

**COMMON AGENCY:
NEW MODELS FOR STRATEGY AND ORGANIZATION?**

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ABSTRACT (68 words)

This paper reviews and evaluates common agency's theoretical contributions in light of strategy and organization theory. The paper suggests areas in which strategy and organization theory might gain theoretical elaboration from common agency theory, and offers several novel propositions relevant to management-stakeholder relationships. Finally, the paper proposes several operationalizations of the propositions' constructs, and suggests ways in which these propositions might be tested empirically.

INTRODUCTION

While strategy and organization theorists (e.g., Evan & Freeman, 1983; Hill & Jones, 1992; Beatty & Zajac, 1994—more, and maybe take out E&F, H&J?) have certainly recognized the utility of the bilateral principal-agent models described by the classic works of agency (Jensen & Meckling, 1976; Fama, 1980; Fama & Jensen, 1983a&b; Holmstrom and some other normative stuff), they have not yet taken advantage of the multilateral models described by the common agency literature (Bernheim & Whinston, 1986; Martimort, 1996; Laffont & Martimort, 1997). Bernheim & Whinston suggest that while “[the] bilateral principal-agent model...provides a highly flexible framework for studying a variety of important economic phenomena...frequently....the action chosen by a particular individual (the agent) affects not just one, but several other parties (the principals), whose preferences for the various possible actions typically conflict. We refer to such situations as ‘common agency’.” (p. 923, their emphasis). The relevance of these situations to those between management and its stakeholders (competitors, suppliers, buyers) is clear: the actions chosen by managers generally affect not one, but multiple, stakeholder groups, and the actions these groups prefer for managers often differ. In an effort to evaluate the theoretical contributions made by common agency theory, and for the purposes of potentially providing new, empirically-testable models for strategy and organization theory, we review the common agency literature and propose several propositions relevant to the study of management-stakeholder relations.

BACKGROUND

Many discussions of common agency in the economics literature closely resemble those of stakeholder theory in the management literature. In the introduction to their latest contribution to common agency research, Laffont and Martimort (1997) write, “The firm is

often characterized as a nexus of both explicit and implicit contracts linking the management and its different stakeholders, including claimholders, workers, unions, customers, suppliers, and the state, among others.” (p. 201). (put in similar quote from Freeman? i.e., Edward Freeman, the arguable originator of stakeholder theory, similar describes the firm as “”). Ignoring any theoretical development in the stakeholder literature of these relationships, however limited it may be, Laffont and Martimort (1997) further comment that “It is striking that very little theoretical work has been devoted to the analysis of the interactions between such contracts [between the firm and its stakeholders].” (p. 201). Certainly, the origins and theoretical focus of common agency theory and stakeholder theory—and much of strategy and organization theory in general--differ. Thus the theoretical work of common agency theory highlights several areas in which strategy and organization theory might direct its attention.

Common agency theory stems from a desire among economists to address certain situations not covered by standard (economic) incentive theory—namely, those in which a given principal is forced to contract on only a subset of a given agent’s activities given “constrained communication” (find cite, page number) with other principals who contract for the rest of the agent’s activities (Figure 1). Within “constrained communications”, strategy and organization theorists and researchers might include issues of power, collective action, and strategic behavior. Common agency theory’s ubiquitous example is that of the manufacturer who contracts with a retailer who also sells other manufacturers’ products (Bernheim & Whinston, 1985, 1986; Martimort, 1996). These retailers are common agents.

Insert Figure 1 about here

Exclusive retailers and non-exclusive, or common, retailers are characterized by very different information structures, contractual opportunities for each competing manufacturer-retailer hierarchy, costs of providing incentives, and levels of competition, faced by both principals and agents. An exclusive retailer is required to serve only the manufacturer by whom he is hired. A common retailer is instead responsible to each of the several manufacturers with whom he contracts. Manufacturers face an incentive problem because retailers observe characteristics of the demand for and/or the costs of selling the manufacturer's product that the manufacturer does not observe (Martimort, 1996). Similarly, stakeholders are often at a relative information disadvantage with respect to managers, as managers observe the demands of all stakeholders, while individual stakeholders may only be informed of their own.

(Unless leads to a proposition—like delegated leads to stronger relationships for each of our propositions than does intrinsic, in which case we could put this at the end, after the other propositions--leave out the following?:)

Bernheim and Whinston (1986) provide an additional insight into common agency relationships which is of particular relevance to stakeholder theory. In their seminal contribution to common agency theory, Bernheim and Whinston (1986) distinguish between delegated and intrinsic agency. Delegated common agency arises when several parties voluntarily and independently bestow the right to make certain decisions upon a single (common) agent. Delegated agency is thus the agency represented in the relationships described above between manufacturers and retailers. Intrinsic common agency arises instead when “an individual is ‘naturally’ (i.e., not voluntarily and not independently) endowed with the right to make a particular decision affecting other parties, who may in turn attempt to influence that decision.” (Bernheim & Whinston, 1986: 924, our parentheses). Intrinsic common agency thus resembles the relationship found between many stakeholders and managers: communities do not choose to

entrust decisions to firm managers, but find themselves subject to these managers' decision-making activities. In response, communities often attempt to influence these managers' resource allocations.

