other party may retaliate by breaking trust as well. Thus, the threat and size of immediate punishment is larger in symmetric trust relationships, than when trust is asymmetric.⁵⁶

The principal may act as a trust intermediary while the agent is the economic intermediary. This is the case when the third person trusts the principal but does not know the agent. If the third person trusts the principal, then he will also be willing to trust the agent. Making the principal liable for the agent's actions facilitates and reinforces trust intermediation by the principal.⁵⁷ Social relationships between the principal and the third party and between the principal and the agent thus can substitute for social relationships between the agent and the third party. For example, if the agent is the sales representative of an entrepreneur, the entrepreneur presumably hires agents that she trusts and the third party trusts the agent by virtue of their social relationship of trust with the entrepreneur. Figure 2 illustrates this situation.

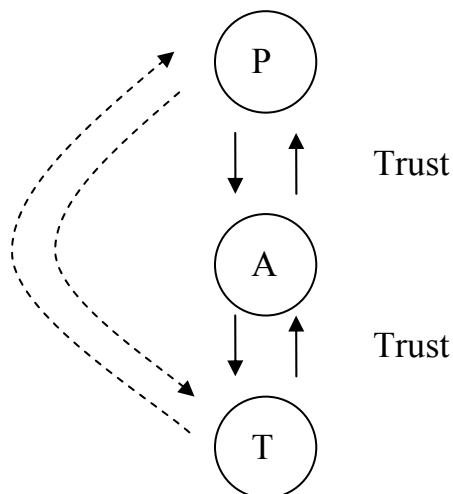


Figure 1: Agent as a trust intermediary between Principal and Third Party

⁵⁶ James S. Coleman, *supra* note 39, at 177.

⁵⁷ See RESTATEMENT (SECOND) *supra* note 11, at §144 (The general rule is: a principal is liable to third persons on contracts made by her agent. She is also liable for torts of the agent committed while the agent is acting within the scope of the agency).

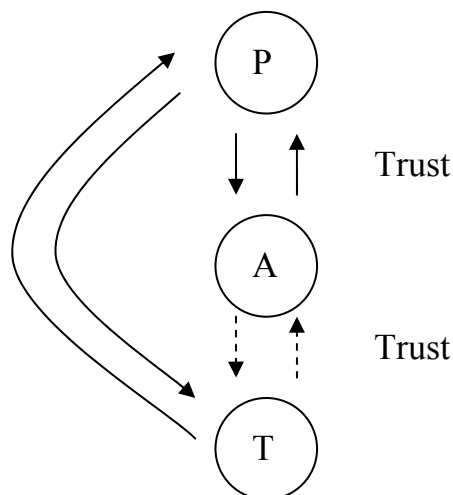


Figure 2: Principal as a trust intermediary between Agent and Third Party

III. IMPLICIT INCENTIVES: THE LEGAL CONTEXT

Agency law provides a context for principal-agent relationships that spells out a complex set of duties and remedies for nonperformance. Agency law specifies the terms of the relationships between the principal, the agent, and the third party with whom the agent deals. The principal acts through the agent to create contractual obligations between the principal and the third party. Agency law illustrates the important effects of context on contracts and transaction costs.⁵⁸

Contract rules and remedies also enhance the efficiency of agent performance when there is an agency contract. The system of trust enforced by agency law contributes to the delegation of authority and flexibility of agency relationships. By specifying the duties between the three parties, agency law greatly simplifies negotiation and contracting between principals and agents as well as between principals and third parties. It is important to notice that many of these rules are *default* rules — that is, they apply if the parties have not otherwise specified these duties. Hence the rules reduce the costs of contracting while not necessarily interfering with the expressed interests of the parties to the agency relationship.

⁵⁸ See DOUGLASS NORTH, INSTITUTIONS, INSTITUTIONAL CHANGE AND ECONOMIC PERFORMANCE 54 (Cambridge Univ. Press 1990) (emphasizing the importance of context in understanding contracts by stating that, “[a] good deal of literature on transaction costs takes enforcement as a given assuming either that it is perfect or that it is constantly imperfect. In fact, enforcement is seldom either, and the structure of enforcement mechanisms and the frequency and severity of imperfection play a major role in the costs of transacting and in the forms that contracts take.”).

A. LEGAL DUTIES, LEGAL REMEDIES, AND AGENT PERFORMANCE

Legal remedies for breach of fiduciary duties create incentives for agents to act in the interest of the principal and to report information accurately. As Tamar Frankel observes, fiduciary law helps to create a “trusting commons.”⁵⁹ Agency law identifies a complicated set of duties and remedies associated with the agent’s representation of the principal, thus establishing standards for performance.

Agency law spells out duties of the agent to the principal and to the third party.⁶⁰ Oliver Wendell Holmes, observes that the maxim *qui facit per alium facit per se* has been recognized by the English law “as far as it is worthwhile to follow it.”⁶¹ There are numerous instances in the law of agency where the acts of the agent are the acts of the principal. The principal, not the agent, is liable for authorized contracts made in the name of the disclosed principal.⁶² The principal is liable for the agent’s statements and representations.⁶³ Notice to the agent is notice to the principal, even if the agent has not communicated the notice to the principal.⁶⁴

The duties of the agent reflect the task of representing the principal’s interest in interacting with third parties. There are two main categories of duties. The first category, *service and obedience* (hereafter referred to simply as service), denotes the agent’s actions in carrying out the interest of the principal. The duties of service and obedience include various contractual duties, care and skill, good conduct, giving information, keeping and rendering accounts, acting only as authorized, not attempting the impossible or impracticable, obeying instructions, and duties after

⁵⁹ Tamar Frankel, *Trusting and Non-Trusting: Comparing Benefits, Cost and Risk*, (Boston Univ. School of Law, Working Paper No. 99-12, at 30, 1999).

⁶⁰ For a classic exposition of the various duties and liabilities in agency law see FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY 14 (Callaghan 2d. ed. 1914). See also JOHN J. SLAIN, CHARLES A. THOMPSON, & FRED A. BAIN, AGENCY, PARTNERSHIP & EMPLOYMENT: A TRANSACTIONAL APPROACH xi-xii (1980).

⁶¹ Oliver Wendell Holmes, *Agency* 4 HARV. L. REV. 345 (1891), reprinted in OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 52 (Peter Smith: New York 1952).

⁶² The agent is generally responsible for acts performed on behalf of a principal whose existence or identity is kept undisclosed.

⁶³ A principal is liable as a consequence of an agent’s statements and representations only when the agent had actual or apparent authority to make them. A principal is treated as having notice of facts known to the agent only when the facts are relevant to actions for which the agent has actual or apparent authority. Apparent authority is highly useful in determining whether a principal is liable to a third party because it requires an examination of whether the principal led the third party to believe that the agent acted with authority. This may be easier to establish than instructions given by the principal to the agent, since these are internal to the agency relationship.

⁶⁴ That the acts of the agent are those of the principal does not necessarily mean that the agent is never accountable in law for acts performed on behalf of the principal. Agency is usually no defense in tort cases. Both principal and agent are liable for torts committed by the agent acting within the limits and in execution of the agency. The agent is also responsible for contracts made for a principal when the third person extends credit exclusively to the agent. See FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY, (Chicago: Callaghan, 2d. ed. 1914) (observing that “[i]t is sometimes said that ‘in torts the relation of principal and agent does not exist. They are all wrongdoers and the liability of each and all does not cease until payment has been made or satisfaction rendered or something equivalent thereto.’ The wrongdoer purported to do the act as agent for another is entirely immaterial so far as his own liability is concerned. That fact may make the alleged principal liable also, but it will in many cases have no tendency to exonerate the alleged agent.”).

termination of authority.⁶⁵ Beyond the agent's duty to obey all reasonable instructions and not exceed his authority, two types of duties stand out: First, the duty to exercise care and skill in representing the principal's interests; second, the duty to accurately report information to the principal.

The second category, *loyalty*, generally refers to limitations on the agent's pursuit of his own interests when there may be a conflict with those of the principal. The duties of loyalty include accounting for profits arising out of employment, restrictions on acting as (or for) an adverse party with and without the principal's consent, restrictions on competing with the subject matter of the agency, and using or disclosing confidential information.⁶⁶

Legal remedies for breach of duty are necessarily *ex post* — that is, they only take place after an agent has breached his duty and is found to be liable. The agent's expectation of penalties for a breach of duty serves as a deterrent, creating incentives for agents to honor their contractual commitments to the principal. In this way, *ex post* remedies function as if they were *ex ante* contractual incentives — that is, it is in the agent's interest to take the penalties into account if the agent contemplates a breach of duty. *Ex post* remedies correspond to particular states of the world and therefore function as *ex ante* contingent contracts.

As with standard remedies for breach of contract, remedies for breach of the agent's duty create implicit incentives to perform. The courts tend to interpret duties and remedies as reflecting contract terms that the parties would have wanted. Frank H. Easterbrook and Daniel R. Fischel point out that “legislatures, courts, and commissions treat fiduciary duties as presumptive contractual terms, promoting the parties' welfare in the absence of express contracts.”⁶⁷ When the principal and agent enter into a formal contract, legal remedies for breach of contract help to create incentives for efficient performance of contracts.⁶⁸ The incentives for contract performance and reliance that stem from legal remedies for breach are well understood in the economics literature; however, the implications of remedies for breach of duty in agency have not been given much attention by economists. By creating incentives for performance, remedies for breach of duty in agency law promote trust between principal and agent.

⁶⁵ See RESTATEMENT (SECOND) *supra* note 11, at §§ 13.377-13.386.

⁶⁶ *Id.* at §§ 13.387-13.397.

⁶⁷ Easterbrook & Fischel, *supra* note 12, at 431.

⁶⁸ The following sources discuss the effects of alternative remedies for breach of contract on incentives to perform. See generally Richard A. Posner, ECONOMIC ANALYSIS OF LAW 105-114 (3rd ed. 1986); J. H. Barton, *The Economic Basis of Damages for Breach of Contract*, 1 J. LEGAL. STUD. 277 (1972); Charles J. Goetz & Robert E. Scott, *Liquidated Damages, Penalties and the Just Compensation Principle: Some Notes on an Enforcement Model and a Theory of Efficient Breach*, 77 COLUM. L. REV. 554 (1977); Stephen Shavell, *Damage Measures for Breach of Contract*, 11 BELL J. ECON. 466 (1980); William P. Rogerson, *Efficient Reliance and Damage Measures for Breach of Contract*, 15 RAND J. ECON. 39 (1984). See Daniel F. Spulber, *Auctions and Contract Enforcement*, 6 J.L. ECON. & ORG. 325 (1990) (discussing the efficiency of contract auctions in revealing information under different remedies for breach of contract). See J. Gregory Sidak & Daniel F. Spulber, *Deregulatory Takings and Breach of the Regulatory Contract*, 71 N.Y.U. L. REV. 851 (1996) (discussing the efficiency of performance by regulators when there is a regulatory contract with remedies for breach).

A principal in a relationship of common law agency has the power to revoke the agent's actual authority even though this constitutes a breach of contract for which the agent may recover money damages. The agent does not have an enforceable right to continue acting as an agent.⁶⁹ This would allow the principal to end a relationship if the agent is no longer trustworthy.

Despite the resemblance between *ex post* incentives provided by remedies for breach of duty and *ex ante* incentives provided by explicit contract rewards and penalties, there are some fundamental differences. Regarding enforcement mechanisms, *ex post* incentives usually require a credible enforcement mechanism, while *ex ante* incentives require a credible commitment to an announced schedule of rewards and penalties. A more subtle distinction derives from observed practice — *ex post* legal incentives tend to penalize breach of duty, while *ex ante* contractual incentives tend to spell out rewards for good performance. This distinction is important since in the economic model of agency, the agent is induced to act in the principal's best interest by setting the appropriate *ex ante* incentives. *Ex post* penalties applied by law are generic and differ from specific contract contingencies that are negotiated by the parties. Still, any *ex post* penalty can be formally described as if it were an *ex ante* contract contingency.

The law of agency imposes penalties for breach of duty when there is evidence that the agent has failed to exercise his duties as fiduciary. These can take the form of standard penalties for breach of contract. Penalties for breach of duty include legal sanctions and termination of contract. The agent can be liable for the loss caused, for misuse of the principal's property or assets, and for things received in violation of the duty of loyalty. The agent may be required to make restitution to the principal of the profit obtained by the agent, sometimes referred to as *disgorgement*. Disgorgement generally removes the agent's benefit if the malfeasance is proven. The disgorgement remedy presumably leaves the principal in the same position as if there had not been any breach of duty if the principal's loss is equal to the agent's gain.

Legal remedies create incentives for the agent to carry out duties of service and loyalty. Damage remedies for breach of contract cause the promisor to compare the costs of performance with the expected penalties for breach of contract. The penalties for breach of contract are generally based on the promisee's expectation, although they can also be based on repayment of the promisee's reliance expenditure. In agency contracts, the agent's performance decision also entails a comparison of the costs of performance with the expected cost of breach of duty, that is, the penalty for breach of duty weighted by the likelihood that the breach of duty will be detected.

The disgorgement penalty for breach of duty would appear to differ from contractual penalties because it is based on the agent's profit rather

⁶⁹ See RESTATEMENT (THIRD) *supra* note 10, at § 3.10(1).

than the principal's loss. However, E. Allan Farnsworth notes that courts often award the beneficiary the fiduciary's profit netted from the opportunity cost incurred by the beneficiary, which Easterbrook and Fischel point out corresponds to the principle of cover when there are markets for the goods and services in question, which is a standard way of estimating expectation damages.⁷⁰ Therefore, penalties for breach of duty function in a similar manner to contractual breach remedies in motivating performance by agents.

Robert Cooter and Bradley J. Freedman consider the fiduciary relationship in which an agent entrusted with the principal's asset may either (1) misappropriate the asset or some of its value through an act of malfeasance or (2) act negligently in managing the asset by shirking. In the case of misappropriation, which is a breach of the duty of loyalty, they suggest that since the agent's actions are unobservable, detection of wrongdoing is imperfect. The combination of the disgorgement penalty and imperfect enforcement would thus make the agent's misappropriation of the principal's assets profitable on average. This assertion assumes that there are no other incentives to perform. Improving the agent's incentives requires an increase in the enforcement probability or an increase in the penalty for malfeasance. They argue that fiduciary law achieves this by creating presumptive rules of conduct that raise the enforcement probability, such as the rule against conflicts of interest and duty and rule against secret profits. They further suggest that fiduciary law establishes the different standards of proof by presuming agents act in their self interest thus shifting the burden of proof to agents as defendants.

Cooter and Freedman compare the fiduciary analysis to the duty of care in which the agent shirks in managing the principal's assets. They apply Judge Learned Hand's standard of reasonable care as the effort level at which the cost of care does not exceed the reduction in expected losses, which corresponds approximately to an economically efficient care standard.⁷¹ However, as in the standard economic model of agency, the agent's care level is imperfectly observable, which leads to contracts under which the agent is careless in the management of the principal's assets. To induce reasonable care, Cooter and Freedman apply the standard argument that punitive damages are needed to offset imperfect enforcement: "imperfections in compensation often add a further element of punishment" in the sense of "superdisgorgement damages." They suggest that courts should "discount the victim's actual harm by the expected harm that would have occurred without the injurer's negligence." The punitive-damages

⁷⁰ Easterbrook & Fischel, *supra* note 12, at 443. See also E. Allan Farnsworth, *Your Loss, My Gain? The Dilemma of the Disgorgement Principle in Breach of Contract*, 94 YALE L.J. 1339 (1985). Easterbrook & Fischel argue that the resemblance of disgorgement remedies to expectation damages supports their view that all fiduciary relationships, including agency, are merely types of contracts. Yet, the fact that agency is a form of contract, does not prevent agency from being a meaningful category within the full set of contractual relationships. As special types of contracts, agency contracts have special duties and remedies for nonperformance of those duties). *Id.*

⁷¹ See John Prather Brown, *Toward an Economic Theory of Liability*, 2 J. LEGAL STUD. 323 (1973).

approach is constrained by the limited wealth of the agent and the unpredictability of such damages.⁷²

Agency relationships are formed against the background of agency law. Accordingly, agency contracts need not specify all of the agent's duties or provide remedies for breach. The law provides generic specification of both duties and breach remedies. Moreover, agency contracts need not provide explicit pay for performance since the agent has legal duties to perform that are created by entering into the relationship. Incentives to perform these duties are enforced through legal remedies.

