

## **GOVERNANCE AND CONTROL FOR FIRMS IN TRANSITION**

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## **ABSTRACT**

This paper provides a very brief review of the corporate governance literature, pointing out some of its problems and shortcomings. We then redefine the firm as a nexus of investments, rather than a nexus of contracts. With this new view, the claims of many of the firm's participants become more clearly focused. Additionally, attention is directed away from shareholders and toward the providers of firm-specific resources important to competitive advantage. Using the nexus of investments perspective, we consider the case of firms in transition – defined as firms that are making discontinuous changes in their nexus of investments. Most frequently, these firms seek outside capital, but they also often seek outside executives, new suppliers, and new partners. We develop a set of propositions that refine our nexus of investments perspective among firms in transition, and to guide research in corporate governance generally and firms in transition specifically.

## INTRODUCTION

Corporate governance, the manner in which decisions are made about how organizational resources are used, has been practiced for more than a thousand years, although the theoretical exploration of governance is relatively new and the expression corporate governance was not widely used until the 1980s. The modern concept of corporate governance arose in the early years of the twentieth century with the development of large public companies in the United States and the United Kingdom. Berle and Means (1932) drew interest to the growing separation of power between the executives of major public companies and their increasingly diverse and remote shareholders. This was the first seminal work on corporate governance, though the term *governance* was not used in the book. For the next forty years the professional activities of directors and boards remained the domain of legal studies. In the 1970s Pfeffer (1972) drew attention to the importance of the links between organizations, their environments and their boards of directors. Since that time, corporate governance has become a popular topic among researchers and currently is one of the most investigated areas in organizational research (Finkelstein and Hambrick, 1996).

Much of the influential work on corporate governance can be traced to the fields of economics and finance. For example, Jensen and Meckling (1976) explain how the modern corporate form exists despite the assumption that managers are self-interested. Additionally, Fama (1980) assigns a key role to labor markets outside the firm in helping managers to discipline boards as well as helping boards to discipline managers, and Fama and Jensen (1983) explain how some special features of residual claims can lead to different organizational forms. In all of these works, the various forms of organization

are assumed to represent efficient approaches to controlling conflicts of interests inherent in organizations. Of particular interest are conflicts of interests between those who make decisions and those who bear the wealth effects of those decisions.

Agency theory has clearly enjoyed overwhelming success, in terms of its diffusion and acceptance among governance researchers (Daily, Dalton and Cannella, forthcoming). It is by far the most widely used theoretical framework in governance studies. However, a careful evaluation of the evidence raises a number of important and troubling questions. For example, Baker, Jensen and Murphy (1988) note that agency theory is very clear in its prescription that executive compensation should be closely tied to firm performance. However, the lack of evidence in support of this very basic and simple prescription is so overwhelming that the authors are forced to conclude that either the theory is wrong or it has missed some key components. Additionally, in two separate meta analyses, no support was in evidence for three of the most widely prescribed governance mechanisms from agency theory. In the first, Dalton & Daily (1998) find no support for the assertion that board structure (the ratio of inside directors to outside directors) or CEO duality (whether the CEO also holds the title of Board Chair) have any implications whatsoever for firm performance. In the second, Dalton, Daily, Certo and Roengpitya (2002) show that the level of equity held by managers has little or no association with firm performance. Finally, Lane, Cannella, and Lubatkin (1998) argue that agency theory has little explanatory power in the realm of corporate strategy. Indeed, unless there are clear and sharp conflicts of interests between decision makers and residual risk holders, agency theory is of no use whatsoever. Clearly, while agency

theory has a very strong appeal among both scholars and practitioners, its ability to explain at least some widely observed firm-level characteristics is weak.

It is our belief that a key concern in much governance work is a narrow view of what “governance” is, as well as what the objectives of the firm are. We believe that the social and interpersonal nature of both governance and organizations simply cannot be ignored (Mintzberg, 1973; Finkelstein and Hambrick, 1996). While we understand that economists and finance scholars are likely to discount the social and interpersonal nature of organizations, strategy scholars cannot afford that luxury. In fact, the complexity of social and interpersonal phenomena are our stock in trade (Lane, Cannella and Lubatkin, 1999). We do not disagree with the observation that executives act in self-interested ways when their interests are in conflict. The evidence in support of self-interest is overwhelming. A more important point, however, is that public corporations not only survive the self-interested propensities of their participants, but the form itself is arguably the most successful organizational form of all time *despite* the self-interested proclivities of corporate participants. Therefore, while agency costs are important in public corporations, they clearly do not outweigh the benefits of the separation of ownership and control in a very large number of instances.

