



Entrepreneurial Governance

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Introduction

There is a curious dichotomy in the application of regulatory thought to corporate law and governance. The subject matter divides into two groups — securities regulation and corporate governance. Our thoughts about corporate governance are mostly fixated on the public corporation.¹ Because there is widespread agreement about the need for a public corporation raising funds to be subject to a mandatory disclosure obligation, most controversies in securities regulation address smaller firms which need capital, and in particular the entrepreneurial, high-growth small medium enterprise (SME).² Initiatives by regulators and industry bodies have been directed to easing the barriers for these firms to raise capital. What is almost completely lacking, except for fragmentary perspectives from a range of disciplines external to the legal policy literature, is analysis of the governance of the entrepreneurial firm.

Governance considerations affect fundamentally the capacity of small firms to raise capital. Entrepreneurial finance markets are pervaded by problems of information asymmetry — the difficulty of evaluating the quality of the entrepreneur's ideas and management skills, and the difficulty of monitoring and controlling possible moral hazards and strategic behaviour once the project is under way.³ The transaction cost economics and industrial organisation literatures indicate that attempts to economise on these costs will be manifest in the governance of the firm, and the nature of exchange and relations between firms. Governance is thus implicated in the efficiency of entrepreneurial finance markets in essential respects.⁴

There is no fully satisfactory theory of the governance of the entrepreneurial firm. There is an extensive economic literature on financial contracting between entrepreneurs and venture capitalists, but very little in that literature sheds much light on the role of other influences on governance, such as norms, or on the role of third parties in the governance of the investor-entrepreneur relation.⁵ In addition, the empirical literature on informal angel finance is a very

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¹ See, eg, Corporate Law Economic Reform Program, Directors' Duties and Corporate Governance: Facilitating innovation and protecting investors (Proposals for Reform Paper No 3) (1997), § 3.2.

² See, eg, Corporate Law Economic Reform Program, Fundraising: Capital raising initiatives to build enterprise and employment (Proposals for Reform Paper No 2) (1997), § 2.

³ See, eg, J Stiglitz and A Weiss, "Credit Rationing in Markets with Imperfect Information" (1981) 71 *Am Econ Rev* 393; P Gompers and J Lerner, *The Venture Capital Cycle* (1999) 3.

⁴ See generally OE Williamson, "Corporate Finance and Corporate Governance" (1988) 43 *J Fin* 567.

⁵ The principal references are Gompers and Lerner, *supra* note 3; WA Sahlman, "The Structure and Governance of Venture-Capital Organizations" (1990) 27 *J Fin Econ* 473. Compare MC Suchman, *On Advice of Counsel: Law Firms and Venture Capital Funds as Information Intermediaries in the Structuration of Silicon Valley*, unpublished PhD thesis, Stanford University, 1994.

thin one. There is also a rich literature in law and economics on the role of norms, but it has no current place in analysis of venture capital.⁶ A number of disciplines have evaluated the implications of industrial networks, amongst which entrepreneurial firms have a crucial role, but the impact of this literature on corporate governance is inadequately theorised.⁷ Beyond the rational choice literature, the sociological significance of interpersonal trust has been analysed, but, as with network theory, a positive literature on its place in governance does not exist in any adequate form.⁸ In this paper, I use these literatures to theorise the governance of the entrepreneurial firm, and of the investor-entrepreneur relation. The contrasts with our understanding of “public” corporate governance are substantial, and, based on qualitative evidence from private capital market participants, I am not convinced that the differences are solely a consequence of different phenomena.⁹

Initially, I introduce some of the theoretical material that I use in this essay. In the following part, I provide a three-dimensional conceptual map in order to understand the governance of exchange relations in entrepreneurial SMEs. The part that follows discusses aspects of that conceptual map, emphasising two things. The first is the linkages between the concepts; the second is the importance of the board of directors to the operation of the other mechanisms governing the entrepreneur-investor exchange relation. The final substantive part discusses some legal issues that arise from the analysis.

Some Theoretical Inputs

RATIONAL CHOICE AND GOVERNANCE SELECTION

The rational choice paradigm holds that governance is endogenous to exchanges — that is, parties will choose mechanisms, as part of their contracts, to control threats to the exchange that arise from individual self-interest and opportunism, in a way that economises on the transaction costs of implementing these mechanisms and the deadweight loss saved from reduced opportunism. Approaches in economics are differentiable by their assumptions regarding the “comprehensiveness” of this governance contracting, and the significance of limitations on individual rationality.¹⁰

⁶ Principal references include L Bernstein, “Merchant Law in a Merchant Court: Rethinking the Code’s Search for Immanent Business Norms” (1996) 144 *U Pa L Rev* 1765; RD Cooter, “Decentralized Law for a Complex Economy: The Structural Approach to Adjudicating the New Law Merchant” (1996) 144 *U Pa L Rev* 1643; RC Ellickson, “Law and Economics Discovers Social Norms” (1998) 27 *J Legal Stud* 537; JS Johnston, “The Statute of Frauds and Business Norms: A Testable Game Theoretic Model” (1996) 144 *U Pa L Rev* 1859. A major advance towards the use of norms in the analysis of closely held corporations is provided in E Rock and M Wachter, “Waiting for the Omelet to Set: Match-Specific Assets and Minority Oppression in the Close Corporation” (1999) 24 *J Corp L* ____.

⁷ B Axelsson and G Easton, *Industrial Networks: A New View of Reality* (1992); H Håkansson and I Snehota (eds), *Developing Relationships in Business Networks* (1995); MS Mizruchi and J Galaszkiewicz, “Networks of Interorganizational Relations” (1993) 22 *Soc Methods and Res* 46; N Nohria and R Eccles (eds), *Networks and Organizations: Structure, Form and Action* (1992); WW Powell, “Neither Market Not Hierarchy: Network Forms of Organization” (1990) 12 *Res in Org’l Beh* 295.

⁸ A number of contributions to contemporary research on trust are summarised in RM Kramer and TR Tyler (eds), *Trust in Organizations: Frontiers of Theory and Research* (1995).

⁹ I interviewed 12 executives from venture capital firms and 10 other professionals involved in private capital markets in 1998-9. The interviews took place in Sydney, Brisbane, and Melbourne. Interviews were semi-structured and lasted between half an hour and two hours, taking an hour on average.

¹⁰ Compare, eg, OE Williamson, *The Economic Institutions of Capitalism* (1985) [hereinafter, Williamson, *Economic Institutions*] and D North, *Institutions, Institutional Change and Economic Performance* (1990).