B. TRUST IN AGENCY LAW AND DELEGATION TO AGENTS

The law of Agency defines the principal-agent relationship as a fiduciary relationship, that is, one that is based on trust.⁷³ The agent's loyalty to his trust occupies a central position in agency.⁷⁴ Agency law contains an extensive treatment of fiduciary duties with Restatement (Second) devoting twenty-two sections to the fiduciary nature of agency. The need for trust in Agency has generated a substantial body of case law.

The fiduciary relationship requires the agent to act on behalf of the principal so as to further the principal's interests.⁷⁵ The agent must not take advantage of superior knowledge, information, or skill.⁷⁶ Agents are individuals committed to being trustworthy and selfless.⁷⁷ The agent is expected to behave primarily for the benefit of the principal, keeping her interests foremost in mind and acting with care and in a selfless manner.⁷⁸

⁷² See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 N.Y.U. L. REV. 1045, 1060-61 (1991).

⁷³ RESTATEMENT (SECOND) OF AGENCY § 1 (1958) ("Agency is the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act. The one for whom action is to be taken is the principal. The one who is to act is the agent."). RESTATEMENT (THIRD) OF AGENCY § 1.01 (Tentative Draft No. 2, 2001) ("Agency is [a] fiduciary relationship...."). See generally Deborah A. DeMott, *A Revised Prospectus for a Third Restatement of Agency*, 31 U.C. DAVIS L. REV. 1035 (1998).

⁷⁴ According to Mechem, "Loyalty to his trust is the first duty which the agent owes to his principal. Without it, the perfect relation cannot exist. Reliance upon the agent's integrity, fidelity and capacity is the moving consideration in the creation of all agencies; in some it is so much the inspiring spirit, that the law looks with jealous eyes upon the manner of their execution, and condemns, not only as invalid as to the principal, but as repugnant to the public policy, everything which tends to destroy that reliance." 2 I. FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY 867 (2d ed. 1914).

⁷⁵ The First Tentative Draft to the Third Restatement of Agency maintains that the principal's obligations towards the agent are not fiduciary. RESTATEMENT (THIRD) OF AGENCY 22 (Tentative Draft No. 1, 2000). But see ROBERT N. CORLY, PETER J. SHEDD, & ERIC M. HOLMES, PRINCIPLES OF BUSINESS LAW 302-03 (13th ed. 1986) (stating that the fiduciary nature of the agency relationship is a two-way obligation — the principal must also be loyal, trustworthy, and honest in dealing with the agent).

⁷⁶ The term "fiduciary" is defined in the Second Restatement of Agency as "a person having a duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking." RESTATEMENT (SECOND) OF AGENCY § 13 (1958).

⁷⁷ DEBORAH A. DEMOTT, FIDUCIARY OBLIGATION, AGENCY AND PARTNERSHIP 2, (West Publishing Co. 1991).

⁷⁸ In *Pepper v. Litton* 308 U.S. 295, 311 (1939), Justice Douglas stated the Seven Commandments of the Fiduciary Relationship:

He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate

This is to be contrasted with non-fiduciary business relationships, in which parties deal at arm's length and are free to seek purely personal benefits from their transactions.⁷⁹

The emphasis on the fiduciary nature of the relationship helps to distinguish Agency from contract law where parties are free to seek their self-interest. The centrality of the fiduciary benchmark also distinguishes agency from other more limited forms of authority that resemble agency, such as independent contractor relationships and the relationship between an employer and an employee engaged in a manufacturing task.⁸⁰ Still, the concept of trust is sufficiently broad that it does not fully define agency. While all agents are fiduciaries, not all fiduciaries are agents.⁸¹ What distinguishes agents from other types of fiduciaries is an intermediary sent to represent the principal's interest in interaction with third parties.

The purpose of the agent as an intermediary explains why trust is so important in agency. The principal sends the agent because of the opportunity cost to the principal of meeting the third party. The principal is better employed elsewhere in another activity, be it other business dealings or even leisure. The agent may have greater knowledge and skill in comparison with the principal in meeting the particular third parties. The agent also can be a commitment device, with the principal sending a tough

entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own preferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical requirements. For that power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

⁷⁹ The pursuit of self-interest in commercial dealings does not allow opportunism as defined in the economics literature as "self-interest seeking with guile." See WILLIAMSON, *supra* note 28 at 47. According to the Uniform Commercial Code, "the obligations of good faith, diligence, reasonableness and care may not be disclaimed." U.C.C §1-102(3).

⁸⁰ The Restatement of the Law of Agency (Second) defines an independent contractor as one who contracts to do something for another but "who is not controlled by the other nor subject to the other's right to control with respect to his physical conduct." Usually, the independent contractor alone is responsible to third persons for his acts and contracts. Examples include: electricians, plumbers, certified public accountants, builders, engineers, architects, and lawyers. See RESTATEMENT (SECOND) AGENCY § 14N (1958). In the Restatement of the Law of Agency (Second), employment relationships come under the antiquated terminology of the master-and-servant relationship. A servant is an individual employed to provide a service to his employer, the master. The master controls and directs the actions of the servant. Examples of servants include: bookkeepers, machine operators, and repairmen. A servant has no representative capacity on behalf of his master, he deals with things not persons. He has no power or authority to bind his master to contracts with third persons. See RESTATEMENT (SECOND) AGENCY § 2 (1958).

⁸¹ See generally Frank H. Easterbrook & Daniel R. Fischel *Contract and Fiduciary Duty*, 36 J. L. & ECON. 425 (1993) (analyzing a number of diverse fiduciary relationships: including Trustee/Beneficiary, Pension Trustee/Beneficiary, Guardian/Ward, Attorney/Client, Partner/Partner, Corporate Manager/Investor, Majority or Inside Investor/Minority Investor, Investment Adviser/Client, Labor Union/Employee, Lender/Borrower, Franchiser/Franchisee).

negotiator to bargain with a third party. The agent also can be a means of concealing the principal's preferences, with the agent being more conciliatory or patient than the principal.

Agents acting as intermediaries reduce transaction costs for the principal and the third party in many ways.⁸² Agents reduce costs of searching and matching for principals and third parties. For example, a real estate agent manages information in the housing market to reduce the costs to buyers and sellers. An agent working simultaneously for many principals can also pool and diversify risk efficiently. For example a stock broker working as an agent for a diverse group of investor-principals can more easily and cheaply diversify the risk of the individual portfolios than any one of the principals could. Stock specialists also smooth the pattern of exchange and create market liquidity by holding inventories.

By the very nature of the intermediary role, the agent must interact with third parties. The agent must have sufficient delegated authority to propose or respond to business offers and to make contractual agreements. This requires the flexibility to respond to changing circumstances and sufficient autonomy to make decisions. The complexity of this task precludes rigid instructions. Accordingly, the principal must expect that the agent will act in the interest of the principal as expressed in general terms, thus placing trust in the agent.

The agent is subject to liability to a third party. The agent promises the third party, either explicitly or implicitly, that the agent has authority to act on the principal's behalf. If the principal is not bound by the transaction, the agent has breached the warranty of authority and is subject to liability to the third party for damages.⁸³ Liability to a third party creates an additional dimension of trust although one that differs from the relationship with the principal. The agent must act in a trustworthy fashion with regards to the third party in terms of claims of authority to act for the principal and in turn, the third party who deals with an agent places trust in the agent.

Because the agent is an intermediary, sent to act on the principal's behalf, the principal cannot be there to observe the agent. The imperfection in monitoring is another aspect of the need for trust. Since the principal cannot observe the agent's interaction with the third party, she must count on the agent reporting accurately what was observed. The agent is expected to use judgment not only in interacting with third parties but also in deciding what information is to be gathered.

It is these aspects of Agency that create a powerful instrument for the organization of modern business activity. Legal representation has allowed for the operation and development of the modern corporation. As mentioned above, the principle of representation arose because of increased sophistication in commercial activity in the Middle Ages and, most importantly, after the Industrial Revolution. The economic efficiencies

⁸² See DANIEL F. SPULBER, MARKET MICROSTRUCTURE: INTERMEDIARIES AND THE THEORY OF THE FIRM 289 (1999).

⁸³ See RESTATEMENT (SECOND) *supra* note 11, at §§239, 230.

associated to delegation and decentralized information systems pressured the law to regulate fiduciary relationships. Agency permitted business organizations to exploit the benefits of division of labor and delegation.⁸⁴ While the master and servant relationship resulted in increased job-specialization, Agency went one step further. Complex hierarchical organizational forms that leveraged on the knowledge of diverse individuals were now possible. Agency allowed the principal to gain access to information, knowledge, and skill. For example, a principal who knew little about law could use an agent-lawyer to conduct certain transactions because the lawyer's actions were considered those of the principal.

The rules themselves mirror judgments about duties in myriad business and social situations. Oliver Wendell Holmes observation "The life of the law has not been logic: it has been experience" applies well to Agency.⁸⁵ One could trace the development of each individual manifestation of Agency such as salespersons, attorneys at law, auctioneers, or brokers. The diversity of agency relationships in commercial life indicates the economic significance of representation. These include the factor, who has possession of the assets to be sold and conclude a sale at the best possible price, the broker, who makes contracts for the purchase or sale of property on behalf of his principal, the real estate agent, the store salesperson, the traveling salesperson, the auctioneer, the manager of a business, and the attorney at law. The law of agency spells out in a remarkably simple form the types of duties and liabilities that arise with employees and business agents of all sorts.

The law of agency arose from an increased need for representation in conducting business transactions. Because delegation allows for more efficient organization, as commercial activity grew, there was a natural tendency towards hierarchies. This tendency pressured the law to formulate the doctrine of representation. The law of agency arose to regulate ongoing commercial practices. Originally, Roman law rejected the principle of legal representation. In general, no agent was allowed to create obligatory rights and duties between principal and third party. Nevertheless, the head of the household was allowed to transact business through his dependent sons or even slaves, but not through free persons. Dependent sons and slaves were conceived as long-arm extensions of the contracting master, not agents.⁸⁶

Legal advances in the Middle Ages attempted to overcome the inconveniences in commercial life caused by the Roman law denial of the

⁸⁴ Smith was first to identify the economic benefits the specialization of function and the division of labor. See ADAM SMITH, AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS, (Edwin Cannan ed., Random House 1937) (1776).

⁸⁵ OLIVER WENDELL HOLMES, JR., THE COMMON LAW 1 (Boston, Little, Brown, and Co. 1881).

⁸⁶ According to Oliver Wendell Holmes, "[o]nly innkeepers and shipowners (*nautae, cauponae, stabularii*) were made answerable for the misconduct of their free servants by the praetor's edict." Oliver Wendell Holmes, *Agency*, 4 HARV. L. REV. 345 (1891), reprinted in OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 57 (Peter Smith 1952) (1920).

concept of representation. New developments were brought about by Canon and Germanic laws.⁸⁷

By 1200, Canon law had introduced a form of agency relationship to solve the representation problem in all except legal matters. Simultaneously, the master and servant doctrine was being expanded in England.⁸⁸ The quasi-agent figure of the *ballivus* was empowered to conduct commercial transactions for his master.⁸⁹ Early in the 14th century, a master was liable in action of debt for goods acquired by her servant or agent for her use or benefit and a husband was liable for the debts of his wife.⁹⁰ Under Henry V (1387-1422), the lease made by the seneschal of a prior was the lease of the prior, and under James I (1394-1437), an *assumpsit*⁹¹ to a servant for his master was laid as an *assumpsit* to the master.⁹² In 1469, a court said that "if I command my servant to buy certain things, or if I make someone my factor or attorney to buy merchandise etc., and he buys the merchandise from another, in that case I shall be charged by this contract even though I have no knowledge of [what the agent has done], and the reason is because I have given him such a power [to purchase]."⁹³

Even with all these early manifestations, most analysts concur in that Agency did not become a unified subject until after the turn of the 19th century. For example, in the early 17th century there were a variety of views as to the principal's liability when the agent had bought merchandise on credit when he was not authorized to do so, as the principal had given him sufficient cash for the transaction. One view held that the principal was liable because she should have been more careful in choosing the agent. A second view maintained that the principal was liable if the merchandise came to his use and she had not forbidden the third party to sell to the agent on credit. But maybe the most widespread view was that if the principal sent his servant with cash to buy goods and the servant bought on credit, the principal was not chargeable. But, if the servant usually transacted on credit with the seller and he had bought some goods without the principal's

⁸⁷ Canon law was a body of laws made within the Roman Catholic church, Eastern Orthodox church, independent churches of Eastern Christianity, and the Anglican Communion by ecclesiastical authority for the government of both the behavior and actions of individuals as well as the church. Canon law was heavily influenced by Hebraic theological concepts. Germanic law was the law of Germanic peoples from the time of their initial contact with the Romans until the change from tribal law to national territorial law in the Middle Ages. See Encyclopædia Britannica Online (2006), "canon law," available at <http://www.search.eb.com/eb/article-9105947> (last visited Feb. 18, 2006).

⁸⁸ The custom-based common law that developed in England after the Norman conquest in 1066 was similar to Germanic law. See Encyclopædia Britannica Online (2006), "common law," available at <http://www.search.eb.com/eb/article-9108636> (last visited Feb. 18, 2006).

⁸⁹ See Encyclopædia Britannica Online (2006), "agency," available at <http://www.search.eb.com/eb/article-9106105> (last visited Feb. 18, 2006). In addition, the quasi-agent *attornatus* acted in litigation as representative of one party. *Id.*

⁹⁰ *Randolph v. Abbot of Hailes*, 27 The Selden Sources, Annual Series 32 (1313-14), Eyre of Kent, 6 & 7 Edw. 2. See also S. J. STOLJAR, THE LAW OF AGENCY: ITS HISTORY AND PRESENT PRINCIPLES 37(1961).

⁹¹ In common law, an *assumpsit* is an action to recover damages for breach of contract.

⁹² Oliver Wendell Holmes, *Agency II*, 5 HARV. L. REV. (1891), reprinted in OLIVER WENDELL HOLMES, COLLECTED LEGAL PAPERS 83, (Peter Smith, 1952) (1920).

⁹³ STOLJAR, *supra* note 84, at 40.

authorization, then the principal was chargeable if she was trusted by the seller.

At the end of the 17th century, commercial activity changed significantly. Offices and shops substituted for markets and fairs as the main method of distribution. Businesses became larger and more stable. As a consequence, there was a need for delegating functions such as those performed by clerks and managers (selling merchandise and obtaining supplies for the business). With the concomitant growth of banking, the principal banker was not able to conduct all transactions personally, especially issuing bills and notes. Agency law evolved to facilitate such economic exchanges between principals and third parties.⁹⁴ The 1804 French Civil Code, for example, recognized the concept of representation, and Samuel Livermore published the first American treatise on Agency in 1811.⁹⁵ Because of the increasing complexity of commercial transactions agency soon became one of the most important legal concepts.

Against this background of legal duties and remedies for breach of duty, it makes sense to speak of trust in the principal-agent relationship. The implicit incentives provided by agency law give some incentives for agents to perform their duties, so that agents behave in a trustworthy manner and principals trust their agents. Agency relationships are thus designed based on trust behavior between principal and agent. Formal contracts can contain explicit performance incentives that stand on the foundation of legal duties and remedies without having to rebuild the entire structure.