We define corporate governance as the setting of the overall direction for the firm – i.e. the mission and goals, and the intended means for realizing those goals. Our view of governance places it under the direct control of the firm’s senior executives and its board of directors. Additionally, we highlight that corporate governance is about resolving conflicts of interest among participants (investors) in the firm, and recognize that the power of those participants varies widely.

We also develop further the notion of the firm as a *nexus of contracts* (Williamson, 1975; Fama, 1980) by describing the firm as a *nexus of investments*. In this way, we return to a long-accepted view of organizations (that of a nexus of contracts) but examine it under fresh lenses, by emphasizing that shareholders are only one of the contracting agents involved. Additionally, the word “contracts” suggests that the interrelationships among the participants to organizations are much more fully specified than we believe to be the case. Redefining the firm as a nexus of investments highlights that while the financial capital of shareholders is essential to the firm, because those financial resources are completely fungible, it matters not *which specific investors* provide the capital. On the other hand, many other organizational participants, like executives, employees, suppliers and some large financial investors, may provide very specific and relatively unique resources, such as specialized skills and knowledge, or dedicated assets, and therefore retaining the participation of the specific individuals is frequently quite important (Barney, 1991; Castanias and Helfat, 1991; Castanias and Helfat, 1992).

More specifically, we investigate the key parties to the organization as those who have important levels of capital invested in the firm – thus those who are important investors in the firm. That capital can be financial, human, physical, or organizational. This point of view is nearer to the stakeholder approach than the agency one. The term *stakeholder* refers to groups of constituents who have a legitimate claim on the firm (Freeman, 1984; Pearce and Zahra, 1992). While the term is quite broadly interpreted in much research, our use of it will be restricted to those who have made investments in firm-specific assets, or who bring rare and valuable assets to the firm and therefore have

an important stake in organizational outcomes. In our discussion, because financial assets are not rare, small financial investors have little or no power. On the other hand, large financial investors may be critically important.

It is important to remember fact that shareholders are residual claimants, and are protected by law (Fama, 1980; Fama and Jensen, 1983). Other investors of capital, be it human, physical, or financial, may have no legal claim, or a lesser legal claim on the firm. However, two factors weaken the claims of financial investors in decision making about corporate resources. First, firm-level performance outcomes arise from extremely complex processes with a large stochastic component, and the actions of executives and other organizational participants are only loosely connected to observed market-based performance outcomes (Magenheim and Mueller, 1988).

Second, the setting we focus on is a dynamic one, in which firms are evolving and transforming their governance processes. Every firm must, in an ongoing way, resolve conflicts of interests among its participants – whether the firm is a large, public corporation or a small proprietorship. As firms grow larger and more complex, the conflicting interests can also grow. For larger firms, resolving these conflicts is an important role for boards of directors (Daily et al., forthcoming). Firms in transition, by our definition, are firms shifting from the exclusive hands of their managers (usually their founders) to joint ownership involving one or more large outside investors. Most typically, the transition is initiated by taking on private equity, rather than through an initial public offering. We emphasize the private equity setting, because it is one in which an entirely new system of conflict resolution must be worked out, and in the

process the firm makes the transition from a business unlikely to outlive its founder to one with an indefinite length of life (Schillaci and Faraci, 1999).

Taking the notion of the firm as a nexus of investments, and the setting of firms in transition, our purposes are the following: (1) refocus emphasis from a separation of ownership and control to a separation of investment and control; (2) refocus governance research away from the protection of shareholder interests to the resolution of conflicts among the contributors of firm resources and the overall establishment of strategic direction in a context of inherent conflicts of interest; (3) outline how the adoption of widely diffused systems, procedures, and practices helps to resolve a number of governance problems; (4) explain in more detail the role of a board of directors, as illustrated by (but not limited to) firms in transition. We begin with a brief discussion of firms in transition. We move subsequently to our discussion of the 4 issues outlined above.

## **FIRMS IN TRANSITION**

We define “firms in transition” as those that are undergoing discontinuous and substantive changes in the nexus of investments that comprises the organization. In particular, we will consider the addition of new large investors in the firm, as its owners begin to shift the firm from a sole proprietorship or family business to one with a more diffused ownership structure. Recall that our definition of investment includes, but is not limited to, financial capital. However, most of our discussion will emphasize the addition of external financial capital from a private equity investment.

Any large and discontinuous change in the nexus of investments that comprises the firm will prompt a resorting of priorities and claims among those who have made

investments, and will often lead to re-negotiation of the relationships with other major parties to the firm, leading to important governance effects (Pfeffer, 1992).

