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## Supervisory boards in high growth SMEs and mandated board members: two dilemmas

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**Abstract:** Two dilemmas for boards of growing small and medium-sized enterprises in a two-tier context as a result of their need for external resources (i.e., capital) and the concomitant introduction of external directors (expertise) are discussed in this paper. Firstly, split loyalties can occur when an externally mandated non-executive director may be pressured to act primarily in the interests of his/her mandating firm (e.g., a major investor), which may diminish the incentive to act in the best interest of the focal firm. Secondly, a culture clash is likely when external directors in the much prevalent family-based SME prefer formal control above informal governance which may harm the board's effectiveness. We propose that a one-tier board structure in combination with an effective chairperson is a solution to mitigate both dilemmas.

**Keywords:** SMEs; boards; board structure; mandated; governance; external directors; family business.

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## **1 Introduction**

There has been increased scholarly and practitioner attention to the governance of small firms. Corporate governance structures can be distinguished by the set of mechanisms also called institutions (Williamson, 1996) that regulate the interests of share- and other stakeholders in a firm (cf., Aguilera and Jackson, 2010; Aoki, 2001; Denis and McConnell, 2005). Active investors provide risk capital in addition to their advice and monitoring capabilities (Arthurs and Busenitz, 2003), which may be conducted through a board of directors (cf., Lynall et al., 2003; Huse, 2009). In this paper, we focus on the board of directors as one of the prime mechanisms of internal control. This focus is, among other things, motivated by evidence that across corporate governance regimes, the role of boards is becoming increasingly important, while the disciplinary power of external control and ownership structures is declining (cf., Raaijmakers and McCahery, 2000; Huse, 2007; Maclean et al., 2006). Although SMEs are usually not legally obliged to have a supervisory board, many do have a separate supervisory board installed (in a two-tier governance structure) or have non-executive members on their one-tier board (OTB). Supervisory or non-executive directors are supposed to add value through their activities to the focal firm, because they increase the firm's value for the firm's stakeholders (Huse, 2007). They do this by performing different roles (e.g., monitoring, providing services such as giving strategic advice, acting as a sounding board, and providing legitimacy) in the governance of an organisation in order to obtain better (i.e., more effective or social) decisions (cf., Farquhar, 2011; Huse, 2009; Zahra and Pearce, 1989). As firms develop, and their need for capital and/or knowledge grows, they may strengthen relationships with external investors to gain access to these resources, who may in return require representation on the board to monitor and protect their interests.

In this article, we concentrate on the board structure of fast growing small and medium-sized enterprises (SMEs) as the main internal governance institution. Board structure basically refers to how non-executive board members relate to executives. This article aims to discuss what happens to this relationship when external board members as representatives of large shareholders like venture capital firms join the board. We will refer to such representatives as nominated or mandated directors. While the literature does not agree on the exact definition of high growth small firms (cf., Delmar and Davidsson, 1998), we use as a guideline the OECD definition of high growth: "All enterprises with average annualized growth greater than 20% per annum, over a three year period should be considered as high-growth enterprises. Growth can be measured by the number of employees or by turnover" (OECD, 2007). It is clear that a central characteristic of such firms is their need for additional resources [such as access to capital and management skills; Lee (2014)], which often leads them to attract external (venture) capital. Such a step poses governance challenges, because the initial situation of a powerful owner-manager is replaced by a new power balance between the owner-manager and the new co-owners. The new co-owner often demands some form of control through one or more mandated non-executive directors and associated decision rights.

The extant governance literature uses the agency theory to argue that supervisory boards and their chairs should be independent to adequately fulfil their monitoring task. Independence refers to non-executives being independent from the firm and its management. In this article, we introduce and explore another kind of dependence, i.e., dependence on mandating institutes, and explain how the appointment of externally mandated directors may negatively affect the effectiveness of (supervisory) boards. This negative effect has two manifestations; firstly, externally mandated board members have dual loyalties which may lead to role fulfilment which is not per sé in the best interest of the firm. Secondly, most small firms are family firms that are generally defined as firms in which several members of the same family are simultaneously involved in ownership and management of the firm. The importance of family-firms for developed economies is substantial (see Flören et al., 2010).<sup>1</sup> Family firms are managed differently from non-family firms; family norms and values, shared identity, a long term vision, and trust-based relationships are important characteristics of these firms (cf., Miller and Le Breton-Miller, 2005). The entry of externally mandated board members in family firms presumably will lead to more formalisation and bureaucratisation which might diminish cohesiveness and trust and therefore might ultimately affect board effectiveness (cf., Mustakallio et al., 2002).

