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**BOARD COMPOSITION FROM ADOLESCENCE TO MATURITY:**

**A MULTI-THEORETIC VIEW**

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## **BOARD COMPOSITION FROM ADOLESCENCE TO MATURITY:**

### **A MULTI-THEORETIC VIEW**

Abstract. We develop theory to show board composition and, consequently firm performance are a reflection of the firm's life cycle stage and the relative power of the CEO and external financiers at the time of founding. This theory provides insight into the predictive validity of agency, resource dependence, institutional and social network theories. We also argue that boards are subject to path dependency and thus, board composition is likely to persist over time. (72 words)

The board of directors and its relationship to firm performance has long been the focus of research (for reviews of the literature see: Forbes & Milliken, 1999; Huse, 2000; Johnson, Daily & Ellstrand, 1996; Pettigrew, 1992; Zahra & Pearce, 1989). Several theories, most notably agency, resource dependence, institutional and social network theories, have been put forward to explain and predict the attributes of boards and how these in turn affect firm performance. Empirical findings of the board's impact on firm performance, however, have been inconclusive (Bhagat & Black, 1999; Daily & Johnson, 1997; Dalton, Daily, Ellstrand & Johnson, 1998; Kaplan, 1997; Patterson, 2000). The lack of empirical support for theoretical models of boards and firm performance calls into question the applicability of existing theories to the phenomena of interest. We argue that it is not a question of *if* existing theories are helpful to our understanding of boards and firm performance, but a question of *when* each is helpful.

A major criticism of extant board research is that it focuses almost exclusively on large, mature organizations (Daily & Dalton, 1993; Dalton & Kesner, 1983) as compared to smaller or newer firms (Huse, 2000). We apply life cycle theory to examine the firm during 'adolescence' and suggest that both the relative power of the CEO/external financier as key stakeholders and the stage of a firm's life cycle in which the board is formed will greatly influence its composition. The preferences of the stakeholder with dominant power and the stage of the organizational life cycle at the time of board formation create different needs for boards as reflected by different theories of boards and firm performance. Furthermore, we contend that boards carry with them vestiges of their history and traditions and as a result, board composition is relatively persistent despite the changing needs for boards as firms move through the life cycle from

adolescence to maturity. One implication of this logic is that research focused on boards of mature older firms may not find a relationship to firm performance because they reflect anachronistic attributes unadjusted for the firm's present situation and needs. We suggest it is therefore important to understand board formation as it relates to firm adolescence to gain fuller insights into the relationship between boards and firm performance in mature older organizations.

Specifically, we examine several important questions about boards of directors. How does the timing of a board's formation shape its composition? What influence does the power of two key stakeholders, the CEO and external financiers, play during board formation, and what effect does it have on board composition? What impact do early board formation decisions have on the board's ability to adjust its composition to meet future demands? And finally, what are the implications for firm performance?

The exploration of these questions contributes to existing literature in several ways. First, our model explicitly incorporates the formation of boards, something that is largely taken for granted in existing literature. We contend that board formation will be influenced both by the stage of a firm's development or organizational life cycle and the relative power of the CEO and external financiers. At this point, then, it is important to explicitly note that we are concerned here with CEO led firms when the CEO is not a material owner --- thus creating the conditions for the traditional "principal-agent" problem discussed below. Second, we focus on board composition longitudinally by developing the concept of path dependence within the context of boards. This focus on path dependence can produce insights with respect to the enduring effects of early stage

board formation decisions and may explain how board characteristics selected early in the life of a board can become entrenched and potentially dysfunctional.

The structure of our paper is as follows. We begin with a brief review of agency, resource dependence, institutional and social network theories of corporate governance. We then review the stages of the organizational life cycle during which board formation may occur. In the next section we integrate the theoretical perspectives by discussing the unique dynamics of board formation and we present propositions regarding the influences on board composition at each stage in the life cycle. We then discuss path dependence among board composition. Finally we present propositions with respect to the performance implications for the firm before concluding the paper and presenting implications for future research.

## **GOVERNANCE THEORY**

Researchers studying strategic leadership have employed a wide set of theoretical perspectives to understand the characteristics, behavior, and effects of executives (Finkelstein & Hambrick, 1996). Agency theory (Jensen & Meckling, 1976) is among the most recognized in research on the contribution of boards (Zahra & Pearce, 1989) as is the use of the board as a mechanism for managing resource dependencies (Johnson, et al., 1996; Pfeffer & Salancik, 1978). Researchers also commonly invoke institutional theory (DiMaggio & Powell, 1983; Meyer & Rowan, 1977) and examined the role of social networks (Granovetter, 1985) in boards (Birley, 1985; Gulati & Gargiulo, 1999; Larson, 1992; Westphal, 1999). We provide a brief overview of these theories and discuss how each informs an examination of board composition. This brief theoretical overview

provides background for our argument that these theoretical perspectives have varying salience, depending on the firm's stage in the organizational life cycle and the relative power of the key stakeholders, with respect to the composition of the board.

### **Agency Theory**

Agency theory is the most dominant theoretical framework in corporate governance research. Its origin stems from Berle and Mean's (1932) seminal work on the separation between ownership (shareholders) and control (management). Separation of ownership and management provides the opportunity for management (agents) to act in their own self-interest by maximizing their own wealth and power at the expense of the owners (principals) (Fama, 1980; Jensen & Meckling, 1976). "Agency costs" result when management pursues their own interests to the detriment of the interests of shareholders (Fama & Jensen, 1983). From an agency theory perspective, boards of directors are put in place to monitor management on behalf of shareholders (Eisenhardt, 1989; Jensen & Meckling, 1976). Boards serve as fiduciaries of shareholders by monitoring management to ensure the interests of shareholders' are pursued (Johnson, et al., 1996; Zahra & Pearce, 1989).

