ASAC 2006 Banff, Alberta

### KEEPING AN EYE ON FOUNDERS AND A THUMB ON MERCENARIES: A STUDY OF CORPORATE GOVERNANCE IN IPOS

This study uses agency theory and stewardship theory to examine differences in governance structures between founder-led and mercenary-led IPO firms. We use a sample of 246 firms and score these firms based on the governance provisions that they employ. We find that founder-led firms are more likely to be more shareholder friendly than mercenary-led firms.

#### Introduction

Recent scandals and regulatory activity point to the importance of empirical investigation into corporate governance and the factors that influence the decisions to adopt various governance practices. In this article, we examine firms at the time they are preparing to issue their initial public offerings and the various governance provisions adopted at this crucial point in their history.

Agency theory suggests three main methods of addressing agency problems: empowering minority shareholders; giving greater managerial oversight powers to the board of directors, and creating a takeover-friendly environment (Gompers, Ishii, & Metrick, 2003). Several studies show that the voluntary implementation of shareholder-friendly governance elements adds to firm value and argue that this occurs because the governance provisions reduce agency costs. For example, Boehmer (1993) and Clarkson et al. (1991) both find evidence of a positive relationship between insider ownership retention and firm value. Outsider-dominated boards (Bhagat & Black, 1996) and smaller boards (Monks & Minow, 1995; Yermack, 1996) are found to be positively related to firm value.

There are mixed results in the small body of empirical evidence exists concerning the importance of strong corporate governance in firms at the time of their initial public offering (IPO). Field and Karpoff (2002) empirically examine the use of takeover defenses by IPO firms. They find that, IPO firms, on average, employ fewer defense mechanisms such as staggered boards, supermajority voting requirements, and, to a lesser extent, poison pills relative to more seasoned counterparts. They also note that having takeover defenses does not significantly affect underpricing. Certo et al. (2001) find that the presence of firm founders increases underpricing, but that board independence (insiders versus outsiders) moderate this relationship, and that founder-led firms with a higher proportion of insiders actually experience lower underpricing. In contrast, Jayaraman et al. (2000) find no relationship between the founder's presence and underpricing.

These findings suggest that corporate governance choices at the time of the IPO are complex and critical to the viability of the firm as a publicly-traded company. As the firm prepares itself for the stock market, it generally undergoes the first major restructuring where it makes choices and enacts provisions that will have a long lasting effect on the firm (Martens, 2004). A traditional corporate governance perspective suggests that the reasoning for these corporate governance choices may be not only to alleviate agency problems, but may reflect concerns about signaling good governance or strong management to potential investors. Balancing these concerns, however, is certain of the unique

characteristics of the IPO context, for example the desire to maintain the entrepreneurial spirit and management that brought the firm to the IPO stage (Baron, Hanna, & Burton, 2001).

In this paper we address two issues critical to understanding corporate governance in the IPO context. Research has pointed to the importance of distinguishing between *founder managed* and *professionally managed* firms (e.g. Wasserman, 2003; Fisher & Pollock, 2004). Within the literature on IPOs and founders, the term *professional manager* typically is used to refer to hiring an experienced manager from outside the firm to serve as the CEO of the firm. Although authors who use this term likely intend no offense to founders, the term professional manager may contain an unstated assumption that founders are not or cannot be professional, especially when the research contrasts firms lead by founders with firms lead by professional managers. As we do not wish to give any impression that founder-led firms cannot be considered professionally managed, we will adopt the terminology used by Fisher & Pollock (2004) where they use the term *mercenary* to refer to outside managers, especially CEOs, brought into the firm just prior to the IPO.

We argue that while agency theory arguments for strong corporate governance may be relevant to mercenary-managed firms, stewardship theory may be the more appropriate theoretical framework for founder-managed firms. We contend that this leads firms to employ different governance levels and provisions when the firm is preparing itself for an IPO. Research has also pointed to the important monitoring role played by venture capitalists and underwriters. We propose that, regardless of management status, pressures from venture capitalists and prestigious underwriters will also be associated with stronger corporate governance.

#### Agents or Stewards? Role Identification in New Ventures

Fama and Jensen (1983) suggest that strong links between management and the firm may reduce agency conflicts. In essence, this formulation suggests that, under certain circumstances, stewardship motives may dominate over the agency costs of managerial self-interest <sup>1[11]</sup>. Stewardship theory, posits that although the interests of management and shareholders may diverge, managers will still act in the best interest of the organization and its shareholders (Donaldson, 1990a; 1990b; Barney, 1990). Fox and Hamilton (1994) suggest that managers are stewards of the companies they work for, and in maximizing the welfare of the company, maximize their own utility functions (that is to say that management and the company's interests are perfectly aligned). Davis, Schoorman, and Donaldson (1997) argue that agency theory presents a negative bias of management and that they are not trustworthy. Within the context of takeovers, Angwin, Stern, and Bradley (2004) argue that CEOs who reject a bidder's offer are acting in the best interests of shareholders, and not just trying to keep themselves from being terminated following a change in control. Davis, Schoorman, and Donaldson (1997) argue that agency theory and stewardship theory are not meant to be seen as competing theories – they simply note that there are some situations where agency theory may be more applicable and vice-versa. In this article we examine a context in which each of the two theories may be more applicable to different situations.

## **Founder Influence**

In the case of founder-led firms at the time of their IPOs, we argue that founders can be considered stewards of the companies they lead. Wasserman (2006) argues that founders are more intrinsically motivated than non-founders and derive more non-monetary benefits from working in the

<sup>&</sup>lt;sup>1[11]</sup>Schultze et al. (2001, 2003) suggest that the motivations of founders and family members may differ from those of outside investors. However, their formulations have largely focused on private firms in which non-economic or 'altruistic' motivations may be more relevant.

companies they started. In contrast, CEOs who are hired by the board of directors to manage the firm may be more likely to act as agents of the firm's shareholders (the classic agency relationship). Considering the firm founders' entrepreneurial characteristics (Wasserman, 2006), we would expect that founders are more likely to act in the best interest of their firm and their firm's shareholders than mercenary CEOs. Recent research is finding performance benefits of founder management (Nelson, 2003; Wasserman, 2003; Fisher & Pollock, 2004). Indeed, research points that the positive performance implications of founder management remains even among large firms in the Fortune 500 (Anderson & Reeb, 2003; 2004). The positive implications of founder management may be particularly relevant to publicly traded firms. Schulze and his colleagues (Schulze et al., 2001; 2003) argue that the interests of founders and their families differ from those of other shareholders. Although there is considerable merit to this argument, particularly in privately held firms, the founders of IPO firms have elected to submit themselves and their firms to capital market scrutiny. Since the IPO process may significantly limit their ability to take advantage of their decision, non-steward founders may prefer to avoid such scrutiny.