C. LEGAL RULES REDUCE TRANSACTION COSTS OF CONTRACTING

Legal rules reduce the transaction costs of forming agency relationships by reducing moral hazard and adverse selection problems. General penalties for breach of duty by agents function as implicit contract contingencies and also avoid the need for complete contingent contracts. The costs of negotiating, writing and monitoring performance of complex contingent contracts are thus mitigated by agency law. Moreover, the information costs associated with evaluating and describing states of the world are avoided by generic contract contingencies.

The information asymmetry between principal and agent arises from several sources. The purpose of the agent is to exercise delegated authority, because the principal chooses to act through an intermediary. Because the agent is the one actually doing the job, he will generally have better knowledge of the circumstances surrounding the relationship. The agent is often a specialist on the task he has been hired to perform, having a comparative advantage if not an absolute advantage relative to the principal, giving the agent greater capacity to process information and determine the most desirable course of action. The information asymmetry

⁹⁴ STOLJAR, *supra* note 90, at 50.

⁹⁵ SAMUEL LIVERMORE, TREATISE ON THE LAW RELATIVE TO PRINCIPALS, AGENTS, FACTORS, AUCTIONEERS, AND BROKERS (1811).

between principal and agent brings the agent to a position of power in the relationship that makes the principal dependent on the agent's judgments and actions. By specifying the duties of service and loyalty, as well as remedies for breach, agency law reduces the transaction costs that stem from moral hazard and adverse selection.

Principals, agents and third parties may not have dealt with each other previously. By specifying the complicated interconnections and responsibilities in advance, agency law simplifies the contracting process. Ian R. MacNeil points out that contract law simplifies the process of contracting because contracts can result from discrete transactions, that is, transactions in situations in which the parties do not know each other.⁹⁶ This general insight has particular resonance in agency relationships, since agency law reduces the costs of forming new relationships without the need for principals and agents to be part of a social network or to engage in long-term relationships. Moreover, there is no need to rewrite the entire law of agency each time an agency relationship is formed. The parties need only address a limited set of transaction-specific requirements.

The law of agency, as with law generally, reflects standards of socially acceptable behavior. Such provisos act as norms that lower several transaction costs of the contracting process, such as those associated with monitoring and enforcing contractual performance.⁹⁷ For example, the agent has an obligation to act in the principal's best interests, he must satisfy not only the letter of the contract, but also its spirit. By imposing this fiduciary criterion, the law solves a problem: agents are committed to being loyal and acting in the interest of the principal.⁹⁸ The fiduciary nature of agency is extremely convenient, as it allows for very simple, highly incomplete contracts to work well in practice.

The many duties and liabilities of the agent, principal, and third parties in agency relationships are related to social norms in two ways. On the one hand, social norms and their ensuing trust provide the context for the law. Trust acts as a lubricant that lowers the costs of formulating the law. In agency law, trust allows for a rather broad and generic layout of the duties and liabilities of agents, principals, and third parties. Thus, social norms allow for some degree of incompleteness in the law. For example, specific terms and expressions like fiduciary or "good faith" do not need to be overly defined because there is a shared understanding that confines the scope of such terms. This common understanding is also reflected in case law. Judges interpret these terms in light of prevailing social norms. Some concepts are left somewhat vague because they are better interpreted in the

⁹⁶ See Ian R. Macneil, *Contracts: Adjustment of Long-Term Economic Relations under Classical, Neoclassical, and Relational Contract Law*, 72 NW. U. L. REV. 854, 856 (1978) ("A truly discrete exchange transaction would be entirely separate not only from all other present relations but from all past and future relations as well. In short, it could occur, if at all, only between total strangers, brought together by chance.") See also IAN R. MACNEIL, *CONTRACTS: EXCHANGE TRANSACTIONS AND RELATIONS* 12 (2d ed., 1978).

⁹⁷ See generally ERIC A. POSNER, *LAW AND SOCIAL NORMS* (2000). See also Robert Axelrod, *An Evolutionary Approach to Norms*, 80 AM. POL. SCI. REV. 1095, 1111 (1986).

⁹⁸ Ronald F. Duska, *Why Be a Loyal Agent? A Systemic Ethical Analysis*, in *ETHICS AND AGENCY THEORY. AN INTRODUCTION* 147 (Norman E. Bowie & R. Edward Freeman eds., 1992).

broader social context given a specific situation. Most people would agree that the agent is fulfilling his fiduciary duty when she behaves primarily for the benefit of the principal, keeps her interests foremost in mind, and acts with care and in a selfless manner. The exact meaning of fiduciary depends crucially on the circumstances that surround each specific situation. The law could further define concepts such as fiduciary, loyalty, or authority, but in doing so it would be narrower in scope and more vulnerable to defeat (individuals could easily satisfy the letter of the law but not its spirit).

On the other hand, the law is a disciplined reflection of the way the social group understands the world. The law guides behavior through a well crafted set of rules that has been refined through experience over several hundreds of years. Over time, many of the provisions included in the law become norms. Usually, individuals' behavior conforms to the law not because individuals have to, but because they want to. In particular, the law of agency announces in a rather clear way what is and what is not appropriate conduct in the context of the relationship. Just as social norms guide the behavior of individuals, the specific duties in the law of agency guide the behavior of principals, agents, and third parties. For example, agency law indicates the degree of selflessness and altruism that is expected from the agent. The agent is expected to be loyal to the principal's trust. This is one primary defining characteristic and thus one of the most fundamental aspects of Agency. Because the principal is vulnerable to the agent's judgments and acts, the agent owes her an obligation of full loyalty and trustworthiness. Even where it is difficult for the principal to check whether or not the agent acted unselfishly, the principal's trust is honored. Such behavior is founded on social norms that are supported by the law.

Because the preferences of the principal and the agent need not be naturally aligned, the law facilitates the working of principal-agent contracts by recognizing and enforcing fiduciary duties. The agent, in the exercise of his fiduciary obligation, cannot exploit contractual gaps, instructional vagueness, or informational advantages to further his self-interest at the expense of the principal's benefit.⁹⁹ The fiduciary benchmark thus reduces transaction costs by lowering monitoring requirements.

Floyd R. Mechem's *Treatise on the Law of Agency* observes that since there are three parties to an agency relationship, six relationships with corresponding duties and liabilities are created.¹⁰⁰ In addition to the duties of the agent to the principal and to the third party, agency law spells out the other relationships as well. Transaction costs are lowered by the standardization and formalization of duties in agency relationships. By

⁹⁹ According to the Draft of the Third Restatement of Agency, "An agent's fiduciary position requires the agent to interpret the principal's statement of authority, as well as any interim instructions received from the principal, in a reasonable manner to further purposes of the principal that the agent knows or should know, in light of facts that the agent knows or should know at the time of acting." RESTATEMENT (THIRD) OF AGENCY § 1.10 (Tentative Draft No. 2, 2001).

¹⁰⁰ FLOYD R. MECHEM, A TREATISE ON THE LAW OF AGENCY (Chicago Callaghan and Company, 2d. ed. 1914).

specifying aspects of these six relationships, agency law reduces the cost of contracting.

The principal has duties to the agent. The principal must compensate the agent for his work or services, reimburse the expenses that the agent has incurred on her behalf, and indemnify the agent if he becomes liable to third parties while following her commands. Finally, the principal must also take the appropriate steps to protect the agent from injury. The law of Agency includes provisions in case the agency contract does not specify the compensation to be paid.¹⁰¹ This is significant because the economic approach to agency assumes that the agency contract is the sole compensation agreement between principal and agent. Thus, in economics, in the absence of an explicit monetary incentive scheme, there is no agency relationship.

The principal has duties to third persons. In general, the principal is liable on contracts made in her name by her authority. She is legally responsible for performance of such contracts. The principal is also liable for the agent's statements and representations that have been expressly authorized in the course of negotiating and carrying out a contract. Also, it is generally understood that notice to the agent is notice to the principal. This is the case even if the notice is not communicated to the principal by the agent.

Third persons have duties to the agent. In general, the agent has no rights against third persons. This is a consequence of the concept that the acts of the agent are the acts of the principal, and the right of action is in the principal alone, not the agent. (This is not the case, however, if the identity of the principal is left undisclosed.) The agent has the right of action against the third parties for torts committed against him. For example, the agent may sue for personal trespass: an agent who sells merchandise on commission may recover damages for loss of reputation and potential future sales for an allegation of fraud by the third person in reference to his agency.

Finally, *third persons have duties to the principal.* Since the principal is accountable for the acts performed and contracts entered by the agent in the exercise of his agency, she is entitled to all rights against third persons that would have arisen had the principal acted or contracted directly with the third party. The principal has the right to sue on contract made by the agent. She has also the right to recover money wrongly paid or used by the agent on the principal's account and money wrongfully appropriated to the agent's uses. Under certain circumstances, the principal also has the right to recover property. In addition, she may rescind contracts affected by the agent's fraudulent conspiracy with other contracting parties. Finally, the

¹⁰¹ "If the amount of compensation is not otherwise agreed upon, as where no specific amount is stated and there is no customary rate for the services, it is inferred that, in a transaction in which some compensation is due, the parties have agreed that the agent is to receive the reasonable value of his services. In determining this, evidence of what other agents receive for similar services is competent, together with other factors, including the reputation of the agent, the skill with which the work is done, and the difficulty or danger of the task." RESTATEMENT (SECOND) OF AGENCY § 443 (1958).

principal may recover for injuries to her interests by a third party's tortious conduct.

The contractual relationship between the principal and agent, that is, the relation *inter se*, presents questions of consent, control, fiduciary, and allocation of gains or risk. They, in other words, "present housekeeping questions."¹⁰² While providing a generic set of duties and remedies, agency law views these *inter se* issues as relatively standard and routine. The transaction costs of the agency contract itself are relatively less important perhaps than the complex issues of interaction with third parties, the ultimate purpose of agency. The implicit incentives created by agency law serve to reduce the transaction costs of the *inter se* relationship, including moral hazard and adverse selection problems. The focus of agency law is to reduce the potentially greater transaction costs in the principal and agent relationships with third parties.

IV. IMPLICIT INCENTIVES: THE MARKET CONTEXT

Market standards, the third category of implicit incentives, are valuable when monitoring actions that require industry knowledge and where remedies that affect future business dealings are more effective than legal remedies. Social norms are especially beneficial when actions are hard to verify legally and ethical standards often apply to actions that are difficult to observe. Legal duties are particularly effective in sustaining trust when the acts of the participants are observable and easy to verify in court, but costly to specify contractually. Thus, market standards are complementary to social norms and legal duties.

Market networks foster the emergence of market standards of behavior. A network is defined as a close-knit group of individuals or organizations that "know each others' relevant characteristics or can learn them through referral."¹⁰³ The relationships between members of the network are sometimes called *ties* and the members (individuals and organizations) are referred to as *nodes*.¹⁰⁴ Market networks differ from hierarchies in that there is no legitimate, central authority to settle conflicts that may arise among the members of the network. Market networks also differ from pure exchange markets — relationships in market networks create continuity between transactions whereas relationships in pure exchange markets are

¹⁰² ROSCOE T. STEFEN, AGENCY-PARTNERSHIP IN A NUTSHELL I, 27 (1977).

¹⁰³ James E. Rauch, *Business and Social Networks in International Trade*, 39 J. ECON. LITERATURE 4, 1177, 1179 (Dec. 2001).

¹⁰⁴ The literature distinguishes between strong and weak ties. Strong ties are characterized by long periods of mutual interaction, high emotional intensity and intimacy as well as reciprocity. Weak ties, on the other hand, refer to sporadic relationships or acquaintances. Individuals or organizations linked by strong ties generally have access to the same opportunity set. Individuals linked by weak ties may have a stronger interest in communicating with each other when searching because of the different environments and opportunity sets to which individuals connected by weak links are exposed. See generally Mark Granovetter, *The Strength of Weak Ties*, 78(6) AM. J. SOC. 1360 (1973); MARK GRANOVETTER, *GETTING A JOB: A STUDY OF CONTACTS AND CAREERS* (2d ed. 1995). The definition of network that we adopt, allows for both types of links.

short-term and are formed for the purpose of a discrete exchange transaction in the sense of MacNeil.¹⁰⁵

Mechanisms that enforce market standards have some similarities to those that induce individuals follow social norms and standards of ethical behavior. In addition, market networks are themselves somewhat social in nature, as they are characterized by the ongoing nature of the relationships among their members. Repeated interaction between members of a network fosters trust, which is the focus of the discussion in this section. The potential future punishments that members may experience if they deviate from the market standards also promote trust. To the extent that agents interact within a stable group including both potential principals and third parties that can communicate with each other, agents have an incentive to develop a reputation for trustworthiness.

A. MARKET STANDARDS, MARKET EXCLUSION, AND AGENT PERFORMANCE

Market standards are behavioral guidelines applicable to specific types of business interactions. Market standards for agents apply to product quality, customer service, employee effort, and other business activities. Various types of pressure serve to reward business behavior that conforms to these norms and to punish behavior that does not conform. Individuals that conform to these market standards can develop a reputation for being trustworthy, while those that do not follow market standards can suffer damage to their reputations. Reputations for being trustworthy yield greater returns to future business relationships, as well as greater numbers of business referrals. Agents that conform to market standards are thus rewarded through future business relationships and failure to conform can be penalized by exclusion from the market.

Market standards that are enforced through business relationships and other market pressures take on the nature of duties of business agents. Generic standards of behavior for market transactions have been compiled in the Uniform Commercial Code and the Law of Agency.¹⁰⁶ Other generic standards may not be codified, as with social norms. However, there are other equally important market standards that are specific to the industry and demographics of the group within which the agent performs his

¹⁰⁵ Joel M. Podolny & Karen L. Page, *Network Forms of Organization*, 24 ANN. REV. SOC. 57 (1998). See GERARD DEBREU, *THEORY OF VALUE* (1959) for a formal analysis of pure market transactions.

¹⁰⁶ The U.C.C. is thick with generic standards. For example,

Where the seller [who may be an agent – see U.C.C. § 2-707] is required or authorized to send the goods to the buyer [the third person in an agency relationship] and the contract does not require him to deliver them at a particular destination, then unless otherwise agreed he must: (a) put the goods in the possession of such a carrier and make such a contract for their transportation as may be reasonable having regard to the nature of the goods and other circumstances of the case; and (b) obtain and promptly deliver or tender in due form any document necessary to enable the buyer to obtain possession of the goods or otherwise required by the agreement or by usage of trade; and (c) promptly notify the buyer of the shipment. Failure to notify the buyer under paragraph (c) or to make a proper contract under paragraph (a) is a ground for rejection only if material delay or loss ensues. U.C.C. § 2-504.

business activities. There are professional guidelines and governing bodies for various professions, including attorneys, accountants, realtors, and physicians.

The desire to create and preserve a reputation for honesty creates incentives for the behavior of agents, principals, and third parties to conform to market standards.¹⁰⁷ A poor reputation may lead to restricted access to the network and, in extreme cases, to ostracism. Reputation is built by consistently abiding by market standards and by exhibiting honest behavior. As the parties build their reputations, economic performance improves and overall efficiency is enhanced.

Individuals have incentives to build reputations when they interact repeatedly and their behavior is observable.¹⁰⁸ Repeated interaction creates incentives for individuals to report information truthfully and to build reputations for honesty.¹⁰⁹ Agents that repeatedly enter into a relationship with a principal have increased incentives to behave cooperatively.¹¹⁰ A number of circumstances foster the establishment of a good reputation as the equilibrium of the repeated interaction game. The dynamic nature of the relationship allows for future punishments and rewards to discipline behavior. A real estate broker acting as a buyer's agent may expect to meet that buyer-principal in the future when she decides to sell the house. To some extent, the threat of future business loss regulates the broker's present behavior. Individuals cooperate in the short run because there are expected *future* gains from cooperation. The threat of exclusion from the network and the consequent loss of future profit induce agents to act honestly.¹¹¹

There are a number of factors that motivate the agent to develop a reputation for integrity and truthfulness. First, the more patience the parties in the agency relationship display, the greater the agent's incentives to build a reputation for trustworthiness. Because the gains associated with having a

¹⁰⁷ ADAM SMITH, *THE THEORY OF MORAL SENTIMENTS* (Prometheus Books 2000) (1759) ("The success of . . . (most) people. . . almost always depends upon the favour and good opinion of their neighbours and equals; and without a tolerably regular conduct these can very seldom be obtained. The good old proverb, that honesty is the best policy, holds, in such situations, almost always perfectly true.")

