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Outside directors' experience, TMT firm-specific human capital, and firm performance in entrepreneurial IPO firms

Son A. Le [a,*], Mark J. Kroll [b,1], Bruce A. Walters [a,2]

[a] Louisiana Tech University, PO Box 10318, Ruston, LA 71272, United States
[b] University of Texas at Brownsville, 80 Fort Brown, Brownsville, TX 78520, United States

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ABSTRACT

Drawing on the behavioral agency perspective and entrepreneurship literature, we examine the impact of board configuration at the time of an IPO on top management team (TMT) firm-specific human capital, and firm performance in young IPO firms. The results show that the ratio of outside directors at the time of an IPO has a positive relationship with the attrition of TMT firm-specific human capital in the first two years following the IPO. Outside directors' industry- and firm-specific experiences negatively moderate this relationship. Finally, our study provides evidence that TMT firm-specific human capital attrition negatively affects subsequent firm performance.

1. Introduction

Transition to the public domain often requires IPO firms to reconfigure their boards of directors. Although scholars and practitioners are concerned with how to structure boards to reduce agency problems and achieve short-term IPO performance (Certo, Holmes, & Holcomb, 2007), focusing excessively on such concerns may adversely affect long-term performance (Filatotchev, Toms, & Wright, 2006; Kroll, Walters, & Le, 2007; Walters, Kroll, & Wright, 2010). In young firms, top management team (TMT) human capital represents one of the most important sources of competitive advantage (Eisenhardt & Schoonhoven, 1990; Reed, Lubatkin, & Srinavasan, 2006). Yet, few studies have directly examined the impact of boards of directors on TMT human capital in the IPO context.

Underwriters' and new blockholders' interests play an important role in shaping IPO boards (Arthurs, Busenitz, Hoskisson, & Johnson, 2009; Baker & Gompers, 2003; Bruton, Filatotchev, Chahine, & Wright, 2010). Prestigious underwriters and powerful outside investors often reduce ownership and board seats for TMT members on the new board (Baker & Gompers, 2003; Certo, Daily, & Dalton, 2001; Finkle, 1998). Firms typically increase the number of outsiders (Jain & Kini, 1994; Mikkelson, Partch, & Shah, 1997), but high ratios of outsiders may adversely affect the retention of TMT firm-specific human capital, which is referred to as the knowledge, skills, and experience executives acquire during the course of working in their firms. According to the behavioral agency model, TMT members make decisions toward lowering their risk bearing, or the “perceived risk to agent wealth that can result from employment risk or other threats to agent wealth” (Wiseman & Gomez-Mejia, 1998: 136). A higher ratio of outsiders means less TMT board participation and control of the firm's direction, thus increasing TMT risk bearing. Managers may be less committed to developing firm-specific human capital in the present firm, and may look for new jobs elsewhere (Becker, 1964). Entrepreneurs and executives in young firms value discretion and freedom in decision making, and have strong psychological ownership in their firms (Bruton, Fried, & Hisrich, 2000; Finkelstein & Boyd, 1998; Nelson, 2003). Greater board control by outsiders may reduce TMT members' discretion, potentially increasing their exit following the IPO.

We argue that higher ratios of outsiders negatively affect TMT firm-specific human capital, and that the extent of this influence on TMT risk bearing and discretion may depend on outside directors' experience bases. We also examine the impact of the attrition of TMT firm-specific human capital on subsequent IPO performance. Board structure's influence on TMT firm-specific human capital has not been directly examined in the context of IPOs, although both boards (Certo et al., 2007) and TMTs (Fischer & Pollock, 2004; Kroll et al., 2007; Walters et al., 2010) are critical and have received considerable research attention. We also provide insight into which specific types of outside directors' experience may diminish the attrition of TMT firm-specific human capital. Finally, we contribute to research on relationships among board composition, TMT firm-specific human capital, and long-term IPO performance (e.g., Arthurs et al., 2009; Kroll et al., 2007; Walters et al., 2010). In doing so, we help to illuminate

* Corresponding author. Tel.: +1 318 257 3536.
E-mail addresses: Sle@latech.edu (S.A. Le), mark.kroll@utb.edu (M.J. Kroll), bwalters@latech.edu (B.A. Walters).
[1] Tel.: +1 956 882 6791.
[2] Tel.: +1 318 257 3293.

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whether IPO boards should be configured toward strengthening board control or reducing TMT members' risk bearing and preserving their psychological motivation.

2. Theory and hypotheses

2.1. The effect of outside directors on TMT firm-specific human capital

Scholars have argued that TMT firm-specific human capital is an important source of competitive advantage because it is often tacit, context-specific, and path-dependent, and thus valuable and inimitable (e.g., Barney, 1991; Eisenhardt & Schoonhoven, 1990; Hatch & Dyer, 2004; Reed et al., 2006). Retaining executives with firm-specific human capital is crucial (Castanias & Helfat, 1991), as success in reaching the IPO milestone is largely attributable to these TMTs (Nelson, 2003; Walters, Kroll, & Wright, 2007; Zimmerman, 2008). An IPO firm's board is restructured to reflect concerns and interests of influential outside stakeholders such as underwriters and investors (Baker & Gompers, 2003; Finkle, 1998). Even before enactment of the Sarbanes–Oxley Act (2002), IPO firms generally had high ratios of outside directors (Jain & Kini, 1994; Mikkelson et al., 1997). Wiseman and Gomez-Mejia (1998) build on agency and prospect theories to propose a behavioral agency model of managerial risk taking, which suggests that governance mechanisms, such as board monitoring, may affect top managers' risk bearing and thus their decision making. A governance mechanism designed to align or control executives may affect their perceived risk involving compensation and employment. Allcock and Filatotchev (2010: 664) stress that "because IPO firms may be particularly dependent on the existing top management team that usually includes the original founders, they may be more sensitive to managerial preferences for minimizing risk bearing than would larger firms."

