

## CAN SUCCESSFUL FOUNDERS HOLD ON TO THEIR SEATS AFTER GOING PUBLIC? THE IMPACT OF VENTURE CAPITALISTS ON FOUNDER TURNOVER

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### ABSTRACT

*In this study, we explore the impact of venture capitalist involvement on the relationship between a new venture's pre-IPO performance and the subsequent likelihood of founder turnover. Using new venture perspectives, and the life cycle and agency theories of the firm, we argue that owner-venture capitalists act as effective governance mechanisms to induce changes in new ventures from founder management to professional management. We argue that in the absence of venture capitalist involvement, founder turnovers occur only when the firm underperforms at the pre-IPO stage, whereas when venture capitalists are involved, the relationship between pre-IPO performance and turnover becomes U-shaped. In the presence of venture capitalist involvement, founders may be encouraged to step down even when the firm is performing well. We contribute to the entrepreneurship literature in two ways. First, we investigate how the involvement of venture capitalists changes the dynamics of founder-CEO turnover and performance in entrepreneurial firms. Secondly, we explore the role played by venture capitalists in the evolution of a firm beyond the earliest stage of its life cycle, particularly when the firm is about to transition from a private to a public entity. From the practitioner's point of view this study provides insights for the founding team, their incentives, and choices about their role in the firm they created after it goes public. In particular, if the propositions are empirically tested and confirmed, one can conclude that bringing in VCs guarantees departure for founder-CEOs.*

**Keywords:** *New Ventures, Founder Turnover, Venture Capital, IPOs, Firm Performance*

### 1. ENTREPRENEURS AND THE FIRM

In an entrepreneurial venture, the founding team plays an extremely critical role in the development of the venture. The manner in which the founding team leads and manages the start-up has a significant impact on firm performance. The talents, skills, and capabilities of founders and top managers of new ventures are not only valuable resources *themselves*, but they are also determinants of how *other* firm resources are used (Eisenhardt and Schoonhoven, 1996). According to upper-echelon theory, top management team (TMT) characteristics have important impacts on organizational outcomes because top executives are empowered to make strategic decisions for organizations (Wiersema and Bantel, 1992; Bantel and Jackson, 1989). Leadership theorists have long claimed that through determining which opportunities the venture will pursue, top management directs a company's strategy, structure, and culture (Barnard, 1938; Wasserman, Nohria, and Anand, 2001). However, founders of a start-up might not possess the necessary skills to manage an established enterprise, regardless of how successful they were in creating it. Consequently, the replacement of founders by professional managers might be crucial to the future success of the firm. In this context, it becomes important to study the conditions under which the leadership of entrepreneurial organizations changes.

Top management team succession carries even more significance for young firms than it does for older, more established entities. First, replacing the CEO represents a critical non-routine, high level decision in young firms (Reiganum, 1985). Secondly, CEO succession can have a greater disruptive impact on small firms compared to large firms (Grusky, 1961). For one thing, CEOs of small startups not only set the vision and overall strategy for the company, but also carry it out by making allocation decisions, responding to changes in the environment, and pursuing opportunities, therefore contributing significantly to, or maybe even driving the firm's performance. Clearly, these dynamics are significantly different from what happens in larger firms, where it is more difficult and not even desirable for CEOs to oversee everything that is taking place within the company. In smaller firms, however, such a broad span of control is not only easier for the CEO but also might be one of the reasons that the founder started the

firm in the first place. Thus, compared to an established firm, CEO succession in a start-up represents an even more dramatic change. In spite of this, CEO succession in new ventures has remained a relatively under-explored area, even though there has been an extensive amount of prior research on top management turnover in large firms. On the one hand, the broader strategy literature has established a strong empirical link between prior firm performance and subsequent founder turnover as well as providing us with much theoretical insight into its antecedents and consequences. On the other hand, there is very little evidence to support this relationship in the entrepreneurship literature. This study aims to contribute to both fields by examining founder turnover in new ventures.