In cases of common agency, multiple principals could benefit from sharing information, or other forms of mutual cooperation. When principals do act collectively, application of the bilateral agency framework (treating the set of principals as a single entity) is appropriate. Cooperation between principals is, however, often unlikely (given lack of communication or the gains to be had from being the first to break collusive agreements) or impossible (given legislative proscription). The choice of incentive schemes for common agents is then a noncooperative activity. Agents earn rents on their superior information, relative to principals, in these noncooperative games (Laffont & Martimort, 1997). Principals design contracts meant to minimize agent rents while at the same time providing an incentive that draws the agent's focus away from other principals' contracts. While stakeholder theory similarly recognizes the firm as the center of a constellation of constituencies that have an interest in the operations of the firm, and emphasizes the role of managers in balancing these different stakeholder interests (e.g. Evan & Freeman, 1983; Donaldson & Preston, 1995; Jones, 1995a), little stakeholder work expressly addresses the issue of information-sharing or other forms of cooperation among stakeholder groups (Rowley, 1997). Related work in ethical rule-building for managerial decision-making is similarly limited to the stakeholder-manager relationship (e.g. Donaldson & Dunfee, 1994), rather than information-sharing between stakeholders. (more contrast between what exists in strategy and organization theory—not just stakeholder theory—and common agency? i.e., emphasis on information, non-cooperative activity? Need to fill out this theory section a bit more, although it's close to long enough)

DEVELOPMENT OF RESEARCH PROPOSITIONS

(follow format of AMR theory paper)

Recently, however, researchers have begun to explore how interaction among stakeholders affects their relationships with management (Figure 2). Rowley (1997) (add non-stakeholder cites—need to look for other papers that do this! Network stuff? Make this less specific to Tim’s work, or review several examples) explicitly models stakeholder interaction using network analysis. While his propositions are based on a synthesis of resource dependence and institutional theory, their implications for stakeholder relationships are quite similar to those of common agency theory. While common agency models suggest that interaction (information-sharing) between principals enables them to expropriate rents from agents, Rowley proposes that interaction between stakeholders (measured by the density of stakeholder ties) shifts the balance of power from managers to stakeholders. While Rowley suggests that interaction enables the diffusion of shared expectations, he also emphasizes the informational advantages of network centrality. The latter corresponds directly to common agency’s emphasis on information asymmetries. Common agency theory focuses similar attention to the benefits that might accrue to stakeholders given asymmetric information

Insert Figure 2 about here

and information-sharing between them. Rather than utilizing managers to balance stakeholder demands, stakeholders could instead negotiate a balance themselves, enabling them to retain rents generally paid to managers (given information asymmetries) for this activity. In addition, stakeholders might capture these rents simply by sharing information about managers.

Decreased managerial rents suggest the following proposition (**develop this a bit more!—talk**

about how executive compensation reflects managerial rents, say existing regular agency theory has had much to say about the levels of these rents, and now common agency as well has something to say...after, perhaps generate a few more propositions on boards, saying organizational theories who have relied on bilateral agency theory have used it to make hypotheses primarily about executive compensation, the structure of boards, and the market for corporate control—what else?—and common agency has something to say about those as well—that market for corporate control more effic with info-sharing—i.e., see more acqui? More outsiders on board when info sharing—and institutional investors as information sharers and their presence leads to outsiders on board=extracting rents from management?):

Proposition 1: Firms subject to information-sharing among stakeholders will evidence lower levels of management compensation than firms not subject to information-sharing among stakeholders.

Saved rents by all stakeholders given reduced management compensation, resulting in improved stakeholder resource allocation, suggest too the value of stakeholder negotiation (**awkward?**).

Hill and Jones (1992) cite related work in game theory which suggests that it is often more efficient for stakeholders to cooperate than negotiate individually with managers. Drawing on Aoki's (1984) work, Hill and Jones (1992) argue that if an "organizational equilibrium" has been established (in which no one group of stakeholders can better its situation without harming that of another group of stakeholders), rational stakeholders will be loathe to change the distribution of organizational resources, since doing so could "precipitate open conflict between stakeholders" (p. 145) and thus reduce rents to all stakeholder groups (**how does this sentence flow from the one before it?**). Common agency theory similarly suggests that negotiation between stakeholders will only occur if gains obtain to all stakeholders groups.