The transaction cost economics paradigm, for example, holds that in some exchanges, parties will be content to rely on the protection available in competitive markets — the right to take their custom elsewhere. Williamson recognises that this protection gradually becomes weaker, as exchanges and the investments supporting them become more idiosyncratic.¹¹ In these cases, contracts will cease to look the classic spot exchange in which the parties perform instantaneously and simultaneously. Instead, the parties might make credible commitments to support their pledges, or, in extreme cases, convert their bilateral relation to one in which control is shared or surrendered.¹²

This perspective has strengths in explaining the relation between an entrepreneur and a venture capitalist. Investments in entrepreneurial firms invariably are sunk into specialised and idiosyncratic assets, and are difficult to recover over time. The consequent incentive problems are typically addressed by the entrepreneur surrendering or sharing some of their control rights, for example, by conferring significant voting rights on the investor or ceding rights over the board of directors. This explanation also has its limitations — it fails to explain the coexistence of sharply specified contract terms and control sharing in venture capital contracting. In addition, it tends to have only a limited amount to say about the content of the parties' bargain and about the means of enforcement.

THE CONTENT OF EXCHANGE RELATIONS

Williamson basically treats formal contracts and the use of hierarchical administration as substitutes: the former can be introduced as a means of economising on limited foresight in ex ante contracting.¹³ What he tends to understate is the *complementary* characteristics of the two. Sociological examinations of contracts have often emphasised that parties who have detailed contracts often act in ways formally at variance with what they have contracted for.¹⁴ They often ignore the rights they have, and act on the basis of rights that do not appear in the contract. Nonetheless, when these contracts are litigated judges normally enforce (at least historically) the parties' formal bargain. This perspective is very much in accordance with the qualitative evidence we gathered in interviews with venture capitalists who indicated that was very much the way of their relations with the entrepreneur — the contract “stays in the bottom drawer” unless serious problems arise.

The resolution of this apparent paradox lies in the recognition that the parties' obligations may be enforced by more than one means.¹⁵ Litigation and lawyers do not have a monopoly on enforcement. Obligations may be enforced in at least three other ways. These are by self-enforcement, where performance is in a party's best interest irrespective of enforcement;¹⁶ by second-party enforcement, where a party is able to punish the other party for not performing, for instance by degrading his or her own performance or withholding future business;¹⁷ and by third-party enforcement, where some non-party to the exchange punishes the party in breach of the obligation. Litigation is the “legal” variety of third-party enforcement, but other third

¹¹ O Williamson, *The Mechanisms of Governance* (1996) 59-65 [hereinafter, Williamson, *Mechanisms*].

¹² Williamson, *Economic Institutions*, *supra* note 10, at ____; Williamson, *Mechanisms*, *supra* note 11, at 75-6.

¹³ See, eg, O Williamson, *Markets and Hierarchies* (1975).

¹⁴ S Macaulay, Non-Contractual Relations in Business: A Preliminary Study (1963) 28 *Am Soc Rev* 55.

¹⁵ The analysis that follows draws substantially on Johnston, *supra* note 6, and Bernstein, *supra* note 6.

¹⁶ L Telser, “A Theory of Self-Enforcing Agreements” (1980) 53 *J Bus* 27.

¹⁷ See Johnston, *supra* note 6.

parties besides courts enforce extralegally, such as by social ostracism or cutting off valuable information.¹⁸ The strength of extralegal enforcement depends on a number of factors — the nature of the parties’ performance, differences in the parties’ opportunity costs of contract performance, the structure of the markets and communities of which the contract and parties form part, and the flow of information to these markets and communities.

If we admit the possible impact of extralegal enforcement, it follows that the parties may not have a single, indivisible, universal set of obligations. The parties may consciously partition their obligations, so that some are entrusted to legal means, but others, which need not be the same as the former, are enforced extralegally. There may be several reasons for doing this.¹⁹ I will mention two. First, the capacity for and cost of legal enforcement of some obligations may be high. Economists recognise that the ability of the parties to observe, and of third parties to verify, the truth of information may vary markedly.²⁰ In general, much observable information is unlikely to be verifiable by a court, and some information unverifiable by a court may yet be observable by other parties in the industry. In these circumstances, parties might rationally prefer *not* to enforce some obligations legally and rely on second- and third-party extralegal enforcement. Second, where one party has private information about the probability that he will perform, the other party may prefer not to attach legal consequences to an obligation to function in an “accommodating” fashion that is generally enforced between parties with a history of performance.²¹

These ideas enable us to offer an obligational schema which synthesises these ideas with the sociology of contracts noted above. The first set of obligations are designed to preserve and enhance the exchange relation; the second are designed to be applied — typically by a third-party adjudicator, such as a court — to disputes arising at the end of relation. These are “relation preserving” norms (RPNs) and “end game” norms (EGNs), respectively.²² EGNs being typically applied by courts, are subject to the usual constraint that they need to predicate on verifiable information, whereas RPNs are not similarly constrained. There are at least two different sources for each norm type. EGNs may come either from the explicit contract, or from the law. Obviously, some legal rules (*defaults*) are capable of being changed by contracts. RPNs may derive from communities, of which one or both contractors form part,²³ or they may be endogenous to the exchange itself. Much research into norms has focused on defined communities which have evolved formal norms.²⁴ The capacity of a transactional community to formulate specific norms depends on the complexity of the paradigm exchange — trading in, say, flax seed is much simpler than managing a relation between an entrepreneur and an investor.

¹⁸ Cooter, *supra* note 6.

¹⁹ See Bernstein, *supra* note 6.

²⁰ A Schwartz, “Relational Contracts in the Courts: An Analysis of Incomplete Agreements and Judicial Strategies” (1992) 21 *J Leg Stud* 271.

²¹ L Bernstein, “Social Norms and Default Rules Analysis” (1993) 3 *S Cal Interdisc LJ* 59

²² Bernstein, *supra* note 6.

²³ E Abrahamson and C Formbrun, “Forging the Iron Cage: Interorganizational Networks and the Production of Macro-culture” (1992) 29 *J Mgt Studies* 175.

²⁴ Much of Lisa Bernstein’s work is of this character: Bernstein, *supra* note 6; Lisa Bernstein, “Opting Out of the Legal System: Extralegal Contractual Relations in the Diamond Industry” (1992) 21 *J Legal Stud* 115.

INDUSTRIAL NETWORKS

A huge amount of research over the last two decades has identified the use of industrial networks as part of the organisation of modern firms.²⁵ The concept of the network cuts through conventional economic dichotomies between contracting in markets and hierarchical governance in organisations. The literature indicates that much exchange, even in some of the most dynamic industrial sectors, occurs between autonomous firms which are linked together as an informal community by flexible horizontal relations. This model repeats itself with variations in a number of different contexts — examples include the Japanese *keiretsu*, the innovation networks found in Silicon Valley, the industrial districts of Italy, the use of strategic alliances, and so on. Small firms often exist in a network milieu with their suppliers, customers and creditors, as networks dominate autonomous market contracting and bureaucratic hierarchy given high demand uncertainty, customisation, and transaction-specific investments.²⁶ Particular relations and contracts become “structurally embedded” — that is, linked with each other.²⁷

Network membership may have decisive implications for the success of entrepreneurial firms. Network membership affects the firm’s access to resources and information, and thus its viability, its capacity to innovate, and its responses to environmental changes.²⁸ Dependence on networks will influence the governance of member firms. Because networks depend on cooperative behaviour and free information flows, the firm’s governance needs to facilitate two-way communication with other network members.²⁹ Firms that cannot do that will be cut loose, usually with fatal consequences.