In particular, we propose that the involvement of venture capitalists (VCs) in a pre-IPO venture changes the nature of the relationship between firm performance and founder turnover. In the sections that follow, we review the literature on the impact of firm performance on top management turnover, and the effect of VC involvement on start-up performance. Using new venture perspectives, and the life-cycle and the agency theories of the firm, we explore the role of venture capitalists as governance mechanisms in new ventures before they transform into public companies. We argue that VCs are instrumental in inducing changes in new ventures from founder to professional management.

## 2. TOP MANAGEMENT PERFORMANCE AND FOUNDER TURNOVER

Top management turnover has been studied extensively in past strategic management research. The theoretical basis for this research lies primarily in agency theories on incentive based contracting. Conflicts of interest between stockholders (principals) and top management (agents) of a firm give rise to the agency problem of aligning the interests of agents with those of the principals (Fama, 1980; Jensen and Meckling, 1976). Incentive-based as well as monitoring-based mechanisms have been prescribed in order to solve this agency problem. Incentive-based solutions such as compensation contracts that align top management pay to performance of the firm are thought to be an efficient way for the principal to ensure that the agents enhance the performance of the firm (Jensen and Murphy, 1990). A performance-based threat of dismissal is one of the mechanisms used to provide an incentive for top managers of a firm to make decisions that maximize the performance of the firm. This suggests that poor performance is considered a signal of top management team's incompetence, or opportunism, or both (Fama and Jensen, 1983).

In fact, empirical studies in management have found evidence that prior firm performance, tightly linked to top management performance, is a significant factor that affects top management turnover (Grusky, 1963; Jensen and Murphy, 1990; Boeker, 1992; Puffer and Weintrop, 1991; Cannella and Lubatkin, 1993). These studies support agency theory and establish a negative relationship between performance of the firm and subsequent top management turnover. If the firm performs well, top managers retain their jobs and if the firm performs poorly, the top management team is held responsible and is replaced.

Despite the above findings for large, established firms, there is little empirical evidence to support the inverse relationship between firm performance and founder turnover in the *entrepreneurship* literature, even though there has been much theoretical and anecdotal discussion. The few empirical studies of top management turnover and performance in the context of new ventures (Boeker and Karichalil, 2002; Rubenson and Gupta, 1992; Wasserman, 2003) report mixed findings. In an early study, Rubenson and Gupta (1992) found no significant differences in the timing of founder departure between low- and high-growth startups. However, evidence from more recent research (Boeker and Karichalil, 2002; Wasserman, 2003) while demonstrating the *significance* of the performance-turnover relationship, diverges with respect to the *nature* of it.

In his study of early stage new ventures, Wasserman (2003) argues that the founding team can leverage superior performance of the new venture as evidence that they possess the skills required to manage the firm, thus lowering the likelihood of management changes. Conversely if a founding management team fails to achieve performance expectations, then the likelihood of top management team turnover is higher. Instead of finding support for the negative relationship hypothesized above, Wasserman (2003) finds that firm success and founder-CEO turnover are positively related. He explains his findings by arguing that completion of product development, which has been used as the measure of firm performance in the study, is a key milestone in the development of a new venture. At this juncture, the needs of the firm

outstrip the skills of the founder-CEO and precipitate founder-CEO turnover since the firm needs a leader with different skills and capabilities who can help the firm grow into an established entity.

Boeker and Karichalil (2002) find a curvilinear relationship between founder turnover and new venture growth. At low levels of new venture growth, founder departure is negatively related to growth, but at high levels of growth this relationship becomes positive. At high levels of growth, Boeker and Karichalil (2002) point to life cycle theory of the firm to argue that high growth in a firm is accompanied by the need for a change in the ability and styles of its founders. As the firm transitions from an early growth stage to a later stage, it requires leaders with professional rather than entrepreneurial management styles. The new needs of the firm reduce the value of the founders to the firm, and control of the firm passes on to new, professional managers. Thus, at high levels of growth, Boeker and Karichalil (2002) hypothesize that founder departure in a new venture is more likely with increasing firm growth. Low levels of firm performance create different dynamics, but produce the same result within the new venture. The failure of founders to grow the firm at the expected rate precipitates founder departure. Taking both arguments together, Boeker and Karichalil (2002) make a case for, and find evidence of, a U-shaped relationship between founder turnover and firm growth.