¹⁰⁸ Beginning with the work of Robert Axelrod on the nature of cooperation and Clive Bull on self-enforcing implicit contracts, there has been growing interest in economics and political science on reputation building and its effects. See ROBERT AXELROD, *THE EVOLUTION OF COOPERATION* (1984); Clive Bull, *The Existence of Self Enforcing Contracts*, 102 Q. J. ECON. 147 (1987). But see David M. Kreps, *Corporate Culture and Economic Theory*, in PERSPECTIVES ON POSITIVE POLITICAL ECONOMY (James E. Alt & Douglas C. North eds., 1990); Drew Fudenberg & David K. Levine, *Maintaining a Reputation when Strategies are Imperfectly Observed*, 59 REV. ECON. STUD. 561 (1992); Drew Fudenberg & David K. Levine, *Reputation and Equilibrium Selection in Games with a Patient Player*, 57 ECONOMETRICA 759 (1989); Roy Radner, *Monitoring Cooperative Agreements in a Repeated Principal-Agent Relationship*, 49 ECONOMETRICA 1127 (1981).

¹⁰⁹ The main analytical tool used in this literature is that of infinitely repeated games (or supergames) where a given stage game is repeated ad infinitum. A stage game is generally a model of a static competitive situation. The elements of a stage game are: players, actions or strategies, and outcomes. The payoffs to any one player depend on the actions of the player and all or some of the other players. A supergame consists of infinitely many repetitions of the stage game.

¹¹⁰ Roy Radner's *Monitoring Cooperative Agreements in a Repeated Principal-Agent Relationship*, is the first published dynamic model of economic agency.

¹¹¹ See Avner Grief, *Reputation and Coalitions in Medieval Trade: Evidence on the Maghribi Traders*, 49 J. ECON. HIST. 857 (1989) (hereinafter "Reputation and Coalitions"); Avner Grief, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders' Coalition*, 83 AM. ECON. REV. 525 (1993) (hereinafter "Contract Enforceability").

reputation for honesty are realized in the future, the more patient the parties are, the more faithful their short term behavior will be. Patience or lack thereof is intimately related to the discount factor used by individuals to compute the net present value of future streams of cash flows.¹¹² With a large discount factor, distant future transactions are very present in the mind of the agent. It is this vivid presence of the future that bends present behavior towards honesty. On the contrary, a low discount factor translates into myopic behavior — narrow-minded maximization of short term gains without regard to future returns.

Second, the more there is *information transparency*—that is, the less scrambled the signals from which specific actions are inferred—the easier it is to punish misbehavior and to build a reputation.¹¹³ If the principal and third parties with whom the agent transacts are specialists on the agent's task, then it is easier for the agent to build a reputation than if the other participants know little about his work and cannot reliably infer the agent's actions from the observed outcomes. Thus, it is easier for a lawyer agent to build a reputation for honesty if his clients are other lawyers than if they know nothing about law or what to expect from the agent-lawyer. For economic pressures to enforce market standards, the acts of the participants must be reasonably easy to observe but not necessarily verifiable; that is, the situation must be one in which the principal and third parties can observe or can easily infer the agent's acts, even if they would have a hard time proving breach of contract in court.

Third, the *size of the network* of business relations is also a crucial aspect impacting reputation building. The larger the network, the more the potential punishment from exclusion from access to the network.¹¹⁴ Similarly, the greater the returns to creating trust through market networks, the larger will be such networks for similar costs to organizing networks.

Fourth, *lower costs of communication* make it easier to publicize the parties' performances to potential future transacting parties. This increases the likelihood that a violation of market standards will be penalized. If every potential transacting party were fully aware of each other's complete history of past interactions, reputation would be enough for honest behavior to emerge and there would be little need for social norms and the legal system.¹¹⁵

¹¹² If the interest rate is r , then the discount factor equals $1/(1+r)$.

¹¹³ There is a sizable economic literature on repeated games with imperfect monitoring. See Dilip Abreu, D. Pearce, and Ennio Stacchetti, *Toward a Theory of Discounted Repeated Games with Imperfect Monitoring*, 58 *ECONOMETRICA* 1041–63 (1990); Drew Fudenberg, David Levine, & Eric Maskin, *The Folk Theorem with Imperfect Public Information*, 62 *ECONOMETRICA* 997–1039 (1994); Jerry Green & Robert Porter, *Non-cooperative Collusion Under Imperfect Price Information*, 52 *ECONOMETRICA* 87–100 (1984).

¹¹⁴ See *Reputation and Coalitions*, *supra* note 101; see *Contract Enforceability*, *supra* note 101; see Avner Grief, Pual Milgrom & Barry R. Weingast, *Coordination, Commitment and Enforcement: The Case of the Merchant Guild*, 102 *J. POL. ECON.* 745 (1994).

¹¹⁵ Michiro Kandori, *Social Norms and Community Enforcement*, 59 *REV. OF ECON. STUD.* 63 (1992) (Extending the Folk theorem in repeated games to a setting where the agents change partners over time. Cooperation is sustained because defection against one agent causes others to punish.)

The fifth feature of market relationships that promotes cooperation is *frequency of interaction*. The more frequently the parties meet, the more quickly a reputation for honesty can be built.¹¹⁶ Effectively, frequency of encounters translates into a larger discount factor and thus in a larger weight of future business relationships relative to immediate transactions.

Sixth, the *relative rewards* from defection and compliance affect the willingness of agents to cooperate with principals. The lower the immediate benefit from defection, the lesser the incentives to take advantage of agents, principals, and third parties. Likewise, the larger the future benefits from having built a reputation, the greater the incentives not to defect in the short term.

The parties compare the material rewards from behaving cooperatively with the immediate pecuniary benefits of defection.¹¹⁷ The notion of a market standard must be extended to include the equilibrium strategies of the dynamic game that parties play against each other. As mentioned previously, market standards are actions that the members of the network regard as trustworthy behavior. In contrast, the equilibrium strategies in the dynamic game are *sequences* of actions, contingent plans of action. The self-enforcing equilibrium strategies should also be regarded as market standards themselves because they constitute the dynamic behavior that parties expect from each other in the course of the agency relationship (and this is the definition of a market standard). Notice that the equilibrium strategies may prescribe actions that by themselves would not be deemed as

¹¹⁶ See ADAM SMITH, LECTURE ON THE INFLUENCE OF COMMERCE MANNERS, *reprinted in* LECTURES ON JURISPRUDENCE 538-541 (R. L. Meek, D. D. Raphael, & P. G. Stein eds., 1978), stating:

A dealer is afraid of losing his character, and is scrupulous in observing every engagement. When a person makes perhaps 20 contracts in a day, he cannot gain so much by endeavouring to impose on his neighbours, as the very appearance of a cheat would make him lose. Where people seldom deal with one another, we find that they are somewhat disposed to cheat, because they can gain more by a smart trick than they can lose by the injury which it does their character.

¹¹⁷ One main drawback with the game-theoretical literature on reputation building is multiplicity of equilibria. The model identifies the factors that ultimately determine the agent's incentives to behave honestly (patience, information transparency, advertising technology, frequency of interaction, and relative rewards), but does a poor job at predicting the sequence of actions that parties will take as well as the more likely equilibrium outcomes. If the parties are sufficiently patient, everything is an equilibrium of the dynamic game. Almost any feasible payoff allocation that give the parties at least what they could get against the worst punishments that the other players could use against them can be achieved in an equilibrium of a standard repeated game. Thus the lack of predictive power. In a sense, supergame theory is too successful at explaining cooperation. The multiplicity of equilibria is usually referred to as the "Folk Theorem." See J. FRIEDMAN, OLIGOPOLY AND THE THEORY OF GAMES (1977); J. Friedman, *A Noncooperative Equilibrium for Supergames*, 28 REV. ECON. STUD. 1 (1971); See also R. Aumann & L. S. Shapley, *Long Term Competition: A Game Theoretic Analysis* (1994) and N. Megiddo, *Essays in Game Theory in Honor of Michael Maschler* (1976) (on file with author); Drew Fudenberg & Eric Maskin, *The Folk Theorem in Repeated Games with Discounting and with Incomplete Information*, 54 ECONOMETRICA 533 (1986); Ariel Rubinstein, *Equilibrium in Supergames with the Overtaking Criterion*, 21 J. ECON. THEORY 1 (1979). In the last few years there has been work on refining the equilibrium concept to narrow the set of predictions, but the work on coordination and focal equilibria is still at a very early stage. See, e.g., Drew Fudenberg & David K. Levine, *Reputation and Equilibrium Selection in Games with a Patient Player*, 57 ECONOMETRICA 759 (1989); Drew Fudenberg & David K. Levine, *Maintaining a Reputation when Strategies Are Imperfectly Observed*, 59 REV. ECON. STUD. 561 (1992).

honest behavior but that in the context of the dynamic game are perfectly acceptable. The punishment phase in the self-enforcing equilibrium path (what the principals and third parties are supposed to do if there is deviation from ‘honest’ behavior by the agent) will typically consist of acts that go against the short-term, myopic general interest. However, both individual actions and market strategies are market standards. We conclude that market networks foster the materialization of market standards and that when the agents’ acts can be observed reasonably accurately, the threat of exclusion induces them not to neglect their duties vis-a-vis the principal and third parties.

B. TRUST IN MARKET NETWORKS AND DELEGATION TO AGENTS

Market standards differ from social norms and legal duties in terms of standards of behavior and enforcement mechanisms. Standards of behavior may be technical industry guidelines for which there are no corresponding social norms or legal duties. Market standards are enforced through the threat of exclusion from the network of business relationships within which the agent performs his activity, rather than through social pressures or legal remedies. Enforcement of market standards requires the agent’s acts to be observable to the members of the network even if they are not legally verifiable.

A substantial empirical literature provides evidence of market standards based on the history of trade diasporas, ethnic or religious groups with settlements in trade routes. Avner Greif, for example, studied the Maghribi Traders’ Coalition in the 11th century, Jewish settlements outside of modern Israel that served as end points and transshipment points of trade with the Muslim Mediterranean, through the documents kept in the *geniza* (a thousand contracts, price lists, traders’ letters, and accounts).¹¹⁸ According to Greif, Maghribi traders felt that transacting through agents was crucial for business success although at that time there were plenty of opportunities for agents to behave opportunistically because they transacted with capital they did not own.¹¹⁹ Greif asks: why did agents not embezzle money and goods more often? Where did trust come from? Why did agents not cheat?

Greif explains that trust in agency relations among the Maghribis was possible because trade relations were governed by the “coalition,” or network of merchants. According to Greif, “[e]xpectations, implicit contractual relations, and a specific information-transmission mechanism constituted the constraints that affected an individual trader’s choice of action. In particular, these constraints supported the operation of a reputation mechanism that enabled the Maghribis to overcome the commitment problem. In turn, the reputation mechanism reinforced the expectations on which the coalition was based, motivated traders to adhere

¹¹⁸ See *Contract Enforceability*, *supra* note 101, at 528.

¹¹⁹ Greif illustrates the importance of agency relationships with two examples: “One trader wrote to his business associate who served as his overseas agent that ‘all profit occurring to me comes from your pocket’ . . . while another mentioned that in trade ‘people cannot operate without people’.” See *id.*

to the implicit contracts, and led to entry and exit barriers which ensured the sustainability of the coalition.”¹²⁰

Abner Cohen studied agency relationships in the Hausa trade diaspora of West Africa, where landlords in Ibadan, Nigeria employed agents to sell cattle from dealers located elsewhere in the trade route.¹²¹ Opportunistic behavior by the landlords vis-a-vis the dealers was limited by their tradition of accumulating wealth in the form of housing assets: “A landlord cannot sell his houses overnight and leave the community after embezzling the money of traders. On the other hand, the Chief can put a great deal of pressure on a landlord in difficulties to sell some of his housing assets in order to meet his financial obligations to traders.”¹²² More puzzling is the trust between the commission agents employed by the landlords (principals) to transact on their behalf with dealers (third persons). According to Cohen, trust between landlords and agents was achieved because of the benefits of repeated interaction and by the development of a “moral community.”

Perhaps the largest transnational market network in the world, the Overseas Chinese, exemplifies market standards. “If a business owner violates an agreement, he is blacklisted. This is far worse than being sued, because the entire Chinese network will refrain from doing business with the guilty party.”¹²³ Joel Kotkin observes that “Chinese entrepreneurs remain, in essence, arbitrageurs, their widespread dispersion a critical means of identifying prime business opportunities.”¹²⁴ Businesses associated with the Overseas Chinese trade diaspora perform a complex set of intermediation roles, including import-export arrangements, trade credit, financing, and supply chain management.

The trust created through repeated interactions in market networks not only facilitates trade but also enlarges the set of potential business opportunities to which the members of the network are exposed. Individuals in different parts of the network have access to different pieces of information. This information may not be valuable to the owner of the information but very valuable to other members of the network. Because the trust between the members of the network implies that communication among them improves, there is better access to these diverse business opportunities. Thus, market standards not only facilitate existing trade relationships between members of the network, but also create additional trade.

¹²⁰ *Id.* at 526.

¹²¹ ABNER COHEN, CUSTOM AND POLITICS IN URBAN AFRICA: A STUDY OF HAUSA MIGRANTS IN YORUBA TOWNS (1969).

¹²² *Id.* at 274.

¹²³ MURRAY WEIDENBAUM & SAMUEL HUGHES, THE BAMBOO NETWORK: HOW EXPATRIATE CHINESE ENTREPRENEURS ARE CREATING A NEW ECONOMIC SUPERPOWER IN ASIA 51 (1996).

¹²⁴ JOEL KOTKIN, TRIBES: HOW RACE, RELIGION, AND IDENTITY DETERMINE SUCCESS IN THE NEW GLOBAL ECONOMY 169 (1992). In a recent paper, James E. Rauch and Vitor Trindade attempt to distinguish the relative force on trade creation of the business opportunity and trust effects for the Overseas Chinese network. See James E. Rauch & Vitor Trindade, *Ethnic Chinese Networks in International Trade*, NAT. BUREAU OF ECON. RESEARCH Paper 7189 (1999).

Agents may also sell access to a network, typically for a commission on the value of the transactions realized, and act as *network intermediaries*. We have in mind a situation where the agent has access to a large network of third parties and where there is trust between the agent and these third parties. Now, a principal who would like to access the network of third parties can try to contact them directly. Typically this will be at high cost because of lack of knowledge and trust between the principal and the third parties. Alternatively, the principal may contact an agent intermediary and, even if initially there is no trust between them, the ongoing nature of the relationship may be enough for trade to be possible. The agent would effectively be selling trust. The price of that trust is the agent's fee. The networks that these agents provide access to may consist of densely interconnected firms or firms that do no business with each other. The value of the trust the agent provides is larger in this second case because it is harder to substitute for the agent's services. When firms are highly interconnected, once access has been gained to anyone of them, they can provide the trust intermediation function directly and there is little need for the agent-intermediary.

The two situations are represented in Figures 3 and 4 below. The value of the trust created through agency can be larger in the case of Figure 3 because the agent organizes the network: if the principal wants to transact with any one third party, she must do it through the agent, and not through another third party as a trust intermediary. Moreover, interacting with any one of the third parties gives no information to the principal about other possible business opportunities because all the transactions (Ts) are disconnected. However, in Figure 4, if the principal gains access to any third party, she may be able to use that third party as an agent to interact with other third parties. In addition, third parties may be able to provide valuable information about other third parties. Thus, the agent does not have this monopoly either. The empirical prediction is that, other things equal, the agent in Figure 3 should be paid a premium over the agent in Figure 4, because the trust that she offers is more scarce and, thus, more valuable.