In contrast, the mercenary-led context may be one in which agency theory formulations are more relevant. Specifically the mercenary lacks the founder's deep ties to the firm (Wasserman, 2006). Indeed, the mercenary's shorter time horizon within which to 'prove themselves' may exacerbate agency problems. Further the IPO context is characterized by uncertainty and ambiguity and information asymmetry may contribute to agency problems (Beatty & Ritter, 1986).

The higher agency problems more prevalent in mercenary-led IPO firms may be reflected in stronger corporate governance at the time of the IPO to reassure investors and reduce agency costs. Particularly given the benefits of founder-management, founder-led IPO firms may choose less stringent corporate governance to allow the founder greater latitude. This suggests the following:

# *H1:* Founder-led firms will have less stringent corporate governance than firms led by a mercenary CEO.

Kelly and Switzer (2005) find that governance characteristics and bases of power, most notably CEO ownership and CEO duality, are substitutes. Building on this, stewardship theory suggests that managers be empowered to fulfill organizational objectives (Donaldson & Davis, 1991), so, assuming that founders act in the organization's best interests as advocated by stewardship theory, we anticipate that founders will acquire no more power than is necessary to execute the tasks required by the organization.

H2: Strength of corporate governance in founder-led firms will be positively associated with the level of founder ownership.

# H3: Strength of corporate governance in founder-led firms will be higher for firms whose CEO is also the Chairman of the Board.

As previously noted, an agency theory framework appears to be more appropriate when investigating relationships involving mercenary CEOs. Agency theory identifies ownership as a mechanism linking the interests of the CEO with those of other shareholders. However, there is growing evidence that, particularly in high risk firms, large ownership stakes can have significant drawbacks. As CEO ownership (and power) increases, the CEO's personal portfolio, which includes human capital personally invested, becomes less diversified (Morck, Shleifer, & Vishny, 1990; Wright & Ferris, 1997). This has two important implications. First, the CEO tends to *discount* the value of their ownership (Anderson et al., 2000; Meulbroek, 2001). If this is the case, additional ownership provides limited incentive value. These trends are particularly relevant to high risk firms such the high technology IPOs in our study. Further the CEO's lack of diversification choices may result in the firm making sub-optimal investment decisions as a result of the CEO's risk aversion and managerial opportunism (Agrawal &

Mandelker, 1987). Baker and Gompers (2003) find that as CEO power increases, outside board membership decreases. In order to facilitate the making of decisions that favor management, we would expect further efforts on the CEO's part to concentrate power, resulting in the following prediction:

- *H4:* Strength of corporate governance for firms led by a mercenary CEO will be negatively related to the level of CEO ownership.
- H5: Strength of corporate governance in mercenary-led firms will be weaker for firms whose CEO is also the Chairman of the Board.

## **Firm Structure**

Dalton et al. (1998) performed a meta-analysis of firms' leadership structures (which include the top management team and the board of directors). The authors argue that as firms grow larger and more complex, they set up more elaborate organizational structures in order to manage the increased number of relationships in the organization. Given the difficulty of informal monitoring, large size may be associated with more stringent corporate governance in IPO firms. Wasserman (2006) finds that managers in larger organizations tend to act more like agents than stewards, and are more likely to extract private benefits if they are able to. Thus, we expect the following:

## *H6:* Larger firms will have weaker corporate governance than smaller firms.

IPO firms may suffer from a resetting of the liability of newness clock (Amburgey, Kelly, & Barnett, 1993.). Given that investors have limited history or benchmarks from which to judge the strength of firm management, directors, and corporate governance, new firms may adopt strong corporate governance as a signal. If successful, the need to use strong corporate governance as a signal to investors dissipates. Indeed, the continued success of the firm and its management may reassure investors, and enable the firm to relax its original corporate governance choices. Field and Karpoff (2002) find that, over time, firms are more likely to implement anti-takeover measures. Although the implementation of takeover defenses is only one way that managers can take power away from outside shareholders, the authors note that IPO firms that adopt takeover defenses also have weak levels of outside monitoring. Thus, we expect that:

H7: Older firms will have weaker corporate governance than younger firms.

## **Third Party Certification**

Several works provide evidence of venture capitalists influencing the governance of entrepreneurial firms. Gompers (1995) and Lerner (1995) both find evidence of monitoring activities by VCs. Baker and Gompers (1999) find that VCs simultaneously attempt to enhance the incentive effects of CEO equity holdings and mitigate the negative aspects of control that comes with higher levels of CEO ownership. Baker and Gompers (2003) find that venture-backed firms have more independent board members and fewer directors who are insiders. Based on previous findings, we would expect that:

# *H8:* Venture-backed firms will have stronger corporate governance than non venture-backed firms.

Venture capitalists have long investment horizons, often extending several years past the IPO (Barry, Muscarella, & Vetsuypens, 1990). As large shareholders, VCs have an incentive to monitor the activities of the firms in their portfolios because the compensations VCs receive as well as their ability to raise additional funds in the future are driven by the returns they generate on their current portfolios

(Hochberg, 2003). As the stakes that VCs take in a firm increases, so do the incentives of monitoring; therefore, we predict that:

# *H9: More rounds of venture capital financing will be positively associated with stronger corporate governance.*

Research has also pointed to role of underwriters, particularly underwriter prestige (Carter, Dark, & Singh, 1998). Lamertz and Martens (2005) investigated the deal networks created between IPO firms by VCs, underwriters, and strategic partners, and find that firms that go public with the same underwriter, as well as firms that have financing from the same VC, have similar characteristics, as proxied by the firm strategies, risks, and uses of proceeds. In effect, VCs, underwriters, and strategic partners mould the firm to their liking in preparation for the IPO. Because firms with more shareholder-friendly provisions (lower governance provisions) perform better (Gompers, Ishii, & Metrick, 2003), firms that go public in the future may use governance as a signal of firm quality. Fernando, Gatchev, and Spindt (2005) suggest that the matching process between issuers and underwriters is based on mutual choice and find that high quality firms will go public with more reputable underwriters.

