Title:
Corporate governance: reflecting on core theories in context of VC-backed startup boards

Author:
Natalia Blagburn, Newcastle Business School, Northumbria University

Contact Address and email:
Newcastle Business School, Northumbria University,
City Campus East, Newcastle upon Tyne, NE1 8ST
n.blagburn@northumbria.ac.uk
Title:
Corporate governance: reflecting on core theories in context of VC-backed startup boards

Summary:
The research topic of boards of directors in companies in general and in startups in particular has been addressed by several disciplines including, management, finance, and organisational behaviour.

This developmental paper reviews and reflects upon a selection of core corporate governance theoretical frameworks that have been extended to study boards of directors in the context of VC-backed startups, including agency theory, resource-dependence theory, team production theory and emerging behavioural theory of boards.

The discussion will serve as an input into research design of a study into processes, working relationships and dynamics of startup boards.

Track:
Corporate Governance

Word count:
2,277
**Introduction**

The research topic of boards of directors in companies in general and in startups particular has been addressed by several disciplines including, management, finance, and organisational behaviour (Durisin and Puzone, 2009).

This developmental paper reviews and reflects upon selection of core corporate governance theoretical frameworks in the context of Venture Capital (VC) backed startups, specifically agency theory, resource-dependence theory, team production theory and emerging behavioural theory of boards.

The findings will serve as an input into research design of a study into processes, working relationships and dynamics of startup boards.

**Background**

Traditionally, corporate governance studies have been concerned with board structures, demographics, board roles (inputs) and how these link to the overall performance of the firm (outputs) (Roberts, McNulty and Stiles, 2005). Thus, majority of theoretical knowledge and policy recommendations built up over the evolution of corporate governance board literature seem to be constructed with little or no concern for what actually happens on boards, i.e. processes and associated with them behaviours in and around boardrooms (Pettigrew, 1992). Despite the long tradition, the mainstream research failed to produce consistent and unambiguous results (Van Ees, Gabrielson and Huse, 2009). Recently, this led to a growing number of calls for studies of behaviours and inter-relationships of the board members (Huse, 1998, Forbes and Milliken, 1999, McNulty and Pettigrew, 1999, Huse, 2005, Van Ees, Gabrielson and Huse, 2009, Durisin and Puzone, 2009). As McNulty and Pettigrew (1999) eloquently put it, in order to better understand boards, “we need to know more about the behaviour of those who sit on boards”. Behaviour has been defined in the literature as the ability of directors to carry out their responsibilities and tasks (Forbes and Milliken, 1999, Huse, 2005, van Ees et al, 2008, Voordeckers, 2014).

VC-backed startups have “much more active boards” as opposed to boards of directors in traditional contexts such as large corporations. (Fried, Bruton and Hisrich 1998, p.499). As a result of having active boards, VC-backed startups are perceived to achieve a “superior firm performance, increased value for investors and increased value for society” (Fried, Bruton and Hisrich, 1998, p.501). Consequently, boards of VC-backed startups represent a very rich context setting for researchers of corporate governance, especially in the wake of recent calls for qualitative studies of board dynamics, processes and working relationships of directors “to open up the black box of boards” (McNulty, Zattoni and Douglas, 2013, p.191).

**Review and reflections**

*Agency theory* is by far the most dominant theory used to study boards of directors (Durisin and Puzone, 2009; Huse and Rindova, 2001). The two key themes explored through the theoretical lens of agency theory on the subject of boards include the relationship between the composition of the firm’s board and the overall performance, with seminal works by Zahra and Pearce (1989), Pettigrew (1992), Johnson et al. (1996), and the relationship between the leadership structures and the overall

The conceptual and empirical body of knowledge of the agency theory has been extended to include VC-backed startup boards (Sapienza and Gupta, 1994, Arthurs and Busenitz, 2003, Zahra and Filatotchev 2004, Garg 2013). From the agency perspective, the key distinct feature of investor-backed startups is that there is no or little separation between control and ownership, where both new investor-owners (principals) and founders (agents) have equity stakes in the business (Sapienza and Gupta, 1994; Arthurs and Busenitz, 2003; Zahra and Filatotchev 2004; Garg 2013).