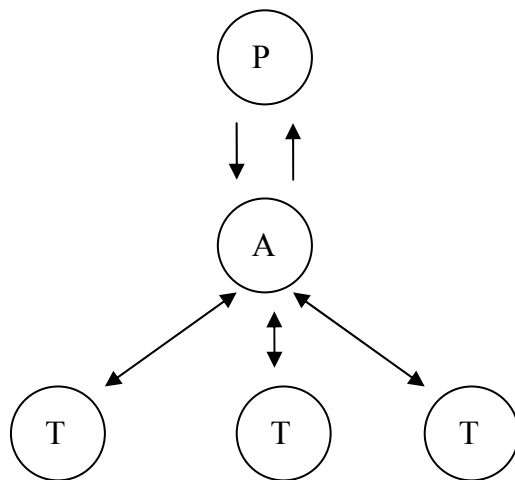


Figure 3 Access to a set of disconnected third parties

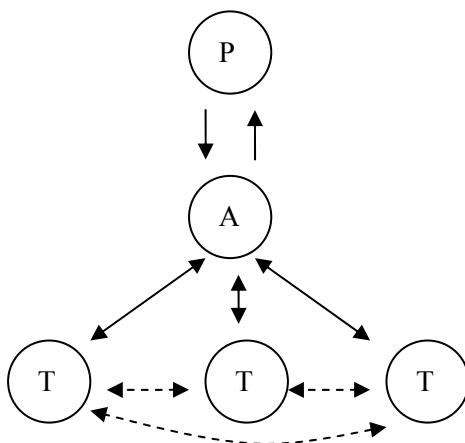


Figure 4: Access to a network of interconnected third parties

C. MARKET STANDARDS REDUCE TRANSACTION COSTS OF CONTRACTING

Established market standards reduce transaction costs by simplifying the terms of agency relationships. In addition to social norms and legal duties, market standards provide industry-specific patterns of behavior for employers, employees, independent contractors, and companies. Such

industry-specific standards allow the principal and agent to reduce the complexity of instructions. Where explicit contracts are involved, industry-specific standards allow for simplification of contract contingencies and reduce the costs of negotiating, writing and monitoring contracts. Because market standards are enforced through reputation and referrals in market networks, there is less need for costly monitoring of contractual performance.

Some market standards are maintained through self-enforcing agreements. An agreement is *self-enforcing* when the present value of complying with the agreement outweighs the short-term benefit from breaching the implicit contract. The factors that promote the emergence of trust in market networks also foster self-enforcing agreements (patience, information transparency, network size, costs of communication, frequency of interaction, short term vs. long term rewards). An agreement is self-enforcing if the parties to that agreement want to comply with it, even if they are not monitored by a central authority.¹²⁵ Self-enforcing implicit contracts are economically advantageous because parties do not need to spend resources writing down the duties and liabilities in each contingency. Thus, they economize on drafting costs. Also, because these contracts are self-enforcing, the parties also economize on the resources that otherwise would have to be devoted to monitoring and ensuring performance.

Some types of explicit contracts can be replaced by unwritten agreements known as *implicit contracts*.¹²⁶ An implicit contract may be complete; it may specify the contingent obligations of each participant in full detail even though these are not written down explicitly.¹²⁷

For example, a firm may offer to certain of its employees an implicit insurance contract in the form of wages and employment that do not vary over the business cycle. For implicit contracts to work well in market networks, they must be self-enforcing.¹²⁸ The implicit contract can be enforced through reputation and trust relationships.¹²⁹

¹²⁵ There are two main approaches to thinking about self-enforcement. A strong notion of self-enforcement involves contracts in which the actions of any party to the agreement are best responses to all possible actions of all other parties (dominant strategies). A weaker notion of self-enforcement requires that the actions of each party be best responses to actions that the contract prescribes to all other parties (Nash equilibrium). The second notion requires more rationality on the part of the participants but it also enlarges the scope of allowed contracts.

¹²⁶ The pioneering paper that coined the term "implicit contract" is Costas Azariadis, *Implicit Contracts and Underemployment Equilibria*, 83(6) J. POL. ECON., 1183(1983). See eg., Sherwin Rosen, *Implicit Contracts: A Survey*, 23(3) J.ECON. LIT., 1144(1985).

¹²⁷ In real agency relationships implicit contracts will also be somewhat incomplete. Since we have already analyzed the role of trust when contracts are incomplete and since implicit contracts do not necessarily need to be incomplete, we now center attention on the role of trust in the case of implicit complete contracts.

¹²⁸ In fact, some authors restrict the term "implicit contract" to unwritten agreements that are self-enforcing. See Clive Bull, *The Existence of Self-Enforcing Implicit Contracts*, 102 Q. J.ECON. 147, (1987). According to Bull, "An implicit contract is a noncontractual agreement that corresponds to a Nash equilibrium to the repeated, post-hiring, bilateral trading game other than the degenerate agreement consisting of a sequence of Nash equilibria to the one-shot trading game." *Id.* at 149.

¹²⁹ See H. L. Carmichael, *Self-Enforcing Contracts, Shirking, and Life Cycle Incentives*, 3 J.ECON. PERSP., 65 (1989).

If contracts were complete and explicit, deviation from the written contractual terms would define breach. However, when agency contracts are implicit, it is necessary to develop alternative breach remedies. Greif explains that the Maghribis solved this problem through the use of a “Merchants’ Law,” that specified a set of cultural rules governing behavior: “The Merchants’ Law was shared by all the Maghribi traders and served as a default contract between agents and merchants.”¹³⁰ For contracts, specifically the explicitly enforceable part of the contract, direct inspection is sufficient to determine whether or not the agent has failed to perform. For the implicit portion, prevailing social norms and the law of agency play an important role. Social norms and the law help define what is and what is not acceptable behavior in agency relationships; they serve as a type of Merchants’ Law that reinforces implicit contracts.

Another important type of self-enforcing agreement is the *efficiency wage*.¹³¹ The principal pays the agent a wage that is substantially greater than the agent’s expected market wage. The agent has a set of required duties that are spelled out explicitly. If the principal discovers that the agent shirks or otherwise breaches his duties, then the principal terminates the relationship. Because the efficiency wage is above the agent’s expected market wage, termination constitutes a penalty since the agent foregoes the premium of the efficiency wage over the market wage. The efficiency wage is the lowest wage such that the agent prefers to carry out his duties. The agreement is self-enforcing since the agent has an incentive to comply and since the principal commits to the agreement by paying the wage up front and the principal will dismiss the agent if the agent shirks.

The efficiency wage contract has a number of features relevant to the development of trust. The principal trusts the agent since the observation of shirking is necessarily imperfect. The threat of termination may be explicit, but a broad definition of the agent’s duties and imperfect observation of performance create implicit incentives to perform. Moreover, the agent performs his duties without explicit contractual incentives that reward performance. The termination of the employment agreement serves as a penalty for shirking, much as legal remedies penalize breach of duty or social pressures penalize deviation for norms of behavior. If the agent expects that the relationship with the principal will be long-term, the value of the relationship is increased and hence the greater the cost of dismissal. Thus, long-term relationships build trust. The wage that the employee stands to earn elsewhere if he is laid off is determined by market supply and demand for the abilities that he has to bring to the market. Those employees that have developed a great deal of human capital specific to the

¹³⁰ Avner Greif, *Contract Enforceability and Economic Institutions in Early Trade: The Maghribi Traders’ Coalition*, 83(3) AM. ECON. REV. 525, 543 (1993).

¹³¹ See PAUL MILGROM & JOHN ROBERTS, *ECONOMICS, ORGANIZATION & MANAGEMENT* 250 (1992); W. Bentley MacLeod & James M. Malcomson, *Implicit Contracts, Incentive Compatibility, and Involuntary Unemployment*, 57 *ECONOMETRICA* 447 (1989); Carl Shapiro & Joseph Stiglitz, *Equilibrium Unemployment as a Worker Discipline Device*, 74 AM. ECON. REV. 433 (1984); Janet L. Yellen, *Efficiency Wage Models of Unemployment*, 74 Am. Econ. Rev. 200 (1984). Efficiency wage theory helps to explain involuntary unemployment, real wage rigidity, dual labor markets, wage dispersion, and discrimination.

current employer will generally have a hard time to find highly paid alternative jobs. Thus, the company can increase the employee's trustworthiness by promoting the development of skills specific to the company.

The efficiency wage model is consistent with the observation that many employment relationships involve fixed wages rather than more complex incentives schemes. The greater the employer's reliance on efficiency wage to enforce performance, the higher must be the efficiency wage premium. Conversely, the greater is the trust created by social norms, legal duties and market standards, the lower can be the efficiency wage premium. If many employers rely on wages above the employee's marginal product, there will be a corresponding unemployment in the economy. This means that a high level of trust, resulting from social norms, legal duties and market standards can lower the efficiency wage premium and in turn increase the level of employment in an economy.

V. EXPLICIT INCENTIVES: THE PRINCIPAL-AGENT MODEL IN ECONOMICS

The contractual problems examined by economists contrast markedly with the treatment of trust in agency law. The differences between these two approaches are so substantial that one wonders if it might be simply a matter of economists mislabeling the model. However, economists have clearly expressed an intent to examine delegation of authority in agency contracts. Because the economists' principal-agent model is such an important and valuable instrument of theoretical analysis and has been applied to study a wide variety of relationships, it is important to point out where it differs from its legal counterpart. Confronting the theoretical framework with these disparities should stimulate economists to adapt and extend the principal-agent model to help explain actual institutions as embodied in law and observed in markets.

Economic analysis of the principal-agent model tends to focus only on explicit contractual incentives, assuming away the social, legal, and market contexts. Economic analysis of agency begins with a clean slate — the Aristotelian or Cartesian *tabula rasa* — that excludes many of the characteristics that are observed in actual agency relationships. Accordingly, the economic model of agency generally seeks to derive the optimal contract between principal and agent from first principles without reference to implicit incentives. Although this approach yields important insights about contract design, the model is unlikely to generate meaningful empirical predictions without reintroducing the implicit incentives that derive from the social, legal and market contexts. By ignoring the social, legal and market foundations of trust, the economic model of agency generates dramatic but questionable conclusions regarding shirking and lying by agents.

The principal-agent model is without question a dominant theoretical framework in economic analysis.¹³² It is the main mode of analysis in the study of contracts, organizations, incentives, the theory of the firm, corporate control, labor, law and economics, regulation, health economics, public and private procurement, and tax and subsidy policies.¹³³ The principal-agent model has profoundly influenced several generations of economic theorists. Economists consider problems associated with the design of efficient contracts such as contracting costs and inefficient performance. The model is used to study explicit incentives created by the terms of the formal contract between the principal and agent such as pay for performance, profit sharing, and various other contingencies. The economic model of agency also exerts a strong influence on other disciplines such as legal studies, political science, and management.

The definition of agency in economics departs considerably from the legal definition and from standard business experience. In economics, the agent often is a subordinate employee who performs a productive task for the principal, anything from farming to piece-rate manufacturing.¹³⁴ Yet the legal definition of agency is clear: an agent is a representative sent by the principal to represent the interests of the principal in transactions with third parties.¹³⁵ Employees are agents when they act in ways that affect their employer's legal relationships with third parties, including acquiring relevant information and entering into transactions on the employer's behalf. Agency case law is replete with examples of agents acting as intermediaries for principals in such diverse activities as attorneys, auctioneers, brokers, realtors, stockbrokers and factors.¹³⁶ Agents acting as

¹³² The economic literature on agency has experienced phenomenal growth since the early 1970s. The number of papers in Econlit with agency in the title, abstract, or heading gives some indication of the growth of the literature: 1971-1975, 19 papers; 1976-1980, 47 papers; 1981-1985, 107 papers; 1986-1990, 424 papers; 1991-1995, 767 papers; 1996-2000, 1125 papers. Excellent surveys include: Daniel Levinthal, *A Survey of Agency Models of Organizations*, 9 J.ECON. BEHAV. & ORG. 153 (1988); David Sappington, *Incentives in Principal-Agent Relationships*, 5 J.ECON. PERSP. 45 (1991); Robert Gibbons, *Incentives in Organizations*, 12 J.ECON. PERSP. 115 (1998); and Canice Prendergast, *The Provision of Incentives in Firms*, 37 J.ECON. LITERATURE 7 (1999). There are also several books on the economics of agency, see for example, INES MACHO-STADLER & DAVID PEREZ-CASTRILLO, *INTRODUCTION TO THE ECONOMICS OF INFORMATION: INCENTIVES AND CONTRACTS* (2d.ed. 2001); BERNARD SALANIE, *THE ECONOMICS OF CONTRACTS: A PRIMER* (1997); JEAN-JACQUES LAFFONT, *THE ECONOMICS OF UNCERTAINTY AND INFORMATION*, (1989).

¹³³ For expositions of agency-based economic theories of the firm and corporate control see Armen Alchian & Harold Demsetz, *Production, Information Costs and Economic Organization*, 62 *Am. Econ. Rev.* 777 (1972), reprinted in Harold Demsetz, *Ownership, Control, and the Firm: The Organization of Economic Activity* 119 (1988). See also eg., Eugene F. Fama, *Agency Problems and the Theory of the Firm*, 88 *J. POL. ECON.* 288 (1980).

¹³⁴ The agent performs a productive task requiring costly effort that is unobservable to the principal. See eg., Stephen A. Ross, *The Economic Theory of Agency: The Principal's Problem*, 63 *AM. ECON. REV.* 134 (1973). Cooter and Freedman adopt the economic definition of agency. They consider the principal-agent relationship as one type of beneficiary-fiduciary relationship: "a beneficiary entrusts a fiduciary with control and management of an asset," which they suggest may include cash, stock, land, a patent or copyright, valuable information, a business opportunity, or a business enterprise. See Robert Cooter & Bradley J. Freedman, *The Fiduciary Relationship: Its Economic Character and Legal Consequences*, 66 *N.Y.U. L. REV.* 1045, 1046, 1048 (1991).

¹³⁵ "Agency's intellectual distinctiveness is its focus on relationships in which one person, as a representative of another, has derived authority and a duty as a fiduciary to account for the use made of the representative position," Deborah A. DeMott, *A Revised Prospectus for a Third Restatement of Agency*, 31, *U.C. DAVIS L. REV.* 1035, (1998).

¹³⁶ I. FLOYD R. MECHEM, 1-2 *A TREATISE ON THE LAW OF AGENCY*, (2d. 1914)

intermediaries are pervasive in commercial transactions.¹³⁷ Property owners and companies hire representatives to buy or sell goods and services for them. The large modern business organization could not exist without delegating the authority to engage in economic transactions to representatives charged with sales, purchasing, hiring, and finance.¹³⁸

Economic agency models identify two main types of inefficiencies depending on the nature of information asymmetries between the principal and the agent. In the *moral hazard* model, the principal cannot observe the agent's actions and the first best contract¹³⁹ involves shirking by agents because undetected shirking results in less personal cost and thus in higher utility. In the *adverse selection* model, the principal is ignorant about the agent's intrinsic productivity and the first best contract involves lying by agents because by misrepresenting their true skill level agents can obtain more favorable terms.¹⁴⁰ The moral hazard and adverse selection problems are derived in models that effectively disregard implicit incentives for trust that might arise from the social, legal or market contexts.