In this paper, we particularly look at the situation in The Netherlands. The Dutch context is interesting, because in the governance literature it is often considered a country that has characteristics of different corporate governance contexts, i.e., the Anglo-Saxon and the Germanic context and it is therefore illustrative, for instance, due to its legally underpinned board structure of allowing either a one or a two tier board (cf., Barca and Becht, 2002; Luo, 2007; Van Ees and Postma, 2004).

This paper contributes to the literature in the following ways: We identify two governance-related dilemmas for high growth SMEs that are caused by the SMEs' need for additional external resources (capital and/or expertise) and concomitant introduction of external directors (cf., Huse, 2007). One of these dilemmas is particularly relevant for smaller family owned high growth firms. Furthermore, we suggest several ways of how to deal with these dilemmas, based on a comparison of board structures.

## **2 Background and context of this study**

About a decade ago, more and more authors began to question the effectiveness of mainstream corporate governance research, which still was dominated by the agency theory and largely ignored actual board behaviour and processes (cf., Huse, 2007, 2009). At the same time, several authors noted that most of the empirical board research focused on relatively large established firms in a one-tier context (cf., Gabrielsson and Huse, 2009; Nordqvist and Minichelli, 2009; Pugliese et al., 2009). Based on these observations in the literature, in 2010, we initiated a small scale exploratory case study in order to reveal the actual governance issues small Dutch firms ran into at that time. The objective was to identify interesting and empirically relevant research topics that could be addressed in future board research. At that time, Dutch law only recognised two-tier boards, but legislation was being drafted, which ultimately led to the recognition of OTBs as of January 1st 2013. This change in legislation gives small firms new opportunities for developing an effective governance structure. The exploratory study aimed at high growth SMEs, since they go through various developmental cycles

simultaneously; i.e., organisational and financial cycles, including the introduction of external shareholders (cf., Zahra and Pearce, 1989). We used a staged approach for selecting the cases. We first selected two government owned investment companies with a solid reputation as investment partners in the SME sector. We then used their networks to find adequate case firms and interviewed the CEOs of these firms, who were deemed to be the most knowledgeable people with respect to the governance structure of their respective firms; in family firms these persons were usually the director-owner. All in all, we interviewed the CEOs of six high growth SMEs and discussed their governance structure and the actual functioning of their supervisory boards. The six case firms were selected because they were fast growing and had attracted and in some cases were still attracting additional resources from venture capitalists. Three of the firms turned out to be family firms. The most common conceptualisation of a family firm is that of an organisation in which ownership and management are intertwined by involvement of several members of one family. Some authors also require that the family has the intention to transfer the ownership to future generations (cf., Chua et al., 1999; Lubatkin et al., 2006). Although many types of operationalisation have been proposed in the literature, there is no objective way of setting cut-off points as regards level of family involvement and ownership to define a firm as family or non-family firm (Cruz et al., 2010; Zahra, 2005). In the three family firm cases, we observed both significant family influence on the management of the firm and the same family having a decisive vote in the shareholders meeting.

One important finding of these exploratory interviews was that every one of the six firms indicated to have issues with the role of mandated board members. Since we were not able to find a clear explanation for these problems in the literature, we decided to develop this explanation ourselves by building on multiple theories that have proven their value in the corporate governance literature. This ultimately led to the identification of the two dilemmas presented in this paper. This approach implies that, although a small empirical study has actually led to the present paper by pointing at practical issues encountered by the case firms, this paper itself is of a conceptual nature.

To better understand the institutional context from which our dilemmas originate, we briefly sketch the Dutch governance context. As mentioned before, ante January 2013, Dutch law only recognised two-tier supervisory boards; while after that date an OTB structure is allowed also. A good description of the pros and cons of this two-tier board (TTB) system can be found in Peij et al. (2012); see also Section 4.2 below. Dutch incorporated or limited liability SMEs are in principle not obliged to have a supervisory board, but when they do have one, it legally has three main functions:

- 1 to appoint, monitor, suspend or dismiss executives of the management board
- 2 to act in the general interest of the firm and provide advice to the management board
- 3 to approve major business decisions proposed by the management board (cf., Van Ees and Postma, 2004; Department of Justice and Safety, 2012).

