



A contingency theory of entrepreneurial debt governance



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ABSTRACT

Access to debt can be crucial for entrepreneurs who need capital. Embedding economic ties within a social relationship with the debt provider can ensure capital availability and attenuate opportunism. However, such a relationship requires substantial investments in time and effort. We advance a solution to this entrepreneurial conundrum by proposing a contingency theory which prescribes aligning the fundamental transactional properties (i.e., asset specificity, uncertainty and frequency) with the nature of the entrepreneur-bank relationship (i.e., embedded versus arm's length). Our theory predicts that transactional properties affect the optimal governance of the entrepreneur-bank relationship, and that social embeddedness can transform what looks like a market transaction (e.g., a debt transaction) into a hybrid form of governance more akin to a hierarchy. Using a sample of small businesses in the U.S., we find that congruence between the optimal governance structure and the actual governance structure results in higher firm performance.

1. Introduction

Gaining access to the capital needed to start, manage, and grow a small business is a crucial challenge to entrepreneurs, most of whom rely primarily on commercial loans from banks for external financing (Ang, Lin, & Tyler, 1995; Binks & Ennew, 1996). Yet, in deciding how to structure the banking relationship, the entrepreneur faces a critical conundrum. The entrepreneur can invest in developing an embedded relationship with a bank (i.e., coalescing the economic relationship with social ties), or forgo this effort and maintain an arm's length relationship with the bank (Dacin, Ventresca, & Beal, 1999; Uzzi & Lancaster, 2003). An embedded relationship can be distinguished from an arm's length relationship by “three main components that regulate the expectations and behaviors of exchange partners: trust, fine-grained information transfer, and joint problem-solving arrangements” (Uzzi, 1997, p. 42). Concentrating transactions with a single bank is the first step to developing an embedded relationship. However, it is not sufficient, as the entrepreneur must also cultivate the interpersonal ties that underpin trust and reciprocity, which in turn help mitigate concerns about expropriation by the bank (Sharpe, 1990; Uzzi, 1999).

While developing an embedded relationship can attenuate the incidence of opportunism by either transacting party, it does come at a cost. Cultivating and maintaining an embedded relationship requires substantial investments in time and effort. These resources are of limited supply for most entrepreneurs. Although interpersonal ties can

alleviate fears of deliberate malfeasance, concentrating the lending relationship with just one bank does expose the entrepreneur to certain risks. If the bank itself experiences trouble, it may simply be unable to assist the entrepreneur, despite its best intentions. Moreover, the bank may be unable to assist the entrepreneur during those times when the entrepreneur is most likely in need for assistance (e.g., during an economic downturn). Furthermore, acquisitions and personnel turnover at the bank can erode away the investments made by the entrepreneur in developing an embedded relationship. While the extant literature concerning embeddedness theory (ET) has developed a good understanding of the pros and cons of developing an embedded relationship, the literature offers relatively little insight to entrepreneurs on how to weigh those pros and cons, and hence on deciding whether or not it would be worthwhile to develop an embedded relationship.

Following contingency theory, we contend the optimal structure of the entrepreneur-bank relationship hinges on the characteristics of the entrepreneur-bank transactions. Combining insights from ET and transaction cost economics (TCE), we argue that the entrepreneur-bank relationship serves as a mechanism to govern their transactions, and that, in line with TCE's major proposition, the optimal form of governance depends upon the fundamental properties of the transaction. More specifically, while market governance characterizes an arm's length relationship, an embedded relationship shares characteristics with hybrid governance and hierarchical governance. As such, the benefits of an embedded relationship are accentuated when the entrepreneur invests more heavily in specific assets, when there is more

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uncertainty regarding the entrepreneur's investment, and when the entrepreneur operates in a high growth industry and hence has to transact more frequently with the bank. Thus, the optimal nature of the entrepreneur-bank relationship depends upon both the firm's strategy and the environment in which it operates. Our empirical analysis of a large sample of small businesses, derived from the National Survey of Small Business Finance (NSSBF), supports our theory and reveals that the choice between arm's length and embedded debt can have profound performance consequences.

This paper makes three important contributions to the literature. First, we combine ET and TCE in order to advance a solution to the configuration of the entrepreneur-bank relationship. Although TCE offers an 'under-socialized' depiction of economic agents (Ghoshal & Moran, 1996; Granovetter, 1985; Uzzi, 1997), Williamson (1999b) has acknowledged that TCE is not all-encompassing, but can be fruitfully combined with other theoretical perspectives to yield a more complete picture of organizational issues. Indeed, all organizations are simultaneously influenced by economic, institutional, and ecological processes (Dacin, 1997). Accordingly, management scholars have integrated TCE with other organizational theories (Martinez & Dacin, 1999; Roberts & Greenwood, 1997). Notwithstanding that, ET has generally been regarded as being at odds with TCE (Uzzi, 1997). We show, however, that the two theories can be synergistically combined to better understand the nature of governance in an embedded relationship. By so doing, we complement previous research that advanced alignment theories connecting transactional property with either institutional setting (James & McGuire, 2016) or strong relational ties (David, O'Brien, & Yoshikawa, 2008). We extend this research into the governance properties of different types of debt by showing how the same type of debt may have very different governance properties depending on whether or not it is embedded in social ties.