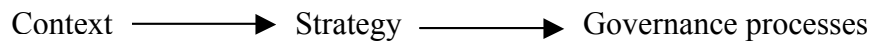
There are two main reasons for the occurrence of transitions. They can be generally classified as proactive (intentional or deliberate) and reactive (unintentional or passive). Proactive reasons for transitions are those that derive from initiatives within the firm – typically those from the recognition of opportunities. Those initiatives can be, for example, a desire for firm growth, which requires financial investment from outside the firm. Other examples might be the desire to expand to new markets through new alliances or partners, a new and risky technology, or an attempt to lower the risk of development and commercialization by bringing together a group of other firms through a merger or large-scale strategic alliance. We refer to this behavior as proactive because the firm's leaders have intentionally decided to change its strategy in ways that require additional investment from outside the firm's current borders.

Reactive reasons for transitions are those that are due to negative events or unforeseen situations arising from the external environment. In the reactive case, the firm is frequently in financial trouble and seeks to attract the resources necessary for a return to health. Here, external forces have forced the firm's managers to realize that they must change their strategies, and the firm does not have the resources to do so (Schillaci and Faraci, 1999).

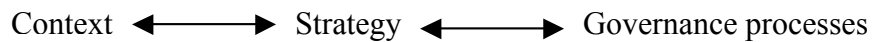
Organizations, on a day to day basis, run on repetitive processes and policies (March and Simon, 1958; Weick, 1995). Under stationary conditions, these processes are highly consistent over time, and add much to the efficiency and reliability of firms (Hannan and Freeman, 1984). Linking the ongoing processes of firms to the nexus of

investments concept, we argue that the processes must be relatively stable in order to develop (or attract) and maintain the kinds of investments that are essential to success. Additionally, the parties to the firm must feel that there is at least a relatively free flow of information (Williamson, 1975), so that they can evaluate the fairness of their treatment at the hands of the other investors. Governance processes must be such that investors feel confident of their investments, and are satisfied enough to continue their participation in the firm.

The most frequently posed relationship among external context, strategy and corporate governance suggests that strategy arises from context, and leads to governance processes, as indicated below (Airoldi, 1998).



This relationship is very useful to explain the dynamic process of firms in transition. However, the relationship above could also be written in this way:



When a firm is in transition, its strategy is changing, and that change can both arise from its context, and lead to a change in its context. As the firm attracts new investors, it must re-sort its governance processes to attract and satisfy those new investors, and the new processes may themselves lead to a new strategy. Put differently, the transition will frequently lead to two key outcomes: (1) a renegotiation of the agreements among the key parties to the firm, and (2) a reconsideration of the basic direction of the firm. Frequently, both the contributions from the firm's investors, and the associated inducements to the firm's investors will need to be changed in order to successfully

complete the transition. This brings the board and the top management group into focus, as they are in charge of the re-negotiation process.

## **GOVERNANCE AND CONTROL FOR FIRMS IN TRANSITION**

In this section, we discuss some critical factors that are likely to impact the governance process for firms in transition. The factors that we discuss are markets, (product markets, capital markets, and labor markets), boards of directors, and executives. Each of these factors is considered to have an important influence on the governance process.

### **Markets**

**Product/service markets.** In order to survive, virtually all organizations must generate cash, and they do so by offering products and or services to others through a market mechanism. Further, aside from the rare monopoly situation, customers have choices regarding the products and services offered. Put differently, firms cannot force their customers to purchase products or services – the customers must make choices on their own. When the forces of competition are very sharp in the organization's product or service market, it forces the market participants to sharpen their efficiency, and to squeeze slack out of their internal systems. Therefore, competition has a very important influence on the corporate governance process (Jensen and Meckling, 1976).

For firms in transition, the existence of sharp competitive forces in the external environment will make it more difficult for them to come to a negotiated agreement about who among the participants to the firm will take what risks, and who will share in the residuals (if any) that remain. Note that the firm in transition must attract new investors,

and to the extent that it faces sharp competitors in its product markets, it will have more difficulty attracting qualified investors.

The firm in the best bargaining position is one which clearly has a competitive advantage which it wishes to extend to a new geographic or product area, and the competition in the new area is not a large threat to the firm. In this case, the firm expects to generate a large residual, and investors will be attracted by the prospect of this large return. On the other hand, the firm in the worst position is one that has little or no competitive advantage, and needs to attract outside capital in order to survive. In this setting, the outside investors are likely to dictate very stringent conditions on their investments, and the firm's original executives (perhaps the founder) are likely to be forced to give up control in after the investment is made. This is a very difficult position for the firm's founder or founding family. In effect, all the parties to the original nexus of investments will be forced to provide large inducements to outside investors, be they investors of financial capital, human capital, or specialized assets, in order to attract these investors to the firm (Pfeffer, 1992).