A. CONTRACTUAL TERMS, CONTRACTUAL PENALTIES, AND AGENT PERFORMANCE

1. *Moral Hazard and the Cost of Effort*

In the moral hazard model of agency, the principal pays the agent to carry out a designated task and the agent decides how much effort to devote to the task. The principal's problem is to design an incentive schedule that motivates the agent to choose a desired level of effort. The main

¹³⁷ Daniel F. Spulber emphasizes the role of agents as intermediaries in market allocation and in the theory of the firm. DANIEL F. SPULBER, MARKET MICROSTRUCTURE: INTERMEDIARIES AND THE THEORY OF THE FIRM, (1999).

¹³⁸ Tentative Draft No. 2 of the Third Restatement of Agency recognizes the importance of agents to large organizations, including both for-profit business corporations and not-for-profit organizations, such as universities. See DeMott, *supra* note 125, at 1040.

¹³⁹ In economics, the expression "first best contract" refers to the optimal contract under symmetric and complete information for both principal and agent. When information is symmetric and complete, shirking and lying are always detected with probability one. The first best contract consists of a fixed fee and a harsh punishment when the agent shirks or lies. The punishment is such that it is never to the agent's advantage to shirk or lie. When the agent is untrustworthy and there are information asymmetries, the principal can do better by offering a contract different from the first best contract.

¹⁴⁰ The terms moral hazard and adverse selection have their origins in the insurance literature. An insured customer has reduced incentive to take care in avoiding accidents. This reduced incentive is a form of moral hazard. On the other hand, a person seeking insurance has an incentive to over-represent his natural tendency to avoid accidents. This willingness to misrepresent a skill is known as adverse selection. Economists see moral hazard and adverse selection as rational economic behavior while insurance writers originally looked at these as ethical problems. For example, EDWIN J. FAULKNER, HEALTH INSURANCE 327 (1960), observes that "moral hazard reflects the hazard that arises from the failure of individuals who are or have been affected by insurance to uphold the accepted moral qualities." J. M. Buchanan, *The Inconsistencies of the National Health Service*, INS. OF ECON. AFFAIRS OCCAS. Paper 7, 22 (1964) defines moral hazard as "every deviation from correct human behavior that may pose a problem for an insurer." Pauly (1968) in an influential paper, suggested that "rational economic behavior" and "moral perfidy" are mutually exclusive categories. Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AM. ECON. REV. 528 (1968). This notion, although criticized by Kenneth Arrow, was quickly adopted in economics and still today it is the dominant view. See Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 Am.Econ. Rev. 537, 538 (1968).

assumption in the moral hazard model is that the principal knows the agent's preferences with certainty but she cannot observe the agent's action or effort level. The principal needs some productive work to be done. In essence, the work consists of exerting some well defined, unidimensional, effort. The principal hires an agent because she does not have the time or capability to do the work herself.¹⁴¹

The agent is motivated only by the explicit incentives for performance that are contained in the contract. This follows not only from the assumed economic rationality of the agent but also from the assumption that there are no incentives for performance outside the contract. In consequence, the principal must use a written contract to provide incentives to work. The contract provides the minimum payment needed to induce the agent to exert effort in a well-defined task. Because the agent is rational and there are no incentives outside the contract, the principal places no trust in the agent.

In addition, the economic model of agency assumes that effort is costly to the agent. As a result, an agent will devote no effort, time, or attention to the task unless explicit monetary incentives are tied to performance. This conclusion is not surprising in view of the assumptions that the agent's only incentives are contractual and that effort is costly. In short, the agent does not behave in trustworthy fashion and the principal does not trust the agent to perform the task.

Moreover, the agent's effort is assumed to be unobservable. The principal does not have the time or the technology to monitor the agent's effort so that the contract cannot directly specify effort nor can the contract provide rewards or penalties based on effort. What the principal can observe is the outcome following the agent's effort. The agency contract specifies how much money the agent will get as a function of the observed outcome. The contract is optimally designed so that the agent enters the relationship (this is known as individual rationality) and so that he is eager to work as much as the principal would like him to work (this is known as incentive compatibility).

As with any contract, agency involves offer and acceptance. In the economic model of agency, the principal makes a take-it-or-leave-it contract offer to the agent. Then, the agent decides whether to accept or to reject the offer. If he rejects it, then the relationship is over. If he agrees to the offer, then he decides on how much effort to devote to the task. Next, nature plays: a random outcome that is correlated with the agent's level of effort ensues. Outcomes are assumed to be observable and verifiable, so

¹⁴¹ Several important assumptions underlie the economic model of moral hazard in agency. First, effort is unidimensional. Thus, there is one single aspect of performance that matters to the principal. Second, the principal knows precisely the agent's preferences. Third, principal and agent have the same beliefs on the probability distribution on outcomes induced by each effort level. Fourth, there is no future to the relationship: the model is static and the principal makes a take-it-or-leave-it contract offer to the agent. The moral hazard model has been extended to relax a few of these assumptions. For instance, Holmstrom and Milgrom (1992) have studied the consequences of multidimensional effort or attention. See Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991).

that fully enforceable contracts can be based on them.¹⁴² Finally, after the outcome is observed, the agent is paid according to the contract.

Economic analysis of the agency model seeks to characterize the terms of an optimal agency contract. Because of moral hazard, the principal must rely on performance based rewards such as bonuses and commissions to induce the agent to work. The contract could potentially induce the agent to devote an efficient level of effort by allowing the agent to keep all the returns to his effort. Yet such a performance-based rewards system has the significant drawback that it shifts risk to the agent. Because the agent is risk averse, the principal needs to compensate the agent for the cost of risk-bearing to induce him to enter the relationship. Accordingly, to reduce the risk borne by the agent (thus reducing the cost of compensating the agent for that risk), optimal contracts consist generally of a fixed payment plus some performance-based rewards.¹⁴³ Just as in the sharecropping contract, the principal and agent share the results of the agent's effort and thus share risk. As in the discussion of sharecropping due to Adam Smith and Alfred Marshall, sharing output necessarily results in some shirking because the agent's rewards are not entirely based on performance.

Because there is no context to contracting: there are no social or psychological penalties to shirking and the agent takes no pride from hard work and good performance, there is no legal enforcement of contractual duties, and there are no other market standards. The principal and agent transact only once, so the incentives for performance that might emerge from a long-term relationship are absent.¹⁴⁴ Because there is no role for trust, the focus of economic analysis tends to be on problems that arise from the design of complete contracts. A contract is said to be complete if it indicates precisely the duties and liabilities of each party in every possible future set of circumstances, that is in all states of the world.

The moral hazard model of agency has had a profound impact on the way economists think about firms and organizations of all types. For example, in a highly influential article, Michael Jensen and William Meckling apply the model to explain the capital structure of corporations and provide a theory to explain observed ownership patterns: shares held

¹⁴² *Observability* means that the principal can inspect the outcome. Because the outcome provides information on the agent's choice of effort, the principal pays the agent contingent on the outcome. *Verifiability* means that the principal can prove in court that a specific outcome that has been realized. If outcomes were not verifiable, then contracts that made the agent's compensation contingent on them, would not be enforceable and, thus, would be worthless. When the agent's actions are observable and verifiable, the three types of incentives for trust sustain cooperation. When agent's acts are observable but not verifiable, a reputation for honesty can be built and market reputation and social norms help promote economic exchange. Finally, when actions are non-observable and, thus, non-verifiable, there may only be social incentives for trust. In that case, without trust resulting from social norms, trade would break down and overall welfare reduced. Of course, actions may be observable or verifiable only under certain conditions so that information or a signal is obtained with some probability.

¹⁴³ Bengt Holmstrom & Paul Milgrom, *Multitask Principal-Agent Analyses: Incentive Contracts, Asset Ownership, and Job Design*, 7 J.L. ECON. & ORG. 24 (1991); Bengt Holmstrom & Paul Milgrom, AGGREGATION AND LINEARITY IN THE PROVISION OF INTERTEMPORAL INCENTIVES, 55 ECONOMETRICA 303 (1987); Canice Prendergast, *The Provision of Incentives in Firms*, 37 J.ECON. LITERATURE 7 (1999).

¹⁴⁴ See however the dynamic principal-agent model with moral hazard in Roy Radner, *Monitoring Cooperative Agreements in a Repeated Principal-Agent Relationship*, 49 ECONOMETRICA 1127 (1981).

by inside managers, outside equity, and debt.¹⁴⁵ According to Jensen and Meckling, the manager's incentives to shirk increase as his ownership share falls.¹⁴⁶ The firm's optimal capital structure is chosen by taking into account how it will affect incentives for performance.¹⁴⁷ Jensen and Meckling's main prediction is that the value of the firm is affected by its capital structure because capital structure influences the manager's incentives to exert effort.¹⁴⁸ Such results suggest that forces other than contractual incentives may motivate agents and they show that empirical validation of the economics model of agency can be problematic.

Jensen and Meckling define agency in terms of contracts rather than duties: "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 authority to the agent."¹⁴⁹ According to Jensen and Meckling, the principal must bear monitoring expenses and provide incentives through the contract so as to align the agent's actions to the principal's goals.¹⁵⁰ The agent incurs bonding expenditures to guarantee that he will not harm the principal in the course of his agency.¹⁵¹ Even with monitoring and bonding expenses, the agent will generally undertake a course of action that will not maximize the principal's welfare, which generates some residual loss.¹⁵² Jensen and Meckling designate the sum of monitoring expenditures, bonding expenditures, and residual loss as agency costs.¹⁵³

2. Adverse Selection and Information Rents

The adverse selection model of agency captures the idea that agents may wish to misrepresent their abilities or preferences. If an agent wishes to exaggerate his cost of effort, for example, the principal must pay a premium, known as an information rent, to induce the agent to reveal that information truthfully.¹⁵⁴ In the adverse selection model, the principal pays

¹⁴⁵ See Michael C. Jensen and William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305 (1976).

¹⁴⁶ See *id.*

¹⁴⁷ See *id.*

¹⁴⁸ See *id.* at 305-360. Empirical validation of the economic model of agency is problematic. Jensen and Murphy show that "the pay-performance relation for [CEOs] indicate that CEO wealth changes \$3.25 for every \$1,000 change in shareholder wealth." Michael C. Jensen & Kevin J. Murphy, *Performance Pay and Top-Management Incentives*, 98 J. POL. ECON. 225 (1990). They conclude that their "results are inconsistent with the implications of formal agency models of optimal contracting. The empirical relation between the pay of top-level executives and firm performance, while positive and statistically significant, is small for an occupation in which incentive pay is expected to play an important role." *Id.* at 227. Such results suggest that forces other than contractual incentives may motivate agents.

¹⁴⁹ Jensen & Meckling, *supra* note 138, at 308.

¹⁵⁰ See *id.*

¹⁵¹ See *id.*

¹⁵² See *id.*

¹⁵³ See *id.*

¹⁵⁴ See, e.g., MICHAEL SPENCE, MARKET SIGNALING: INFORMATIONAL TRANSFER IN HIRING & RELATED SCREENING PROCESS (1974); David Baron & Roger Myerson, *Regulating and Monopolist with Unknown Costs*, 50 ECONOMETRICA 911 (1982); Roger Guesnerie & Jean-Jacques Laffont, *A Complete Solution to a Class of Principal-Agent Problems with Application to the Control of a Self-Managed Firm*, 25 J. PUB. ECON. 329 (1984); James A. Mirrlees, *An Exploration in the Theory of Optimum Income Taxation*, 38 REV. ECON. STUD. 175 (1971); Michael Mussa & Sherwin Rosen, *Monopoly and Product Quality*, 18 J. ECON. THEORY 301 (1978).

the agent to carry out a designated task without full knowledge of the agent effectiveness in performing the task. In contrast to the moral hazard model, the principal can observe the agent's effort. However, even if the principal knows with certainty how much effort the agent devotes to the task, the problem of designing an efficient contract remains because the principal cannot directly observe the agent's preferences.

Consider, for example, the case of a principal who contracts with an agent to perform some task. The agent may have either a low or a high personal cost of performing the necessary work.¹⁵⁵ The agent's cost of effort is said to be the agent's type, where a low cost of effort can be interpreted as a high level of skill and a high cost of effort represents low skill. The principal and the agent obtain gains from trade whether the agent has a low or a high skill level but the relationship has greater value if the agent has a high skill level.

The timing of events in the model is as follows. Nature plays first by selecting the agent's type. The agent learns his own type, but the principal and other third parties cannot observe it. The principal can observe everything else, including the agent's effort. As before, the contracting process includes offer and acceptance, with the principal making a take-it-or-leave-it offer to the agent. Since the agent is assumed to be opportunistic and his type is unobservable, both the low and high-cost agents have an incentive to claim to be high-cost agents, and therefore, the low-cost agent misrepresents his preferences. The adverse selection problem arises when the principal cannot distinguish between the two types of agents.

Similar to the moral hazard model of the principal-agent relationship, the goal of economists is to characterize the optimal contract. Optimality is always from the point of view of the principal because in the model she makes a take-it-or-leave-it offer to the agent. However, in practice, it is often the agent who states the terms under which the agent will represent a principal. A more general approach would allow for negotiation of the terms of the agency relationship.

Under adverse selection, the principal will offer not one contract, but a *menu of contracts* from which the agent will be allowed to choose. The agent will then choose the contract that best fits his interests. The principal designs the menu of contracts so that she will know the agent's preferences with certainty by observing the agent's choice from the menu. Thus, contracts are self-selecting and the agent ends up revealing his type. Each contract in the menu consists of payment and effort levels and is tailored to

¹⁵⁵ There are several interpretations for the agent's cost of effort or disutility of work. One often cited possibility is that the object of the agency is new to the agent and he needs to spend some time learning what he needs to do. The principal has to pay extra for the additional time that the agent needs to devote to the case. Another possibility is that the object of the agency is against some principle that the agent stands for. Now, the principal needs to pay him more to overcome the psychological cost of performing a task against the agent's principles. Notice that even if the agent knows well how to perform the task and even if the object of the agency does not go against any of the agent's principles, he may have an incentive to pretend that this is the case. Since the principal does not directly observe the agent's preferences (his real tastes and skill level), she needs create incentives that will lead the agents to reveal that information.

one of the agent's types. In the case of two types of agents, the contract written for the low-cost agent provides a large payment in exchange for a large effort, while the contract written for the high-cost agent has lower payment but also requires lower effort. If both contracts gave the same payment, both types of agent would choose the same contract, the one that required less effort. The high-cost agent gets the income he could get elsewhere in the market—his reservation utility—and the low-cost agent obtains informational rents — a level of income over and above the ongoing market rate.¹⁵⁶

There are several assumptions underlying the model. First, as in the moral hazard model, there is no context to contracting; an agent that misrepresents information suffers no social, psychological, legal, or market penalties. Second, the principal knows the population of possible agent types although she does not know the type of each individual agent. Third, the task to be performed by the agent is unidimensional and the high-cost agent is less efficient than the low-cost agent in all respects. Fourth, the principal can only provide incentives by use of written contracts; in particular, job design cannot be used to modify the agent's cost to perform the task. Fifth, the principal makes a take-it-or-leave-it offer and no negotiation is possible. Sixth, the model is static so there is no future to the relationship.¹⁵⁷

B. ABSENCE OF TRUST IN THE ECONOMIC MODEL OF AGENCY

Since the agent does not represent the principal in the transactions with third parties the agent in economic analysis exerts effort and deals with things, not persons. In this model of agency, the agent has no *fiduciary duties*; that is, the principal places no trust in the agent. Instead, she designs a *complete* contract to induce the agent to work hard enough or to accurately report his type. In addition, there is a very limited notion of *authority* because the principal does not actively control or monitor the agent.¹⁵⁸ The principal's role is limited to writing contracts that consist of a payment schedule.¹⁵⁹

¹⁵⁶ If information rents are too costly or if there are transaction costs of designing a complex menu, it is worthwhile for the principal to design a menu such that more than one type of agent chooses the same contract, a phenomenon known as *pooling*. Menus of contracts that induce agents to self select are called *separating*. See Ines Macho-Stadler & J. David Perez-Castrillo, *An Introduction to the Economics of Information: Incentives and Contracts* 190 (Oxford University Press, USA 2001).