Agency theory acknowledges that boards will vary in their incentives to monitor on behalf of shareholders and as a result, incentives are an important precursor to effective monitoring (Fama & Jensen, 1983; Jensen & Meckling, 1976). Board independence, or the degree to board members are dependent on the current CEO or organization, is seen as a primary incentive that is key to board monitoring (Baysinger & Butler, 1985; Daily & Dalton, 1994a, 1994b; Weisbach, 1988). Boards consisting primarily of insiders (current or former managers/employees of the firm) or dependent

outside directors (directors who have business relationships with the firm and/or family or social ties with the CEO) are considered to be less effective at monitoring due to their dependence on the organization. Independent boards, or those primarily consisting of independent outside directors, are thought to be the most effective at monitoring because their incentives are not compromised by dependence on the CEO or organization. Therefore, from the viewpoint of the shareholder, the agency perspective on board composition is primarily concerned with creating independent boards or otherwise aligning the interests of directors with those of shareholders to ensure effective monitoring of management. Conversely, the agency perspective presupposes that managers are predisposed to board composition that allows significant managerial independence and discretion.

### **Resource Dependence Perspective**

Resource dependence theory views a firm as an open system, dependent upon external organizations and environmental contingencies (Pfeffer & Salancik, 1978). Corporate boards are viewed as a means to manage external dependency (Pfeffer & Salancik, 1978), reduce environmental uncertainty (Pfeffer, 1972) and reduce transaction costs associated with environmental interdependency (Williamson, 1984) by linking the organization with its external environment. The primary role of boards from a resource dependence perspective therefore is to serve as resource providers. Four types of resources are provided by boards: 1) advice and counsel, 2) legitimacy, 3) channels for communicating information between the firm and external organizations, and 4) assistance in obtaining resources or commitments from important elements outside the firm (Hillman, Cannella, & Paetzold, 2000; Pfeffer & Salancik, 1978). Research in this

tradition has found boards to be important sources of advice and counsel to management (Baysinger & Butler, 1985; Gales & Kesner, 1994; Westphal, 1999) and to enhance the reputation and legitimacy of the firm (Daily & Schwenk, 1996; Hambrick & D'Aveni, 1992). Similarly, director interlocks have been found to play an important role in disseminating information across firms (Burt, 1980; Useem, 1984) and in securing preferential access to critical resources (Boeker & Goodstein, 1991; Mizuchi & Stearns, 1994; Selznick, 1949).

A general tenet of resource dependence theory is that corporate boards will reflect the environment of the firm (Boyd, 1990; Hillman, et al., 2000; Pfeffer, 1972) and that corporate directors will be chosen to maximize the provision of important resources to the firm. In contrast to agency theory, resource dependence theorists argue that boards are vehicles for co-opting important external organizations. An implication of resource dependence theory, then, is that each director may bring different linkages and resources to a board. Underlying patterns of board composition will be more finely grained than the traditional insider/outsider distinction common in agency theory. Composition is thus theorized to reflect a matching of the dependencies facing an organization to the resource acquisition potential of its board members (Hillman, et al., 2000).

### **Institutional Theory**

Neo-institutional theory asserts the importance of normative frameworks and rules in guiding, constraining, and empowering behavior. In particular, firms can be regarded as consisting of cognitive, normative, and regulative structures and activities that give meaning to social behavior (Scott, 1995). Cultures, structures and routines operating at multiple levels of jurisdiction become the carriers through which institutions

impact firms (Scott, 1995). Organizational practices can become, in Selznick's words, "infused with value beyond the technical requirements at hand" (1957:17) and be adopted for the sake of legitimacy rather than improved performance (DiMaggio & Powell, 1983). Thus, over time, organizations reflect the enduring rules institutionalized and legitimated by their social environments (DiMaggio & Powell, 1983; Meyer & Rowan, 1977; Scott, 1995).

Societal norms have been shown to influence board decisions regarding CEO selection and executive compensation (Zajac & Westphal, 1996) and how boards explain the adoption of CEO incentive plans to shareholders (Zajac & Westphal, 1995). Zajac and Westphal (1995) argue that while either agency theory or alternative theories of compensation could have been used to justify CEO incentive decisions, congruence with investor norms was more instrumental to the board's decision, or at least to the post hoc rationalization of the decision.

By implication, organizations' quest for legitimacy and the process of structuration results in the homogenization of organizations with respect to their most visible attributes (e.g., board composition). It is important to note, however, that this convergence of attributes does not necessarily result in efficient organizations. Institutional theory thus argues that board composition will be determined largely by prevailing institutionalized norms in the organizational field and society. Theories of institutional isomorphism (DiMaggio & Powell, 1983; Hawley, 1968), or the propensity of organizations in a population to resemble other organizations that operate under similar environmental conditions, suggests that boards of organizations in the same

institutional set will tend to be more similar to each other than to the boards of organizations outside of their set.