Proposition 2: Firms subject to information-sharing among stakeholders will evidence higher levels of performance across stakeholder groups than firms not subject to information-sharing among stakeholders. (how does this flow from previous discussion? Develop more.)

Negotiation additionally enables decreased information asymmetries between stakeholders. Stakeholders holding the information advantage in asymmetric information settings also hold the performance advantage. Therefore, decreased information asymmetries between stakeholders enabled by stakeholder negotiation suggests the following proposition:

Proposition 3: Firms subject to information-sharing among stakeholders will evidence less variance in performance levels across stakeholder groups than firms not subject to information-sharing among stakeholders. (needs more lead in: strategy lit xyz talks about performance variability—e.g., managerial discretion—and common agency has something to say about it that's different)

By highlighting the gains to be had by stakeholders through negotiation among themselves, rather than through managers, common agency theory also highlights the motivation managers have to prevent stakeholder communication and keep stakeholders uninformed of the requests of other stakeholders. Common agency theorists **generally focus on this state of affairs, often** assuming that no cooperation between stakeholders is possible. **These theorists concern**, then, rather than principal **or stakeholder** behavior, as we have described above, is the characteristics of managerial contracts in multiple principal situations.

Common agency theorists suggest that the key determinant of the shape of these contracts is the relationship between the agent's work and each of the principals' desired outcomes (Martimort, 1996; Laffont & Martimort, 1997). If the agent's work is complementary across principals, contracts between the agent and his/her principals will be relatively less performance-contingent than will contracts between agents and principals in which the agent's work is

substitutable across principals. Complementarity suggests that any work engaged in by the agent that benefits one principal benefits the others as well, while substitutability instead suggests that any work engaged in by the agent for one principal detracts from the ability of the agent to satisfy other principals. **(give examples? Go into more detail about what's been said? see Martimort)**

Stakeholder theory, however, has not examined the substitutable or complementary nature of management's work across stakeholder groups, nor has stakeholder theory adequately addressed the importance of incentive systems in motivating managerial behavior **(need non-stakeholder stuff)**. The incentive implications of substitutability and complementarity of management's work across stakeholder groups therefore stem solely from common agency theory. Common agency theory suggests the following proposition:

Proposition 4: Contracts in which management's work is complementary across stakeholders will be less performance-contingent than contracts in which management's work is substitutable across stakeholders.

Stakeholder theorists have, however, stressed the importance of groups of stakeholders working together in their interactions with managers **(non-stakeholder stuff as well?)**.

Mitchell, Agle, and Wood's (1997) typology categorizes stakeholder classes on the basis of three attributes: power, legitimacy, and urgency. Mitchell, Agle, and Wood suggest that "dependent" stakeholders (those that possess urgency and legitimacy but lack power) will find alliances with more powerful stakeholders particularly useful. Such alliances assume, however, that the more powerful stakeholder has an interest in the agenda of the dependent stakeholder. Krackhardt (1992), for example, found that relationships among organizational members are more likely to be sustained when these organizational members share common goals. These insights lead to the

following proposition: **(note also that if you share info under this model, you can be more powerful—add more on power, and maybe add in collective action discussion)**

Proposition 5: Information-sharing between stakeholders is more likely to occur when management’s work is complementary across stakeholders than when management’s work is substitutable across stakeholders.

Stakeholder theorists would suggest the importance of power differentials to all five propositions (Hill & Jones, 1992; Mitchell, Agle, & Wood, 1997) **(and organizational theorists....add cites)**. Hill and Jones (1992), for example, suggest that managers may rely on a number of suppliers to reduce reliance on any one supplier, weakening the power of all members of that stakeholder group. Common agency theorists also recognize the importance of power—however, for them, power is simply information. Common agency theorists would instead suggest that reliance on multiple suppliers provides managers with increased information about suppliers’ production functions.

EMPIRICAL APPROACHES

An empirical literature explicitly testing common agency theory’s hypotheses has not yet developed, but previous empirical tests of stakeholder theory and several network analyses offer suggestions about how to proceed with the empirical testing of Propositions 1-5. Testing these propositions requires operationalizing information-sharing, substitutability, complementarity, management compensation, and stakeholder performance. Propositions 1, 2 and 3 all depend on a gauge of information-sharing: a seemingly difficult phenomenon to measure. Network analyses suggest proxies as diverse as friendship, frequent conversation, and strategic alliances (Brass & Burkhardt, 1992; Rowley, 1998) **(more here on how network analyses have measures info sharing)**. Alternative measures might address the presence of stakeholders other than shareholders on a firm’s board of directors, presuming such presence indicates information-

sharing between stakeholders. Daimler-Chrysler's recent announcement that the new German company's board will include a United Auto Workers' representative (German labor will have nine) emphasizes that a cross-cultural study might provide a more fertile environment in which to study this phenomenon than one limited to the U.S. (Mitchener, 1998). A 1952 German law, for example, grants elected labor representatives the right to half the seat on large companies' boards, while U.S. companies tend not to include labor representatives on their boards (Mitchener, 1998). Such legal requirements, however, might limit the level of variation in stakeholder representation on boards of directors even outside the U.S. **(all that necessary?)**