TRUST

The network concept indicates how important flexibility is to entrepreneurial firms. In much the same way, we saw how contracting parties could achieve flexibility in their relations by committing some of their obligations and governance to extralegal enforcement, and limiting contracts to the expression of formal EGNs. Flexibility between and within firms is, however, very difficult to achieve unless these relations can be built on a foundation of trust.³⁰ Otherwise, transaction costs will swamp the gains from trade otherwise available.

Trust is only meaningful if understood bilaterally.³¹ That is, trust posits not only that both parties will act according to various standards or ethics — such as cooperation, candour, and so on — but that those commitments are common knowledge to the parties. Each expects the other to act so, the other knows that expectation, and so on. However, the bases or reasons for

²⁵ See the references in note 7.

²⁶ C Jones *et al*, “A General Theory of Network Governance: Exchange Conditions and Social Mechanisms” (1997) 22 *Acad Mgt Rev* 911.

²⁷ M Granovetter, “Problems of Explanation in Economic Sociology” in Nohria and Eccles, *supra* note 7, 25.

²⁸ J Pfeffer and G Salancik, *The External Control of Organizations* (1978); R Miles and CC Snow, “Causes of Failure in Network Organizations” (1992) 34 *Calif Mgt Rev* 53.

²⁹ Powell, *supra* note 7, at 304, 322, 324.

³⁰ Tolerating flexibility subjects a party not just to greater uncertainty, but to opportunism and hold-out behaviour where the exchange is supported by transaction-specific assets: Williamson, *Mechanisms*, *supra* note 11, at 59-61.

³¹ L Mitchell, “Trust and Team Production in Post-Capitalist Society” (1999) 24 *J Corp L* ____; D Kipnis, “Trust and Technology” in Kramer and Tyler, *supra* note 8, 39 at 40.

trust may differ.³² Deterrence-based trust is the lowest level, in which trustworthy behaviour occurs in equilibrium as a result of the sanctions deterring opportunism.³³ Knowledge-based trust results where the parties are sufficiently informed about each other to recognise each other's disposition to act in a trustworthy way. Identification-based trust, the highest level, results where the parties internalise the effect of their own behaviour on the other party.

The literature identifies several factors that contribute to the development of trust. First, the extent to which parties perceive themselves as partaking of a group identity seems to be critical.³⁴ It breaks down the adversarial quality of bilateral relations and encourages cooperation. Second, trust seems to be closely related to the procedural content of the relation.³⁵ Trust does not emerge in a vacuum, but frequently requires opportunities for debate and discussion about courses of action, in which each party has the means of monitoring the other.³⁶ Where the parties interact hierarchically, or there is some other power relation, perceptions of procedural fairness are important. Third, trust seems to be positively influenced by the presence of third party "watchers".³⁷ These may function as witnesses, or as conduits of information to other parties. Network organisation may often depend on the watchers performing these functions. We also know that trust seems to be self-enforcing, beyond some point — experience of reciprocity, even if initially deterrent-based, increases the parties' knowledge of each other, and their identification with each other. Trust, we are told, begets trust.³⁸ With these concepts in hand, I build in the next part a model of the entrepreneurial firm's governance, which draws together the principal theoretical themes in this part.

A Governance Model for Entrepreneurial Firms

PRELIMINARY COMMENTS ON THEORIES OF CORPORATE GOVERNANCE

Most policy analysis of corporate governance builds on a generally complementary set of economic theories. The relation between shareholders and managers is stylised as an agency relationship contracted under rational expectations between a small management group and a large changing body of shareholders.³⁹ The agency problems, such as overreaching, perquisite consumption, and suboptimal incentives in financing, dividend and investment policy, are addressed by various means. These include alignment of incentives through compensation contracts, separation of ratification and monitoring of decisions (vested in a substantially non-

³² D Shapiro, B H Sheppard and L Cheraskin, "Business on a Handshake" (1992) 8 *Negotiation J* 365.

³³ This form of trust is the only species recognised in the mainstream economic literature: O E Williamson, "Calculativeness, Trust, and Economic Organization" (1993) 34 *J L & Econ* 453.

³⁴ RM Dawes, AJC van de Kragt and JM Orbell, "Cooperation for the Benefit of Us — Not Me, or My Conscience" in JJ Mansbridge (ed), *Beyond Self-Interest* (1990) 97.

³⁵ J Thibaut and L Walker, *Procedural Justice: A Psychological Analysis* (1975); J Brockner and P Siegel, "Understanding the Interaction Between Procedural and Distributive Justice: The Role of Trust" in Kramer and Tyler, *supra* note 8, at 390.

³⁶ WW Powell, "Trust-Based Forms of Governance" in Kramer and Tyler, *supra* note 8, 51 at 63.

³⁷ RS Burt and M Knez, "Trust and Third-Party Gossip" in Kramer and Tyler, *supra* note 8, at 68.

³⁸ D Gambetta, "Can we Trust Trust?" in *Trust: Making and Breaking Cooperative Relationships* (1988) 213; A Lawson, "Network Dyads in Entrepreneurial Settings: A Study of the Governance of Exchange Relations" (1992) 37 *Admin Sci Q* 76; H Thorelli, "Networks: Between Markets and Hierarchies" (1986) 7 *Strat Mgt J* 37.

³⁹ MC Jensen and WH Meckling, "Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure" (1976) 3 *J Fin Econ* 305; EF Fama, "Agency Problems and the Theory of the Firm" (1980) 88 *J Pol Econ* 288; EF Fama and MC Jensen, "Separation of Ownership and Control" (1983) 26 *J L Econ* 301; OE Williamson, "Corporate Governance" (1984) 93 *Yale LJ* 1197.