### **Social Network Theory**

The final theoretical perspective on board formation that we consider is a sociological perspective that builds upon resource dependence theory, specifically, the influence of social networks on board formation and composition. Fundamental to this perspective is the notion that a firm's economic actions are embedded in social networks, where embeddedness refers to the extent that economic actions are informed, influenced, and enabled by the network of accumulated stable and preferential social relations (Granovetter, 1985). As Gulati and Gargiulo (1999) observe, managers have a "widespread preference for transacting with individuals of known reputation," for turning to "trusted informants" who have dealt with the other party to the transaction and found this party trustworthy, or preferably, for relying on "information from one's own past dealings with that person" (Gulati & Gargiulo, 1999: 1445). Moreover, social network theory suggests demographic similarity among board members is reflective of the organization's emergent inter-organizational network (Gulati & Gargiulo, 1999). From this perspective, board composition will reflect the social networks of the principal stakeholders (e.g., CEO, external financiers).

Although social networks have been posited to play an important role in the formation of boards (Birley, 1985; Khurana, 1996), we believe much greater elaboration of the impact of networks on boards is justified. Boards, for example, enable the firm to create a network without the full costs of true vertical integration. Resource-poor entrepreneurial organizations can achieve required strategic benefits by building network

exchange structures with outsiders who are identified as critical resource suppliers. These relationships can stabilize the new firm in its targeted markets. While this view is consistent with the resource dependence perspective, social network theory emphasizes the importance of network formation on reputation, trust, reciprocity, and mutual interdependence (Larson, 1992). Thus, for example, our earlier discussion of resource dependence focuses on the role of the board as facilitating the acquisition of resources. In contrast, social networks theory considers the predictable paths (based on preexisting relationships) that may be used to acquire these resources. Therefore the social network perspective is closely aligned with other theoretical perspectives. This perspective is distinct, however, in that it focuses on social networks as the primary predictor of board composition.

### **A Multi-Theoretic View**

While agency, resource dependence, institutional and social network theories have all been applied to the board phenomenon, a question arises as to their varying utility. As suggested earlier, we contend that it is not a matter of choosing one theoretical perspective over another, but rather, identifying under which conditions each is more applicable. We see a parallel to this challenge in Graham Allison's analysis of the Cuban missile crisis. Commenting on Allison's work, Pfeffer wrote:

One of the points of Allison's (1971) analysis of the Cuban missile crisis is that it is not necessary to choose between analytical frameworks. Each may be partly true in a particular situation, and one can obtain a better understanding of the organization by trying to use all of the models rather than choosing among them....Allison's argument is that insight can be gained from the application of all the frameworks in the same situation. This statement is true, but only within limits. At some point, the various perspectives will begin to make different predictions about what will

occur...At that point, the participant will need to decide where to place his or her bets (1981:30-31).

We contend the predictive validity of these theories is contingent upon the life cycle stage at formation and the relative power of important stakeholders. We now turn our attention to these relationships.

### **THE ORGANIZATIONAL LIFE CYCLE**

Organizational life cycle theorists have long been interested in how a firm's stage of development shapes its behavior. Chandler's early work on organizational life cycles was focused on the relationship between the stages of a firm's development and how, as firms progressed through distinct stages, their strategies and structures changed accordingly (Chandler, 1962). Researchers have since focused on the relationship between stages of the organizational life cycle and a host of organizational variables such as the criteria used to evaluate effectiveness (Quinn & Cameron, 1983); the priorities of top management (Smith, Mitchell, & Summer, 1985); the most dominant problems as perceived by managers (Kazanjian, 1988); human resource practices of organizations (Milliman, Von Glinow, & Nathan, 1991); and the relative importance of stakeholders at each stage in the life cycle (Jawahar & McLaughlin, 2001).

Several models of organizational life cycles have been put forward depending, in part, on the organizational phenomena under investigation (e.g., structure, cognitive orientations, and contextual factors). Central to most life cycle models is that the firm's challenges and opportunities vary across different stages of the life cycle (Anderson & Zeithaml, 1984; Cameron & Whetten, 1981; Dodge & Robbins, 1992; Milliman, et al.,

1991). Among the most cited differences across life cycle stages are changing resource needs, sophistication and complexity of systems and structures, and managerial capabilities (Jawahar & McLaughlin, 2001).

Our arguments are grounded in Quinn and Cameron's (1983) well-established integrative model based on nine different, but empirically supported models. Their model suggests a four-stage life cycle comprised of: 1) an entrepreneurial stage (early innovation, niche formation, creativity), 2) a collectivity stage (high cohesion, commitment), 3) a formalization and control stage (stability and institutionalization), and 4) a structure elaboration and adaptation stage (domain expansion and decentralization).

The entrepreneurial stage refers to the period during which the organization is seeking to achieve a survival threshold (Quinn & Cameron, 1983). While the dominant concerns may be producing and selling a new product or service (Greiner, 1972) and entering the marketplace (Jawahar & McLaughlin, 2001), there may be little appearance of planning or coordination. Real-time decision-making prevails as management is less likely to plan, and more likely to react to immediate marketplace feedback (Greiner, 1972).

The collectivity stage is the second stage within the organizational life cycle and typically accompanies a period of growth that may continue into the formalization and control stage. Greiner notes, "a company's problems and solutions change markedly as the number of employees and sales volumes increase . . . problems of coordination and communication magnify, new functions emerge, levels in the management hierarchy multiply, and jobs become more interrelated" (1972: 38). Informal communication and structure, a sense of family and cooperation among members, high member commitment,

and personalized leadership (Quinn & Cameron, 1983) characterize the collectivity stage. Effective organizational activities result from cooperation among organizational members based on their common needs and expectations (Katz & Kahn, 1978). Consistent with the social cohesiveness of an organization in the collectivity stage, long hours of work are rewarded with modest salaries and the promise of ownership benefits (Greiner, 1972).