Note that from a legal point of view the supervisory board's main responsibility is the general interest of the firm, not the interests of specific stakeholders.

In the following section, we posit and explain the existence of two dilemmas that many high growth small firms face; these dilemmas have negative consequences for the task performance of the supervisory boards and thus probably diminish the added value

of these boards. Subsequently, we discuss how extant theory can help to understand these dilemmas by introducing the main theories used in corporate governance literature, and discussing the differences between the OTB- and TTB structures. Building on this knowledge, the paper concludes with a discussion on whether these theoretical insights are helpful to growing small and medium sized firms in dealing with these dilemmas.

### **3 Dilemmas**

#### *3.1 Dilemma 1: split loyalties*

Directors on supervisory boards are nominated and accordingly mandated by certain stakeholders or stakeholder groups. In SMEs these stakeholders are typically parties with a large financial stake in the firm, such as the founder/family, the bank or external investors. External funds are usually necessary to start-up or spin out capital-intensive firms (e.g. in the pharmaceutical and biotech sectors) or to provide funds if the firm turns out to be successful and is growing rapidly. Financing by banks is usually not adequate (and since the 2008 crisis in short supply), therefore risk bearing capital, such as equity, is needed. Such shareholders want a return on their investment and expect the firm to make decisions that ultimately result in a profitable firm and/or high shareholder value. In practice, these shareholders themselves cannot participate in the management of a firm, and therefore they often require the firm to grant them a seat on the supervisory board in order to monitor their investment (cf., Huse, 2007). If the firm does not have a supervisory board as yet, it is often asked to install one. Additional risk-bearing capital may come from parties such as venture capitalists, business angels, regional development companies and/or investment funds from the local or national government. Our exploratory interviews had indicated that the supervisory boards of the high growth SMEs typically consisted of three members (while the Dutch legal minimum for 'voluntary' boards is one member). Typically, one director had been put forward by the entrepreneur or his/her family, additionally there was a mandated external director nominated by a dominant investor. Finally, a third director had been co-opted/proposed by these two directors or by the other shareholders. Probably, this third type of director might be considered the most independent director, the other two types of directors are not really independent as such, since they represent specific stakeholders. Supervisory directors may interpret their role and responsibilities differently, dependent on who has nominated them, the content of their mandate, the life cycle stage of the firm, and other situational factors. Furthermore, directors may be affiliated elsewhere (for example employed by the investor itself, cf., Huse et al., 2011), which may even enlarge the professional and social aloofness towards the focal firm. It may be clear that a 'nominated director' must make a trade-off between two loyalties, or – in other words – has to manage two agency relationships at the same time. To what extent will (s)he use his/her own judgement and competences to perform the task role(s) within the board? Is (s)he primarily guided by the 'mandate' of his/her nominating principal or by the interest of the focal firm? In high tech start-ups, for example, exploratory innovation needs committed long term investments in R&D, while the investment horizon of an investment firm might be much shorter. When a non-executive director is appointed on behalf of a certain stakeholder's interest, which position should (s)he take? Especially when the firm

gets into stormy weather and a trade-off of interests must be made, this dilemma can become challenging for the mandated director.

### *3.2 Dilemma 2: culture clash*

In family firms, the family controls the governance of the firm (by having majority ownership and occupying top management positions), and therefore the family life cycle is intertwined with the firm development (cf., Gersick et al., 1997). When ownership and management are concentrated in one family or person, there is practically no agency relationship, so there is little need for formal monitoring. The introduction of governance mechanisms that stress formal monitoring, such as a separate supervisory board, a family charter, financial reporting systems, and contracts, may even signal distrust (Busenitz et al., 1997). Family firms typically apply more relational oriented informal governance-institutions that largely rest in trust (e.g., a family council, family meeting, family plans or a family behaviour code) (cf., Gersick et al. 1997; Huse, 2007; Mustakallio et al., 2002; Siebels and Zu Kneiphausen-Aufseß, 2012; Uhlaner, 2008). Also, from a behavioural point of view, the board's decision making is shaped by social processes that are largely determined by the family culture (Westphal and Zajac, 2013).