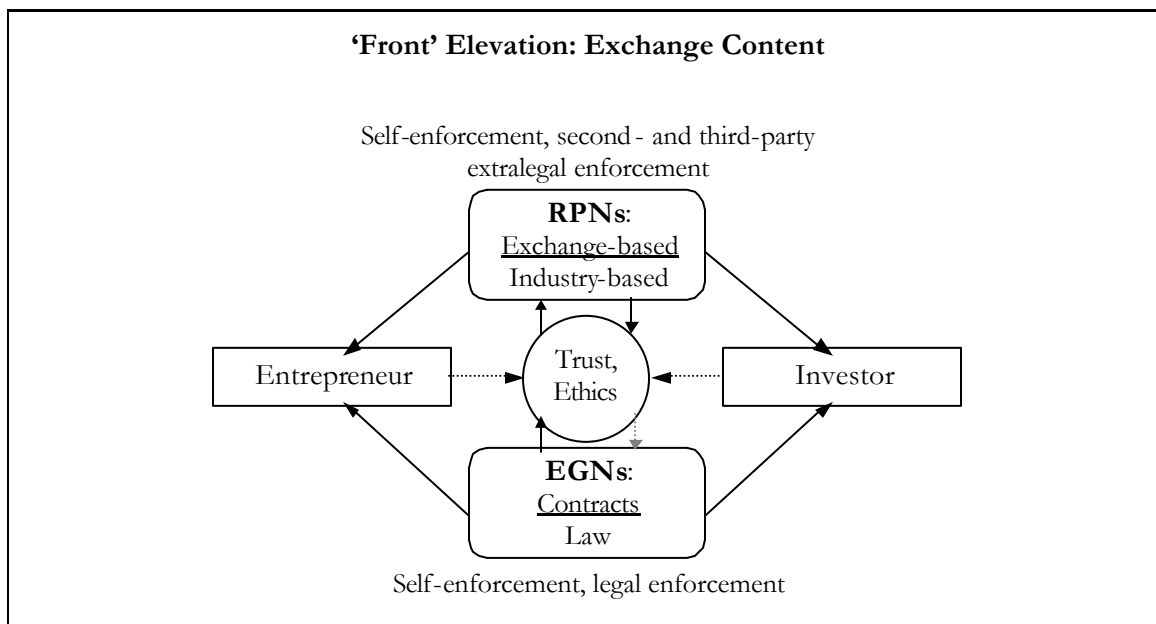
executive board) from their initiation and implementation, and the disciplinary effects of markets for capital and corporate control.

The public corporation inhabits a world quite unlike the milieu of the entrepreneurial firm. Relation between the entrepreneur and the investor is far more social than that between manager and shareholder, as the latter constituencies regularly change. While both the entrepreneurial firm and the public corporation face external “forces”, those forces are quite different. Both confront capital markets, but the markets create different incentives. There is no market for corporate control in the entrepreneurial firm. In contrast, the entrepreneurial firm’s interactions in factor and product markets and networks will differ from those of an established firm. We therefore need a quite different perspective on governance. In the next section, I provide a conceptual map of the entrepreneurial firm, and its governance.

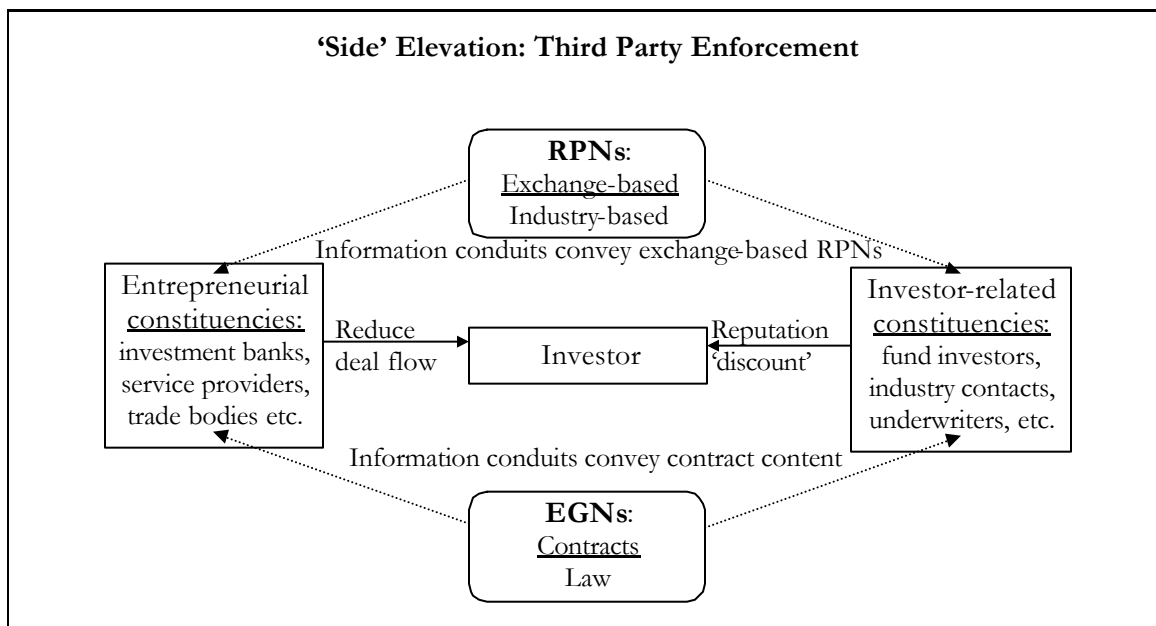
CONCEPTUAL MAP

My representation of the entrepreneurial firm is a three-dimensional one. These dimensions correspond to the investor-entrepreneur relation, the content of their relation and the norms which impact on it, and the networks of which the parties form part. This requires multiple two-dimensional representations, which I provide in Figures 1-3. Intuitively the reader might appreciate the model as taking the form of a three-dimensional diamond (◆), or of two pyramids joined together at their bases.

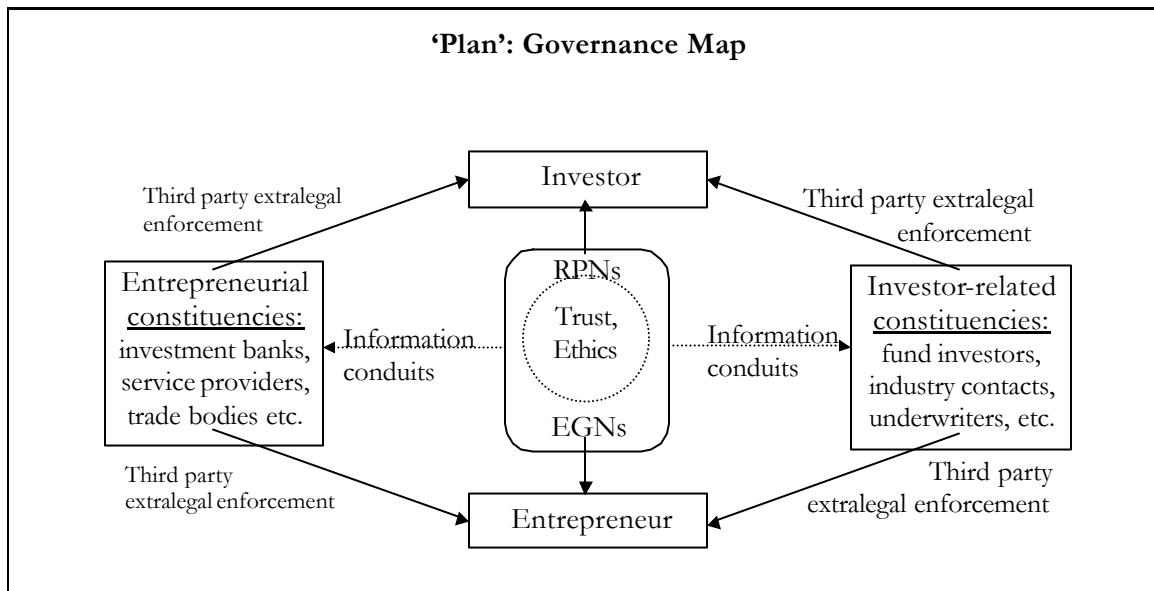
The “front” elevation in Figure 1, examines the content of the investor-entrepreneur relation. It demonstrates the interaction between the parties, their norms, and the trust concept. RPNs derive from two sources — industry praxis and the exchange itself. EGNs arise from contracts and the law. The move towards flexible RPNs in governance may come from two sources — from pre-existing trust or other ties, or from deterrence, which will typically be reflected in the EGNs. The experience of reciprocity, greater socialisation of the relation, and participation in debate and decision-making should strengthen the quality of trust, which will in turn facilitate the development of more idiosyncratic exchange-based RPNs. Should trust fail, the parties fall back to formal EGNs.