There are several reasons why association with a prestigious underwriter is associated with stronger corporate governance. Given that underwriter prestige is a major factor in the success of the IPO (Carter, Dark, & Singh, 1998), use of a prestigious underwriter is a valuable resource for the IPO firm. Therefore, a prestigious underwriter is in a better position to promote strong corporate governance to better attract investors and protect their reputation. Baker & Gompers (2003) found that venture capital backing to be associated with stronger IPO governance and we argue that underwriter prestige will likely have a similar effect. From this, we anticipate that:

# H10: Firms associated with more prestigious underwriters will have stronger corporate governance than those with less prestigious underwriters.

## Methodology

#### Data

Our sample consists of 246 computer software and business service firms that went public between 1996 and 2000. This sample is a subset of a dataset of all 435 computer software firms that went public during the 1996 – 2000 time period. We are currently collecting the data for all 435 firms and the results reported in this paper are the preliminary results in this research. The sample was derived by performing a search for U.S. equity IPOs in the Securities Data Corporation (SDC) Global New Issues database. We excluded spin-offs, roll-ups, and secondary share offerings, and restrict our search to SIC codes 7360-7379 (Software and Business Services). In order to obtain information on firm characteristics, we collected all data from IPO prospectuses, which, starting in mid-1996, are filed electronically on the Securities and Exchange Commission's EDGAR database at <a href="http://www.sec.gov">http://www.sec.gov</a>. All information pertaining to information on management characteristics, underwriters, offering sizes, stock holdings are available within the prospectuses, with distinct sections often presented for each item. The firms in our sample are, on average, just over eight years old at the time of the IPO, have 447 employees, and had an average IPO valuation of \$60.2 million. Founders lead 60% of the firms and, when they do, retain 20% of the total shares of the firm.

### **Governance Provisions**

Gompers, Ishii, and Metrick (2003) created a governance index that measures the degree to which shareholder rights are favored over management, and find a positive relation between shareholder rights in firms and stock price performance. Their system is simple, yet effective and comprehensive. For every management-friendly provision that a firm has, the firm scores a point in the index. It follows that firms with higher scores for the governance index have greater restrictions on shareholder rights and instead give greater power to management, whereas firms with lower scores for the governance index promote the rights of shareholders or do not restrict them as much.

The Gompers, Ishii, and Metrick (2003) corporate governance index contains five different categories<sup>2[12]</sup>. *Delay* provisions are those which have the effect of making it more difficult for large shareholders to acquire a controlling stake in the firm, such as having a board with staggered terms, or authorizing the board to issue new shares without shareholder approval. *Protection* provisions include contracts which limit the personal liability of officers and directors, and compensation packages payable to executives upon termination of their employment. Elements in a company's charter or by-laws that reduce the power of voting shares, such as supermajority requirements to approve mergers or to amend said elements fall into the *Voting* provision category. Companies are also afforded different levels of takeover protection depending on the state they choose to incorporate in. These *State Laws* may contain restrictions on the minimum length of time before a company can be acquired by an interested shareholder, as well as price provisions for tender offers. There are also *Other* provisions that companies may adopt, such as allowing directors to consider stakeholders other then shareholders when evaluating bids from other firms, and poison pills, which allows the firm to issue new shares at deeply discounted prices to shareholders not soliciting a tender offer.

Scoring firms' governance is simple; for each provision that limits shareholder rights or provides managers with more power, the firm scores a point. Although there are 28 provisions that make up the governance index, only 24 are unique because four of them (Antigreenmail, Director's Duties, Fair Price, and Supermajority/Business Combinations) may either be state laws, provisions adopted by a firm, or both. To account for this, firms may only score one point for each of the above provisions, resulting in a maximum score of 24.

We constructed the governance index for our data using information from firm's IPO prospectuses. Since IPO prospectuses contain a fairly standardized format, governance provisions generally appear exclusively in three sections of the document. In the *Risk Factors* section, there is usually a heading that discusses the potential impact of firm charter and by-law provisions on the stock price. In nearly all of the prospectuses, a firm's *Delay* provisions will be listed in this section. These, along with *Voting* and *Other* provisions, can also be found in the *Description of Capital Stock* section near the end of the prospectus, which follows the *Principal Shareholders* section. The *Management* section contains information on the firm's board structure, as well as any agreements that the company has entered into with its executives (*Protection* provisions). Mentions of limitations of liability and indemnification for directors may appear in this section or in the *Description of Capital Stock* section. Finally, we used the information available in Pinnell (1989) for descriptions of the *State Laws* that concern takeover defences. In Table 1 below, we present the relative frequency with which firms adopt governance provisions.

There are several noteworthy differences between founder-led firms and mercenary-led firms. First, mercenary-led firms appear more likely to adopt a number of the protection provisions, which

<sup>&</sup>lt;sup>2[12]</sup> For more detailed descriptions of the various provisions firms may employ, see Gompers, Ishii, and Metrick (2003), and Rosenbaum (1998).

would appear consistent with our expectations that mercenary CEOs will encourage the adoption of these provisions in order to protect their personal human capital. Interestingly, contrary to our expectations, we observe that founder-led firms adopt delay provisions more frequently. Although we cannot infer with a great deal of confidence that this may be the case, it is possible that they more readily encourage the adoption of these provisions because they want their firm to grow and operate independently.