A dilemma comes into existence when the family firm is successful and continues to grow. Often, a need for additional capital develops, in order to finance the family firm's investment needs. Based on the same logic as described at dilemma 1, mandated externals enter the governance structure. Usually, both the family and other supervisory board members have no shared history with these new external board members. There are also few other communalities, so the initial level of trust is not very high and the mandated director can even be seen as an intruder that disturbs the social processes in the relatively close group. It may be expected that, depending on his/her professional background, experience, and mandate, the new board member will prefer or even demand the introduction of formal governance mechanisms. This actually clashes with the history and culture of a family firm and also with the preferred more relational-oriented governance mechanisms of the existing board. All in all, the advantage of getting access to money and knowledge through an external investor might go with the possible disadvantage of informal governance mechanisms becoming less effective (due to diminishing cohesion, shared identity, and trust) and a pressure to introduce formal governance mechanisms that do not fit well within the family business culture.

## **4 Governance**

### *4.1 Governance theories*

In this section, we shall use different theories to explain the existence of the dilemmas presented above. The choice of these theories is based on the fact that they offer complementary insights that help us to understand these dilemmas. Donaldson and Preston (1995) differentiate between three types of use of theories, i.e., descriptive/empirical, instrumental and normative. In this section, a descriptive focus of these theories is maintained, while in the following sections, we shall apply an instrumental focus as we discuss some structural solutions for the dilemmas presented above. We

abstain from a normative discussion which refers to moral or philosophical principles, as this is outside the scope of this paper.

Following Daily et al. (2003, p.371) we define corporate governance as “the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations”. Board structure concerns the formal organisation of the governance organs (including initiating, execution and monitoring of main activities and decisions) within an organisation. Executives are regarded as agents who act on behalf of principals (usually the owners). The executives comprise the top managers of the firm while the non-executives are the supervisory, usually external, directors. The non-executives may constitute a separate body, i.e., the supervisory board. The non-executives usually hire, fire, suspend and remunerate the managers. The general council of shareholders as legal owners has certain so-called controlling rights, such as appointing the non-executives and approving specific strategic decisions, which can be delegated to the supervisory board. An efficient board structure facilitates effective decision-making and improves board role performance by directors (Zahra and Pearce, 1989). There are several theories that can provide useful insights in the mechanisms leading to the two dilemma’s that we identified. We will discuss five theoretical approaches that we think are the most relevant in this respect.

The dominant theoretical approach to explain a board structure design as an efficient internal control solution to curtail possible opportunism by agents is the agency theory, which considers a company as a bundle of assets joined through contracts, and states that top managers function as agents for the principals (main stakeholders), while non-executive directors guard the interests of these same principals by monitoring, controlling and advising top management. It is argued that monitoring can be performed best by independent outside directors in order to obtain an effective system of checks and balances (cf., Zahra and Pearce, 1989). Some members of the supervisory board are viewed as representatives of the main stakeholders, therefore they may have a mandate to act on their behalf. In agency terms, such a mandate may be defined as a delegation of certain control rights by a stakeholder to an agent who acts as a non-executive director in the supervisory board in the interest of that specific principal. This is where dilemma 1 comes to the fore. In more general terms, a problem comes into existence when agents have specific information about the functioning of the organisation and act opportunistically on that, which may diminish the performance and value of the firm (cf., Jensen and Meckling, 1976; Eisenhardt, 1989; Huse, 2007; Roberts et al., 2005; Zahra and Pearce, 1989). In order to counter opportunism, a so-called bundle of governance mechanisms can be deployed (cf., Aguilera and Jackson, 2010; Aoki, 2001; Denis and McConnell, 2005) that influence the decisions made by managers. Agency theory implies the use of various internal and formal governance mechanisms (e.g., a certain board structure, a reporting system, a specific code of conduct, or a reward system), while at the same time external mechanisms like the labour market for top managers, the takeover market, and also the final product market may act as disciplining forces. Since agency theory avoids looking into the black box of board behaviour, it does not contribute to a better understanding of dilemma 2.