If the viewer examines the model from 90° to the side, the picture reveals the impact of third parties on the enforcement of the exchange content *partially* examined in Figure 1. Figure 2 is thus a model of third-party enforcement. I have aggregated and dichotomised third parties into entrepreneurial and investor-related constituencies. Information will flow through various conduits to them of the RPNs used in the exchange, as well as of relevant contract content, since, as Jason Johnston has argued, parties may commit more complex obligations to writing even if they are intended to be enforced extralegally. Third parties also need to know the content of contracts in order to gauge potential strategic behaviour in reliance on the contract. The side elevation can only show one party at a time. Figure 2 shows that principal sanctions of a norm-violating investor are reduced deal flow and discounted reputation. A norm-violating entrepreneur will be punished through refusals of future business and decreased access to information and resources.



The model can then be viewed from “above” as a governance plan, as in Figure 3. In a sense, this picture comes to mind when one thinks of the network context of small firms. However, this perspective obscures the exchange content, which is my vertical dimension. Figure 3 superimposes the two bodies of norms and the trust context.



The model necessarily simplifies. Third party constituencies do more than receive information about RPNs, and enforce them — their aggregated activity shapes industry-based RPNs, and, following positive political theory, they may influence the content of positive law. It is also unclear whether the existence of trust or ethical behaviour actually influences EGNs. In Figure 1, I have put a lighter, dotted line from trust to EGNs. This reflects the debate in the legal literature about whether the parties’ past behaviour, and their expectations of the relation, should influence the legal resolution of any disputed matters. The answer increasingly being given by academics is that they should, and that they have begun to do so.⁴⁰ The model also leaves open the crucial issues of network trust between the entrepreneur and investor, on one hand, and those with whom they transact, on the other; or, still more complicated, the relationship between the trust subsisting between the entrepreneur and investor, and these network relations.

Nonetheless, the model is, I think, an improvement over conventional conceptions of closely held corporations, or uncritical assimilation of the normal agency theorisation with the entrepreneurial firm. Compared to the former, the model appropriately reflects the wider context of the relation, and differentiates the exchange content into RPNs and EGNs. Compared to the latter, the model adds the concept of trust, which is fundamental to understanding a relation which has a high degree of social embeddedness.⁴¹ Likewise, it makes fewer question-begging assumptions about, and tends less to reify, the effects of “market forces” by showing how these depend on the existence of information conduits, while also showing analytically distinct sources of these.

We may think of the centre of the model as being at the core of the entrepreneurial firm’s governance, and the region which rational parties can, and will seek to, order to increase the firm’s survival prospects. Because there is more to the model than Figure 1 shows, the ordering of governance must necessarily take two things into account — first, the role of third

⁴⁰ The arguments and empirical evidence are summarised in IM Ramsay, “An Empirical Study of the Use of the Oppression Remedy” (1999) 27 *Aust Bus L Rev* 23.

⁴¹ MS Granovetter, “Economic Action and Social Structure: The Problem of Embeddedness” (1985) 91 *Am J Soc* 481.

parties, and second, the effect of governance mechanisms on interparty trust. I discuss these issues in the following part.

Governance Processes in Entrepreneurial Firms

THE BOARD OF DIRECTORS

Interviews with capital market participants, both venture capital executives and those matching angels with entrepreneurs, confirmed their view of the importance of the board of directors to the success of entrepreneurial firms. It is also clear from interviews with venture capital firms that they will require the presence of at least one non-executive director, often more. The board is the principal forum for making many of the hard decisions, even though it is clearly possible for many of these to be reserved to bilateral bargaining between the investor and the entrepreneur.

The board's centrality in entrepreneurial firms is not so easy to understand. In many ways, it defies conventional theorisations of the board's importance. First, the substantial identity between owners and managers makes the separation of decision management and control appear suboptimal.⁴² Second, the need for investors to monitor management through the board is not self-evident. The investor does not face substantial collective action problems. Why can't the investor do the same job with regular meetings with the entrepreneur and unrestricted rights of access to information? Third, venture capitalists have all the incentive and power they need to keep management in line — why pay substantial fees to non-executives? Fourth, if the persons appointed to non-executive directors are capable of providing, say, special technical or strategic information, why appoint them as directors rather than consultants under a contract with defined responsibilities? In short, the conventional rational choice paradigm gives an undistinguished explanation. I suspect that the full story is incapable of narration without involving both third parties and interparty trust.

First, the board may function as an educational forum. It is a well-established proposition that venture capitalists and sophisticated angels add value to the corporation in addition to contributing capital. They can add value by establishing a governance culture in the firm, and imparting these disciplines to the entrepreneur and other members of the management team.⁴³ A governance culture and a functional board are necessities for an entrepreneurial firm for which an IPO is proposed. An underwriter must evaluate the firm's governance in order to value it, and to be able to provide information to possible subscribers; the underwriter also takes instructions primarily *from* the board, so the investor will be anxious to see it properly constituted. In other words, the board is a vital part of information conduits to IPO markets.

Second, the board has a crucial part in fostering trust between, and mediating RPNs applicable to, the entrepreneur and the investor. Following on from the last point, imparting a governance culture regularises interactions between the parties and enables third parties, in particular non-executive directors to witness these. These things are important structural elements in the development of trust to the parties. The board's essentially collegial, collective decision-making shifts the frame of the entrepreneur-investor relation from the bilaterally bargained, adversarial context in which the contract was formed. In addition, the board has a

⁴² Fama and Jensen, *supra* note 39.

⁴³ The financier may also have a role in imparting the macro-culture of the network or industry, that is, its principal values and commitments: E Abrahamson and CJ Fombrun, "Macro-cultures: Determinants and Consequences" (1994) 19 *Acad Mgt Rev* 728; S Hill, "The Social Organisation of Boards of Directors" (1995) 46 *Brit J Soc* 245, at 266.

vital role in furthering identification-based trust. Although economic theory treats the separate legal entity status of the corporation as a fiction, the idea, when coupled with a “constitutional” requirement for formal entity instrumentalities, may enhance the parties’ perception that they form part of a group.