As ratios of outsiders post-IPO decrease executives' control, TMT members' risk bearing likely increases. Top managers may feel less certain about the firm's future direction, their job security, and the return on their firm-specific human capital which is less valuable in other firms than in the focal firm (Becker, 1964; Hatch & Dyer, 2004, Wu, 2008). Outsiders often lack in-depth firm knowledge and may rely heavily on financial controls and corporate governance practices popular in established firms but perhaps less appropriate in entrepreneurial IPO firms (Beatty & Zajac, 1994; Zahra & Filatotchev, 2004). Viewpoints regarding evaluation of strategies and performance become more diverse (Arthurs et al., 2009; Bruton et al., 2010), and task uncertainty and information asymmetry may increase outsiders' disagreements with executives regarding the firm's direction, priorities, and performance measures (Sapienza & Gupta, 1994). Outsiders are less tolerant when firms do not meet financial performance targets (Weisbach, 1988), and board monitoring may increase TMT affective conflict (Buchholtz, Amason, & Rutherford, 2005).

The executives are often founders or original managers who can be distinguished from their counterparts in mature firms in that they tend to value discretion and freedom in decision making, have a unique vision for their firms, are passionate in their pursuit of that vision, have a psychological attachment to their firms, and are sensitive to losing control of their firms (Bruton et al., 2000; Gimeno, Folta, Cooper, & Woo, 1997; Nelson, 2003). Outsider-controlled boards reduce TMTs' structural power and discretion, decreasing psychological motivation (Zajac & Westphal, 1994). Over-reliance on financial controls may increase conflict and executive frustration, and may lower psychological commitment (Buchholtz et al., 2005), increasing the likelihood of TMT exit post-IPO. Thus:

Hypothesis 1. The ratio of outside directors at the time of an IPO is positively related to the attrition of TMT firm-specific human capital in the first three years following the IPO.

2.2. The effect of outside directors' firm-specific experience

Top managers' risk bearing and discretion may be affected in different ways depending on outside directors' experience. Firm- and industry-specific experiences are critical to directors' ability to perform their functions (Arthurs et al., 2009; Filatotchev, 2006; Kor & Sundaramurthy, 2009; Le, Walters, & Kroll, 2006). Directors' experience can impact TMT decision making and performance (e.g., Kor, 2006; Kroll et al., 2007), and may help mitigate the adverse consequences of outside directors on TMT exit.

Harris and Helfat (2007: 231) argue that "repeated communication between individuals can help to build and strengthen relational ties …. As a result, individuals may come to have greater trust …." Lawler, Thye, and Yoon (2000: 616) reason that "… frequent social exchange results in positive emotions that solidify and strengthen the person-to-group bond…." Outside directors with longer tenure may have a better and more trusting relationship with the TMT. Westphal (1998) suggests that over time, CEOs can use interpersonal tactics such as persuasion and ingratiation to influence outside board members in order to maintain their own discretion over the firm's strategic direction. Outside directors with long tenure may buy in and have a better understanding of the TMT's current vision and strategies. Outsiders who have been with the firm since long before the IPO were likely brought in more for resource provision than control, and have a better and more trusting relationship with the TMT than those who have recently joined (Eisenhardt & Schoonhoven, 1990). Mutual understanding and trust between outsiders with long tenure and TMT members may lower executives' perceived risk as they face a new board and enjoy less structural power and control of the firm in the post-IPO years (Wiseman & Gomez-Mejia, 1998). Such outsiders are less likely to monitor, evaluate, and impose their ideas in ways that subdue and weaken TMT discretion and psychological commitment to the firm. Outsiders with more firm experience may have a less adverse impact on TMT members' risk bearing, discretion, and psychological commitment than those with less firm experience. Given a certain ratio of outside directors, firms in which outside directors have greater firm experience may have fewer TMT departures and less attrition of TMT firm-specific human capital. Thus:

Hypothesis 2. The impact of the ratio of outside directors at the time of an IPO on the attrition of TMT firm-specific human capital in the first three years following the IPO is weaker when the board has longer rather than shorter firm tenure among outside directors.

2.3. The effect of outside directors' industry-specific experience

Industry-specific human capital is tacit knowledge and experience about an industry's structure, technologies, competitive conditions, and dynamics (Kor & Sundaramurthy, 2009). Outsiders with such human capital can appraise strategies and evaluate performance more accurately and realistically. Although these directors are able to discern TMT members' weak performance and take actions against them accordingly (Fama, 1980; Jensen & Meckling, 1976), fair evaluation will not likely impose greater risk bearing for managers who are sufficiently capable and act more like stewards than agents (Sapienza & Korsgaard, 1996). Having successfully grown their firms to achieve the IPO milestone, these executives likely have the ability and motivation to grow their firms further (Nelson, 2003; Zimmerman, 2008). They may perceive less risk if they work with outside directors who have common knowledge and an appreciation of industry dynamics, and can interact with them effectively and evaluate their performance fairly (Adams & Ferreira, 2007; Fischer & Pollock, 2004). Kor and Misangyi (2008) find that outside directors' industry-specific experience can enhance board–management collaboration in young firms. TMT members likely have more understanding and trust in this context, and thus