The somewhat inconsistent findings reported in the above studies of entrepreneurial firms reflect a need for more research on top management turnover in new ventures in order to determine the conditions under which founder-CEO changes occur. The inconsistencies may be attributed in part to industry and sample specific differences, as well as differences in measures of firm performance used in the above studies. For example, Boeker and Karichalil (2002) study new ventures in the semiconductor industry, while Wasserman (2003) considers only those Internet companies that received venture capital funds.

We propose that further tests of the relationship between founder turnover and prior firm performance in the context of entrepreneurial ventures should investigate samples with both VC-backed and non-VC backed startups in order to observe the impact of VCs on this relationship, and should also focus on the pre-IPO stage of the new venture. We posit that the IPO is one of the most important events in the life of a young start-up and that it represents a radical change in the nature of the firm performance-turnover relationship, not only because the contingencies of the firm shift at that point, but also because the IPO is critical to the VCs due to their investment concerns. We will examine the performance-turnover relationship just before a new venture goes public.

When new ventures perform poorly before the IPO, the founders, who also have significantly large equity holdings in the new venture, are more likely to step down to make way for a more capable successor. It is in the interest of the founders, as well as other stakeholders, to bring in a new, professional CEO to instill confidence in the market before the IPO and increase the value of their own equity. Founder managers at this point are still holding large amounts of equity and are, by definition, not only agents (managers), but also owners (principals) of the firm – *there is no agency problem*. Thus, during the pre-IPO period, founder managers may be more likely to recognize their own limitations and voluntarily give up some of their power (Zahra and Filatotchev, 2004) when confronted by poor organizational performance. On the other hand, when new ventures are performing well before the IPO, founders can attribute this to their own (good) management skills and more easily make a case for holding on to their positions.

Following this set of arguments, we argue that compared to poorly performing ventures, successful startups are more likely to retain their founder CEOs in the pre-IPO period.

### 3. INVOLVEMENT OF VENTURE CAPITALISTS

The role of VCs in the evolution of the start-ups that they fund has been well documented mainly in the finance literature.

Venture capitalist investors have strong incentives to maximize the value of a new venture, as on average, they receive 20% of the profits of their portfolio firms and act as equity partners (Kaplan and Stromberg, 2001). Before they invest, VCs evaluate the attractiveness of the opportunity by investigating the firm's market size, strategy, technology, customer adoption, and competition. Thousands of rough concepts and business plans cross VCs' desks every year while only a few advance to formal funding.

VCs have the specialized skills to screen ideas, while identifying and refining the business models most likely to succeed.

In other words, the involvement of venture capitalists with their portfolio companies goes beyond that of simply providing financial assistance. VCs add value to a pre-IPO firm through different functions. Their knowledge, expertise, and networks help new venture managers not only in strategic planning but also in the day-to-day running of the business. According to Jain and Kini (2000), venture capitalists provide valuable support to the entrepreneurs "through their screening, monitoring and decision support functions" in the "strategic, financial, and operational planning of the firm".

VCs repeatedly interact and have interlocking arrangements with investment bankers and analysts, important actors for a pre-IPO firm. VCs have the ability, skills, and reputation (that the new venture lacks) to provide complementary assets to the new firm. As a result, they can support the IPO firm by not only providing funding, but also assisting in the optimal allocation of it. The extant research has found a positive association between venture capital investment and organizational outcomes such as innovation (Jain and Kini, 2000), survival, (Zacharakis, Meyer, and DeCastro, 1999; Jain and Kini, 2000) and stock performance (Sapienza, 1992).