By the third stage of formalization and control, in contrast to the informality and collective action of the collectivity stage, it is necessary to introduce a functional structure and greater specialization as a result of continued success and increasing structural complexity (Greiner, 1972). Stabilization of production, product reliability and maintaining cash flow are also central concerns at this stage (Dodge & Robbins, 1992). Formalization of structure and institutionalization of rules and procedures are accompanied by strategic conservatism, as the firm pursues activities intended to ensure the supply of critical resources (Jawahar & McLaughlin, 2001).

Finally, the elaboration of structure stage marks a commitment to the firm's chosen market domain and its transition from adolescence to maturity. Jawahar and McLaughlin (2001) suggest that this stage is accompanied with strong cash flows and fewer attractive investment opportunities. This leads to management resource allocation decisions focused on expansion within the chosen domain and adoption of strategies emphasizing productivity enhancement. In order to facilitate further growth, responsibility for the business is often distributed such that each unit can consider and pursue opportunities appropriate to its particular capabilities (Gupta, 1987).

While firms may also increase in size as they progress through the life cycle, they will not do so at the same rate, resulting in variation in size across firms within the same life cycle stage. Therefore we suggest that complexity, not size, is more salient to progression through the life cycle with respect to governance requirements (cf. Dewar & Hage, 1978). For example, several life cycle researchers (Greiner, 1972; Katz & Kahn, 1979; Quinn & Cameron, 1983; Scott, 1971) suggest that transitions to different managerial and organizational systems (e.g., increased delegation of authority, centralization of administration, adoption of functional structures) are associated, not necessarily with firm size, but rather with the inability of the existing systems to cope with the complexities associated with firm growth and development.

In the same way that an organization's challenges and opportunities vary across life cycle stages, boards of directors also are generally believed to fulfill different needs for organizations as they move through the life cycle. Zahra and Pearce note that "though the link between the board role and the firm's life cycle is yet to be clearly defined, boards are expected to perform qualitatively different roles at various points in the cycle as exemplified by the different way a board performs its control function in an entrepreneurial firm as opposed to a well established, mature corporation" (1989: 298). This suggests that board composition may vary depending on the stage of the life cycle. We now turn our attention to the various theoretical perspectives that inform our theorizing about board composition.

## **BOARD FORMATION**

Boards can be formed at several stages of a firm's development. We are primarily concerned with the formation and subsequent development of boards with accountability to external investors<sup>1</sup> because these are the boards for which governance is a key issue. Most commonly the time horizon immediately preceding and subsequent to an initial public offering (IPO) is the period in which externally accountable boards are formed and a formalized governance structure established (Fama 1980; Fama & Jensen, 1983). At this critical juncture of a company, the CEO has made the decision to seek equity financing, either through private placement or public offering. While this decision provides the financing necessary to enable the firm's continued development, it also introduces a greater level of external scrutiny and a prescribed set of expectations regarding financial disclosure (both historic and projected), insider transactions, and oversight by a board of directors. The introduction of a board of directors into the financial, strategic and operational matters of the firm can be highly beneficial. Nevertheless it is an intrusion. The separation of ownership and management, or at least the dilution of ownership, represents an exchange of power from the CEO to external financiers.

## **Power**

As suggested above, the introduction of external financing and the associated institutions of governance represent an exchange of power from the CEO to the sources of financing and financiers. At the time of board formation, these two stakeholders (i.e., CEO and external financiers) can be considered the most salient to the organization and

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<sup>1</sup> Many small private firms also have boards (Fiegener, Brown, Dreux, & Dennis, 2000). While the ownership pattern typical of these firms reduces a need for monitoring by the board, (Ward, 1989) many do have outside directors to serve as advisors and thus can be characterized as advisory rather than governing

thus most likely to influence board composition (Mitchell, Agle & Wood, 1997). While other stakeholder might influence board composition, the urgency and salience of the CEO's and external financier's claims on the organization identify them as the most important vis-a-vis board composition (Mitchell, et al, 1997; Wartick & Mahon, 1994).

Most definitions of power include an element indicating the capability of one social actor to overcome resistance in achieving a desired outcome or aim (Pfeffer, 1981). Finkelstein (1992) provides several dimensions of power (structural, ownership, expert, and prestige), each of which are relevant to the relative influence over board formation. Structural power is based on formal organization structure and hierarchical authority; ownership power reflects the position in the principal-agent relationship; expert power is the ability to deal with environmental contingencies; and prestige power is based upon reputation in the institutional environment and among stakeholders. We might expect ownership power to be associated with the prerogative to form the board since it is the protector of shareholder interests. Yet, while ownership power usually resides in the external investor, the CEO may also have significant equity in the business. Expert power, particularly if it is an area critical to an organization (Hickson et al., 1971), can also accrue to either the CEO or external financier. As we discuss later, the financial position of the organization and its degree of dependence on additional future financing at the time of board formation is likely to influence whether the CEO's or external financier's expertise is most salient. Structural power may be located in the role of the board chair as the formal board leader (e.g., through duality or an independent chair) or the role of the CEO by virtue of more direct control over the organizations resources. A

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boards (Huse, 2000; Whisler, 1988). Given our interest in governance, we choose to focus instead on

firm's legitimacy depends in part on the prestige of its managers (D'Aveni, 1990). Prestige power, such as a CEO's standing in the "managerial elite" or an investor's reputation in the financial community, is likely to be reflective of the value of and ability to leverage one's social network to attract the most capable board members.