Proposition 1: The level of competition in the firm's product market will have an important influence on the bargaining position of the firm's original investors relative to potential new investors. The sharper the competitive forces, the weaker the bargaining position of the original investors as they strive to attract new investors.

**Capital markets.** Capital markets have a long history in research on corporate governance, and perhaps the bulk of research on corporate governance has relied on capital markets, or capital market theory as important to the governance process (e.g. (Jensen and Meckling, 1976)). We do not examine capital markets directly in this manuscript, because the firms we focus upon are not publicly traded, and therefore do not utilize capital markets. However, a fundamental aspect of capital markets is the free flow

of information among all investors and potential investors to the firm. Hence, the US Securities and Exchange Commission (SEC) requires that all publicly-traded corporations make certain information public each year. This information includes audited financial statements and proxy statements which indicate the ownership structure of the firm, the identities and ownership positions of each member of the board of directors, and the compensation of the firm's 5 highest paid officers.

An important concern in private firms is the fact that they are not required to report any financial information to the public. Additionally, the history of private firms tends to be quite idiosyncratic and therefore the systems and procedures that these firms develop over time tend to be relatively unstandardized and ad-hoc (Carroll, 1993). Frequently, the financial reporting systems are designed to aid the founders, and no one else. While the founders frequently understand the system completely, others from both outside the firm and inside the firm are unable to make sense of the records or record-keeping systems. Because the firm is controlled by a single person or a very small team, all of whom have access to the information, this does not cause a governance problem. However, as new investors are sought, a free flow of information among all those who have made investments is key to both securing and maintaining the commitments of new investors (Pfeffer, 1992).

For example, many private firms with only 1 or 2 investors will not have used auditors or public accountants in prior years, and the attraction of new investors is very likely to move the firm toward standardized rules and procedures in reporting financial numbers. Even though the numbers are not made public, unless the financial statements adhere to generally accepted accounting principles, they will be of minimal use to those

striving to understand the full and true financial picture of the firm's health and performance. The attraction of large outside investors will force the firm to move its accounting systems and procedures toward generally accepted accounting principles.

Proposition 2: Firms in transition will alter their accounting and record-keeping practices so that they conform with generally accepted accounting principles. The change will take place either before new investors are attracted, or as a condition of the new investment.

Note that this change has very important implications for the subsequent health and survival of the firm. Because it has adapted standardized accounting systems and procedures, it is much easier for new executives and/or new large investors to step in and replace existing ones. The acceptance of widely diffused and fully institutionalized systems and practices will help ensure that the firm will survive its founding management team (Meyer and Rowan, 1977; Freeman, Carroll and Hannan, 1983). While the impetus for adopting the standardized procedures is the attraction of new outside investors, the result is a more open and understandable flow of information, and an associated easier replacement of existing personnel – thus increasing the survival likelihood of the firm in the long term.

**Labor markets.** Fama (1980) was the first to develop the notion that labor markets outside the firm can have a very important influence on the governance process. Basically, if managers cannot convince directors to pay them their full marginal value product, then the managers can go elsewhere and demand that marginal value product from other firms. Further, should incumbent executives turn out to be overpaid, as compared to other executives in the marketplace, then the incumbent executives can be replaced by those from outside the firm. Cannella, Fraser, & Lee (1995) found support for the assertion that executive labor markets can infer executive competence from

observable organizational outcomes, though the authors caution that there may be clear limits to these inferences. For firms in transition, new talent may need to be attracted from outside the firm. In order to secure new executive talent, the firm must entice the talent away from other employers with inducements.

Sharp competition in the firm's product markets, leading to poor performance at the firm level, will make it difficult to attract new (and perhaps essential) executive talent to the firm. First, according to Fama's (1980) theory, those outside the firm use the observed performance of the firm to infer executive competence. Thus, by definition, highly talented executives will tend to come from high-performing firms, and will be reticent to leave those firms in order to take positions at firms that are not in strong competitive positions, or are suffering from poor performance, for fear that their own reputations will be damaged (Cannella, 1995). Put simply, it is very risky to join a firm in financial trouble (Hambrick and D'Aveni, 1988). As a firm spirals downward, talented executives are much more likely to leave the firm than they are to join the firm (Cannella and Ortin Ángel, 1999). Additionally, those who join the firm are likely to require large inducements to cover the personal career risks that they are taking.