One important indicator of a new venture's early success is its performance at its initial public offering (IPO). The stock price and the capital raised at IPO are objective, market-based indicators of the pre-IPO performance of the new venture. Some studies in the finance literature have extensively used underpricing as a measure of the new venture's success at IPO in order to explore the impact of VCs on firm performance. Extant work in this field points to the role of venture capitalists as providers of legitimacy to new ventures. Specifically, VCs provide a way to bridge the information asymmetry that exists between new ventures and outside investors at the time of IPO. As a result, the market is more likely to price the IPO closer to its offer price, reflecting all available and relevant inside information about the new venture. This mitigates the problem of underpricing (defined as the offer of a security below its market value) in IPOs. Underpricing is undesirable and is viewed as a cost to the owners of the firm. Therefore, if a new venture at IPO exhibits lower underpricing, it is considered more successful. Thus, the finance literature has measured the performance of the new venture primarily as the degree of underpricing present at the time of IPO – the greater the underpricing, the lower the performance and the smaller the underpricing, the more superior the performance.

These studies, however, provide us with a mixed bag of conclusions on *how* VCs impact the success of the IPO firm. Megginson and Weiss (1990) conducted a matched sample study of VC backed and non-VC backed firms and found lower underpricing in VC backed IPOs. Lin and Smith (1998) report similar findings. These studies contradict the findings of Barry, Muscarella, Peavy, and Vetsuypens (1990) who did not find a significant difference between the underpricing associated with VC backed IPOs and non-venture backed IPOs. Gompers and Lerner (1997) provide evidence that the relationship between underpricing and venture performance varies over time.

The impact of VC involvement on the long-term performance of new ventures has yielded more consistent results. Long-term performance has been measured as financial returns (Brav and Gompers, 1997; Jain and Kini, 1995), time to market (Schoonhoven, Eisenhardt, and Lymen, 1990; Hellman and Puri, 2000), growth (Davila, Foster, and Gupta, 2000), and survival (Jain and Kini, 2000; Zacharakis, Meyer, and DeCastro, 1999).

Brav and Gompers (1997) tracked VC backed and non-VC backed ventures for five years after IPO and demonstrated that *financial returns* for VC backed ventures were greater. Jain and Kini (1995) analyzed venture backed IPOs and non-venture backed IPOs and found that the change in operating return on assets and operating cash flows was less negative for VC backed new ventures. Manigart and van Hyfte (1999) used long-term growth in total assets and cash flow over a five-year period to show that VC backed ventures perform better than non-VC backed new ventures. In their sample of Belgian new ventures, Manigart and van Hyfte (1999) found that VC involvement is negatively related to new venture survival.

Using *firm growth* as a measure of new venture performance, Davila, Foster and Gupta (2000) found evidence that venture capital backing is positively and significantly associated with growth in the number of employees of the new venture.

*Time-to-market* for a product is a significant event in the life cycle of a new venture and is a favorable indication of performance in high technology ventures (Schoonhoven, Eisenhardt, and Lyman, 1990). Schoonhoven, Eisenhardt, and Lyman (1990) found that VC involvement in new ventures in the semiconductor industry shortened the time to market for the ventures. In a different study, Hellman and Puri (2000) found support for the negative relationship between VC involvement and new ventures' time-to-market, concluding that VC backing leads to greater venture performance.

*Survival* of the new venture is considered an important measure of performance especially for new ventures, since these firms typically exhibit higher rates of failure than established ones. Post-IPO survival of a new venture has been positively associated with VC involvement in new ventures (Jain and Kini, 2000).

Even though studies using underpricing have provided mixed results on the impact of VC involvement on new venture performance, the above findings point to a positive relationship between VC involvement and performance of entrepreneurial firms when other measures of firm performance are used. Thus, we conclude that the association of a company with a VC should help reduce the likelihood of failure for it. The risk of the new venture is alleviated to a degree with VC financing and specialized help in management of the enterprise in general, and in development of competencies required in particular. Therefore, VC involvement should contribute positively to the success of the new venture.