## Table 1

	Total cample	Foundar-led	Marcanary_lad		
Provision	(n=246)	firms (n=147)	firms (n=99)		
Delav	(		()		
Blank Check	96.34%	96.60%	95.96%		
Classified Board	58.54%	60.54%	55.56%		
Special Meeting	71.14%	75.51%	64.65%		
Written Consent	56.10%	59.18%	51.52%		
Protection					
Compensation Agreements	3.25%	0.68%	7.07%		
Golden Parachutes	17.07%	15.65%	19.19%		
Severance	47.97%	45.58%	51.52%		
Indemnification	87.40%	87.07%	87.88%		
Contracts	60.98%	59.86%	62.63%		
Liability	86.18%	86.39%	85.86%		
Voting					
Bylaws	30.08%	31.97%	27.27%		
Charter	30.08%	30.61%	29.29%		
Cumulative Voting*	1.63%	2.04%	1.01%		
Secret Ballot*	0.00%	0.00%	0.00%		
Supermajority	6.10%	4.76%	8.08%		
Unequal voting	2.44%	4.08%	0.00%		
State Laws					
Antigreenmail	4.07%	3.40%	5.05%		
Directors' Duties	16.67%	16.33%	17.17%		
Fair Price	10.98%	11.56%	10.10%		
Cash-out	1.63%	1.36%	2.02%		
Control Share Acquisitions	11.38%	10.20%	13.13%		
Business Combinations	75.20%	75.51%	74.75%		
Other					
Antigreenmail	0.00%	0.00%	0.00%		
Directors' Duties	5.69%	4.76%	7.07%		
Fair Price	1.63%	1.36%	2.02%		
Poison Pill	1.22%	2.04%	0.00%		
Pension Parachutes	0.00%	0.00%	0.00%		
Silver Parachutes	0.00%	0.00%	0.00%		

# **Relative Adoption Frequency of Individual Governance Provisions**

Note: Provisions marked with an asterisk (\*) are considered to favour shareholders

Finally, we note that the high presence of the business combination provision relative to other state law provisions is due to the majority of firms in our sample (59%) being incorporated in Delaware, which has business combination provisions as its only anti-takeover statue. **Empirical Model** 

**Dependent Variables**. We are interested in what drives differences in the provisions that firms adopt. As such, our dependent variable is the governance index (*Gov-Index*) score, which is a discrete variable which ranges from zero to 24. As noted earlier, higher governance index scores imply more power for managers and lower scores imply more power for shareholders. We also examine the effects that the independent variables have on the *Delay*, *Voting*, *Protection*, and *Other* sub-sections of the governance index.

**Independent Variables.** For each firm in our sample, we code firms as being founder-led if, at the time of the IPO, a founder remains as a firm's CEO. The variable *Founder-CEO* is a dummy variable that takes a value of one where the founder is the CEO, and zero when a mercenary is the CEO. The *CEO-Chair* variable is an indicator variable that takes a value of one if the CEO is also the Chairman of the Board, and zero otherwise. Because we expect the presence of firm founders to moderate the effects of *CEO-Own* on the governance index, we include an interaction variable (*Founder-CEO \* CEO-Chair*) to evaluate the data for the relevant hypotheses. The variable *CEO-Own* represents the portion of the voting power of the firm that is retained by a firm's CEO after the IPO, and ranges from zero to 100 percent. As with the *CEO-Chair* variable, because we expect the presence of firm founders to moderate the effects of *CEO-Own* on the governance index, we include an interaction variable (*Founder-CEO \* CEO-Chair*) to evaluate the data for the relevant hypotheses. The variable *CEO-Own* represents the portion of the voting power of the firm that is retained by a firm's CEO after the IPO, and ranges from zero to 100 percent. As with the *CEO-Chair* variable, because we expect the presence of firm founders to moderate the effects of *CEO-Own* on the governance index, we include an interaction variable (*Founder-CEO \* CEO-Chair* expective) to the hypotheses associated with these variables.

To measure firm size at the time of the IPO we use the natural log of IPO Valuation as comprehensive measure of IPO firm size. IPO Valuation is the offering price of the IPO times the number of shares offered. The first is an appropriate firm size metric for young and rapidly growing firms while the second is the standard measure of the size of the IPO. To proxy for size, we also use the natural log of the number of employees that a firm has at its IPO, but we do not present the results because the natural log of IPO Valuation is found to be a superior proxy. We measure *Firm Age* as the difference in years between the time the firm went public and when it was founded. On a few occasions no original founding date was specified in the prospectus. To compensate for these missing data points, we used the date of incorporation of the firm. Also, to control for the skewness in the data, we employ the natural logarithm of the *Firm Age* variable in our models.

Venture capitalists' involvement with the firms are measured by *VC-Backed*, a dichotomous variable where a value of 1 indicates that the firm had at least one round of venture financing prior to the IPO and zero otherwise. Because of the possibility of different levels of VC involvement, we also include *VC Rounds*, a discrete variable that measures the number of rounds of venture financing prior to the IPO, as an alternate measure. Finally, we measure underwriter prestige (*UW-Rank*) using the rankings published by Loughran and Ritter's (2004) updated underwriter prestige measures, which are based on the ratings published in Carter, Dark, and Singh (1998).

**Control Variable**. We include a dummy variable (*IPO Bubble*) to control for any potential differences among firms that went public during the dot-com bubble that occurred in 1999 and 2000 (Ritter & Welch, 2002). A value of one indicates that the firm issued the IPO during the 1999–2000 bubble and a zero indicates that the IPO occurred between 1996 and 1998.

**Statistical Model**. To test our hypotheses, we estimate the following Ordinary Least Squares (OLS) regression model:

Gov-Index =

(1)

We also estimate similar models for each of the sub-sections of the governance index. We expect the coefficients of *Founder-CEO* to be positive, *Founder-CEO* \* *CEO-Chair* and *Founder-CEO* \* *CEO-Own* to be negative,  $\ln(IPO \ Valuation)$  and  $\ln(Firm \ Age)$  to be positive and *VC-backed*, *VC Rounds*, and *UW-Rank* to be negative.

#### **Analysis and Results**

Table 2 in Appendix A presents the descriptive statistics and correlation matrix for the variables in our model. The matrix provides some initial indications about the relationships among the variables in our model. The first noteworthy results found in this table are the low correlations among the governance provision sub-sections. The highest correlation among the five sub-sections is .26 between delay and voting provisions. This suggests that adoption of the various governance sub-sections is independent of each other and that firms do not tend to adopt many or few of the provisions but rather select some provisions over others for various reasons.