To this point, Garg (2013) argued that although it may seem that the agency problem is somewhat reduced in investor-backed startups as managers are also shareholders, their interests may still be hugely misaligned, and therefore the agency problem would still exist.

However, research and empirical works using agency to analyse investor-backed startup boards seem to simply verify the existence of agency relationship between new shareholders and owners and provide reasons for why VCs employ “more elaborate governance structures for monitoring and control” when aligning the interests of founders with their own (Daily et al., 2002, p.401). Nevertheless, there is also evidence that startup boards are more active and add a huge value rather than merely monitor (Zhang, Baden-Fuller and Pool, 2001). Yet, agency as a theoretical perspective, appears to over-emphasize an input-output relationship between the characteristics and structure of the board and the overall performance of the firm, failing to shed any light on behaviours of board members, such as “dealing with the complexity and uncertainty associated with strategic decision making” (Van Ees, Gabrielsson and Huse, 2009, p. 2).

Resource dependence theory is another prominent theory in corporate governance for researching boards of directors (Nicholson and Kiel, 2007). The theory considers an organisation as open system influenced by the external environment and suggests that in order to understand its behaviour, one “must understand the context of that behaviour – that is, the ecology of the organisation” (Pfeffer and Salancik, 1978, p.1). In contrast to agency theory, which regards the board of directors as one of the solution mechanisms to the agency problem placing its monitoring function above all, resource dependence theory calls for the main function of the board to be a link to the external environment and a provision of important resources required to maximise the performance of the firm (Pfeffer, 1973; Pfeffer and Salancik, 1978). The theory argues that a company with a board that possesses a high number of links to the external environment and stakeholders, such as customers and suppliers, sources of
capital and market or other information, will have a better and faster access to those resources compared to its competitors (Nicholson and Kiel, 2007).

A number of researchers argue that resource dependence theory is particularly relevant as a theoretical lens when examining boards of early stage entrepreneurial firms, including investor-backed startups (Lynall, Golden and Hillman, 2003; Zahra and Filatotchev, 2004). During the initial stages of development, majority of startup businesses lack resources, including finance and human resources (Wasserman, 2014). On their journey to minimize risk and resource dependence on the external environment, startups set up boards, attracting directors with skills and experiences that at the time are perceived to be of most importance for the growth of the business. Resource dependence theory seems to provide an explanation of how startup boards are formed and their role in the development of the business to quickly acquire a wide range of skills, expertise, customer contacts and capital (Zhang, Baden-Fuller and Pool, 2011). Using resource dependence as a theoretical lens it has even been established that attracting important and valuable resource can result in a significantly increased value of the startup, however the trade-off is to give up founder control either in a form of shareholding or a board seat (Wasserman 2014).

However, similarly to agency theory, the resource based perspective has been criticised for a very narrow focus on just a “single aspect of a board’s role” (Nicholson and Kiel 2007, p. 601). In the context of entrepreneurial firms backed by VCs, the theory also seems to downplay a “potential for damaging appropriation of their resources” highlighting only a cooperative side of parties that act as linkages to the external environment (Katila, Rosenberger and Eisenhardt, 2008, p.31). Finally, over the recent years, it has also been argued that the predictive power of the theory has declined considerably and it requires some modification to reflect challenges and realities of the modern day (Davis and Cobb, 2009).

