ABSTRACT

The principal-agent relationship (Ross, 1973; Jensen & Meckling, 1976) has been analyzed extensively in economics, in political science and, increasingly, within sociology (Kiser, 1999). The majority of economic papers on the principal-agent relationship has focused on a single principal and a single agent, or in our context, a single investor and a single investee. There is an increasing interest in moving beyond this traditional investor-investee dyad (Lockett et al., 2006). The present paper represents such an attempt, as it studies the dynamics in a specific case with multiple investors and a single founder. The case shows that in agency situations, principals can cooperate to influence the agent by taking on different roles towards the agent. In the case, some principals are distanced from the agent, while the one responsible for communication with the founder decreases his principality in order to reduce perceived hierarchical distance and emphasize perceived goal congruence.

INTRODUCTION

According to Paul et al (2007), the investment process of informal investors can be divided into five stages: familiarization, screening, bargaining, managing and harvesting (Ibid., p. 113). The present paper is concerned with the managing stage. Berggren & Fili (2008) also looked at this managing stage in post-investment relationships between informal investors and their entrepreneurs, formulating a tentative model for how the informal investors judged when things were beginning to go wrong in the relationship. In comparison, the present paper looks closely at a single case where an informal investor has already become aware of a problem in the relationship and a particular strategy being used by that investor to remedy the situation. By utilizing the principal-agent framework, we try to see how the informal investor uses the other investors to influence the founder. Thus, the purpose of the present paper is to expand on the principal-agent framework by looking at a case with multiple principals versus a single agent.

METHOD

Since the purpose of the paper is to expand on current theory by describing the occurrence of a single case, the obvious choice of approach is a qualitative one using interviews. This is to obtain a rich description of data on the process, where we need to access the perceptions of the interviewee
During the spring of 2008, I conducted an initial interview where I gained an initial understanding of the situation and the actions taken, as perceived by the informal investor. After this, I went back to theory in order to increase my theoretical understanding of the particular situation described by the interviewee. This was followed by an additional in-depth interview focusing on penetrating deeper into key points of the story, and on understanding the process, the roles and the reasoning behind the strategy. The second interview was prepared by furnishing the interviewee with the main questions in writing a few days before the interview, in order to enable him to put the facts together. During the second interview, I continually used the questions to inquire into the time dynamics of the case; who did what at what time? After this interview, I gave the interviewee a transcript of the case description in order to ensure that I had not misunderstood any of the facts, and that the story gave a strong reflection of his perception of the situation. After this, I once again went back to the literature in order to saturate my understanding of the now complete case description.

In order to minimize biases of retrospective accounts, my interviewee was told to focus on a recent experience (Paul et al, 2007). In this way, the account was of a recent actual single investment, where an actual investment minimizes the risk of hypothetical answers, recency ensures accuracy of recollection, decision making over time can be established, and since the investment is not yet terminated or closed, the risk of bias through self-reporting is minimized (Fried & Hisrich, 1994).

Validity of the study is not a central concern, as this case illustrates an interaction between principals and agents that I have not encountered in literature. Therefore, the focus is on expanding our understanding of the possible dynamics of informal investor-investee post-investment relationships.

THEORY

At heart, agency theory is concerned with the relationship between individuals (Jensen & Meckling, 1976; Fama & Jensen 1983). "We define an agency relationship as a contract under 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 making authority to the agent. If both parties to the relationship are utility maximisers there is good reason to believe that the agent will not always act in the best interests of the principal." (Jensen & Meckling, 1976, p. 308) According to Kiser (1999), "The key feature of all agency relationships is that once principals delegate authority to agents, they often have problems controlling them, because (1) agents' interests often differ from theirs, and (2) agents often have better information about their actions than do principals." (Kiser, 1999, p. 146). Gomez-Mejia et al (2005) argue that agency theory often does not take local context into account but on the other hand achieves a greater generalizability of theory. Examples of agency theory are universal (Ross, 1973). The principal's problem entails how to assure that the agent will do what the principal wants him or her to do (Mitnick, 2007), since the central tenet of theory is that there is potential for mischief when the interests of owners and those of managers diverge (Dalton et al, 2007). In economics, agency theory is basically defined as an incentives problem (c.f. Ross, 1973), which has made some researchers call it undersocialized in assuming that individuals act utility maximizing (Cable & Shane, 1997; Eisenhardt, 1989).

However, it is not necessary to subscribe to the assumptions of self-interested utility maximisers in order to apply the principal-agent framework (Petersen, 1997). “Overall, the domain of agency theory is the relationships that mirror the basic agency structure of a principal and an agent who are engaged in cooperative behavior, but have differing goals and differing attitudes toward risk.” (Eisenhardt, 1989). In other disciplines than economics, the framework has been applied to a multitude of relationships in different contexts. In a review paper, Shapiro (2005) discusses applications of agency theory in economics, management, political science, law and sociology. She underlines that the basic assumptions of the economic theory are not as common in the other disciplines. In fact, Perrow (1986)
has warned against the one-sidedness of agency theory in that it neglects the possibility of principals exploiting their agents. Cable & Shane (1997) argue that both sides can defect from the relationship and that therefore the prisoner's dilemma framework is more fruitful, as it doesn't assume that the agent is the only party which can defect.