In order to understand leadership succession in new ventures where VCs are involved, it is critical to examine the control structure in such organizations. Maintaining control of and supporting the firm before the IPO is of interest to VCs, acting as outside owners and investors of the firm. Since the ability of VCs to raise more funds depends on their investment returns, which, in turn, are dependent on the performance of their portfolios, it follows that VCs are likely to be actively involved in monitoring how their investments are managed. Hence, we can expect venture capitalists to take steps to protect their return on investment during the IPO process for the entrepreneurial firm, by monitoring the management of the firm, initiating changes in the top management team and the composition of the board and other governance structures in order to ensure the continuity of the success of the firm at IPO.

Control over the succession decision comes from the VC's role on the board of the new venture (through their voting rights as a result of equity ownership), or even through explicit contractual agreements (Hellmann, 1998). Venture capitalists negotiate control rights at the time of funding (Kaplan and Stromberg, 2001) and exercise those rights in order to monitor the firm and put governance systems into place. "When management risk is present, the VCs ensure that the contractual structure provides a higher degree of control to the VCs, both in terms of votes and board seats and by withholding a higher fraction of the committed financing if performance milestones are not met" (Kaplan and Stromberg, 2001: 428). According to Lerner (1995), on average, two out of six board members in a new venture are VCs. Within the board, VCs are less likely to have fewer personal or relational ties to founders than other (inside or outside) owners, and thus, more likely to optimize the interests of the firm, even if that leads to replacing the founders.

For one thing, VCs hold that professional management would add more value to the firm during and after the IPO process than founder management. The IPO is a significant inflection point in the lifecycle of the firm as compared to product development and early financing rounds. It is the time when founder ownership is reconfigured and diluted. VCs typically argue that an agency problem emerges when the founder-CEO's equity holdings are diluted, and that founding management is more likely to act in its own interest rather than the company's. Also, VCs favor professionalization of the management of the firm since they want to make the firm (a) more attractive to other outside investors at the IPO, and (b) less dependent on the founder (Zingales, 2000).

Boeker and Karichalil (2002) propose that founders of firms have neither the aptitude nor the inclination to manage established businesses. Rubenson and Gupta argue that "entrepreneurial firms tend to (1) be overly dependent on one or two key individuals, (2) be highly centralized, (3) lack adequate middle-management skills, and (4) exhibit a paternalistic atmosphere,...characteristics [that] are incompatible with the needs of a mature organization" (1992:54), even though they might enable the nimble structures necessary for early growth. This underscores the need for more 'professional' and experienced managers while transitioning into and maintaining an established business.

Life-cycle theories of management argue that the capabilities and management styles required for effective management of a firm change as the firm grows from an entrepreneurial endeavor to an established entity (Rubenson and Gupta, 1992). Going public is a fundamental transformation for an entrepreneurial firm in terms of the changes required to its strategy, structure, control processes, and standard operating procedures (Jain and Kini, 2000). Meeting the new needs of the more complex firm requires a broad range of skills that founder managers of the firm are not likely to possess. Addressing these needs just before the new venture goes public, rather than after, is likely to enhance the value the market places on the new venture at IPO. The VCs represent the one governance mechanism that has not only the *willingness* but also the *ability* to carry out the necessary professionalization of the firm.

Just before the IPO, while the founder-CEO feels a path-dependent level of qualification to manage the firm, having led the way through initial product development, the VCs fully realize that the range of tasks required for superior performance after this point vary greatly compared to the past. Marketing, sales, finance, after-sales service, and product support skills take the front stage whereas product development is the most important capability in the early stages of the startup (Wasserman, 2001). This represents a dramatic shift from investments in R&D to an emphasis on profitability since the stockholders will be typically more concerned with it than the founders were as the holders of the equity (Rubenson and Gupta, 1992). According to Wasserman (2001), VCs' default assumption is that the founder-CEO cannot lead the company as a professional manager would, especially if it is their first time in an entrepreneurial role. In addition, when the firm goes public, the new financial resources should trigger a higher rate of growth for the firm, thus leaving less time to the founder-CEO to develop management skills.