Proposition 3: The record of performance of a firm in transition will importantly influence its ability to attract new executive talent. Firms with strong records of performance will be able to attract quality executive talent at lower costs than firms with weak records of performance.

Note that proposition 3 extends well beyond the very top-level executive positions of CEO and Board Chair. Firms in transition will frequently need to attract executives with specialized talent in finance, marketing, or product development, and the higher the needed levels of talent, the more inducements that the executives will require in order to make an investment in the firm. Recall that all executives have undiversified portfolios

when considering their human capital, and they are likely to be very concerned about employment risks when evaluating the potential for investing their human capital in a specific firm (Lane et al., 1998). This argument differs from that of Amihud and Lev (1981), who argued that executives will diversify the firm in response to concerns about employment risk. What we argue here, is that before an executive will join a new firm, he or she will carefully evaluate the risks and rewards offered by that new firm, especially relative to the current employment position. In order to attract new and quality executive talent, all firms must offer better risk-reward tradeoffs than the original employers. Those firms in weak competitive positions or otherwise suffering from poor performance or poor reputations will have to provide relatively more inducements, or accept executives of lower abilities.

### **Boards of Directors**

Most of the research on boards of directors takes a governance perspective, in which the primary role of boards is to monitor executives and in which the fiduciary responsibilities of directors are highlighted (Fama, 1980; Fama and Jensen, 1983; Daily et al., forthcoming). However, among firms in transition, boards of directors serve much broader roles. The roles of boards in private firms have not been widely investigated, but are expected to differ substantially from those of public firm boards. Certainly, the monitoring role of boards is minimized in the privately held firm, as the firm's owners and executives are typically one and the same (Jensen and Meckling, 1976; Jensen, 1989).

For firms in transition, boards of directors will be of central and increasing importance. First, the firm is shifting its nexus of investments away from domination by

a single individual or family, and toward a more diffuse investment structure. This transition to increased diversity in investors will lead to conflicts of interest that would not exist under the sole proprietorship or closely held structure prior to the transition. Second, because of the more diffuse participants in the organization, the firm's linkages to its external environment will also become more diffuse, and the firm will move away from its reliance on the networks of its founders to a diffuse and decentralized networks that involve other organizational participants (Pfeffer and Salancik, 1978; Granovetter, 1985). Additionally, organizational legitimacy becomes more important, as the founder no longer can speak for or answer for the entire organization, and many of the lower-level employees in the firm will rely upon legitimacy to evaluate their investments of human capital (Haveman, 1993). The board of directors is well-suited to these tasks, and in public corporations these are important (though frequently overlooked) roles of directors (Hillman, Cannella and Paetzold, 2000).

Directors of public corporations frequently serve in service roles, providing advice and counsel to the executive team (Johnson, Daily and Ellstrand, 1996; Hillman et al., 2000). Directors can also provide valuable resources to the firm (Pfeffer, 1972; D'Aveni, 1989). This is particularly critical if the firm needs substantial new and different resources in order to complete its transition. Finally, as mentioned earlier, boards can help resolve conflicts of interests among the firm's various investors, and help retain the commitments of important investors to the company. In this final role, boards serve as an appeal for dissatisfied investors who have not received satisfaction from the dominant coalition (March and Simon, 1958). In effect, this is the board's key role in resolving conflicts of interest among the investors to the firm.

As in the public corporation, boards tend to play a secondary role in the everyday management of the firm. As noted by Fama & Jensen (1983), boards typically ratify and monitor decisions, while executives initiate and implement decisions. The “firm in transition” setting is expected to see the board increase sharply its service role (the provision of advice and counsel to the executive leadership) and its resource dependence role (securing important resources from the external environment). In public corporations, where the fiduciary duty to shareholders is emphasized, it is not infrequent to find boards initiating transitions, especially in situations in which the current executive team has not taken any action, and the firm is suffering from the lack of action or change (Vancil, 1987; Fredrickson, Hambrick and Baumrin, 1988; Johnson, Hoskisson and Hitt, 1993). Most frequently, however, this will occur in situations of duress, where the changes needed are understood, but the current executive group, for whatever reason, is unwilling to make the changes. Of course, as long as the ownership of the firm is concentrated in the hands of its executives, the initiation of transitions can be forced only by the executive owners (McEachern, 1975).

For firms in transition, as we have defined them, it is virtually impossible for a board of directors to initiate a transition, because the ownership of the firm is concentrated, not diffuse. Therefore, any transition must be initiated by the party or parties holding a controlling interest in the firm. However, once the controlling interest has decided to initiate a transition, the board can quickly become a central player in the implementation of that transition.