Third, the board enables interaction with third parties and networks.⁴⁴ Initially, persons with network affiliations may be appointed to the board in a manner resembling the gifts often given to qualify a person for network membership.⁴⁵ The gift is a credible commitment to further the network, since the gift will have no value if later behaviour is opportunistic. The appointee can serve two roles: one is to provide the necessary confidence for other network members to deal with the firm. The appointee can also disseminate information to other members. The director may be one of the most crucial information conduits for third party enforcement as shown in Figure 2. Board membership may often be a precondition for accurate, complex information such as the content of RPNs and contracts, and of party behaviour, to be disseminated to third party contacts only loosely tied to the firm.⁴⁶ To the extent that third-party enforcement is a substantial means of enforcing norms, both parties will favour non-executive appointments. Non-executives nonetheless may facilitate *second-party* enforcement, as well. They may be important sources of information for the investor, regarding “industry” opinions of the entrepreneur and the business. Given the difficulty for the investor in valuing idiosyncratic assets, the investor’s need for credible soft information may be addressed through the board.

These arguments are significant in two ways. First, they have an ambivalent relation to the arguments pro and con the proposition that directors act for a single constituency, the shareholders.⁴⁷ I do not suggest that directors will or should be appointed by anyone but shareholders. On the other hand, while the director will be appointed for the welfare of the business, and thus its shareholders, the agent analogy is inaccurate, the focus is outward not inward, and the director’s identification with other social groups may be quite as strong as that with the investors.

Second, this theorisation challenges the concept of the monitoring board advanced in the legal policy and corporate governance literatures.⁴⁸ A number of recent rulings and other statutory provisions adopt this concept in imposing personal liability on directors where they have failed to monitor the corporation and its business. Some directors, such as the venture capitalist or his nominee, will monitor intensively, because they have strong self interests to do so. It seems likely that non-executives monitor only to the extent required to perform their other functions including those related to the network. Intensifications of these obligations seem dysfunctional, and to achieve nothing of value.

⁴⁴ R Burt, *Corporate Profits and Cooptation* (1983); MS Mizruchi, “What do Interlocks do? An Analysis, Critique, and Assessment of Research on Interlocking Directorates” (1996) 22 *Ann Rev Soc* 271; M Useem, *The Inner Circle* (1984).

⁴⁵ R Kali, “Endogenous Business Networks” (1999) 15 *J L Econ & Org* ____; MK Bolton *et al*, “The Organization of Innovation in the United States and Japan: Neoclassical and Relational Contracting” (1994) 31 *J Mgt Stud* 653, 656 (“collateral bond”).

⁴⁶ A Bhidé and H Stevenson, “Trust, Uncertainty and Profit” (1992) 21 *J Socio-Econ* 191.

⁴⁷ FH Easterbrook and DR Fischel, *The Economic Structure of Corporate Law* (1991) ____

⁴⁸ Committee on the Financial Aspects and Code of Best Practice of Corporate Governance, Sir Adrian Cadbury (Chairman), Report (1992); Melvin Eisenberg, *The Structure of the Corporation: A Legal Analysis* (1976).

OTHER GOVERNANCE PROCESSES

I want to refer to certain other governance practices, particularly characteristic of formal venture capital, to demonstrate how they can be integrated into my model of the entrepreneurial firm. The first of these is staged financing.⁴⁹ Here, the investor staggers his capital contributions over time, to correspond to the needs of identified stages of the future venture, although the investor rarely commits to funding future stages. Economists have argued that staged financing is the principal control over opportunism by the entrepreneur, since it provides the investor with a call option over future investment in the project. It minimises financial slack in the enterprise, and decreases the amount at hazard in the earlier stages of the project. In addition, staging compels the entrepreneur to disclose further information at the end of each stage when new capital is sought.

Although staged financing creates a risk of opportunism,⁵⁰ the trust engendered through a functional board limits the incentive to act opportunistically, as does the deterrent of third party enforcement. However, staged financing can itself function to increase trust. It does this by increasing the number of exchanges between the parties. The parties anticipate the need to deal with each other in the future — if they did not, it would make little sense to make the first stage investment. Other things being equal, the occurrence of a number of successful exchanges should enhance the sense of cooperation between the parties, compared to the making of a one-time capital contribution. The fact that each new financing stage increases the stakes of failure suggests that an investor may refrain from predatory behaviour in order to preserve the trust that subsists between the two.

The second practice is syndication, in which the venture capitalist invites other investors to participate in the investment.⁵¹ This happens for several pragmatic reasons — it enables risk diversification, it enables financing that would otherwise be precluded by covenants granted by the venture capitalist to his investors limiting the amount that can be invested at any one time or in any one firm, and it provides a “second opinion” on the entrepreneur’s prognosis of the investment. It is most likely in later stage investments (where capital requirements are larger), although it also happens in early stage investments.⁵²

In addition to these justifications, there are other governance effects. First, by increasing the number of investors, the entrepreneur will find it harder to act opportunistically by making threats not to cooperate if the contract is not renegotiated.⁵³ A higher number of parties who must agree, unanimously, to contract changes greatly increases transaction costs. Second, syndication increases the amount of mutual monitoring within the venture capital industry. Opportunistic behaviour by an investor will be capable of rapid diffusion amongst other venture capitalists, who are, in Australia, quite few in number. Apart from further diffusion of

⁴⁹ PA Gompers, “Optimal Investment, Monitoring, and the Staging of Venture Capital” (1995) 50 *J Fin* 1461.

⁵⁰ Specifically, the investor can refuse to finance the next stage unless the entrepreneur redistributes gains to the financier. The investor can threaten this because he or she usually is able to prevent other people investing through anti-dilution covenants, not to mention the negative signal arising from a refusal to fund the next stage. Nonetheless, the policy does not seem particularly sensible, if the investor can achieve the same result by “unfair” terms of the next stage of finance.

⁵¹ Gompers & Lerner, *supra* note 3, at 185-202.

⁵² *Id* 190-1.

⁵³ PA Gompers, “Resource Allocation, Incentives and Control: The Importance of Venture Capital in Financing Entrepreneurial Firms” in ZJ Acs, B Carlsson & C Karlsson, *Entrepreneurship, Small and Medium-Sized Enterprises and the Macroeconomy* (1999) 206 at 220-2.

the information, third-party enforcement measures are possible, such as venture capitalists decreasing “redirected” deal flow to that investor and decreased opportunities for that investor to participate in other syndicates. Other investors have incentives to take the latter step, in particular, because opportunistic behaviour will often diminish the trust and cooperation essential to successful, low-transaction-cost investing.

FORMAL AND INFORMAL VENTURE CAPITAL

Thus far, much of my analysis has used an implicit paradigm of formal venture capital. However, empirical evidence clearly demonstrates that informal venture capital — angel finance — is an appreciably larger market segment.⁵⁴ The relation between the two is variable. Angel finance may capitalise an earlier stage of an investment, and venture capital a later stage. Some firms may never get into the venture capital “class”. A principal difference between informal angel financing and venture capital relates to expectations of exit and duration. Because venture capital funds are obliged to liquidate after the passage of time, about ten years on average, the venture capitalist will only invest if he expects an appropriate exit opportunity to be available, such as a trade sale or an IPO. Although angels may often have a similar expectation, it need not be so, since they rarely make any commitment alike the venture capitalist’s. Angels may invest as a form of lifestyle or employment choice, so they may actually plan an indefinite involvement.