In fact, a couple of empirical studies have suggested that VCs might have a role to play in the replacement of founder-CEOs in the early stages of a firm's development. More specifically, according to one study, the founder-CEO succession may come about at certain inflection points in the venture's evolution, such as new financing rounds and completion of the product development stage (Wasserman, 2001). Hellman and Puri (2002) also provide support for founder-CEO turnover – they find that venture capitalists may be instrumental in replacing insider CEOs with outsider CEOs.

The pre-IPO success of the firm should not necessarily mean that the founder team is well-suited to run the firm post-IPO. When the firm is preparing for the IPO and as such, the founders believe they are competently running the business, they may be less willing to step down and let professional managers take over. They may have developed a psychological attachment to their company/position, or find leaving humiliating or damaging to their reputation in external circles (Hellmann, 1998). Whether or not the founder-CEOs are willing to leave, VCs are likely to bring in professional managers, through their monitoring and control rights, even when the firm performs well before the IPO. Therefore, in the presence of VC involvement, the negative association between pre-IPO performance and the likelihood of founder-CEO turnover does not hold; instead, there is a positive relationship between firm performance before IPO and likelihood of founder-CEO turnover.

When the new venture performs poorly before the IPO, the founder-CEO will most likely agree to step down in the interest of the continuity of the firm and the VCs will not have to "encourage" this process. Therefore, the negative association between firm performance and CEO turnover will still hold.

In the absence of venture capitalist involvement, if the new venture is successful, founder-CEOs have a greater chance of entrenching themselves through the institution of appropriate governance structures. On the other hand, when new ventures perform poorly before the IPO, the founder-CEOs will step down voluntarily and bring in more capable leadership to protect the firm as well as their personal equity

interests. In both cases, the negative relationship between performance and turnover will hold. Thus, VC involvement moderates the effect of firm performance before the IPO on the likelihood of founder-CEO turnover such that this association becomes U-shaped. In other words, in case of VC involvement, new ventures are more likely to experience founder-CEO turnover under conditions of low performance and high performance before the IPO.

As mentioned before, the amount of industry and startup experience the founder-CEO has can have a confounding effect on the relationships discussed above. This effect can manifest itself as enhancing the performance of the venture and/or the VCs' perception of the competence of the CEO. Founders who have been active in that particular industry before they got involved with the current startup have a lot to contribute in terms of knowing how the industry functions. In fact, Vesper (1980) reviewed a number of studies that examine factors associated with survival and found that success was more likely to be achieved by those who undertook entrepreneurial efforts in a business they knew well.

Moreover, those founders who have prior experience in starting companies will not only derive direct learning benefits from their past, but also will be perceived by other stakeholders (including VCs) as more reliable and competent. "Prior experience provides knowledge about resources that help to start new firms, entrepreneurial skills, and reputations that help to influence the reallocation of resources to the new venture" (Shane, 2001: 211). Therefore, it is important to account for the effects of past industry and startup experience of the founder-CEO. Future empirical research should do this by controlling for prior experience.

#### 4. CONCLUSION

This study lays out a theoretical model of founder-CEO turnover in entrepreneurial firms with venture capitalist involvement. We contribute to the literature in two ways. First, we investigate how the involvement of venture capitalists changes the dynamics of founder-CEO turnover and performance in entrepreneurial firms. Second, we present arguments to suggest that venture capitalists play a role in the evolution of a firm beyond the earliest stage of its life cycle, particularly when the firm is about to transition from a private to a public entity.

From the practitioner's point of view, the theoretical arguments of the paper provide insights for the founding team, their incentives, and choices about their role in the firm they created after it goes public. In particular, following our arguments, one can conclude that bringing in VCs guarantees departure for founder-CEOs. The next step would be empirically investigating whether this relationship holds. If the proposed relationships are confirmed, then founders should take into account the governance role of VCs (as well as their financial roles) very carefully when making investment decisions in the early stages of a startup.

Theoretically, our study was initially motivated by the inconsistencies in entrepreneurship studies that examined the relationship between new venture performance and founder turnover. We contribute to the entrepreneurship literature by identifying idiosyncratic governance structures at work in new ventures. We also expand on the traditional performance-turnover model in strategic management by incorporating the role of VCs.

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