The significant correlation between valuation and founder CEO shows that founder-led firms tend to acquire slightly lower valuations compared to mercenary-led firms. This is consistent with recent research (Fischer & Pollock, 2004; Nelson 2003) and suggests that the firms in our data are similar to IPO firms used in other research. This suggests that, even though our study focuses on a single industry and a specific historical period, the results are generalizable and not unique to the industry or time period.

Table 3 presents the results of the OLS regression models for the overall governance index. In interpreting the results, it is important to keep in mind that the Gompers et al. (2003) governance index is essentially reversed scored. High scores on the Governance index scale are less shareholder-friendly and thus are weaker governance as higher scores indicate higher managerial power. Conversely, lower governance index scores are shareholder friendly and thus indicate stronger governance. In general, the results show very small adjusted R-squared values, however this is fairly typical in IPO research (Beatty & Ritter, 1986; Ritter & Welch, 2002).

Hypothesis 1 (Founder-led firms) is not supported, however, the results do provide support for hypothesis 2. A greater level of ownership by the founder is associated with lower governance index scores. This negative coefficient reflects stronger governance oversight in terms of a higher level of shareholder-friendly provisions. Hypothesis 3, Founder CEO-Chairman duality is not supported in these analyses.

The results support for hypothesis 4 (mercenary CEOs) as higher levels of ownership by mercenary CEOs is associated with higher governance scores. However, as with the Founder duality variable, the Mercenary duality measure is not significant and the results do not support hypothesis 5. Our analyses do not support the notion that corporate governance may weaken when additional power is held because either a founder or mercenary CEO hold both the CEO and Chairman positions.

#### Table 3

	Model	1	Model	2	Model	3	Model	4	Model	5
Variable	b	s.e.	b	s.e.	b	s.e.	b	s.e.	b	s.e.
Intercept	9.98***	0.22	9.36 ***	0.37	11.12 ***	1.06	10.80 ***	1.22	11.18***	1.23
IPO Bubble	-0.32	0.28	-0.26	0.29	-0.15	0.30	0.30 -0.21		-0.19	0.31
Founder CEO			0.69	0.47	0.66	0.47	0.70	0.47	0.69	0.48
Founder CEO x CEO-Own			-0.05 *	0.02	-0.05 *	0.02	-0.05 *	0.02	-0.05*	0.02
Founder x CEO-Chair			0.43	0.58	0.36	0.58	0.24	0.58	0.34	0.58
Mercenary CEO-Own			0.05 *	0.02	0.05 *	0.02	0.05*	0.02	0.05*	0.02
Mercenary x CEO-Chair			-0.25	0.45	-0.18	0.45	-0.05	0.46	-0.15	0.46
Ln(Firm Age)					0.00	0.18	0.11	0.19	0.04	0.19
Ln(Valuation)					-0.47 *	0.23	-0.38	0.26	-0.39	0.26
VC-Backed							0.68 *	0.32		
# of VC Rounds									0.07	0.08
Underwriter										
Prestige							-0.09	0.12	-0.07	0.12
R2	0.52%		4.72%		6.37%		8.21%	6.85%		
Adj R2	0.11%		2.33%	3.21%			4.30%			

### **OLS Regression Results for Governance Index Scores**

Note: p-values: \*\*\* = p < .001; \*\* = p < .01; \* = p < .05; † = p < .10

In hypothesis 6 we posited a positive association between firm size, as measured by the IPO valuation, and the governance index. This coefficient for this variable was significant in one of the models but the sign is the opposite direction from our expectations. The result in model 3 not only does *not* support the prediction, it is contrary to what we had expected. Extending the work of Field and Karpoff (2002), who noted that larger and older firms tend to adopt more anti-takeover defences, we posited that larger firms would be more likely to adopt governance mechanisms that are less shareholder-friendly and thus would produce higher governance index scores. The negative coefficient suggests that larger firm size is associated with lower governance scores and thus, more shareholder friendly governance. One possible explanation for this result is that management in larger firms may have an easier time extracting private benefits because of greater dispersion in stockholdings. Although there typically is a positive correlation between firm size and firm age, the firms in this sample did not produce that association. The expected positive coefficient for firm age is there but the results are not significant and thus the results to not support hypothesis 7.

We included three variables to examine for potential influence of third parties such as Venture Capitalists or Underwriters. We expected to observe stronger corporate governance effects by finding negative coefficients for both the *VC-Backed* and the *VC Rounds* variables. The results do not support either hypotheses 8 or 9. The significant positive coefficient for *VC-Backed* variable is the opposite of our expectations and indicates that VC backing is associated with weaker corporate governance. Finally, the coefficient for the underwriter prestige variable is not significant and hypothesis 10 is not supported.

As discussed earlier, adoption of each of the provisions in the governance index sub-sections may be independent from each other. To examine this possibility, we conducted OLS regression analyses for our model using the sub-section scores as the dependent variables to investigate governance differences at a more fine-grain level. We do not report the results for the OLS regression on *Other* sub-section provisions because none of the variables were found to be significant. We also did not include the *VC rounds* variable as it did not appear to have an impact on the overall Corporate Governance results.

As indicated by the results presented in Table 4, we do find significant and interesting results among the tables presenting the sub-section regressions. For example, VC backing is significantly associated with higher scores on the delay provisions. This finding suggests that VCs appear to be promoting provisions which delays challenges to their power. The positive and significant coefficient on the Mercenary CEO ownership variable also suggests that Mercenaries are able to promote delay provisions but only when they have higher levels of ownership in the firm. The Founder-CEO ownership variable is significantly associated with decreases in the adoption of protection and voting provisions These findings may suggest that IPO firms try to protect the human capital of the founder CEO.