First, in the resource dependence role, directors can provide valuable resources to the firm. As Stearns & Mizruchi (1993) concluded, directors can provide valuable

financial ties to the firm, such as access to corporate financing through banks or investors. In the setting we are most interested in, the firm is seeking private equity investors, and these must be located and an agreement negotiated (Schillaci and Faraci, 1999). Clearly the prestigious contacts of board members will be of value in this search and negotiation process. Additionally, prestigious and well-connected directors can help assure private equity managers that their funds will be well-used. Here, the monitoring role of directors is seen to increase, although the firm is still privately held.

**Proposition 4:** As a firm initiates a transition through an infusion of outside equity, the networks of outside directors will play a key role in the identification of and negotiation with equity investors.

**Proposition 5:** After a firm has secured a private equity investment, boards of directors will be an important monitoring mechanism in assuring the private equity investors that their interests are given careful consideration.

In privately held firms, boards of directors are selected entirely by the firm's owners, and tend to be close friends and associates of the firm's founders and executives. Indeed, because the primary roles of directors in such firms are the service and resource dependence roles, and close associates of the executives in charge are best suited to serving in these roles, the close linkages to executives is to be expected. However, because transitions increase the diversity of the investors to the firm, the board of directors will shift toward a more diverse structure, with more representation from the firm's non-executive financial investors. Put briefly, the addition of very large investors requires that the firm adopt a governance structure that helps to assure all of the large investors that their interests are protected. The large investors to the firm are clearly also the most powerful, and can demand such protection for their investments (Pfeffer, 1992).

**Proposition 6:** After a firm has secured a private equity investment, the composition of the board of directors will shift away from friends and close associates of the executives to a broader representation of the investors in the firm.

Additionally, as a transition proceeds, the firm will tend to seek out directors with broader networks of contacts who are better able to help the firm secure the essential resources that it needs to survive and prosper (Miner, Amburgey and Stearns, 1990; Johnson et al., 1996). This is a very important step in securing the firm's legitimacy beyond that of its founders, as the networks that support the firm are broadened from the base of its founder and toward a more diverse and diffuse set of network contacts. As the passing of the founder is likely to be a very traumatic phase in the life of the firm (Carroll, 1984), the securing of a prestigious board of directors, with diffuse and valuable networks of contacts that can serve the firm's interests, the likelihood of the firm surviving its founder is greatly increased (Carroll and Teo, 1996). We note that this increase in prestige and in the size and diversity of the networks of directors is likely to correspondingly reduce director abilities to provide the service role – advising the CEO – as the interpersonal relationships between the CEO and directors are likely to be more formal.

**Proposition 7** As firms make the transition from concentrated to more diffuse investment, the composition of the board of directors will change to reflect the board's greater role in organizational legitimacy. That is, directors will be more prestigious, and have larger and more diverse networks.

Finally, as the firm broadens and adds more diversity to its board of directors, the role of the board in securing important resources to the firm is likely to increase. In the privately held firm, the founder or owner's network of contacts is the primary, and often the sole, source of resources from outside the firm. As the firm takes on more diverse

investors, those investors will begin to move the firm away from a total dependence on its founder or executive leaders, and toward a more diverse and replaceable set of individuals. Additionally, the firm will rely more upon the specific and diverse investors to the nexus of contracts. As the firm attracts more prestigious directors, and more widely connected directors, those directors will naturally play a more prominent role in securing important external resources (Johnson et al., 1996).

We have already discussed some of the key resources that directors can provide, such as the identification of and negotiation with private equity investors. Additionally, sources of debt capital, legal advice, regulatory and political advice and support, and help in identifying and negotiating with important suppliers and buyers are all tasks that the board of directors may be called upon to provide.

**Proposition 8:** Increases in the diversity of the investors to the firm will lead to more reliance on the board of directors in the resource dependence role.

From the above discussion, it is easy to see that firms in transition are an excellent source of new insights into the roles and responsibilities of boards of directors, especially in situations where the monitoring role is not as prominent as in the very diffuse ownership structure of the public corporation. While boards of directors play very important roles in public corporations, those roles are likely to differ substantially from those in the transitional setting, or in the setting where a private firm has a diverse set of investors. Many firms in transition are shifting away from the networks and resource dependence roles of their founders, and toward the more replaceable and flexible networks and resource dependence roles of the directors that the firms can attract. This is surely a rich arena for future research.