Research on mature and established organizations has examined the relative power of the CEO and the board (Dailey & Schwenk, 1996; Westphal & Zajac, 1995; Westphal, 1998). For example, CEO dominance has been associated with insider dominance (Daily & Schwenk, 1996), greater demographic dissimilarity of directors to CEO (Westphal & Zajac, 1995), and coincidence of the chair and CEO role (Daily & Schwenk, 1996). Westphal and Zajac (1996) have shown that relative CEO/board power can predict whose preferences are realized in selecting a successor CEO, while Golden and Zajac (2001) report that power influences the board's impact on strategic change. Balance of power in favor of the board has been linked to primacy of the monitoring role, higher ratio of outside to inside directors, separation of the chair and CEO roles (Daily & Schwenk, 1996), and greater CEO demographic similarity to the directors (Westphal & Zajac, 1995). The balance of power between the CEO and the board has been considered with respect to the degree to which the CEO uses ingratiating and persuasive behavior as a means of obtaining board support (Westphal, 1998). Our contention, however, is that the stage of the firm's development at the time of board formation, with the relative power of the primary stakeholders, together provide a more comprehensive explanation of the board's composition than relative power alone.

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boards formed at the time of external financing as opposed to privately held firms and their boards.

The conditions under which equity is initially sought is reflected in the relative power of the CEO and the external financier. For example, the circumstances around initial equity financing might range from a rescue from potential insolvency to the opportunity to invest in a highly profitable and promising venture. In the former instance, an entrepreneur may have exhausted all available resources and is facing certain failure in the absence of new financing. Relative power is in favor of the external financier. At the other extreme, the upside opportunity places relative power in favor of the CEO. This power dynamic will be manifested in the subsequent governing structures and will reflect the priorities and perceptions of the most powerful stakeholder. Zald (1969) contends that relative power will be a result of the balance of resources for specific situations and decisions each party brings to bear. In the event of a pre-existing non-externally accountable (i.e., advisory) board, CEO dominance at the time of governing board formation will likely be reflected in continuity in membership. In contrast, investor dominance will likely be reflected in board re-composition as the investor seeks to align the board with its interests. This view is consistent with that of Daily and Schwenk (1996), who consider the relationship between several attendant conditions and dominant or balanced governance configurations. However, while Daily and Schwenk are interested in the interaction of strategic leaders (i.e., top management teams and boards of directors) and the conditions in which they operate, we are interested in the creation of those conditions.

### **Bringing Power and Life Cycle Stages Together**

We have argued above that both the relative power of the CEO/external financiers and the stage of the life cycle at formation will influence board composition. In this

section we apply the governance theories to develop propositions regarding how each specifically influences board composition.

**The Entrepreneurial Stage.** Some organizations will seek equity financing in the entrepreneurial stage. Given the scale of the operation at this stage it is likely that the securing of equity financing has required a substantial investment of the CEO's time and energy. From the CEO's perspective the injection of funds is attached to what is perceived as critical business-specific investments. The financier's perspective, in contrast, may be weighted towards the ability of the business to provide a high overall return on the initial investment over a specified time period. The CEO may seek to maximize flexibility and personal discretion in the allocation of new funds, while the financier seeks to ensure that plans, financial returns and market value guide expenditures. The newness of the relationship promotes uncertainty on both sides with respect to their future ability to exercise their priorities. The uncertainty is not necessarily with respect to the business but more in the exercise of management authority.

Uncertainty with respect to the business and its environment are likely to be addressed by the addition of management and the development of strategic alliances. We propose that, since management authority is at risk, both parties will turn to confidants and other people in whom they have a high degree of personal trust for board appointments, thus turning to their social networks for directors (Gulati & Gargiulo, 1999; Larson, 1992).<sup>2</sup>

Hence:

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<sup>2</sup> Even in the case of institutional investors, we suggest that such investors are not "faceless" and that their transactions are socially embedded. For such investors, we expect the investment manager to rely on his/her network of confidants and trusted associates.

*Proposition 1a* – Boards established during the entrepreneurial stage, and when the CEO has dominant power, will reflect the social network of the CEO.

*Proposition 1b* – Boards established during the entrepreneurial stage, and when the external financier has dominant power, will reflect the social network of the external financier.

**The Collectivity Stage.** Other organizations will seek equity financing in the collectivity stage. By this stage of development, the organization will likely have sufficient opportunity to establish informal communication and structure, a sense of collectivity, a broader management team with financial and psychological commitment to the organization, and a more extensive track record with demonstrated results and position (Quinn & Cameron, 1983). We expect that other members of the management team, in addition to the CEO, will have an interest in board appointments. A more extensive range of initiatives will be underway than in the entrepreneurial stage, and there will be a broader awareness among the management team of the issues currently or potentially impinging on the organization's success. Perceiving the board as a potential asset in the securing of resources and reducing uncertainties in their areas of responsibility, the inclusion of the management team's perspective on board member selection and the board's role is likely to increase the saliency of resource acquisition and stability (Boyd, 1990; Hillman, et al., 2000; Pfeffer & Salancik, 1978). Hence:

*Proposition 2a* – Boards established during the collectivity stage, and when the CEO has dominant power, will reflect the resource dependence needs of the firm.