Similar difficulties obtain in the measurement of Proposition 4 and 5's key theoretical constructs. Rowley (1997) suggests that less dense stakeholder networks lead to situations in which satisfying one set of stakeholders requires defying the expectations of other stakeholders, given the lack of shared behavioral norms. This situation is comparable to the one described by common agency theorists as one of substitutability across stakeholders, and thus substitutability and complementarity might be measured by the density of the stakeholder network. As phrased, however, Proposition 4 and 5 suggest the potential for pure substitutability or complementarity across stakeholders, but the potential for substitutability or complementarity among subsets of stakeholders additionally obtains. A manager's work might be substitutable across one set of stakeholders, while complementary across another set, or complementary across stakeholders for one set of issues, but substitutable across stakeholders for another set of issues. For example, employees, a non-local supplier, and the community might share an interest in the firm's increased production given employment concerns, and the manager's work is thus complementary across these stakeholders for this issue. However, the non-local supplier is uninterested in the increased pollution accompanying increased production, while employees and

the community are, and the manager's work is thus substitutable across the same set of stakeholders for this issue. Network analyses could address this complication by examining network subsets. Alternative measures might include the degree of relatedness among stakeholder goals: employees' desire for health care insurance is highly related to the community's interest in public health, suggesting complementarity, while suppliers' interest in high volume production might conflict with the community's desire to limit pollution, suggesting substitutability.

Measures of management compensation are readily available: the key to testing Propositions 1 and 5 is to include all sources of management compensation, and to be precise about what performance-contingent compensation is contingent upon. Measures of stakeholder performance, however, have not been well developed. Previous work in corporate social performance employs a wide variety of measures attempting to capture this construct. Many of these measures, however, focus on only one aspect of social performance, such as charitable giving (e.g., Fry, Keim, & Meiners, 1982) or environmental pollution caused by firm activities (e.g., Fogler & Nutt, 1975). The problem with such measures, from a stakeholder perspective, is that corporate performance is clearly a multidimensional construct (Griffin & Mahon, 1997; Jones, 1995b). Wood and Jones (1995) and Jones (1995b) each make suggestions relevant to the measurement issues presented by the propositions offered here. Wood and Jones (1995) highlight the need to precisely match dependent and independent variables with regard to stakeholder concerns, suggesting that care be taken in operationalizing stakeholder performance in Propositions 2 and 3. Jones (1995b) proffers the use of Data Envelopment Analysis (DEA) as a methodology for designing a composite measure of firm performance which could also be useful in testing Propositions 2 and 3. Wood and Jones (1995) therefore give insight into

measuring performance with respect to single stakeholder groups, while Jones (1995b) offers guidance into assessing performance across stakeholder groups. **(more on performance measurement, not stakeholder theory?)**

CONCLUSION

Common agency theory offers stakeholder theory a coherent theoretical framework with which to develop novel stakeholder-oriented propositions. We have advanced several. The lack of empirical work in common agency theory provides empirical researchers with an opportunity. We have suggested ways in which this research might be directed. Few examples of information-sharing among stakeholders, however, immediately leap to mind (**really?**). This apparent lack of information-sharing, or even communication, between stakeholders suggests an additional avenue of research. Propositions 1 and 4 each predict lost managerial rents given information-sharing among stakeholders. To prevent these losses, management may develop barriers to information-sharing among stakeholders. Examining these *barriers*—and hence the opposite of information-sharing among stakeholders—might provide new information about stakeholder-manager relationships as well as clues about the real value of stakeholder information-sharing. Managers might, for example, be most likely to develop bureaucracies or other organizational structures to prevent information-sharing among stakeholders when management's work is complementary across stakeholders, given the greater ease with which stakeholders can absorb managerial rents through information-sharing when management's work is complementary rather than substitutable across stakeholders. Alternatively, certain stakeholders might themselves institute barriers to information-sharing between other stakeholders in an effort to prevent collusion between these other stakeholders. Shareholders, for example, might not want employees and the community to share information, for fear that the

reduced managerial rents might only limit the management talent shareholders could obtain, without other gain to shareholders. The results of future empirical research on each of these and related scenarios, in addition to research evaluating the propositions offered, may furnish stakeholders with evidence enabling them to better direct the activities of managers, and thus the allocation of resources.

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Figure 1: Common agency

Figure 2: Stakeholder perspective, with communication between stakeholders