¹⁵⁷ The adverse selection model has been extended to more than two types of agents and to allow the agent to signal his type before the principal makes the contract offer. See, e.g., JEFFREY BANKS, SIGNALING GAMES IN POLITICAL SCIENCE (1991); Paul Milgrom & John Roberts, *Prices and Advertising Signals of Product Quality*, 94 J. POL. ECON. 796 (1986); Stewart Myers *The Capital Structure Puzzle*, 39 J. FIN. 575 (1984); John G. Riley, *Informational Equilibrium*, 47 ECONOMETRICA 331 (1979); Stephen Ross, *The Determination of the Financial Structure: The Incentive Signaling Approach*, 8 BELL J. ECON. 23 (1977); Michael Spence, *Job Market Signaling*, 87 Q. J. ECON. 355 (1973).

¹⁵⁸ Because the agency contract as modeled in economics is complete, there is no need for the principal to provide interim instructions to the agent during the course of his agency.

¹⁵⁹ The modern formal treatment of the principal-agent relationship is essentially that of Stephen A. Ross. Economists have devoted little effort to relaxing Ross's original assumptions. See, e.g., Bengt Holmstrom, *Moral Hazard and Observability*, 10 BELL J. ECON. 74 (1979); Jensen and Meckling, *supra*

1. *Origins of the Economic Model of Agency*

The history of the economic model of agency sheds light on why the economic approach differs so markedly from the concept of agency in law and business. The origin of the economic model of agency lies in the analysis of labor contracts in agrarian economies, most notably sharecropping.¹⁶⁰ The neoclassical economics view of the firm as manufacturer also influences the agency model, with the agent as a worker performing production tasks. Extension of the agency model to applications in which agents are managers, accountants, or salespersons has had little effect on the form of the model.¹⁶¹

The different economic arrangements by which sharecropping and land tenancy are organized have drawn economists' attention for more than two hundred years. Economists' discussions of sharecropping help explain why they view agents as producers rather than intermediaries and sheds light on the economic analysis of agency contracts. There are a number of standard alternative contractual arrangements that may exist between a landowner and a tenant farmer. The landowner can hire the farmer at a fixed wage, the farmer can pay a fixed rent to the landowner, or the farmer can pay the landowner a share of the agricultural production. The system of sharing output between a land owner and a tenant is known as sharecropping or share tenancy. Fixed-rent tenancy was the dominant system in England while share tenancy or *metayage* was pervasive in France.¹⁶² Under fixed-rent tenancy the worker pays the owner of the land a fixed amount that is independent of the output actually produced. Under share tenancy rent is paid from the share of output produced from the rented land. Thus, the worker gets a proportion of the output he produces. *Metayage* literally means "splitting in half."

Adam Smith and John Stuart Mill studied the relative merits of the different lease-hold systems employed in England and France.¹⁶³ Smith identified the incentive effects of share tenancy in comparison with fixed

note 138;; Steven Shavell, *Risk Sharing and Incentives in the Principal and Agent Relationship*, 10 *BELL J. ECON.* 55 (1979).

¹⁶⁰ See Keijiro Otsuka, Hiroyuki Chuma & Yujiro Hayami, *Land and Labor Contracts in Agrarian Economies: Theories and Facts*, 30 *J. ECON. LIT.* 1965 (1992) (presenting a comprehensive overview of the literature that relates the existing theory of agency with an empirical examination of agrarian contracts).

¹⁶¹ The prototypical example in this literature is that of a salesperson. The employer (principal) cannot observe how much effort the salesperson (agent) devotes to promote and sell the product. What the principal can observe, though, is the number of units sold. It is reasonable to assume that on average the more units the salesperson sells, the more effort he is devoting to promotion and sale of the product. The optimal contract will specify a commission rate per unit sold. Note that the agent may get lucky: sales may be high for some exogenous reason not related to his effort to sell, for example, a competitor going out of business. Notice that the sales person devotes effort but does not engage in more complex activities such as negotiation, price setting, and binding the principal to contracts. [this footnote may need cites to sources within it]

¹⁶² See STEVEN N.S. CHEUNG, *THE THEORY OF SHARE TENANCY: WITH SPECIAL APPLICATION TO ASIAN AGRICULTURE AND THE FIRST PHASE OF TAIWAN LAND REFORM* 32-33 (1969).

¹⁶³ See generally JOHN STUART MILL, *PRINCIPLES OF POLITICAL ECONOMY AND CHAPTERS ON SOCIALISM* (Jonathan Riley ed., Oxford Univ. Press 1998) (1848); ADAM SMITH, *AN INQUIRY INTO THE NATURE AND CAUSES OF THE WEALTH OF NATIONS*, [Dublin: Whitestone, 1776], Regnery Publishing, 1998, pp. 439-440.

rents. He observed that when produce was divided equally between the proprietor and the farmer, the tenants “have a plain interest that the whole produce should be as great as possible, in order that their own proportion may be so.”¹⁶⁴ Yet Smith expressed distrust of share tenancy because he claimed that the tenant would be reluctant to employ his own capital on the farm:

It could never, however, be the interest even of this last species of cultivator to lay out, in the further improvement of the land any part of the little stock which they might save from their own share of the produce, because the lord, who laid out nothing, was to get one-half of whatever it produced.¹⁶⁵

Share tenancy, while prevalent in France and lingering in some parts of Scotland, had been replaced in England by farmers paying a “rent certain” to the landlord. When farmers paying a fixed rent have a lease for a term of years, “they may sometimes find it in their interest to lay out part of their capital in the further improvement of the farm.”¹⁶⁶

Alfred Marshall was the first to formalize the efficiency implications of each of the two contractual arrangements.¹⁶⁷ As Marshall prophetically observed, “[t]here is much to be gained from a study of the many various plans on which the share contract is based.”¹⁶⁸ Like Smith, Marshall argues that fixed-rent leasehold tenancy is superior to share contracts. According to Marshall, if the tenant’s work effort cannot be observed and monitored by the landlord, then share tenancy results in inefficient resource allocation because the worker receives only a fraction of his marginal cost of effort as his marginal revenue.¹⁶⁹ Marshall’s analysis effectively frames modern economic literature on contracts. His prediction that sharing of output results in inefficient effort is essentially the theme of moral hazard that pervades the economic theory of agency.

D. Gale Johnson models the incentives of the share cropper to devote labor to cultivation, noting that “three-fourths of all rented agricultural land is leased under share contracts.”¹⁷⁰ Johnson considers the effect of allowing the tenant to choose how much land to rent from the landlord and concludes that the alleged inefficiencies of sharecropping are mitigated or even eliminated.¹⁷¹ Steven N. S. Cheung adds that the landowner can enhance incentives for tenant performance by varying the allocation of land to tenants.¹⁷² Comparing short-term and long-term leases, Cheung conjectures that “short-term leases are chosen more as a device to facilitate contractual renegotiation than as a device to reduce the costs of enforcing

¹⁶⁴ SMITH, *supra* note 155, at 439-40.

¹⁶⁵ *Id.* at 440.

¹⁶⁶ *Id.* at 441.

¹⁶⁷ See ALFRED MARSHALL, *PRINCIPLES OF ECONOMICS* (8th ed. Macmillan & Co. 1964) (1890).

¹⁶⁸ *Id.* at 535 n.2.

¹⁶⁹ See ALFRED MARSHALL, *PRINCIPLES OF ECONOMICS* 535 (Macmillan & Co. 1956) (1920).

¹⁷⁰ D. Gale Johnson, *Resource Allocation under Share Contracts*, 58 J. POL. ECON. 111, 111 (1950).

¹⁷¹ *See id.* at 114.

¹⁷² See CHEUNG, *supra* note 162, at 25.

the contracted terms.”¹⁷¹ This suggests the possible presence of trust in long-term contracts.

Perhaps the earliest version of the principal-agent model was given by Marvin Berhold, who anticipated many of the major theoretical results in agency theory.¹⁷³ He also incorporated earlier work on wage incentive systems and labor unions.¹⁷⁴ In Berhold’s framework, a principal designs incentives to motivate an agent to make an “appropriate decision.”¹⁷⁵ He restricts his attention to linear profit-sharing incentives composed of a fixed reward and sharing ratio.¹⁷⁶ Berhold derives the contract that maximizes the principal’s profit such that the agent will accept the contract and the agent will make a decision based on the contract.¹⁷⁷ Assuming that both the principal and the agent are risk averse, Berhold identifies the interaction between risk-sharing and performance incentives for the agent.¹⁷⁸

Although later than Berhold, the work of Stephen A. Ross is generally regarded as initiating the study of agency in economics, most notably in his 1973 article, *The Economic Theory of Agency: The Principal’s Problem*.¹⁷⁹ Building on the ideas of sharecropping and labor contracts in agrarian economies, Ross lays the foundation for the general moral hazard economic model of agency.¹⁸⁰ In technical terms, Ross’s model is more general than Berhold’s because he does not restrict contracts to linear incentive schedules.¹⁸¹ Ross correctly asserts that “an agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as representative for the other, designated the principal.”¹⁸² However, Ross models only the bilateral relationship between the principal and an agent who exerts effort at some task.¹⁸³ The canonical moral hazard model of agency posed by Ross has the following form: the principal chooses a fee schedule to maximize her own expected payoff subject to the constraints that the agent must want to participate in the relationship (given his other opportunities) and must be willing to choose the action that is best

¹⁷³ See Marvin Berhold, *A Theory of Linear Profit-Sharing Incentives*, 85 Q. J. ECON. 460 (1971) [hereinafter Berhold, *Linear Profit Sharing*]; Marvin A. Berhold, *An Analysis of Contractual Incentives* (1967) (unpublished Ph.D. dissertation, University of California, Los Angeles).

¹⁷⁴ See, e.g., ALEX RUBNER, *FRINGE BENEFITS* (1962); WILLIAM FELLNER, *COMPETITION AMONG THE FEW* (1949); Peter B. Clark & James Q. Wilson, *Incentive Systems*, 6 Admin. Sci. Q. 129 (1961).

¹⁷⁵ Berhold, *Linear Profit Sharing*, *supra* note 154 at 461.

¹⁷⁶ *See id.*

¹⁷⁷ *See id.*

¹⁷⁸ *See id.*

¹⁷⁹ Stephen A. Ross, *The Economic Theory of Agency: The Principal’s Problem*, 63 AMER. ECON. REV. 134 (1973) [hereinafter Ross, *The Principal’s Problem*]. See also Stephen A. Ross, *On the Theory of Agency and the Principle of Similarity*, in *ESSAYS ON ECONOMIC BEHAVIOR UNDER UNCERTAINTY* 215 (Michael Balch, Daniel McFadden & S. Wu eds., 1974) [hereinafter Ross, *The Principle of Similarity*].

¹⁸⁰ See Ross, *The Principal’s Problem*, *supra* note 171.

¹⁸¹ *See id.*

¹⁸² *Id.* at 134.

¹⁸³ *See id.* Richard Zeckhauser is perhaps the earliest introduction of a formal analysis of moral hazard, following earlier discussions by Mark V. Pauly and Kenneth J. Arrow. He examines the choice of medical expenditures by patients who have an insurance policy that reimburses a proportion of expenditures. See Michael Spence & Richard Zeckhauser, *Insurance, Information and Individual Action*, 61 AMER. ECON. REV. PAPERS & PROC. 380 (1971). See also Kenneth J. Arrow, *The Economics of Moral Hazard: Further Comment*, 58 AMER. ECON. REV. 537, 538 (1968); Mark V. Pauly, *The Economics of Moral Hazard: Comment*, 58 AMER. ECON. REV. 531.

from the principal's point of view.¹⁸⁴ Assuming an absence of trust, Ross adds: "the problem of the fiduciary or the financial intermediary is fundamentally a problem in the theory of agency."¹⁸⁵

Not surprisingly perhaps, the formal economic model of principal and agent and the historical antecedent of the sharecropping example are quickly reunited in the economics literature. Joseph Stiglitz rationalizes the use of share contracts in a situation where the tenant's effort cannot be costlessly monitored as a risk sharing device: when the agent is risk averse, risk sharing between tenant and landlord may be beneficial.¹⁸⁶ With a fixed wage rate, achieving efficiency requires that a worker's effort be perfectly monitored.¹⁸⁷ Interestingly, Stiglitz draws a parallel between sharecropping and modern corporation, noting that investors and the entrepreneur who establishes the firm receive a share of profits.¹⁸⁸ Because the entrepreneur can divest the shares, it is necessary for the owners of the firm to devise more complex contractual arrangements to maintain incentives that avoid conflicts of interest and alleviate the effects of inside information available to the entrepreneur.¹⁸⁹ The economic model of agency thus returns to its agrarian roots in sharecropping.¹⁹⁰

2. *Absence of trust in the economic model of agency.*

The reliance on explicit contractual incentives in the economic model of agency eliminates trust from the analysis. In the moral hazard setting, the agent incurs a cost of effort and has no other incentive to devote effort to the task at hand. In the adverse selection setting, the agent has no incentive to reveal private information or perform a task for the principal. Because there is no social, legal, or market-related motivation to devote effort to a task or to disclose information, the economic model predicts that the principal places no trust in the agent and the agent does not behave in a trustworthy fashion.

The absence of trust in the economics of agency reflects the common assumption in economics that trust behavior is irrational.¹⁹¹ Such a view is most clearly expressed by Oliver Williamson, who defines opportunism as "self-interest seeking with guile."¹⁹² He maintains that parties to a transaction will seek to take advantage of each other by not revealing private information or by breaching the contract whenever it is to their

¹⁸⁴ See Ross, *The Principle of Similarity*, *supra* note 171, at 216-21.

¹⁸⁵ *Id.* at 216.

¹⁸⁶ See Joseph E. Stiglitz, *Incentives and Risk Sharing in Sharecropping*, 41 *REV. OF ECON. STUD.* 219 (1974).

¹⁸⁷ See *id.* A classic study of moral hazard by James A. Mirrlees, originally completed in October 1975, states that the same issues arise in sharecropping, agency, incentive systems and pay structures, and capital markets. See James A. Mirrlees, *The Theory of Moral Hazard and Unobservable Behaviour: Part I*, *REV. ECON. STUD.* 3 (1999).

¹⁸⁸ See Stiglitz, *supra* note 178, at 252.

¹⁸⁹ See *id.* at 253.

¹⁹⁰ See *id.*

¹⁹¹ Pauly's view that rational economic behavior and moral perfidy are mutually exclusive influenced Steve Ross's model of agency. See Pauly, *supra* note 175.

¹⁹² OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* 140 (1985) [hereinafter WILLIAMSON, *ECONOMIC INSTITUTIONS OF CAPITALISM*].

personal advantage to do so, provided that it is difficult to prove such transgressions to a court.¹⁹³ Williamson argues that trust must be excluded from economic models: “[I]t is redundant at best and can be misleading to use the term ‘trust’ to describe commercial exchange for which cost-effective safeguards have been devised in support of a more efficient exchange. Williamson claims that “calculative trust is a contradiction in terms.”¹⁹⁴ He argues that if a principal finds it rational to rely on an agent, the situation cannot be described as trust.¹⁹⁵ If p is the probability that the agent makes the decision that is to the best interest to the principal, G is the gain the principal obtains if the agent makes the right decision, and L is the loss to the principal if the agent does not honor trust, then the principal will rely on the agent if the principal expects to benefit from doing so, that is, $pG + (1-p)L > 0$.¹⁹⁶ For Williamson, this type of calculation should not represent trust.