There are studies that have looked at multiple principals and/or multiple agents. As noted by Kiser (1999), this tradition is well-established in political science, where politicians (agents) represent many voters (principals), or administrative staff (agents) work for politicians (principals) (c.f. Whitford, 2005). However, the particular institutional context of political science is markedly different from the typical economic case (Worsham & Gatrell, 2005). Recently, there has been a growing interest in investment theory in opening up the dyad between principal and agent. In a special issue of Entrepreneurship and Practice, Lockett et al (2006) argue for studies looking at syndicates, teams, and networks of investors and investees. There are a number of studies looking at situations with several principals who act opportunistically towards each other (c.f. Wright & Lockett, 2003).

In a paper in American Sociological Review, Adams (1996) studies colonial control in the Dutch East Indies in 1600, where agents were sent to the colonies in order to rule and look after the interests of the patrimonial principal. Her contention is that there were network structure characteristics which affected the possibility of disciplinary action towards the agent. Furthermore, there existed several competing hierarchies of (potential) principals, which the agents could attach themselves to in order to further their own interest, a phenomenon she calls the Hydra factor: "the multiple heads or principals lacked institutional mechanisms to resolve resulting uncertainties and infighting." (Adams, 1996, p. 16). Hechter (2008) has looked at the rise and fall of the Arthur Andersen accounting firm in terms of multiple principals. He argues that the agent will comply with that principal upon whom the agent is most dependent (Ibid., p. 672) Principal-principal conflict has also been studied by Young et al (2008), who looked at conflicts between controlling shareholders (who are able to control the firm) and the other - minority - shareholders. In a similar vein, Guthrie, Xiao & Wang (2008) argue that ownership concentration - implying less inter-principal conflicts - results in better performance.

In the original agency relationship as described by Jensen & Meckling, they state that there is usually no account taken of multiperiod, repeat interaction (Jensen & Meckling, 1976). In fact, there is a growing body of research that underlines the dialectic nature of interorganizational cooperation (Vlaar et al, 2007). According to this view, there are no perfectly initially designed contracts that can optimize the relationship and minimize the agency costs; rather the relationship is characterized by opposite forces operating at the same time. For example, formalization of procedures can either create an efficient cooperation, since both parties know exactly what to do, but it can also stifle innovation and creativity (ibid., pp. 442-445). Based on this view, situations will arise during the relationship which cannot be specified and handled in advance through a contract but that will need to be handled at that time through management of the problem.

Saam (2007) expands on agency theory as she proposes that agency problems become power problems as soon as the principal is influenced in her beliefs, attitudes, or behaviour as a result of the action or presence of the agent, and vice versa (Saam, 2007, p. 831). She argues that principals can exert influence over agents by accessing different identification systems. "If the agent identifies positively with the principal, he will behave like the referent. [...] The more attractive the principal, the more far reaching her referent power will be.” (Ibid., p. 834). The central mechanism of identification is that a dyad becomes emotionalised. Therefore, principals should use identification systems to become attractive to the agent.

In an owner-manager relationship, the owner is the principal and the manager is the agent (Petersen, 1997). One type of owner is the informal investor. Informal investors are understood as individuals who invest their own capital, as opposed to the formal venture capital firms, which invest other people's money. One category of informal investors is business angels, defined as active informal repeat investors (Sörheim & Landström, 2001). Research suggests that the volume of business angel investment is larger than that of the formal venture capital industry (Sohl, 2005). Therefore, understanding more about the reasoning on the part of informal investors about their post-investment relationships with entrepreneurs.

THE CASE
The informal investor that I have interviewed (from here on called Investor AA) has been working full-time as an investor of his own capital in small, privately held companies for more than five years. He is ca 40 years old and holds a degree in engineering. He is currently invested in several different businesses. Each investment is sizeable in the sense that it amounts to more than 10% of his total available capital. As early-stage companies represent a riskier investment than later-stage companies, a key component is how to handle this risk. AA adheres to a philosophy which states that risk must be handled through active management of the ventures, by getting deeply involved. This is most often accomplished by being on the board of the ventures. AA is also involved in some ventures where he is completely passive, where someone else is acting lead investor.

In the summer of 2006, AA invested in a 6 months old seed-stage research-based company, which develops applications aimed at the semi-conductor industry. The venture team consisted of the founder (the innovator) and an employee in charge of operations. Owners of the company were the founder and a university incubator. The founder receives a salary and is still the majority owner today.