The dominance of agency theory and resource dependence theory for researching boards in general and startup boards in particular, has been challenged by a “path-breaking” team production theory developed originally by Blair and Stout (1999) (Pollman, 2015, p.619). Specifically, team production theory questions the basic underlying assumption of agency theory – the shareholder wealth maximisation. It argues that rather than protecting and maximising shareholder interests, the wealth of all stakeholders that “add value, assume unique risk, and possess strategic information” must be considered (Kaufman and Englander, 2005, p.9). Using the team production perspective, boards of directors are viewed as “value-adding teams on top of the corporate hierarchy” and their main role is to operate as a “mediating hierarchy that balances the sometimes conflicting interests of the many stakeholders who make up the firm” (Huse and Gabrielsson, 2012). Effectively, a team production model offers companies not only ‘tools’ for creating and managing a value adding board (Kaufman and Englander, 2005, p.20) but also a useful set of dimensions for researchers to explore the inner-workings of boards, such as board team cohesiveness, creativity, cognitive conflicts, openness, questioning attitude and commitment (Huse and Gabrielsson, 2012). Recent work by Pollman (2015) demonstrated that the mediating hierarchy model of team production theory is also reflected in the dynamics of startup boards. However, the main disadvantage of the theory and its concepts is that to date they lack systematic and empirical studies to effectively challenge the dominance of other corporate governance theories (Kaufman and Englander, 2005).
The emerging *behavioural theory of boards and corporate governance* has its roots in the ground-breaking work of Cyert and March (1963) on behavioural theory of the firm, employed to understand organisational decision-making (Van Ees, Gabrielsson and Huse, 2009). The behavioural theory of the firm challenges dominant economic assumptions that corporations exist to maximise profits, placing an emphasis on decision-making processes within the firm in order to predict behaviours in relation to corporate strategic choices (Cyert and March, 1963). More recently and in response to calls to better understand behaviours in and around boardrooms, several corporate governance researchers, Huse, Van Ees and Gabrielsson extended the behavioural theory of the firm into a behavioural framework and a research agenda to explain the role of board’s behaviours in the decision-making processes based on the four core behavioural theory’s constructs, namely satisficing, bounded rationality, routinisation and political bargaining, (Huse, 2005, Van Ees, Gabrielsson and Huse, 2009, Huse and Gabrielsson, 2012). This emerging behavioural theory of boards and corporate governance understands boards as open systems with multiple coalitions of stakeholders possessing varying weight and power and participating in complex processes of decision-making (Huse, 2005). Instead of maximising profits or other non-financial outcomes, the boards engage in satisficing or searching for solutions that are simply satisfactory and not necessarily optimal, owing to various limitations, otherwise defined as bounded rationality, existing in the moment of the decision-making, such as incomplete information available at the time, specific set of circumstances or cognitive prejudices of the decision-makers (Van Ees, Gabrielsson and Huse, 2009, Hendry, 2005). The theory also recognises that board members rely on their knowledge, past experience and lessons, which they routinize and apply during decision-making thus creating environment of learning by doing and experimenting in the boardroom (Huse, 2007). Furthermore, boards, as coalitions of varied stakeholders with their own goals and interests, inevitably engage in political bargaining, not only during resolutions of conflicts but also during cooperation and decision-making (Gavetti et al, 212). On the whole, Van Ees, Gabrielsson and Huse (2009) argue that using this set of behavioural concepts as a theoretical lens to study board decision-making processes would enable corporate governance researchers to better understand conditions for effective corporate governance (Van Ees, Gabrielsson and Huse, 2009). Consequently, researchers could also construe how boards should be behaving and what they should be doing that would enable them to fulfil their responsibilities more effectively (Forbes and Milliken, 1999).

Critically, the behavioural theory of boards is still emerging and, apart from a few recent pioneering studies, for example by Voordeckers et al (2014) examining the relationship between board structures and actual board behaviours in SMEs in Belgium, the Netherlands and Norway, it remains empirically untested. To that end, one of the significant criticisms of the behavioural theory of firms and consequently the behavioural theory of boards has been that its theoretical concepts are very hard to test empirically as it would require data collection and gaining access beyond standard methods of surveys and interviews (Van Ees, Van der Laan and Postma, 2008).
Further Development

This review illustrates that agency and resource dependence theories have been somewhat useful in explaining forces that influence the formation of VC-backed boards and some of their key roles, such as monitoring and resource provision but they fail to shed light on actual board processes. Whilst team production theory does offer a set of dimensions to explore the inner-workings of boards, it has been found that some of its underlying assumptions cannot not be extended to all corporations (Pollman, 2015). The behavioural framework for boards and corporate governance on the other hand, although not yet much empirically tested, has been gaining momentum in the corporate governance research community. Over the past 10 years its concepts have been significantly developed in the literature into a new research agenda in response to calls for better understanding of inner workings of the board through studies of behaviours of those who sit on boards.

This developmental paper contributes to the rationale for adopting the emerging behavioural framework as a theoretical lens in a following-on research study.
References