A much applied alternative theory which is helpful in explaining the relationship between principals and managers is the stewardship theory (cf., Donaldson and Davis, 1991). This theory takes another position with respect to the behaviour and position of directors by arguing that directors act as stewards who identify themselves with the best interest of the entire organisation and focus on common responsibility, intrinsic



satisfaction, cooperation and altruism (Arthurs and Busenitz, 2003; Donaldson and Davis, 1991; Voordeckers et al., 2007). In such a context other, informal, governance mechanisms become effective, for example, developing mutual trust. Following Mayer et al. (1995, p.712), trust is defined as “The willingness to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor or control that other party.” Trust can be an important governance mechanism within a board context; the more trust there is between supervisors and executives, the less formal control/supervision/contracting is needed (cf., Das and Teng, 1998, Van Ees et al., 2008). We consider trust a central element of stewardship theory, especially the trust relationships among directors and between directors and their principals. Trust develops over time, and is particularly stimulated by familiarity or habitualisation. Just like formal mechanisms, such an informal mechanism can be used effectively to counter managerial opportunism. By focusing on the board as a cooperative group acting as stewards and on the importance of trust as a governance mechanism, stewardship theory contributes to a better understanding of dilemma 2.

Stakeholder theory has become a prominent theory in the management literature since it was launched by Freeman (1984). Stakeholder theory considers companies as social responsible institutions managed in the public interest. Organisations are seen as multilateral agreements and institutional arrangements for governing relationships between all of the parties that contribute firm specific assets. This theory takes the interests of stakeholders as a central element and holds that the top management should manage and balance these interests, establish relationships with the main stakeholders, develop policies that are supportive to this aim and are responsible for stakeholder relationships. Management can be held accountable by these stakeholders (especially the shareholders) (cf., Clarke, 2004). By doing so, legitimacy of the organisation in the external environment is fostered. Harrison and St. John (1996) suggest that external stakeholder relationships should be managed, contingent on the strategic importance of these stakeholders. In complex environments where alignment of interests among stakeholders is difficult, this alignment can be facilitated by including a stakeholder representative in the board, and/or developing joint goals. Here we see how stakeholder theory contributes to the explanation of dilemma 1.

Another theory adding a relevant additional perspective to our dilemmas is team production theory which builds on the idea of a board as a cooperative group. This theory builds on the agency theory conception that companies are bundles of contracts on assets, which are collectively owned by stakeholders, and where a productive activity by the corporate team requires the combined investment and coordinated effort of two or more individuals or groups (Blair, 2004). Team members acknowledge that a neutral third party, i.e., the board of directors, should be invested with a control right (Kaufman and Englander, 2005). Team production theory argues that monitoring by the board (as a so-called ‘mediating hierarchy’) is a solution to the risk of shirking or opportunistic rent-seeking by team members (Blair and Stout, 1999). A mediating hierarchy balances the competing claims and interests of the groups that contribute to the team production process (Lan and Heracleous, 2010). In this view, the main governance organs of a firm can be considered a team (cf., Machold et al., 2011) and the primary job of a board of directors is to act as trustees for the firm. The board has the task to balance various team members’ competing interests (Blair and Stout, 1999) and directors contribute by

bringing in the knowledge, experience, and integrity as team members that the board requires to effectively function as a mediating hierarch. In this view, cooperation and trust among board members internally, and external board leadership is of the utmost importance. By conceptualising the board as a team (of trustees) representing the main stakeholders and other team members, and pointing at cooperation and trust as important mechanisms, team production theory contributes to explaining the existence of both dilemmas 1 and 2 (cf., Huse et al., 2011; Huse and Gabrielsson, 2012).