Initially, AA entered the company together with a professor from a high-ranking Swedish technical university. After one year, two new private investors bought equity in the company (Investor BB and CC). These two were not previously known to AA, but had been attracted to the company through investor lunch presentations in the university innovation community. BB and CC were not interested in managing the venture and chose to remain passive, encouraging AA to strengthen his active role in managing the venture team.

In the two years since the initial investment, a pattern has emerged where the venture team persistently misses deadlines in the project plan. Over time, this has become quite costly. Presently, the external investors and the founder have discussed and agreed on the need for new funding by issuing stock. However, there is some argument between the founder and the external investors, who feel that the costs of delay should affect the valuation and the price of the new stocks. In fact, the founder recognizes the problem. "To put it harshly, an outsider could look at the company and state that not much has happened yet – and he would not be entirely wrong." Thus, the problem with time delays is recognized but not how this should reflect on the stock price.

There is no comprehensive contract covering the relationship; AA usually refrains from formalizing the relationship at the start, instead waiting a little until things have settled somewhat. However, in the present case, he feels that the time for formalization has arrived. In the imminent 2 million crowns new share issue, the investor group proposes that 75% of the sum is transferred immediately at the present valuation, while 25% is delayed until spring 2009. These 25% will be valued at the same level as the 75% only on the condition that a number of specified key milestones have been accomplished on time, otherwise the price for the 25% will be lower.

In proposing this deal to the founder, AA has adopted an approach where he goes into direct discussion with the founder and presents the proposal as coming from the investor group. "It is a question of avoiding any unnecessary drama. As owners, we must maintain a unified front, but it is simply easier to discuss a proposal if it comes from the investor group instead of from me. I need to be able to sit on the company board in the future also, and cooperate with the venture team."

In the discussions with the founder, AA de-emphasizes his own investor role, instead focusing on framing the proposal as a constructive solution to a shared problem. "Sometimes I use the other investors as the bad guys and act more as a messenger than an owner myself. I want to make the venture team understand that there is a problem, but avoid direct confrontation. In fact, it is not uncommon for AA to come up with ideas in the investor group, which are subsequently presented by AA in his messenger role to the founder.

ANALYSIS

Borrowing and paraphrasing terminology from other rational choice theory, the Prisoner's Dilemma, in the present case there is a single prisoner who has to decide on proper action (the agent) and several police officers (the principals) who coordinate action and play out different parts in the drama: the
good cop-bad cop scenario. In short, the good cop-bad cop is a common scenario in many police films. Let us recall that the Prisoner’s Dilemma takes place in an interrogation setting at a police station. The good cop-bad cop scenario takes place in the exact same room, but now there are two police officers interrogating the suspect. One of the officers (the bad cop) is usually loud and threatening, verging on physical violence. This officer will eventually frighten the suspect, after which the other officer takes over. The other police officer (the good cop) reasons with the suspect in an understanding and empathetical fashion, trying to evoke an emotional report with the suspect. This interplay between the two officers can be repeated if the suspect is not ready to cooperate after the first round. The scene almost always ends with the confession of the suspect. The key is the dialectic between threatening monologue and emotional dialogue.

In terms of the case, as a single principal distances himself from the other principals, the principals are divided into two separate entities: the formal role of the investor group as one entity and informal messenger role of the single principal as another entity. The bad cops are the investor group in their formal capacity, representing a high level of principality versus both AA in his messenger role and the agent. The good cop in the case is AA in his messenger role, de-emphasizing and downplaying principal characteristics while emphasizing investor group principality. This strategy creates a middle ground, where AA can act. By pushing the investor group as an entity separate from himself upwards they achieve what can be labelled super-principality, while AA necessarily occupies some space in between. In this fashion, three levels are created, two separate levels of principality as well as the agent level.

The case illustrates how principals play out different roles in order to handle the kind of situations proposed by Vlaar et al (2007), which cannot be contractually specified in advance. Furthermore, in the terminology of Saam (2007), the messenger accesses a space where the dyad between the messenger and the agent can be emotionalised and where the messenger can access referent power. As stated by Saam (ibid.), this reduces agency drastically.

**IMPLICATIONS AND FUTURE RESEARCH**

The case analysis shows that in a setting with multiple principals, they can interact to take on different roles with a different level of principality. In this way, the principals can create middle grounds, where the agent can be influenced with other mechanisms than traditional monitoring and control. This shows that the identification framework proposed by Saam (2007) has interesting implications for an increased understanding. By interacting with the agent on this middle ground, a perception of shared goals between equals can be created.

In the future, a further refinement of the model is needed. Studies designed to measure how common the god cop-bad cop behaviour is in multiple principal settings should be undertaken, specifically to
see if there are differences between different contexts and if it is a game that can be played repeatedly in the same principal-agent relationship. Can the principals rotate roles over time? Studies of the agent's perception of the scenario would increase our understanding even more: do entrepreneurs always play along in the game and what happens if they don't believe it?
REFERENCES