External financiers in this situation are facing a larger and more cohesive management team than at the entrepreneurial stage. Since the organization has developed in isolation from the scrutiny of external financial markets, the management team may rely on established mindsets and routines which make it difficult to adapt to the accountability and transparency required by external investors. Establishing legitimacy in the external environment and positioning the organization in the investment community such that its value is recognized and reflected in share price is a new task for management and, hence, represents one way in which the board can be of value (Certo, Daily & Dalton, In Press; Daily & Schwenk, 1996). Hence:

*Proposition 2b* – Boards established during the collectivity stage, and when the financier has dominant power, will reflect the requirements of the institutional environment.

**The Formalization and Control Stage.** Organizations may also seek equity financing during the formalization and control stage. An example is the public listing of a private family-held business in which transition to professional management is accompanied by the family assuming a holding as opposed to a managing interest in the business. At this stage the organization has established structures and systems to enable stable operations, and it is likely that the public offering is predicated on expansion within and beyond its current domain. Managing new environmental interdependencies requires boundary-spanning activities to reduce uncertainty and to obtain necessary resources external to the firm (Pfeffer & Salancik, 1972). In the formalization and control stage, as for the collectivity stage, management's preferred board attributes can be

expected to reflect the resource dependence needs of the organization as it seeks to develop linkages in its expanded environment. Hence:

*Proposition 3a* - Boards established during the formalization and control stage, and when the CEO has dominant power, will reflect the resource dependence needs of the firm.

Organizations at this stage of development have formalized rules, stabilized structure, and institutionalized processes. Emphasis is on elaboration of structure, decentralization, domain expansion and renewal (Quinn & Cameron, 1983). The scale and complexity of the business provides greater latitude for management to act independently of the external financiers. This greater latitude increases the probability of opportunities for agency costs and creates additional incentives for board monitoring (Fama, 1980; Jensen & Meckling, 1976). Hence:

*Proposition 3b* - Boards established during the formalization and control stage, and when the financier has dominant power, will reflect agency perspectives.

### **PERSISTENCE OF BOARD COMPOSITION**

While the preceding discussion addresses the differing explanatory power of alternative governance theories at the time of board formation, an important question remains: Does board composition instituted at the time of board formation persist in the face of a firm's changing situation and needs? Consistent with Romanelli and Tushman, we contend that organizations establish "an initial pattern of activity based on the environmental conditions prevailing and the managerial decisions made during their time

of founding... Then as a result of inertia and institutionalization, organizations develop coherent systems of shared understandings that support continuation of the established patterns” (Romanelli & Tushman, 1994: 1145). In other words, board composition is likely to be path dependent.

Path dependence refers to the observation that once a particular course of action is committed to, only incremental changes from that path are likely to result. These incremental changes in a course of action may lead to a sub-optimal solution due to the lack of large-scale change in the face of changing environments (Arthur, 1989; David, 1985; North, 1990). Arthur (1989) and North (1990) further point out that “lock-in” commonly results from a selected course of action so that once reached, sub-optimal solutions are difficult to exit from.

We suggest board composition is also subject to path dependence and lock-in. As proposed above, board composition is the result of both the relative power of the CEO/financier at the time of founding and pressures characteristic of the stage of the organizational life cycle within which it is formed. Like investments in early technologies, initially selected board composition, director characteristics, structure, and process may display increasing returns to adoption. That is, the more they are adopted, the more experience is gained with them and the more they are improved (Arthur, 1989). Alternative board “technologies” (e.g., different composition, characteristics, structure, process) will be disadvantaged as a result of the initial selection and be locked out. The causally ambiguous relationship between the board’s execution of its role and the performance of the corporation serves as a further impediment to adoption of alternative

board technologies, since boards are unlikely to receive compelling feedback that links their performance to sub-optimal results of the organization.

Boards and their members, like management, may also be subject to image enhancement behaviors (Feldman & March, 1981; Golden, 1992). Because radical changes may publicly signal that that current board composition is ineffective, only incremental changes in board characteristics and processes are likely. Such inertial pressures, which increase the “stickiness” of board characteristics, are exacerbated by the staggered replacement of members (Hillman, et al., 2000) as well as homophilic tendencies. Homophilic selection (Lazarsfeld & Merton, 1954), the tendency to favor (e.g., select) and interact with like others, can be expected to result in the further entrenchment of board characteristics. This observation, joined with Pfeffer’s (1981) arguments about the institutionalization of power in organizations, suggests that changes in board characteristics become decreasingly likely over time. Consequently, the reappointment of board members at the end of their term is the norm (Hillman, et al., 2000).

These forces, resulting in the board’s commitment to previously adopted decisions and strategies; the habituation of rules, processes, and practices; and the homophilic selection of directors combine to make major change in the control of the firm difficult and unlikely. Therefore, we propose:

*Proposition 4* - As the organization matures through different stages of the life cycle, board composition is more likely to reflect the requirements at the time of its founding than the current requirements of the organization.