#### Table 4

## **OLS Regression Results for Governance Index Sub-sections**

	<u>Delay</u>		Protectio	<u>)n</u>	Voting			
Variable	b	s.e.	b	s.e.	b	s.e.		
Intercept	2.49***	0.62	3.37***	0.63	3.33 ***	0.54		
IPO Bubble	0.15	0.15	0.10	0.16	-0.15†	0.30		
Founder CEO	0.27	0.24	0.05	0.24	0.22	0.21		
Founder CEO								
x CEO-Own	-0.01	0.01	-0.02†	0.01	-0.02 †	0.01		
Founder CEO								
x CEO-Chair	0.06	0.29	0.13	0.30	0.15	0.26		
Mercenary								
x CEO-Own	0.02 †	0.01	0.01	0.01	0.01	0.01		
Mercenary								
x CEO-Chair	0.09	0.23	0.09	0.23	0.03	0.20		
Ln(Firm Age)	-0.05	0.10	0.10	0.10	0.04	0.08		
Ln(Valuation)	-0.11	0.13	-0.12	0.13	-0.03	0.11		
VC-Backed	0.71 ***	0.16	0.28†	0.17	-0.03	0.14		
Underwriter								
Prestige	-0.01	0.06	-0.03	0.06	-0.08†	0.05		
R2	13.94%		3.56%	_	5.85%			
Adj R2	10.28%		0.00%		1.84%			

Note: p-values: \*\*\* = p < .001; \*\* = p < .01; \* = p < .05; † = p < .10

#### Discussion

In this paper we provide evidence that stewardship theory may be more appropriate to understanding corporate governance in founder-led firms, whereas agency theory appears to be more appropriate to mercenary-led firms. Although Hypothesis 1, that founder-led firms would have lower governance scores was not supported, results concerning the ownership stake of founder and mercenary CEOs were congruent with our hypotheses. For both the overall governance score, and for the sub-scales of delay and protection, the ownership stakes of the founder-led firms are associated with corporate governance levels that are more shareholder friendly. In contrast, larger shareholdings by mercenary CEOs are associated with greater amounts of shareholder unfriendly corporate governance provisions. These results are congruent with our proposition for the applicability of stewardship theory to founding CEOs and agency theory to mercenary CEOs. These results suggest that stewardship becomes relevant when the founder commits his or her wealth to the firm via ownership. One of our variables concerning third party power provided results contrary to our hypotheses but is still worthy of discussion – VC backing was associated with weaker corporate governance (higher governance index scores). Our finding of stronger corporate governance in larger firms is congruent with our framework that firm size may mitigate CEO stewardship orientation. The greater monitoring difficulties associated with large size may also imply the need for more formal and elaborate protections.

### Limitations and Suggestions for Future Research

Probably the most important issue to take into consideration is that the data we use comes from a specific time period, and thus might not be consistent with different time periods. The IPO market is influenced, to a certain extent, by market patterns that are unstable over time (Tiniç, 1988; Ritter, 1991). Given the uneven distribution of IPOs over time and market cycles, this drawback may be inherent to IPO research. Another important consideration is the single industry in which this research is conducted. It may not feasible to conclude from this research that the results would hold for other industries. The computer software service industry chosen may exhibit particular characteristics that may not exist in other industries. Investors may also react differently when evaluating firms in different industries. The results obtained in this research may not be extrapolated to firms that are at a different stage of their life cycle. Firms that have not gone through the IPO process or firms that had their IPOs decades ago are likely different and will therefore adopt substantially different governance provisions. For example, not all IPOs are start-ups. IPOs can be the result of a decision to spin off a division or a larger company, although this type of firm was not included in our data.

Finally, it is important to point out the limitations related to the collection of archival data, which may result in biases or errors. However, the contribution of multiple individuals to collect and verify the data should have minimized the errors made during the collection process.

Our research examines and contrasts agency theory and stewardship theory within the specific context of firms preparing to become publicly-traded companies. Following Davis, Schoorman, and Donaldson's (1997) contention that each of the two theories are more applicable to different situations and are not competing theories, we compared firms within a similar context that have one key difference, the choice of the executive leading the firm at the time of the IPO. Our research shows that there appears to be substantive governance differences between founders and mercenaries and future governance research examining this context should explore the reasons for these differences. Although our research suggests that founder-led firms are more likely to adopt governance that is consistent with stewardship theory, there may be situations in which founders act more like agents and mercenaries act more like stewards. Researchers examining this context need to further explore and explain the conceptual and empirical differences between founders and mercenaries.

#### References

Agrawal, A. and Mandelker, G., "Managerial Incentives and Corporate Investment and Financing Decisions", *Journal of Finance*, 42, (1987), 823–837.

Amburgey, T.L., Kelly, D. and Barnett, W.P., "Resetting the Clock: The Dynamics of Organizational Change and Failure," *Administrative Science Quarterly*, 38, (1993), 51-73.

American Institute of Certified Public Accountants, "The Changing Accounting Regulatory Landscape," http://www.aicpa.org/info/index.htm [Accessed Dec. 1, 2005].

Anderson, R., Bates, T., Bizjak, J., & Lemmon, M., "Corporate Governance and Firm Diversification," *Financial Management*, 29, (2000), 5-22.

Anderson, R. C. and Reeb, D. M., "Founding-family Ownership and Firm Performance: Evidence from the S&P 500," *Journal of Finance*, 58, (2003), 1301-1328.

Anderson, R. C. and Reeb, D. M., "Board Composition: Balancing Family Influence in S&P 500 Firms," *Administrative Science Quarterly*, 49, (2004), 209-237.

Angwin, D., Stern, P., and Bradley, S., "Agent or Steward: The Target CEO in a Hostile Takeover: Can a Condemned Agent Be Redeemed?" *Long Range Planning*, 37, (2004), 239-258.

Baker, M. and Gompers, P.A. 1999. "Executive Ownership and Control in Newly Public Firms: The Role of Venture Capitalists", SSRN Working Paper, http://ssrn.com/abstract=165173.

Baker, M.P. and Gompers, P.A., "The Determinants of Board Structure at the Initial Public Offering," *Journal of Law and Economics*, 46, (2003), 569-598.

Baron, J., Hannan, M., and Burton, D., "Labor Pains: Change in Organizational Models and Employee Turnover in Young, High-tech Firms," *American Journal of Sociology*, 106, (2001), 960-1012.

Barney, J. B., "The Debate Between Traditional Management Theory and Organizational Economics – Substantive Differences or Intergroup Conflict," *Academy of Management Review*, 15, (1990), 382-393.