## **Executives**

Hambrick and Mason (1984) argue that executives bring very specific knowledge, skills, and more importantly, opinions and desires to the company, and the strategy takes shape from these executive resources. Put differently, firm strategy is intrinsically linked to the skills, desires, and capabilities of a specific group of individuals. Here again, firms in transition may provide an excellent place to examine the implications of adding diversity of experiences to the top management group. As before, the context that we consider is one in which the firm is shifting away from a single individual or very small group of owners to a more diverse group of investors.

As noted earlier in the section on labor markets, the attraction of new executives to the firm will be a key challenge. Privately held firms tend to maintain tight control, and make promotion prospects difficult for those who are not direct family members (McEachern, 1975; Vancil, 1987). Additionally, non-family members are likely to feel somewhat insecure in the private firm, as they cannot be certain how well they will be accepted into the firm's culture and how integrated they might become in the firm's dominant coalition (Hambrick, 1994). Two conditions surrounding firms in transition may alter this situation, making it somewhat easier to attract executive talent from outside the firm. First, the increased legitimacy and broader networks of the firm's board of directors makes it easier to attract and retain outside investors of human capital like executives. The outside directors that are not so closely tied to the firm's executives provide some assurances that systematic procedures will be used to evaluate executives for promotion and other rewards, and help to assure potential investors of executive talent from outside the firm that they will receive fair treatment if they join the firm.

Second, other large investors, such as private equity investors, can help assure the new executives that they will receive fair treatment at the hands of the firm's dominant coalition. The private equity investors may well support, or even push for, the addition of executives from outside the firm's traditional sources, perhaps even to weaken the power of the firm's executive cadre (Pfeffer, 1992). Like the addition of outside directors who will uphold their interests, large equity investors will seek out other mechanisms to increase their power relative to those of the firm's other investors (Cannella, 1995).

**Proposition 9:** Firms that have recently taken on private equity investors will be much more likely to change the composition of their TMTs by the addition of executive talent from outside the firm.

**Proposition 10:** Among firms that have recently taken on private equity investors, the prestige of the board of directors will be positively associated with the quality of executive talent that is attracted from outside the firm.

The addition of executive talent from outside the firm will tend to increase the extent to which the firm uses relatively standardized systems and procedures. Executives who join the firm from outside are likely to change the more ad-hoc systems that have evolved within the firm, moving the firm toward more standardized and widely diffused procedures that are already widely legitimated in the economy overall. This shift will tend to increase the legitimacy of the entire firm (Neilsen and Rao, 1987).

Additionally, the addition of executives from outside the firm is likely to prompt a re-evaluation and re-thinking of the firm's overall strategy and strategic direction. Note that this process was initiated by the transition itself. The fact that the firm sought outside equity implied an important shift in strategic emphasis. However, the addition of executive talent from outside the firm will cement this shift, and the new strategy's implementation will proceed more quickly (Johnson et al., 1993; Finkelstein and Hambrick, 1996).

**Proposition 11:** The addition of executives from outside the firm to the top management group will prompt a strategic reorientation or a change in strategic direction for the firm.

### **Suppliers, Buyers and Alliance Partners**

Large and important suppliers, buyers, and alliance partners frequently make firm-specific investments in their relationships with the firm, and therefore become important participants in the nexus of investments (Hill, 1990). Like other long-term participants in the nexus of investments, they are concerned about protecting their investments and relationships with the firm (Pfeffer, 1992). Much of the logic developed earlier about executives from outside the firm also applies to suppliers and alliance partners. They look for legitimacy, stability, standardized systems and procedures, and reliability (Hannan and Freeman, 1977). They are unlikely to invest in the firm without assurances that their rights will be taken seriously. Therefore, many of the propositions made above for executives can be adopted to cover suppliers and alliance partners.

Additionally, however, pre-existing suppliers, buyers, and alliance partners are likely to be disproportionately influenced by the process of transition. First, a disruption in a long-term relationship could be a cause of the transition, as the firm must seek out new investors to replace those lost in the termination of a prior agreement (Pfeffer and Salancik, 1978). The loss of a key supplier, perhaps because that supplier was acquired by another firm, or simply changed its strategy, can lead the firm to initiate a transition in its nexus of investments.

**Proposition 12** The failure of a long-term relationship with a supplier is likely to trigger a sizeable transition in the firm's other relationships.

Any important shift in the nexus of investments will result in a resorting of priorities and claims by the remaining investors. Therefore, when the firm has initiated a

transition, it will re-examine and probably re-negotiate its relationships with the other investors. Suppliers and alliance partners will be important investors whose relationships with the firm must be re-evaluated in the context of a transition. Of course, many of these participants have contractually specified relationships, and this protects them to a large extent in the transition context (Cannella, 1995).