Recently, Westphal and Zajac (2013) developed and proposed a behavioural theory of corporate governance. They build on a large stream of governance research demonstrating the relevance of social constructs, such as social learning and reciprocity, for explaining board behaviour which they explicitly recognise to be the outcome of individual actor behaviour. This behavioural theory of corporate governance focuses on two mechanisms; socially situated and socially constituted agency. In this view, board conduct does not occur in a social vacuum, but in a socially situated context and by individuals whose interpretation is influenced by their social context and experience. In the situation of a mandated external board member functioning within a small firm's board, this member is functioning within two distinct social contexts; the context of the small firm supervisory board, and the context of the mandating institution's social environment. The mandated board member will probably have strong social connections to the latter and also his/her social constitution will be highly influenced by the social learning and experiences due to that environment. Applying this behavioural lens to our two dilemmas, we see that this approach clearly contributes to a better understanding of the mandated director's opposing loyalties. The director must not only choose between divergent economic interests, his/her social embedding in the mandating firm also pushes him/her towards not putting the focal firm's interest first as described in our first dilemma. A challenge therefore for the mandated director is to bridge these social contexts, i.e., to act as a boundary spanner. In a family firm context, we see that the family is a cohesive and specific type of social group which forms a very different social context from the one the mandated director is accustomed to and still belongs to as well. This 'family' context directly influences the process and content of board decision making (Westphal and Zajac, 2013) and thus contributes to the coming into existence of the culture clash described in dilemma 2.

#### *4.2 Board structure and leadership*

The deployment of governance mechanisms by firms is largely historically, culturally and institutionally determined. However, firms may purposefully adapt the bundle in order to design the 'optimal mix of governance'. A crucial element of that mix is the board structure; the most visible governance mechanism that is also largely controlled by the firm itself. While perhaps the most important aspect of board structure is the formal role of the board chair, extant literature also points to more specific tasks of the chairs, especially relating to board leadership.

The functioning and structure of the board of directors are performed by two archetypical board structures, either through the use of an OTB or a TTB structure, which varies among regions around the world (e.g., Moerland, 1995; Jungmann, 2006). The Anglo-Saxon type of board can be found, for instance, in the USA, UK, Canada and Australia, and is known as the one-tier type (see Zahra and Pearce, 1989; Ezzamel and Watson, 2005). In this structure, the board is the firm's supreme executive and

supervisory body where all directors – both executives and non-executives – function in one common board with simultaneous information disclosure to all board members and also involvement of non-executives in policy formation and execution. In Germanic countries (e.g., Germany, Austria, and The Netherlands) a two-tier or ‘dual’ type of board structure prevails, comprising of an executive board and a separate supervisory board. In this situation, the accountability of executives versus non-executives is clear-cut, but the separation may lead to more information asymmetry, delayed decision-making, and extra coordination costs. In a TTB there is a substantial risk of supervisory directors becoming too distant from the operational functions and performance of an organisation, leading to lack of engagement (cf., Roberts et al., 2005).

Overall, the main advantages and drawbacks of the TTB mirror those of the one-tier structure (cf., Bezemer et al., 2012; Ezzamel and Watson, 2005; Peij et al., 2012; Moerland, 1995). The main difference between OTB and TTB pivots around the chair role. Over the years, there have been a number of studies trying to grasp the essence of ‘good’ chairs. Harrison and Murray (2012), for example, show that chairs may increase the performance of CEOs, help the board to get more committed and increase the efficiency of board meetings. Machold et al. (2011) argue that especially in an OTB-context, the chairperson has a central position and has to demonstrate board leadership. Relevant tasks belonging to this leadership role are, for example, managing and overseeing the board process (Cadbury, 2002) and managing relationships within and around the board (Higgs, 2003). In the next section, we will come to our conclusion by linking our theoretical analysis aimed at understanding how our dilemmas come into existence with a more instrumental view on how board structure and leadership may contribute to partial solutions to these dilemmas.

## **5 Discussion and conclusions**

### *5.1 Solutions to the dilemmas*

In this paper, we discussed some salient corporate governance aspects of SMEs that are expanding and in need of additional capital. In such a context participation companies and/or investment funds play an important role (cf., Gedajlovic et al., 2004) and mandated directors may be installed. The explorative interviews that led to this paper indicated that this indeed happens quite often in the Dutch small business sector and we have no reason to believe this will be very different in other countries. We argue that these mandated directors are less able to perform their legal task as independent directors, as they may not primarily act in the general interest of the firm. The relative importance of formal and informal governance mechanisms is different among firms, and depends on their business environment, ownership structure, lifecycle and other particular internal and external circumstances. Based on this, we developed two dilemmas for supervisory boards in high growth SMEs that may come into existence when externals enter the governance structure:

- Dilemma 1 Split loyalties: an externally mandated non-executive director generally is pressured to act primarily in the interests of his/her mandating firm, which may diminish the incentive to act in the best interest of the focal firm.