However, as we have emphasized, trust involves much more than the outcome of a cost-benefit analysis. The actions of the principal and agent are based on their expectations of the actions of the other party in the relationship. Thus, contrary to Williamson’s views, this suggests that implicit incentives resulting from context will affect the equilibrium actions

¹⁹³ See OLIVER E. WILLIAMSON, *MARKETS AND HIERARCHIES: ANALYSIS AND ANTITRUST IMPLICATIONS* (1975); Oliver E. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.LAW & ECON. 233 (1979); OLIVER E. WILLIAMSON, *THE ECONOMIC INSTITUTIONS OF CAPITALISM* (1985). Governance structures such as contracts and organizations are defined as “the institutional framework within which the integrity of a transaction is decided” or “the institutional matrix within which transactions are negotiated and executed.” Oliver E. Williamson, *Transaction Cost Economics: The Governance of Contractual Relations*, 22 J.LAW & ECON. 233, 234-35 (1979).

¹⁹⁴ See Oliver E. Williamson, *Calculativeness, Trust, and Economic Organization*, 36 J. LAW & ECON. 453, 463 (1993). According to Williamson, there are three types of trust: calculative, personal, and hyphenated. See *id.* at 453. *Personal trust* is the kind of trust that emerges in close personal relationships such as those between friends and family. See *id.* at 484. It is based on three principles: the trusting person must consciously refuse to monitor the trustee, the trusting person must be predisposed to ascribe good intentions to the trustee when things go wrong, and the trusting person must treat the trustee in a discrete structural way. See *id.* at 483-84. There is no calculativeness involved in personal trust. See *id.* at 483. In Williamson’s view, this type of trust is reserved for very special relations, and cannot arise in commerce. See *id.* In his view, personal trust would be irrational and absurd in commercial dealings. See *id.* Williamson further asserts that personal and calculative trust are incompatible because calculativeness will damage personal relationships. See *id.* at 485. According to Williamson, personal trust “is warranted only for very special personal relations that would be seriously degraded if a calculative orientation were ‘permitted.’ Commercial relations do not qualify” *Id.* at 486. Because Williamson assumes that personal trust cannot arise in commerce, he recommends that it not be represented in formal models of economic phenomena. See *id.* at 485. *Hyphenated trust* refers to the effect of the cultural and institutional contexts within which transactions take place. See *id.* at 486. The idea here is that context constrains the acts of agents, principals, and third parties. See *id.* Williamson distinguishes six kinds of contextual variables: societal culture, politics, regulation, professionalization, networks, and corporate culture. See *id.* at 477-78. According to Williamson, because in economics these contextual variables are taken as given, economists should not be concerned about hyphenated trust. See *id.* at 486. Williamson concludes that because, *given an institutional context*, agents act in a calculative way, such rationality is presumably the only type of behavior that should matter in an economic model. See *id.* at 486. Our analysis disagrees with that of Williamson in a number of respects.

¹⁹⁵ By the term calculative trust, Williamson seems to mean simply that individuals act rationally and decide to take a risk. See Williamson, *supra* note 186. See also TRUST: MAKING AND BREAKING COOPERATIVE RELATIONS (Diego Gambetta ed., 1988); JAMES S. COLEMAN, *FOUNDATIONS OF SOCIAL THEORY* (1990).

¹⁹⁶ See COLEMAN, *supra* note 187, at 99.

of the principal and agent.¹⁹⁷ Richard Craswell's critique of Williamson emphasizes that trust *as behavior* should be distinguished from trust *as cause of behavior*.¹⁹⁸ Craswell rightly points out that using trust as an *explanans* is problematic because it involves "a cognitive 'leap' beyond the expectations that reason and experience alone would warrant: where opportunism might be expected, trust prevails."¹⁹⁹ Rather trust should be the *explanandum* in economic models of agency. This relationship between trust and economic, legal, and political institutions has been considered in a growing literature.²⁰⁰

Trust as behavior represents rational equilibrium strategies: principals trust agents and agents behave in a trustworthy fashion, with the expectations of both parties justified by equilibrium actions of the other party. Thus, trust involves actions of the principal that rely on agent performance and actions of the agents that anticipate the principal's trust. By defining trust as behavior, it is no longer necessary to categorize types of trust based on various causes of trust behavior. Rather, the causes of trust can properly be regarded as incentives for trust behavior by agents and principals. Incentives for trust can be identified by examining contextual effects. The resulting trust behavior is generic in that similar types of trust behavior can result from different types of incentives, whether contractual, social, legal or market-based. Thus, agents acting in accord with the principal's interests or reporting information accurately to the principal can result from different types of incentives. This approach allows for the study of trust that distinguishes between incentives for trust and the resulting actions of agents and principals.

C. THE ECONOMIC MODEL OF AGENCY OVERSTATES THE TRANSACTION COST OF CONTRACTING

In the economic model of agency there are no explicit costs of negotiating and designing the contract, so there appear to be no transaction

¹⁹⁷ Richard Craswell points out that trust involves more than a game against nature, since there is interaction with other people. See Richard Craswell, *On the Uses of "Trust": Comment on Williamson, Calculativeness, Trust, and Economic Organization* 36 J. LAW & ECON. 487, 491 (1993). See also COLEMAN, *supra* note 187, at 91.

¹⁹⁸ See Craswell, *supra* note 189, at 492.

¹⁹⁹ *Id.* at 492 (quoting Jeffrey L. Bradach & Robert G. Eccles, *Price, Authority, and Trust: From Ideal Types to Plural Forms*, 15 ANN. REV. SOC. 97, 104 (1989) and J. D. Lewis and A. Weigert, *Trust as a Social Reality*, 63 SOC. FORCES 967 (1985)).

²⁰⁰ See generally Terence Burnham, Kevin McCabe, and Vernon L. Smith, *Friend-or-Foe Intentionality Priming in an Extensive Form Trust Game*, 43 J. ECON. BEHAV. & ORG. 57 (2000); Yongmin Chen, *Promises, Trust, and Contracts*, 16 J. LAW ECON. & ORG. 209 (2000); Jeffrey H. Dyer & Wujin Chu, *The Determinants of Trust in Supplier-Automaker Relationships in the U.S., Japan, and Korea*, 31 J. INT'L BUS. STUD. 259 (2000); Rene Fahr & Bernd Irlenbusch, *Fairness as a Constraint on Trust in Reciprocity: Earned Property Rights in a Reciprocal Exchange Experiment*, 66 ECON. LETTERS 275 (2000); Edward L. Glaeser, David Laibson, Jose A. Scheinkman & Christine L. Soutter, *Measuring Trust*, 115 Q. J. ECON. 811 (2000); Fergus Lyon, *Trust, Networks and Norms: The Creation of Social Capital in Agricultural Economies in Ghana*, 28 WORLD DEV. 663 (2000); Fiona McGillivray & Alastair Smith, *Trust and Cooperation through Agent-Specific Punishments*, 54 INT'L ORG. 809 (2000); Dean A. Shepherd & Andrew Zacharakis, *The Venture Capitalist-Entrepreneur Relationship: Control, Trust and Confidence in Co-operative Behavior*, 3 VENTURE CAP. 129 (2001).

costs.²⁰¹ The task of the agent is simplified as the choice of effort or some other basic indicator rather than more complex tasks such as, interaction with a third party. There are either few possible states of nature or, if many states are allowed, they are described by a simple range of values. Because the states of the world are simple shocks, the principal can easily list all future contingencies and the principal has no difficulty writing down the optimal course of action in every possible state of the world. Contract drafting costs and negotiation costs are assumed to be zero. Language is finely grained enough to describe contingencies in full detail and communicate to the agent exactly what needs be done in every contingency.²⁰² Further, the principal is a specialist on the task to be performed by the agent, she knows what must be done in every possible set of circumstances.

Paradoxically, even though the economic model of agency assumes away explicit costs of negotiation and contract design, the model nonetheless manages to overstate transaction costs. The economic model of agency demonstrates the existence of behavioral inefficiencies in the form of moral hazard and adverse selection. These behavioral departures from an efficient standard result in agency costs, which are transaction costs for the principal and agent.

The economic model of agency effectively overstates transaction costs by emphasizing moral hazard and adverse selection problems. Because the agent has no other motivation to devote effort to the task, the principal relies on explicit incentives. However, the contractual incentives must perform a double duty, stimulating effort and compensating the agent. As already noted, there is a tradeoff because of the agent's aversion to risk, so that the contract is necessarily imperfect, tolerating some level of shirking. This is the classic problem of performing two tasks with a single instrument. The practical solution to the problems of shirking and misrepresentation of information is to motivate the agent with additional incentives, including social, legal, and market forces.

In addition, the contract designed by the principal must be relationship-specific since it is based on the preferences and other characteristics of the principal and the agent. In the moral hazard problem for example, the form of the contract is affected by the degree of risk aversion of the agent, the opportunity cost of the agent, the agent's marginal cost of effort, and the expected productivity of the agent's effort. Relationship-specific contracts raise the costs of forming contracts because a different contract must be designed for each principal-agent relationship. In practice, relationship-specific contracts are costly to implement because they require detailed knowledge of the characteristics of the principal and agent. This is

²⁰¹ The concept of transaction cost was first introduced in economics by Ronald H. Coase. See *The Nature of the Firm*, 4 *ECONOMICA* 386 (1937). Transaction costs are the costs associated with using a specific method of governance to conduct transactions. For example, the transaction costs of conducting an arms-length market transaction include: finding transacting parties, communicating, negotiating, forming and monitoring contracts, and enforcing performance. *Id.*

²⁰² See Nabil Al-Najjar, Ramon Casadesus-Masanell & Emre Ozdenoren, *Probabilistic Representation of Complexity*, 111 *J. ECON. THEORY* 49 (2003).

particularly a problem when the principal and agent are strangers and are not involved in long-term transactions. Moreover, relationship-specific contracts reduce flexibility by making it more difficult to switch to new transaction partners or design auctions for contracts.

Finally, the economic model of agency relies exclusively on explicit contractual incentives and ignores the social, legal, and market contexts of the agency relationship. The principal creates a governance mechanism that provides the agent with ex ante incentives for performance. Because trust is assumed away, written contracts have to describe every possible future contingency and associated payments (or penalties) to the agent.²⁰³ In practice, there are likely to be high transaction costs associated with the design, negotiation, and enforcement of complete contingent contracts. Moreover, the economic approach does not apply to situations in which the principal-agent relationship does not rely at all on a formal contract.²⁰⁴

VI. CONCLUSION

Our discussion shows that the social, legal, and market contexts of agency relationships provide incentives for agents to perform their duties of service and loyalty. These implicit incentives permit delegation of authority, thereby allowing agents to act as intermediaries. Moreover, these implicit incentives provide the context for any explicit incentives for performance offered by the principal to the agent. Social norms set standards of behavior that encourage most agents to perform their duties of service and loyalty to principals. Social norms are also reflected in the codification and interpretation of the legal rules of agency. The law of agency spells out the duties of agents and the remedies for breach of duty that induce most agents to serve the interests of principals and report information truthfully. In the context of social norms and legal rules, markets provide more specific standards for the behavior of agents that are enforced by reputation effects and admission to market networks. These three forces improve efficiency by reducing the transaction costs of agency.

Our analysis resolves the puzzle of why fiduciary standards differ across legal doctrines. In corporate law, for example, where market forces predominate in motivating managers (such as the market for executives and the market for corporate contract) there is correspondingly less emphasis on explicit incentives, social norms, or legal remedies. Here we see deference to managers under the business judgment rule. In the case of sales agents or purchasing agents, there is greater emphasis on explicit incentives such as commissions and market pressures to perform, and correspondingly less reliance on social norms and legal remedies. Trustees who manage assets for beneficiaries are held to high legal standards of loyalty and care since there is relatively less scope for explicit contractual

²⁰³ See Nabil I. Al-Najjar & Ramon Casadesus-Masanell, *Trust and Discretion in Agency Contracts*, Harvard Bus. Sch., Working Paper No. 02-015, 2002), (investigating the circumstances under which fully incomplete contracts are optimal). The paper introduces an agency model with moral hazard where sufficient trust and complexity imply that the optimal arrangement entails no formal written contract.

²⁰⁴ See *id.*

incentives and market forces to encourage trust. In the case of family relationships, including acting for a relative under power of attorney, social norms dominate incentives, since explicit incentives and market forces do not apply.

More generally, our analysis resolves the puzzle of why there are social, legal, and market incentives when the parties can rely on explicit contractual incentives. Alternatively, why have explicit incentives if social, legal, and market incentives promote trust? Multiple types of incentives might appear to be redundant or even in conflict with each other. The answer is that all types of incentives are imperfect, so that diverse incentives can work together.

By the very nature of agency, monitoring is costly and detecting a breach of duty is imperfect. Even if a breach of duty is detected by a principal, it can be difficult to establish legal proof of negligence or malfeasance. Legal rules such as disgorgement limit the agent's liability so that expected penalties create inefficient incentives. Limited liability of agents complicates legal remedies, so that social and market sanctions serve to strengthen remedies. Moreover, legal remedies entail legal fees, court costs and other transaction costs. Social and market sanctions can be brought to bear even if legal remedies are not available or desirable. Conversely, social pressures are imperfect due to their informal nature. Also, market penalties may be limited for some agents who are not seeking repeat business or are not concerned about their reputation. For a significant breach of duty, legal remedies provide sanctions where social and market pressures are less effective.

Finally, explicit contractual incentives have substantial limits. Some types of agency relationships do not involve formal contracts. When an agency relationship involves contracts, there can be substantial transaction costs of writing contingent contracts. Substantial reliance on explicit incentives can shift risk to agents, which requires principals to compensate agents for the risk that they bear. Reliance on explicit incentives also requires costly monitoring and evaluation of performance. By relying in part on implicit incentives, principals and agents can simplify the process of forming the relationship and reduce the need for monitoring performance. Accordingly, principals may choose to limit explicit contractual incentives for performance, relying instead on the legal, social and market context. One might argue that the presence of ex post penalties (including legal remedies) has a deterrent effect and therefore is functionally equivalent to the ex ante incentive schedules so prevalent in economic analyses. However, the qualitative difference is important. In economic theory, the agent is assumed to be untrustworthy in the absence of explicit incentives. However, the law provides remedies to the principal and corresponding penalties to the agent if the agent does not behave in a trustworthy fashion. The incentive deriving from the legal penalty is presumably only binding some of the time if agents tend to behave in a trustworthy fashion, while in the economic model of agency explicit incentives are necessarily binding on the rational agent. Thus, the

difference is more than that between the carrot and the stick, because some agents would choose to perform their fiduciary duties even in the absence of the potential penalty.

Implicit incentives from social relationships, agency law, and market networks allows for the formation of agency relationships in which the formal agreement is mere housekeeping. This helps explain the great variety of agency relationships, in which agents work in some cases without formal compensation, in others for a fixed wage, and still in others for a percentage commission. The implicit incentives for trust explain the simplicity of agency agreements, even when agents perform complex tasks.

The role of agents as intermediaries serves to define agency law. Implicit and explicit contractual incentives have complementary effects in agency relationships. While recognizing the importance of explicit agreements between principals and agents, the Restatement (Third) of Agency in Law rightly continues to recognize the context of agency relationships.²⁰⁵ Trust and explicit incentives share the responsibility of promoting efficient performance in agency. Because of their nature as intermediaries, agents must be fiduciaries. Agents need to exercise independence in making decisions and negotiating contracts. Principals and third parties must trust that the agent represents the interests of the principal and reports information accurately.

Economic discussions of agency generally have neglected the duties of service and loyalty. Economic models of agency, by focusing on productive effort and revelation of information, have tended to miss the role of agents as representatives and decision makers. Even if payments to agents are not tied explicitly to performance, implicit incentives for trust often motivate agents to act in the interests of principals. Thus, even with fixed payments, agents may provide effort and communicate information truthfully. The influence of economic models of agency should be tempered by recognizing that contract design without the legal, social, and economic contexts is unlikely to resemble contracts in practice. Models of agency that neglect implicit incentives are likely to be a faulty guide for courts,

legislatures, and regulatory agencies. Economic models can generate more accurate predictions by integrating the legal, social, and market contexts of agency contracts.

²⁰⁵ RESTATEMENT (THIRD) OF AGENCY, § 1.03 cmt. e.