Angels may have also less expertise available to them in the contracting process or in establishing governance institutions.⁵⁵ The extent to which this is true depends in part on the availability and cost of professional assistance. Anecdotally, the professionals we spoke to who interact with angels and entrepreneurs doubted the expertise or understanding of professional service providers in this market niche. Our anecdotal evidence suggests that informal angels take substantially fewer contractual protections and control rights.⁵⁶

These differences impact in various ways on the governance model I have outlined. First, formal and informal finance may vary in the nature of norm enforcement. The extensive protections and control rights in formal finance give the venture capitalist far greater second-party enforcement power than an angel, whose capacity to make credible threats is less than the formal venture capitalist. The reverse is also true — vis-à-vis an angel, the *entrepreneur* has considerable second-party enforcement power, because his threats to degrade performance are credible when the investor’s formal powers are minimal. I will describe a situation where the parties differ in their reliance on forms of extralegal enforcement as an *enforcement asymmetry*. This has significant, but complex effects on trust. Initially, the formal venture capital model is much more of a vertical relationship than in informal finance. It will build trust initially through deterrence. However, the development of a governance culture offers the opportunity for the vertical relationship to be “levelled” by the development of cooperative RPNs, and the presence of third parties to observe the investor’s behaviour. The informal venture capital model is different. It relies, initially, on the parties’ capacity to build identification based trust through a more symmetrical, horizontal relation. That is, trust can be built through a perception of similar situation and mutual vulnerability, and the expression of confidence implicit in investing without a “safety net”, as it were.

⁵⁴ K Hindle and R Wenban, “Australia’s Informal Venture Capitalists: An Exploratory Profile” (1999) 1 *Vent Cap* 169; S Prowse, “Angel Investors and the Market for Angel Investments” (1998) 22 *J Bank & Fin* 785, 787.

⁵⁵ Prowse, *supra* note 54, 787-8.

⁵⁶ *Id* 790.

It's hard to say which works better — are marriages better than relations of convenience? Much depends on one's perspective. The thicker the relations between the parties, the greater the trust is likely to be, but it may be harder to attempt to adjust the entrepreneur's actions without the relation unravelling, and incentives may be weaker.⁵⁷

Second, the incentive and capacity of the parties to build a strong board of directors may differ. Formal venture capital provides strong incentives for parties to build a board of directors as the principal governance institution. Enforcement asymmetry will increase the demand of entrepreneurs for third party witnesses. The higher value of the venture capitalist's network connections can best be maintained through formal links at the board level. Likewise, the venture capitalist's pervasive need for exit is facilitated by the presence of a sound board, for reasons noted above. Informal venture capital is quite different — the value of network contacts are likely to be lower, exit is either less likely or less immediate, and the enforcement asymmetry is much lower. If my analysis is right, identification-based trust is more likely in angel finance, and the parties will interact substantially out of the board. In addition, the lower profile and the greater uncertainties of angel-financed firms may make the recruitment of non-executives harder and more costly.

Third, the absence of less explicit formal contracts makes the parties to informal finance arrangements much more dependent on legal rules. In these situations, the parties draw their EGNs mostly from the law on members' rights and winding up. Whether or not these effect the parties' relation is a speculative inquiry, especially in light of the infrequent litigation of cases between entrepreneurs and investors. The basic issues are twofold. On one hand, legal rules may affect the willingness of the parties to commit to RPNs.⁵⁸ Recall that RPNs are enforced extralegally. However, if courts attempt to transplant the normative content of what they perceive as the adopted RPNs to the legal rules they apply to disputes — the EGNs — they could undermine the adoption of the RPN. Second, the remedy that a court applies may destroy the incentive compatibility of the corporate form, and increase strategic behaviour by the parties.⁵⁹

For example, A, an angel, supplies capital to an entrepreneur, E. A is granted 51% of the voting equity, and appoints a majority of the board members. A must decide whether to adopt norms to act flexibly and cooperatively. The risk is that if he does, a court may hold at some later time, at which A seeks to exercise his voting power or board control (for example, to replace E), that E had a reasonable expectation that A would not take that action, and that the action is oppressive. A could of course contract for the right to take these actions. Nonetheless, even a contract may be a limited solution, as courts may look at post-contractual behaviour in evaluating claims of estoppel by E. Where E makes out his cause of action, a remedy framed in terms that permits E to have his shares repurchased destroys the incentive compatibility of the corporate form. This is because the corporate form provides parties with a contractual structure that locks each of the parties into the enterprise, and denies them ready exit.⁶⁰ Adopting this form enables parties to give credible commitments to stay with the enterprise, which may be of much value when the enterprise involves developing, over a

⁵⁷ The problems with excessive relational embeddedness are discussed in B Uzzi, "Social Structure and Competition in Interfirm Networks: The Paradox of Embeddedness" (1997) 42 *Admin Sc Q* 35.

⁵⁸ Bernstein, *supra* note 6.

⁵⁹ Rock and Wachter, *supra* note 6.

⁶⁰ Id.

substantial period of time, assets with idiosyncratic value. Diminishing the parties' capacity to make these long term commitments may also diminish trust in the exchange.

The Governance of the Entrepreneurial Firm and the Legal System

Legal reform has been perceived to have a substantial role to play in encouraging entrepreneurial finance. As I have said, this role has rarely been considered in the context of governance. At the end of the last section, I have indicated how the law on members' rights can have a fundamental effect on the governance of the exchange. There we saw that attempts to infuse the flexible cooperative norms of exchange relations into legal principles could be highly dysfunctional. In this section, I want to briefly consider some aspects of directors' duties that I perceive as substantial reform issues.

It should be clear from the last part that the board of directors is fundamental in entrepreneurial firms, especially those financed by formal venture capital. In particular, we saw a clear role for non-executive directors. One question, to which I will limit my observations, is how, if at all, the law can encourage the growth of a market for non-executive directors, and the operation of the board of directors.

One of the principal costs associated with the appointment of directors is the expected costs of legal liability. These costs have often been regarded as a disincentive to serving as a director. The Corporate Law Economic Reform Program has proposed some changes towards this end. In particular, it proposes a formal business judgment rule and clarification of rights to indemnity.⁶¹ These may improve the situation somewhat. However, a basic problem with the business judgment rule is that one of its preconditions is that the director has adequately informed himself. This incorporates a formal monitoring obligation as an affirmative requirement for the defence. We have already seen that the monitoring principle is likely to misapprehend the nature of entrepreneurial governance, and especially for non-executive directors. Their focus is likely to be principally outward, not inward. In any event, courts will always have difficulty in evaluating whether or not directors were adequately informed.⁶² As I argue elsewhere, hindsight biases are likely to overwhelm the analysis.