- Dilemma 2 Culture clash: external directors in the family-based SME may prefer formal control and have little communality with other board members, which may be detrimental to the use and effectiveness of more relational oriented informal governance mechanisms.

We do see some possible solutions to deal with the dilemmas. Generally speaking, a medium sized or small firm that has a governance structure including both executive and non-executive directors, has at least two instruments that directly influence the functioning of the non-executive board members and may diminish or even prevent the negative effects of the dilemmas presented above. These instruments are the choice for a one-tier or TT structure, and the choice of a specific chairperson. As regards board structure, we suggest that an OTB acting as a mediating hierarch will mitigate the negative consequences of mandated board members. The role of directors is to act as an impartial mediating hierarch who balances competing claims of contributors to the team production process, allocates team surpluses, and is in control of the firm's assets and key strategic decisions (Lan and Heracleous, 2010). Moreover, the focus shifts from shareholders to the firm as a whole, in line with stewardship theory. A consequence is that director selection becomes paramount and that the chair should be an outsider to the firm (cf., Osterloh and Frey, 2006). As discussed in our theory section, within an OTB individual directors in all likelihood have broader roles and responsibilities than in a TT. The background of a director (for example, a specific mandating party) is less important then, since all executive and non-executive directors are co-responsible and accountable for their governance tasks. As a result, the directors may be expected to act as a collective team (Huse et al., 2011) and a nominated director will feel more pressure to accommodate the firm's interests instead of his/her other principal's interests, the mandating party (cf., Machold et al., 2011). Finally, we also find some support for this solution in the behavioural theory of corporate governance. Although Westphal and Zajac (2013) take the US (one-tier) situation as the norm (they do not even mention the possibility of two-tier regimes), a nominated director in an OTB will develop more social relationships within the focal firm than his/her peer in a TT. This means that the social context in the OTB leads the mandated director to identify more strongly with the other board members, which in turn will shift the balance of the director's loyalties more towards the focal firm.

Additionally, the choice for a specific chairperson may also help to reduce the negative effects resulting from the two dilemmas. Especially in an OTB, the chairperson has a very crucial role and is responsible for communication, conduct, composition and evaluation of the board, while also ensuring that all board members have the necessary information to perform their job (cf., Bezemer et al., 2012). Moreover, the position of the chairperson becomes pivotal for the supervision and encouragement of non-executive engagement (Roberts et al., 2005) and to help the external directors to become sensitive to the family or firm culture, and to foster open discussion and the development of trust between executives and non-executive board members. See Huse and Gabrielsson (2012, p.243) for a discussion of various leadership roles aimed at motivating the directors to work as a team and to make collective contributions. Similarly, the behavioural theory of corporate governance points at the possibility to use socialisation of the mandated director and the other board members to build a stronger team. An effective chair may purposefully influence this socialisation process which will alleviate both dilemmas. Machold et al. (2011) provide empirical evidence that a board that functions as a team

with an effective board leader will lead to engaged boards; engaged boards will suppress the inclination of mandated directors to put their principal's interests above those of the firm (dilemma 1) and will also be willing to rely more on trust as a governance mechanism instead of asking for more formalisation (dilemma 2). For both dilemmas this would suggest that an OTB with an effective and empowered chairman, i.e., a true board leader, who understands the family context and culture and is sensitive to the different interests of main stakeholders is conditional for an optimal situation. Such a combination of structure and effective leadership would enable all governance mechanisms (including trust relationships) to work towards the same direction in order to obtain optimal board performance.

Although in practice, it is acknowledged that external directors are often seen as representing stakeholders' interests, while in fact they are appointed in the best interest of the firm, academic literature typically ignores the consequences of this misconception. Various authors have argued that supervisory directors should be independent of those that are monitored and should have 'independence of mind' (cf., Anderson and Reeb, 2004; Roberts et al., 2005). Governance codes also usually explicitly point to this type of independence. Moerland (2004) distinguishes between two types of independence:

- 1 independence from those that are monitored (the executives)
- 2 independence from those on whose behalf monitoring is performed (the stakeholders).