## PERFORMANCE IMPLICATIONS

Our arguments thus far have centered on the relative power of the CEO/external financier and its impact on board composition given the life cycle stage at formation. We have argued that each stakeholder will have different interests with regard to board composition in each life cycle stage and that these differing preferences will result in different boards. This leads us to consider the performance implications of our prior arguments. That is, which boards -- those dominated by the CEO or those dominated by external financiers at founding -- will outperform the other and how will performance be affected by path dependency? This question is important as the board composition/performance relationship is at the heart of governance research. Here we are concerned less with absolute performance (e.g., accounting measures such as ROA), as we are with relative performance or shareholder value creation across firms (i.e., market measures of performance).<sup>3</sup>

External financiers as principals are motivated to maximize shareholder value and according to agency theory do so by minimizing agency costs. While management/CEOs as agents may also be motivated to maximize returns to shareholders, they are also influenced by their desire to minimize personal risk, satisfy other stakeholders (including management and employees), build and repay favors and reduce oversight. The consequence of these motivations and resulting behaviors is reduced performance.

However, in addition to agency costs we need to consider the role of investment of “slack” resource to generate future options and improve the firm’s ability to survive

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<sup>3</sup> See Dalton et al’s (1998) meta analysis for a discussion of these two types of measures.

and/or adapt to uncertain environments (Chakravarthy, 1986; Cyert & March, 1963). Slack can be invested in managerial or technical capabilities (Miles, 1982), to expand the organizational capabilities of a firm (Christenson, 1973), or to reduce its resource dependencies (Lawrence & Dyer, 1983). Each of these uses may be in the interests of the firm, and thus, do not represent agency costs deriving from self-interested CEOs. However, Chakravarthy (1986) notes that managers may be reluctant to disclose slack for competitive reasons or because they are not effective at communicating its value (Bettis, 1983). The maxim here is that it is easier to obtain forgiveness than permission might apply here. He particularly notes that managers will be reluctant to disclose slack to the firm's shareholders for fear of "bargaining for its disbursement with the firm's stakeholders" (Chakravarthy, 1986: 450). Under these circumstances slack, from the perspective of shareholders, is indistinguishable from agency costs and is thus a target of elimination by principals and protection by agents.

This suggests that on the whole, boards composed of dominant external financiers will outperform those dominated by CEOs. For example, in the entrepreneurial stage, we have argued that boards will reflect the social networks of the dominant power -- either the CEO or external financiers. Homophily and bias towards preferred expertise and relationships will result in a CEO's preferred board having a managerial perspective and being predisposed to support management's positions. The external financier's preferred board will have an investor perspective, possessing skills and expertise valued by shareholders (e.g., governance/monitoring) and will be predisposed to support the position of the external financier and thus outperform the CEO's board. Similarly, in the collectivity stage, the resource dependence perspective adopted by the CEO's board will

reflect higher costs in order to reduce current and future uncertainties, while the institutional pursuit for legitimacy reflected by the financier's board will drive higher performance. Thus, this logic suggests the following:

*Proposition 5a* - Firms with boards formed in the entrepreneurial stage, and when the external financier has dominant power, will outperform those with CEO dominant power. Or, in the entrepreneurial stage, firms with boards reflecting the social network of external financiers will outperform those with boards reflecting the social network of CEOs.

*Proposition 5b*- Firms with boards formed in the collectivity stage, and when the external financier has dominant power, will outperform those with CEO dominant power. Or, in the collectivity stage, firms with boards reflecting the requirements of the institutional environment will outperform those with boards reflecting the resource dependence needs of the firm.

*Proposition 5c* - Firms with boards formed in the formalization and control stage, and when the external financier has dominant power, will outperform those with CEO dominant power. Or, in the formalization and control stage, firms with boards reflecting agency perspectives will outperform those with boards reflecting resource dependence needs of the firm.

We also argued earlier that board composition reflects the specific needs of a given life cycle stage within which it was formed. Because the needs of the firm and complexity changes from stage to stage, this implies that firms with boards formed in the life cycle stage they are currently in will be those best linked to performance. Path dependency suggests that once formed, board composition will be difficult to change. Thus, over time boards may not be able to rise to the challenges present in the current environment. Thus:

*Proposition 5d* - Firms with boards founded in the stage of the organization life cycle they are currently in will outperform those with boards formed in other stages.

This proposition raises the interesting question of whether the stage at which boards are formed affects subsequent performance. The life cycle arguments presented above suggest the answer to this question should consider whether the board was formed in more or less distant stages relative to the current stage. We propose that adjacent life cycle stages are more similar to each other than non-adjacent stages. Because the governance needs of adjacent stages of the life cycle are more similar to one another, boards formed in adjacent stages are more likely to meet the needs of the current life cycle stage than those formed in non-adjacent stages. For example, the governance demands of a mature organization (in the “elaboration of structure” stage) are more similar to an organization in the formalization and control stage, and less like those of organizations in the entrepreneurial stage. We would expect, therefore, a firm in the elaboration of structure stage and whose board was formed during the formalization and

control stage to outperform one at the same stage but whose board was formed in the entrepreneurial or collectivity stage. Hence:

*Proposition 5e* - Firms with boards founded at adjacent stages in the organization life cycle will outperform firms with boards founded in more distant stages.

### **CONCLUSION AND IMPLICATIONS**

We have argued that the board's composition at the time of founding is likely to be the result of two factors: the relative power of the CEO and financiers and the stage of the organizational life cycle within which it is formed. As our propositions suggest, these theoretical relationships shed new insight into when particular governance theories offer better explanatory power than others. We have argued that social network theory has much to say about board composition during the entrepreneurial stage of the life cycle and the relative power of the CEO/financier will determine whose social network the board reflects. Resource dependence theory, in contrast, helps illuminate board composition in both collectivity and formalization and control stages of the organizational life cycle, when CEOs have dominant power. On the other hand, when financiers have relative power, institutional theory will particularly be applicable to board formation in the collectivity stage and agency theory in the formalization and control stage. These arguments taken in concert suggest that various corporate governance theories will have differential applicability to board formation across the stages of the life cycle and depending on the relative power of the CEO and financier.