There are two means by which this should be addressed. First, monitoring obligations under the general law and under the insolvent trading provisions should be limited to executive directors in closely held corporations. I have already argued that non-executive directors may be appointed with external constituencies in mind, and extralegal enforcement is likely to provide sufficient incentives for the directors to ensure the corporation deals fairly with these constituencies. Second, the provisions on indemnity do not go far enough. It is appropriate for the law to revisit its contractarian past, and to remove from the *Corporations Law* the restrictions on the contractual release of officers from liability that have stood since the 1930s.⁶³ Releases of liability should be restricted to situations in which the director has not compromised his fiduciary obligations to refrain from self-dealing or overreaching. At least in closely held corporations, the shareholders have strong incentives to ensure that directors function diligently in whatever roles they are expected to perform.

⁶¹ Corporate Law Economic Reform Bill, s 180(2).

⁶² Michael Whincop, "Reintroducing Releases of Officer Liability into Australian Corporate Law", unpublished paper, 1999.

⁶³ Michael Whincop, "Empirical Analysis of Corporate Charters and Mandatory Rules: An Australian Study", unpublished paper, 1999.

My arguments to de-intensify obligations of care are in contradistinction to my beliefs about the treatment of fiduciary obligations. Fiduciary duties address a basic source of moral hazard in corporations. In addition, self-dealing is problematic because it may be a means by which one of the shareholders can unilaterally exit the firm in a way not available to the other shareholder.⁶⁴ Consider a situation where A has 40% of the firm, and E has 60% and control of the board. By selling property or services to the firm at supra-market prices, E not only impoverishes A by redistributing rents, but gradually reneges on his commitment to remain in the firm until the entrepreneurial project has matured.

If the corporation is formally a public company, it is subject to the related party provisions of the *Corporations Law*, which requires disinterested consent to every such transaction. In general, their prohibition of interested transactions subject to disinterested shareholder consent achieves the necessary safeguards, but the provisions themselves are heavily formalised. Interested transactions may often be resolved by applying flexible RPNs, so consensual arrangements struck in accordance with these provisions should be respected. If the corporation is formally a proprietary company, the director is only obliged to disclose his interest — all other requirements are subject to the articles. There is no obligation not to vote, either as a director or a shareholder.

The optimal rule might be the traditional fiduciary principle, which took a strict line on conflicts of interest, but permitted the shareholders to approve it, if they were fully informed and their consent was uncoerced.⁶⁵ The rule needs an adjustment to prevent the interested party voting his own shares, but is otherwise a useful rule, since it does not require courts to judge the fairness of the transaction or to apply other rules that predicate on unverifiable information.⁶⁶ It also increases the extent to which parties must bargain with each other in respect of transactions potentially corrosive of trust.

Amongst the directors' duties is the obligation of confidence.⁶⁷ Information learnt by a director in the course of the corporation's business is subject to a duty of confidence. To disclose it without permission of the corporation is a breach of fiduciary duty. In one sense, this principle is helpful, because it enables entrepreneurs to protect the proprietary information of the corporation. The duty of confidence may, however, be unsuitable to the milieu in which entrepreneurial SMEs exist. We have seen how the production-investment opportunities of entrepreneurial SMEs depend on information flows and network connections.⁶⁸ Ron Gilson has argued that the unenforceability of covenants not to compete in California has permitted knowledge spillovers which have enabled Silicon Valley to continue to expand in ways not paralleled in jurisdictions where such covenants are enforced.⁶⁹ We have also seen that third-party extralegal enforcement is of great importance to the contracts and norms of entrepreneurial finance. In particular, directors and other insiders enable enforcement because of their capacity to observe compliance with complex norms. A duty of confidence that

⁶⁴ Rock and Wachter, *supra* note 6.

⁶⁵ *Aberdeen Railway Co. v. Blaikie Bros* (1854) 1 Macq 461, 473; *Parker v McKenna* (1874) LR 10 Ch 96, 124.

⁶⁶ Michael Whincop, "Painting the Corporate Cathedral: The Protection of Entitlements in Corporate Law" (1999) 19 *OxfJ Legal Stud* 19.

⁶⁷ *Ansell Rubber Co Pty Ltd v Allied Rubber Industries Pty Ltd* [1967] VR 37.

⁶⁸ Håkansson and Snehota, *supra* note 7; Blair M Sheppard and Marla Tuchinsky, "Micro-OB and the Network Organization" in Kramer and Tyler, *supra* note 8, at 140.

⁶⁹ Ronald Gilson, "The Legal Infrastructure of High Technology Industrial Districts: Silicon Valley, Route 128, and Covenants Not to Compete", unpublished paper, 1999.

obstructed flows of such information from directors would be dysfunctional. At the least, a duty of confidence should not apply to information relating to the firm's governance or dealings with third parties.

Conclusion

Economic theorisations of corporate governance have, for too long, ignored the unique governance issues that arise in entrepreneurial small firms, and their misapplication by regulators has caused us to ignore the policy issues that require consideration if entrepreneurship is to flourish in SMEs. One private capital market professional observed during the course of an interview that one thing Australian SMEs don't lack is available capital — what they lack is management skills and governance practices. That perspective resonates with the finance literature on capital rationing in information-constrained markets.

Rather than regard entrepreneurial firms as entities, as lawyers do, or as contracts, as economists do, it helps to treat them as a unique bundle of information and other resources, which an entrepreneur seeks, with the assistance of a financier, to introduce as a new node in one or more networks in which access is usually restricted.⁷⁰ Governance therefore addresses the issues that arise between the entrepreneur and the financier, but also the relations each has with other parties in relevant networks. Just as economic analysis broke down monolithic legal conceptions of the entity by illuminating the exchange relations within, network analysis supersedes historic economic classifications of transactions as hierarchically integrated or transacted across a market interface. Governance must be adapted not only to the needs of the investor and the entrepreneur, but to those who control key resources outside the organisation's formal borders. Just as "intra-firm" governance addresses the needs of these "third" parties, the third parties themselves enforce the norms of the contracting parties, through their control of resources, deal flow, information dissemination, reputational discounting, and so on.

Trust is the necessary lubricant for reconciling these conflicting demands. I have shown how trust develops differently in formal and informal venture capital. The weaker ties and greater verticality of formal venture capital encourage reliance on explicit governance, such as the board of directors; informal governance will rely more on socialisation and mutual dependence. Both may use the corporation as a focus for group status and mutual identification.

The implications of this reconception are far-reaching. I have studied in this paper some of the formal changes needed in the law. The law needs to be less prescriptive when it comes to its most significant function in corporate governance, the formulation of directors' duties. On the other hand, approaches which require increased agreement and consensus may reinforce trust as well as protect against opportunism. In general, normative analysis of the law applicable to the governance of the entrepreneurial firm is harder to do — the phenomena are more complex, and thus less tractable to analyse. On the other hand, the prominence of elementary virtues, such as trust, promise a liberation from the dogmatic dismissal of these virtues once thought to be canonical in some academic circles.

⁷⁰ C Jones *et al*, "A General Theory of Network Governance: Exchange Conditions and Social Mechanisms" (1997) 22 *Acad Mgt Rev* 911.