In the extant literature on supervising boards, the focus is usually on the first type of independence. However, when board members are mandated by certain parties, the second type of independence becomes much more relevant. In fact, we see that an additional kind of agency relationship comes to the fore and, with it, a new agency problem. A mandated director has two different principals simultaneously. Especially when such a director is an employee of the nominating party, the director is restricted in his/her board activities and the quality and objectivity of his/her input may be at risk. The nomination of directors may lead to differences in task perceptions and task performance within supervisory boards. The fact that a 'mandated director' is clearly and sometimes even legally (through a labour contract) dependent on a specific stakeholder will definitely have consequences for the content and quality of the advice, strategic choices, and ultimately the task role performance. Both academics and policy-makers should be more aware of these consequences and develop a more comprehensive view on board independence.

## *5.2 Limitations and suggestions for additional research*

Several limitations of this paper must be acknowledged. Firstly, in this paper we made limited use of empirical data on actual board behaviour within high growth small firms. It would be interesting to build on the arguments put forward in this paper by performing a more in-depth study of board behaviour and board processes related to the two dilemmas. Such a follow-up would be an answer to an ongoing call for this type of research (cf., Forbes and Milliken, 1999; Farquhar, 2011; Gabrielsson and Winlund, 2000; Huse, 2007; Nederlandsche Bank, 2013; Roberts et al., 2005; Van Ees et al., 2009; Westphal and Zajac, 2013).

The tentative and mainly conceptual nature of this paper highlights some further limitations. First of all this paper is inspired by a limited number of explorative interviews and mainly based on a literature research. Our conclusions warrant further empirical research; the dilemmas discussed may best be underpinned by a more extensive and comparative case study design. Based on this, hypotheses or propositions may be developed and tested (cf., Huse, 1994). A second issue is that the Dutch context is taken as exemplary, as it has characteristics of two main corporate governance systems across the world, which might be a too specific context for the results and findings to be generalised to other contexts as well, which is an inherent problem for much comparative corporate governance research.

In this paper, we use several theoretical perspectives to explain corporate governance issues in small firms. We have demonstrated that a combination of 'traditional' agency theory, stewardship theory, stakeholder theory, team production theory, and behavioural theory provides a more comprehensive picture and analysis than building on agency theory alone, as we often see in the literature (cf., Blair, 2004; Clarke, 2004; Hill and Jones, 1992; Lynall et al., 2003). These additional theories look at other relevant constructs, such as involved stakeholders, a long-term perspective, team synergy, social context, and alternative governance mechanisms such as altruism and trust. Our discussion of the OTB and its functioning from a team production and a behavioural theory perspective contributes to a redefined agency theory concept (cf., Lan and Heracleous, 2010). For future research, we think that such an eclectic approach can be very valuable since it aims at understanding the complex interplay of formal and informal governance mechanisms that actually takes place in practice.

Extant corporate governance codes, including the Dutch code, are usually not directly targeted at SMEs. Our conclusions indicate that also for SMEs, specific codes or other institutional instruments could contribute to the quality of board performance by developing best practice prescriptions for analysing and handling board independence.

We would like to end with a plea to develop more in-depth research aimed at the specific characteristics of the various board structures and their effectiveness in small business contexts. Board independence should play a major role in understanding these phenomena. At present, such research is really scarce. With more and more countries allowing (small) firms to opt for different board structures, the choice for a specific structure becomes a major strategic decision. KPMG recently conducted a research into the prevalence of the OTB among 500 Dutch family firms indicating that 4% already introduced an OTB since January 2013 and another 20% is considering doing so within the next two years (KPMG, 2013). Obviously, firms already see advantages of an OTB for their own situation. It might be interesting and relevant to study in detail firms that convert their TTB into an OTB and vice versa. In some situations, the drawbacks of the OTB could perhaps outweigh the advantages (see, for example, Jungmann, 2006). With this trade-off, the solutions to the dilemmas we proposed in this paper would run the risk of throwing the baby out with the bathwater.

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## Notes

- 1 According to Flören et al. (2010), in The Netherlands there are about 260,000 active family firms; they contribute 53% to the GDP, and employ 49% of the employed population. Similar figures apply to other developed economies (Siebels and Zu Kneiphausen-Aufseß, 2012).