We further suggest that board composition at the time of founding is likely to have long-lasting effects given tendencies towards path dependence and lock-in. Path dependence within boards suggests that although boards may have been composed to meet environmental needs at the time of founding, as organizations move through the life cycle, board composition may not reflect the needs of the current situation. The path dependent nature of board composition implies that boards may vary in their ability to meet the needs of the current firm situation depending on when the board was initially formed. If the needs in the current situation differ radically from those at the time of founding (e.g., a board formed during the entrepreneurial stage in a firm currently in maturity or the elaboration of structure stage), boards may be ill equipped to positively affect firm performance.

The theoretical arguments we advance here contribute to existing literature in several ways. First, rather than arguing for the dominance of one theoretical approach to boards over others, our theory implies that the four dominant theories of boards all have predictive and explanatory power, but at different stages in the organization's development and depending on the balance of power. This implies a shift away from the current focus on large, mature boards and towards the development of richer theories of board formation and power in adolescent firms. Second, we contribute to a longitudinal understanding of board composition and performance. To our knowledge, despite the widespread belief that boards should mirror the firm's external environment (Pfeffer & Salancik, 1978) and that environmental changes should lead to board changes, researchers have not focused on the persistence of board composition across time. We contend that path dependency will result in a board that is decreasingly able to meet the

needs of a changing environment progressively less as the organization develops.

However, our arguments are merely a first attempt towards a better understanding of boards and firm performance across time. Next steps should include empirical research on adolescent firms and board formation, and longitudinal examination of board composition and firm performance.

Because our study is a first step in many regards, its limitations should be noted. First, our discussion revealed the surface level relatedness of the various governance theories, but suggested that they in fact uniquely predict board composition across the various stages of the firm's life cycle. Future researchers will have to recognize the commonalities of the theoretical perspectives examined here, and conduct empirical work that is explicitly designed to identify and disentangle the forces affecting board composition. For example, agency concerns may initially drive a board practice such as the increasingly common separation of the CEO/Chair position, while concerns for legitimacy may drive the subsequent adoption of the practice by other firms. The work of Zajac and Westphal (1995), which contrasted agency and institutional theories in the context of CEO incentive plans, is illustrative of the type of comparative research that is needed.

Second, we adopt a model of organizational life cycle from existing literature in an attempt to capture the general differences in organizations and their environments as they mature. Other life cycle models may provide additional opportunities to explore varying board needs as firms develop. We have also limited our discussion here to the power dynamics of two significant stakeholders at the time of board formation, the CEO and external financiers. In the tradition of stakeholder research, we recognize these are

not the only two stakeholders of a firm (Freeman, 1984), but have argued that at the time of board formation they are the most salient (Mitchell, et al., 1997). Future research could explore the role of other important stakeholders on the process of board formation. In doing so, and extending our arguments, we suggest that the likely allegiances and dominant perspectives, or interests, of these other stakeholders should be considered. For example, internal board members who have been selected by the current CEO may favor a board composition that resembles the CEO dominated boards described here. Likewise, board members chosen by external financiers (or more independent board members, generally), may reveal board composition preferences closer to those of the external financiers. Related, for the purpose of developing theory, we also have relied on archetypical conceptualizations of the CEO and external financiers. We have treated external financiers as an aggregated group although they may vary from venture capitalists, to institutional investors, to large blockholders and diffused shareholders. The alignment of investor types with the stages in a firm's development has not, to our knowledge, been substantially researched. However, we would expect a continuum of higher risk (e.g., venture capital fund) to lower risk (e.g., pension funds) investors to match the progression of firms through life-cycle stages, with higher levels of risk tolerance associated with earlier stages of firm development. It may also be necessary to distinguish between those investors with a small portfolio of investments and who take a relatively hands-on role to manage their risk versus those who maintain a broader portfolio and manage their risk by diversifying their holdings. In the former case, the mode of governance may be more akin to an advisory board rather than a governing

board (particularly pre-IPO). How the power dynamics of differing investors interact with that of the CEO would also be a fruitful area for future research.

Finally, we have also focused on the factors that cause board composition to persist and suggest that multiple incremental changes do not accumulate to result in fundamental change (Romanelli & Tushman, 1994). Future research is needed to provide a richer understanding of the dynamics of path dependence among boards and what factors may influence radical changes in board composition. For example, such things as sustained poor performance, senior management turnover, and mergers or acquisitions may substantially change the power relationship between the board and the CEO, thus precipitating changes in board composition. Similarly, recent events such as Enron's bankruptcy or ABB's board's admission that it had failed to effectively monitor top management (Woodruff, 2002) may create a "crisis of confidence" in governance generally. Such high-profile cases may act to substantially alter the institutional environment for firms and their boards, and consequently, may change the demands on boards and their composition. Thus, a more fine-grained examination of the *kinds* of institutional change (e.g., regulatory versus cognitive and normative) will likely be worth pursuing. We believe that the multi-theoretic foundation laid in this study will provide a useful starting point to address these issues and, more generally, the relationships between board composition, firm life cycle, and power relationships in the boardroom.

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