Barry, C., Muscarella, C.J., Peavy, J.W. III, and Vetsuypens, M.R., "The Role of Venture Capital in the Creation of Public Companies: Evidence from the Going-public Process," *Journal of Financial Economics*, 27, (1990), 447-471.

Beatty, R. and Ritter, J., "Investment Banking, Reputation, and the Underpricing of Initial Public Offerings," *Journal of Financial Economics*, 15, (1986), 213-232.

Berle, A. and Means, G. 1932. *The Modern Corporation and Private Property*. New York, NY: Harcourt, Brace, and World.

Bhagat, S. and Black, B., "Do Independent Directors Matter?" Working paper, Columbia University, 1996.

Boehmer, E., "The Informational Content of Initial Public Offerings: A Critical Analysis of the Ownership-retention Signalling Model," *International Review of Financial Analysis*, 2, (1993), 77-95.

Bushman, R. and Smith, A., "Financial Accounting Information and Corporate Governance." *Journal of Accounting and Economics*, 32, (2001), 237-334.

Carter, R. and Manaster, S., "Initial Public Offerings and Underwriter Reputation," *Journal of Finance*, 45, (1990), 1045-1067.

Carter, R., Dark, F., and Singh, A., "Underwriter Reputation, Initial Returns, and the Long-run Performance of IPO Stocks," *Journal of Finance*, 53, (1998), 285-311.

Certo, S., Covin, J., Daily, C., and Dalton, D., "Wealth and the Effects of Founder Management Among IPO-stage New Ventures," *Strategic Management Journal*, 22, (2001), 641-658.

Clarkson, P., Dontoh, A., Richardson, G., and Sefcik, S., "Retained Ownership and the Valuation of Initial Public Offerings: Canadian Evidence," *Contemporary Accounting Research*, 8, (1991), 115-131.

Comment, R. and Schwert, G. W., "Poison or Placebo? Evidence on the Deterrent and Wealth Effects of Modern Antitakeover Measures," *Journal of Financial Economics*, 39, (1995), 3-43.

Cox, D. R., "Regression Models and Life Tables," *Journal of the Royal Statistical Society, Series B*, 34, (1972), 187-220.

Cyert, R. M. and Marsh, J. G., A *Behavioral Theory of the Firm*, Englewood Cliffs, N.J.: Prentice-Hall, 1963.

Dalton, D., Daily, C., Ellstrand, A., and Johnson, J., "Meta-analytic Reviews of Board Composition, Leadership Structure, and Financial Performance," *Strategic Management Journal*, 19, (1998), 269-290.

Davis, J., Schoorman, F., and Donaldson, L., "Toward a Stewardship Theory of Management," Academy of Management Review, 22, (1997), 20-47.

DiMaggio, P. and Powell, W. (Eds.), *The New Institutionalism in Organizational Analysis*, Chicago: University of Chicago Press, 1991.

Donaldson, L., "The Ethereal Hand: Organizational Economics and Management Theory," Academy of Management Review, 15, (1990a), 369–381.

Donaldson, L., "A Rational Basis for Criticisms of Organizational Economics: A Reply to Barney," *Academy of Management Review*, 15, (1990b), 394–401.

Donaldson, L. and Davis, J., "Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns," *Australian Journal of Management*, 16, (1991), 49–65.

Fernando, C., Gatchev, V., and Spindt, P., "Wanna Dance? How Firms and Underwriters Choose Each Other," *Journal of Finance*, 60, (2005) 2437-2470.

Field, L. and Karpoff, J., "Takeover Defenses of IPO Firms," Journal of Finance, 57, (2002), 1857-1889.

Fischer, H., Pollock, T., "Effects of Social Capital and Power on Surviving Transformational Change: The Case of Initial Public Offerings," *Academy of Management Journal*, 47, (2003), 463-481.

Fitzgerald, D. and Yau, P., "Corporate Governance," *PriceWaterhouseCoopers Publications*, <u>http://www.pwchk.com/home/eng/corp\_governance.html</u>, 2003, [Accessed Dec. 1, 2005].

Fox, M. and Hamilton, R., "Ownership and Diversification: Agency Theory or Stewardship Theory," *Journal of Management Studies*, 31, (1994), 69-82.

Gompers, P., "Optimal Investment, Monitoring, and the Staging of Venture Capital," *Journal of Finance*, 50, (1995), 1461-1490.

Gompers, P., Ishii, J., and Metrick, A., "Corporate Governance and Equity Prices," *Quarterly Journal of Economics*, 118, (2003), 107-155.

Helland, E. and Sykuta, M., "Who's Monitoring the Monitor? Do Outside Directors Protect Shareholders' Interests?" *The Financial Review*, 40(2), (2005), 155-172.

Hochberg, Y., "Venture Capital and Corporate Governance in the Newly Public Firm," Paper presented at the AFA 2004 San Diego conference, <u>http://ssrn.com/abstract=474542</u>, 2004.

Jensen, M. and Meckling, W., "Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure," *Journal of Financial Economics*, 3, (1976), 305-360.

Johnson, B. R., "Toward a Multidimensional Model of Entrepreneurship: The Case of Achievement Motivation and the Entrepreneur," *Entrepreneurship, Theory and Practice*, 14(3), 1990, 39-54.

Kelly, C. and Switzer, L., "Corporate Governance Mechanisms and Small Cap Firm Performance: Evidence for Canada". M.Sc. thesis, Concordia University, 2005.

Lamertz, K. and Martens, M. L., "The Socialization of Organizations: Formal and Informal Sources of Strategy Homogeneity Among IPO Firms," Paper presented at the Academy of Management Conference, Honolulu, HI, 2005.

Lerner, J., "Venture Capitalists and the Oversight of Private Firms," *Journal of Finance*, 50, (1995), 301-318.

Loughran T. and Ritter, J., "Why Has IPO Underpricing Changed Over Time?" Working paper, University of Florida, Gainesville, FL, 2004.

Martens, M. L., "IPO Effects: Corporate Restructuring When a Firm Goes Public," *Journal of Public Affairs*, 4, (2004), 1258-1398.