**Proposition 13:** Successful long-term agreements with suppliers, buyers, and alliance partners are likely to be disrupted by important changes in the firm's nexus of investments.

### **Employees**

We consider "employees" to be those who work for the firm, but below the executive level. Employees are the source of many (though not all) new ideas and products (Mintzberg and Waters, 1985). Managers often only ratify new products "after the fact." In the process of creating new strategic options, subordinates bond themselves to the firm, and frequently develop highly specific skills that can be applied to the new strategy (Mintzberg, 1978).

Often these new strategic initiatives do not cause transitions directly, because they are not sizeable enough to cause a re-evaluation of the firm's current practices. However, very successful strategic initiatives legitimate executives and their associated skills within the firm, and therefore are very important in the ongoing processes that characterize firms. Additionally, subordinates who are considered key players or drivers in the firm are also most likely to be promoted to more senior positions, thus more firmly establishing their own particular skills and resources as critical to the success of the firm (Mintzberg, 1983; Vancil, 1987; Finkelstein and Hambrick, 1996).

Transitions are likely to disrupt this process significantly, because there are groups of employees who have developed skills and resources for the current strategy,

and within the current nexus of investments. By making sizeable changes in that nexus of investments, the subordinates must re-evaluate their investments striving to understand how the changes will affect them personally. Some of these investments may be firm-specific, and some may not. Certainly, though, transitions will cause some of the subordinates to conclude that the human resources in their possession, in light of their personal goals, will be better suited to employment elsewhere. Thus, we expect transitions to be marked by a wave of employee exits and entries (Pfeffer, 1981; Cannella, 1995).

**Proposition 14** Transitions will lead to a re-evaluation of investments among employees of the firm, and some will conclude that their human resources will be better served by employment elsewhere. Therefore, transitions will be marked by increased levels of both voluntary and involuntary exit among employees.

Employees may need to be attracted to the firm, or kept in place when times are very difficult. Whenever firm-specific abilities are needed, employees confront many of the same issues as executives, but do not have the same level of visibility, power, and influence as executives. Additionally, employees tend to have less invested in the firm than executives, in that their alternative wage in another firm may be closer to their current wage than is the case for executives (Cannella and Ortin Ángel, 1999). Therefore, employees can change employers at lower cost than can executives. However, should the firm need to attract more prestigious employees, or those with special skills and abilities, the firm's reputation and overall legitimacy will be very important to this effort (Amburgey and Rao, 1996).

## DISCUSSION

Our paper has tried to redirect research on corporate governance, using the setting of firms in transition as one in which researchers can more clearly understand the various parties to the nexus of investments and their interests. While our discussion is closely linked to the US public corporation example, our arguments have been deliberately broad. For example, the assertion that in order to attract investors of all kinds (not just those of financial capital) the interests of those investors must be protected is not limited to US, or even European companies.

All organizations must attract investors to survive. Not-for-profit firms must attract individuals willing to invest their time and effort in the organization, and these investors must believe that their investments are leading to outcomes that they value. For-profit organizations must also attract investors of all sorts of resources. In addition to financial investors, organizations must attract suppliers and partners willing to make specific investments in their relationships with the firm. Perhaps most important are employees and executives, who often develop firm-specific human capital in the hopes of establishing the firm in a good competitive position. These investors are quite undiversified, and without assurances that their investments will yield a good return in the future, they are unlikely to be willing participants.

Corporate governance research needs to move beyond the focus on executive-shareholder relationships (Daily et al., forthcoming). The firm has much broader participation than simply executives and shareholders, and the participation of others is absolutely crucial to firm success. The special case of firms in transition is particularly interesting, because these firms are changing the nexus of investments in a significant and

abrupt way (Schillaci and Faraci, 1999). To successfully complete the transition, the participants in the nexus of investments that comprises the firm must re-negotiate their relationships and interrelationships. Our paper has tried to describe some of the mechanisms through which this re-negotiation process would take place.

Firms in transition are both theoretically and empirically interesting. Through the study of these firms and the processes they go through as they alter themselves significantly, we can better understand governance processes in general. Additionally, as firms shrink in size and we observe more and more startup firms, the processes of transition are likely to grow even more important in the future. Finally, as the markets of the world become more open to global competition, many of the successful family businesses that have grown large under protected markets will be forced to alter their internal operating procedures in order to survive. Put differently, the topic of firms in transition is likely to become ever more important in the future.

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