NEW FIRM ORGANIZATION AND THE EMERGENCE OF CONCENTRATED CONTROL RIGHTS: A BAYESIAN APPROACH (SUMMARY)

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SUMMARY

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Principal Topic

This paper explores how entrepreneurs organize firms to exploit new, untried market opportunities. Entrepreneurs in early stage firms face a basic question common to all agents seeking to organize a firm: who in the firm should have rights of control. This paper extends incomplete contract theory to examine the question of how the allocation of residual rights of control is decided in brand new firms.

Currently, most applications of incomplete contract theory assume that parties to an exchange can anticipate the economic consequences of an exchange sufficiently to write contracts that specify residual rights of control, that theory’s defining attribute of a firm. In its current formulation incomplete contract theory is applied when a probability distribution is assigned to the decision outcome at the time the decision is made and when all parties to that decision have shared probabilistic beliefs about the outcomes.

In the early stages of forming a firm entrepreneurs often make residual rights of control choices in early stage firms before the potential economic outcomes associated with exploiting a market opportunity are known, even probabilistically -- a setting described in this paper as uncertain. In other situations, entrepreneurs have sharper beliefs than this but cannot agree on the probability of various outcomes, even as they adjust their beliefs after learning from market outcomes (a context we describe as one of risk).

This paper uses a Bayesian approach to examine how founders of early stage firms make decisions about the allocation of residual rights in risky and uncertain settings. Early stage firm formation is an ideal setting to examine the allocation of residual rights of control since entrepreneurs must regularly make decisions about control rights in these firms. The paper shows that modest differences in the priors of entrepreneurs can cause large differences in organizing choices early in the evolution of the entrepreneurial firm. The model is also used to describe a rich array of organizing decisions.

The article outlines a simple model of decision-making by two founder entrepreneurs, describing the entrepreneurs’ data and beliefs, and defining the notions of “risk” and “uncertainty”. We then model the evolving firm structure and the allocation of control rights under conditions of uncertainty and risk, before concluding with some implications for managers of early stage firms.

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