Meulbroek, L., "The Efficiency of Equity-linked Compensation: Understanding the Full Cost of Awarding Executive Stock Options," *Financial Management*, 30, (2001), 5-44.

Monks, R. and Minow, N., Corporate Governance, Cambridge: Basil Blackwell, 1995.

Morck, R. A., Shleifer, A., and Vishny, R., "Do Managerial Objectives Drive Bad Acquisitions?" *Journal of Finance*, 25, (1990), 31-48.

Nelson, T., "The Persistence of Founder Influence: Management, Ownership, and Performance Effects at the Initial Public Offering," *Strategic Management Journal*, 24, (2003), 707-724.

Ritter, J., "The Long-run Performance of Initial Public Offerings," Journal of Finance 46, (1991), 3-27.

Ritter, J., Welch, I., "A Review of IPO Activity, Pricing, and Allocations," *Journal of Finance* 57, (2002), 1795-1828.

Pickle, H. B. and Abrahamson, R. L., *Small Business Management*, New York: John Wiley & Sons, Inc., 1990.

Pinnell, M., State Takeover Laws, Washington, DC: Investor Responsibility Research Center, Inc., 1989.

Rosenbaum, V., *Corporate Takeover Defences*, Washington, DC: Investor Responsibility Research Center, Inc., 1998.

Schulze, W., Lubatkin, M., and Dino, R., "Exploring the Agency Consequences of Ownership Dispersion Among the Directors of Private Family Firms," *Academy of Management Journal*, 46(2), (2003), 179-195.

Schulze, W., Lubatkin, M., Dino, R., and Buchholtz, A., "Agency Relationships in Family Firms: Theory and Evidence," *Organization Science*, 12(2), (2001), 99-116.

Selznick, P., "Institutionalism 'Old' and 'New'," Administrative Science Quarterly, 41 (1996): 270-277.

Shleifer, A. and Vishny, R., "Large shareholders and corporate control," *Journal of Political Economy*, 94 (1986): 461–488.

Shleifer, A. and Vishny, R., "A Survey of Corporate Governance," *Journal of Finance*, 52, (1997), 737-783.

Tiniç, S., "Anatomy of Initial Public Offerings of Common Stock," Journal of Finance 43, (1988), 789-823.

Wasserman, N., "Founder-CEO Succession and the Paradox of Entrepreneurial Success," Organization Science, 14, (2003), 149-172.

Wasserman, N., "Stewards, Agents, and the Founder Discount: Executive Compensation in New Ventures," Forthcoming, *Academy of Management Journal*, 2006.

Williamson, O., The Economic Institutions of Capitalism, New York, NY: Free Press, 1985.

Wright, P., Ferris, S., Sarin, A., and Awasthi, V., "The Impact of Corporate Insider, Blockholder, and Institutional Equity Ownership on Firm Risk-taking," *Academy of Management Journal*, 39, (1996), 441-463.

Yermack, D., "Higher Market Valuation of Companies with a Small Board of Directors," *Journal of Financial Economics*, 40, (1996), 185-202.

# Appendix A

# **Table 2: Descriptive Statistics and Correlations**

		Mean	SD	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	17	18
1	Gov Index	9.78	2.16																		
2	Delay	2.82	1.13	0.67																	
3	Protection	3.03	1.09	0.44	0.08																
4	Voting	2.67	0.94	0.51	0.26	-0.20															
5	Other	0.09	0.32	0.27	0.00	0.03	0.21														
6	State Laws	1.20	0.92	0.42	-0.02	-0.05	0.07	0.11													
7	Founder-CEO	0.60	0.49	0.13	0.19	-0.03	0.07	0.01	0.05												
8	CEO-Chair	0.56	0.50	0.04	0.05	-0.05	0.09	0.03	0.01	0.06											
9	Founder*Chair	0.35	0.48	0.11	0.15	-0.03	0.10	0.07	0.00	0.60	0.65										
10	Mercenary*Chair	0.21	0.41	-0.07	-0.11	-0.02	-0.01	-0.04	0.02	-0.63	0.46	-0.38									
11	CEO-Own	14.97	15.83	0.14	0.12	-0.08	0.07	-0.03	0.21	0.42	0.18	0.33	-0.16								
12	Founder*CEO-Own	12.17	16.18	0.10	0.13	-0.09	0.04	-0.04	0.16	0.62	0.11	0.45	-0.39	0.89							
13	Merc*CEO-Own	2.80	7.56	0.08	-0.03	0.04	0.06	0.02	0.11	-0.45	0.15	-0.27	0.50	0.19	-0.28						
14	IPO Bubble	0.61	0.49	-0.07	0.11	0.04	-0.16	-0.07	-0.18	0.07	-0.09	-0.01	-0.10	-0.15	-0.07	-0.17					
15	Firm Age	8.11	6.59	0.02	-0.17	0.03	0.09	0.14	0.09	-0.14	0.03	-0.01	0.05	0.16	0.11	0.10	-0.35				
16	Ln(Valuation)	1.68	0.27	-0.16	-0.06	-0.07	-0.10	-0.13	-0.07	-0.12	0.03	-0.08	0.13	-0.09	-0.11	0.05	0.18	-0.05			
17	VC-Backed	0.69	0.46	0.09	0.29	0.11	-0.07	-0.07	-0.19	0.08	-0.13	0.01	-0.17	-0.17	-0.10	-0.15	0.22	-0.40	0.05		
18	VC Rounds	1.91	1.85	0.02	0.20	0.08	-0.10	-0.04	-0.19	0.03	-0.13	-0.04	-0.11	-0.18	-0.11	-0.13	0.26	-0.36	0.05	0.69	
19	UW-Rank	8.20	1.28	-0.09	0.00	-0.05	-0.12	-0.11	0.01	0.03	-0.02	0.00	-0.02	-0.04	-0.05	0.01	0.06	-0.11	0.47	0.10	0.02

n = 246 for all variables

For two-tailed correlation tests, values of  $|r| \ge 0.12$  are significant at the 5% level, and values of  $|r| \ge 0.16$  are significant at the 1% level. Pearson and Spearman Correlations are used where appropriate.