Second, our study complements the relationship lending literature (Butler & Goktan, 2013; Petersen & Rajan, 1994; Stein, 2002). This literature argues that commercial banks have an advantage in providing financial services to informationally opaque firms (Berger & Udell, 2002). Banks invest in relationship lending and acquire soft information about the firm and its context, which banks utilize in financial decisions (Arrow, 1998; Berger & Udell, 2002; Butler & Goktan, 2013; Stein, 2002). Adding to this literature, we do not assume that soft information production accrues automatically from either the longevity of the entrepreneur-bank relationship (Petersen & Rajan, 1994, 2002) or from the concentration of financial activities (Uzzi, 1999). Instead, motivated by ET, we require a social dimension to the economic relationship between the entrepreneur and the bank. Furthermore, motivated by TCE specifications of the nature of the financial transaction (i.e., asset specificity, uncertainty, and frequency), we provide a theoretical framework for understanding the conditions that affect firms' informational opaqueness. More importantly, previous research has examined the direct effect of the entrepreneur-bank relationship or the degree of informational opaqueness on financial decisions (Berger & Udell, 1995; Butler & Goktan, 2013; Petersen & Rajan, 1994). Our approach, which calls for an alignment between the actual entrepreneur-bank relationship and the nature of the transactions, suggests significant performance implications and is a novel contribution to these literatures.

Third, from a practical perspective, we offer prescriptive advice to entrepreneurs regarding the optimal structure of their banking relationships. Specifically, we demonstrate that the desirability of forging an embedded relationship will depend on both firm strategy and on external environmental factors. Moreover, our empirical results indicate that an entrepreneur's relationship with his or her banker can have very consequential performance implications.

In the following sections, we explain why TCE can be synergistically integrated with ET. We present Williamson's (1988) argument that debt serves as a form of market governance for safeguarding the capital invested in the firm. We then extend the TCE perspective by integrating arguments from the ET literature, and in particular work on the

divergent properties of arm's length and embedded debt (Uzzi, 1997; Uzzi & Gillespie, 2002). We follow Williamson's (1991, 1996) conceptualization of governance options as varying along a continuum ranging from the ideal type market to the ideal type hierarchy. We show that what ostensibly might appear to be a form of market governance can be transformed by the social context, moving along the continuum, towards governance structure sharing properties with hybrid governance and hierarchical governance. Theoretically, we present the properties of the ideal governance and relationship types, and test alignment hypotheses in the context of small U.S. firms.

2. Theory

The likely reason why TCE and ET have been juxtaposed as competing theories of organization (e.g., Ghoshal & Moran, 1996; Uzzi, 1997) is that many organizational theorists take exception to TCE's assumption that firms generally make efficient governance choices. However, TCE does acknowledge that significant governance mistakes do occur due to factors such as organizational inertia and adjustment costs (Nickerson & Silverman, 2003), governance inseparabilities (Argyres & Liebeskind, 1999), and perhaps most importantly, bounded rationality (Masten, 1993). In fact, neoclassical economists have disparaged TCE as a heterodox theory of economics because it, in addition to focusing on market failure and eschewing mathematical models in favor of logical arguments, embraces the Simon's (1957) concept of bounded rationality. TCE does not cast managers as all-knowing, it just assumes that the pressures of market competition will tend to select out (albeit weakly) firms that make egregious errors (Williamson, 1988). Therefore, TCE is not inherently incongruent with the notion that in uncertain situations, boundedly rational managers may simply conform to institutional expectations or social pressures, or simply decide to mimic high performing firms. Indeed, in many situations such acts may be quite (boundedly) rational. Accordingly, in integrating TCE and ET, we remain agnostic with respect to the positivist efficiency criterion and instead focus on the normative implications of the theory. That is, we derive predictions about how firms *should* generally organize in order to maximize performance, without assuming that they generally *do* organize in such a manner.

A second assumption that has limited the appeal of TCE to many management scholars concerns the assumption of opportunism. Although some have misinterpreted this assumption as suggesting that people will behave opportunistically whenever given the chance, or worse yet perhaps as advice that they *should* behave opportunistically (Ghoshal, 2005; Ghoshal & Moran, 1996), such is not the intent of this assumption. Certainly the assumption of opportunism is a central tenet of TCE, as the assumption that people *might* act in their own best interest underpins everything from the entire study of governance to the practice of making witnesses swear an oath to be truthful (Williamson, 1999b). Concerns of opportunism in economic transactions are at least as old as the ancient warning caveat emptor (i.e., let the buyer beware), and probably as old as the earliest economic transactions that ever occurred. Hence, we follow Granovetter (1985, p. 491) in assuming that we live in a world where "distrust, opportunism, and disorder are by no means absent". In order for economic activity to flourish, agents need confidence that benefits accruing from their actions will not "all be appropriated by others whom they do not love", and an institutional environment that allows agents to trust that contracts can be enforced is one means to mitigate this threat of opportunism (Stinchcombe, 1965, p. 147). Hence, while we do not assume that all parties will act opportunistically when given the chance, we do assume (like Williamson, and not unlike Stinchcombe) that absent credible assurances, it is safest for transacting parties to assume that the other party *might* act opportunistically. However, following ET but unlike TCE, we do allow the social context to serve as a credible assurance against opportunism, in addition to more formal legal safeguards. Indeed, the social context and formal contracts may even actually reinforce one another

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