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Understanding founder–CEO's replacement in venture-backed companies: A theoretical and empirical analysis

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ABSTRACT

This research provides an accurate picture of situations in which founder–CEOs are replaced (or not) by venture capitalists. Our analysis aims to go further than the schematic case of the founder being simply dismissed by investors in a conflictual context. We first review the literature dedicated to this subject in the light of the agency theory (AT) and the resource-based view (RBV). However, the limits of these theoretical frameworks lead us to investigate their extensions: the entrenchment theory (ET), the dynamic capabilities approach (DCA) and the cognitive governance perspective (CGP). In a second phase, in order to decode the replacement process, we designed an exploratory methodology based on qualitative data, thus deepening our understanding of the issues it entails in venture-backed companies. Finally, this field analysis allows us to build a typology of replacement scenarios, with each scenario being interpreted by combining relevant theories to explain all aspects of it. In line with the AT, the ET focuses on the FCs strategy to retain their position. The DCA analyses the CEOs' resources from a dynamic angle, in accordance with the RBV. The CGP is mobilised to characterise a conflict originating in a lack of skills. These results lead us to rethink the role of time and the nature of conflicts in the relationships between FCs and venture capitalists.

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Introduction

Young, innovative firms with high growth potential need two types of actors to develop: founder–CEOs (FCs) and venture capitalists (VCs). The growth of these start-up companies is based on a partnership between a founder, who is in charge of turning his idea into a business success story, and an investor, whose job is to bring financial resources (Bruton, Fried, & Hisrich, 1997; Lucquin, 2006). However, even if the FCs' skills and personality are recognised as essential criteria in the venture capitalists' decision to invest (MacMillan, Siegel, Subba, & Narsimha, 1985; Patzelt, 2010), FCs can sometimes be replaced by VCs.

Research in management turnover within venture-backed companies developed in the late 1990s (Heibel, 2008). In the corresponding literature, the replacement of CEOs is mainly explained through the prism of the agency theory (AT). Since then, the links between founder's replacement and start-up company's performances have been especially studied (Bruton, Fried, & Hisrich, 2000; Bruton et al., 1997; Pitcher, Chreim, & Kisfalvi, 2000). Wasserman (2003) underlines the specificities of the FCs succession in an entrepreneurial firm context and the central role of outside inves-

tors, of venture capitalists in particular. He shows that the FC is more likely to increase the company's worth, if he accepts to relinquish his position (Wasserman, 2006, 2008). Hellmann and Puri (2002) emphasise the links between these two actors by introducing the supportive role of VCs during FC replacement in terms of facilitating the transition in addition to their traditional controlling role. Another part of the literature studies the replacement process through the resource-based view (RBV) framework (Khanin, Baum, Turel, & Matho, 2009). The scientific knowledge possessed by start-up founders is considered as complex, tacit in nature, and therefore not easily substitutable (Zander & Kogut, 1995). Indeed, the social capital loss of an FC can be critical to the success of a new venture (Bamford, Bruton, & Hinson, 2006a, 2006b). But, the founder does not always have the skills required to run and develop a young, fast-growing business (Gerasymenko, 2008; Gilmore, 1988; Jayaraman, Khorana, Nelling, & Covin, 2000). To summarise, in this AT- and RBV-based literature the replacement occurs at the VC's initiative and is justified by the need to improve financial performance.

However, so far research has not questioned the relevance neither of AT and RBV nor of the assumptions they make in order to study all issues and aspects of FC replacement by VCs. Hence, our objective is to answer the following questions: what theoretical frameworks can explain the practice of FCs replacement by venture capitalists? How can we go further than the academic AT- and RBV-based literature to deepen our understanding of this phenomenon?

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The first section of the present article reviews the AT- and RBV-based literature dedicated to this subject. The limits of these theoretical frameworks have led us to investigate their extensions. The AT can only encompass one scenario – the replacement of the CEO in a situation of conflict of interest – and another basis for explanation is needed when the conflict originates in a lack of managerial skills. In line with the AT, the entrenchment theory (ET) is used to explain cases in which the FCs are not replaced. The RBV allows us to move away from the confining hypotheses of the AT, as it is concerned with the characteristics of the resources provided by start-up founders. To go further in this direction, investigating the literature pertaining to the dynamic capabilities approach (DCA) may be a fertile area for research in order to analyse a CEO's resources from a dynamic angle. Finally, the cognitive governance perspective (CGP) may be fruitful to characterise a conflict originating in a lack of skill.

The second part of this article presents the empirical context and the methodology of our research. The results of primary data – semi-structured interviews of key-stakeholders – combined with secondary data are displayed. Four typical scenarios emerge from our data. News cases are identified in addition to the replacement situations described in the literature.

In the third section this case typology is analysed through a grid that combines not only the usual frameworks (AT and RBV) but also their extensions (ET, CGP and DCA). This integrated approach leads us to rethink the nature of conflict and to underline the role of time in the replacement process. Thus, our contribution consists in expanding the theoretical lenses used to analyse the replacement of FCs by VCs.

Literature dedicated to founder–CEO's replacement by venture capitalists: issues and perspectives

A lot of research studies on CEO replacement refer more or less explicitly to the AT or the RBV. However, researchers do not question the relevance of the assumptions implied in these theoretical backgrounds. The aim of this first section is to identify the limits of these theories and to question the potential contribution of their extensions (ET and DCA).

Scholars' frameworks: agency theory and resource-based view

Agency theory interpretation: replacement initiated by VC, due to conflict of interest

The fundamental hypotheses of the agency theory are detailed in order to question its relevance to study CEO replacement, according to a strict or an extended approach. These hypotheses are based upon the concepts of conflict of interest, asymmetry of information² and the issue of lack of effort.

Academic literature on venture capital often uses the AT³ framework (Landström, 2007). Sahlman (1990) was the first author to conceive relationships between stakeholders as a double agency relationship between VCs and FCs on one hand, and between VCs and their investors on the other hand. The AT is the theoretical

² The AT does not initially postulate the asymmetry of information but only the existence of an underlying conflict of interest (Jensen & Meckling, 1976). However, the AT and the theory of information are combined in order to study the financing relations between external shareholders and managers (whether they be shareholders or not). Therefore, in its later developments, the AT has integrated the asymmetry of information hypothesis.

³ "We define an agency relationship as a contract under which one or more persons (the principal(s)) engage another person (the agent) to perform some service on their behalf, which involves delegating some decision-making authority to the agent. If both parties to the relationship are utility maximizers, there is a good reason to believe that the agent will not always act in the best interests of the principal." (Jensen & Meckling, 1976, p. 308).

framework adopted by Gompers and Lerner (2000). They interpret the whole process of venture capital investment, from the selection of companies to their exit of the VC's portfolio, in terms of incentive, control, and sanction, which are at the core of the AT. The relation of agency between both protagonists is characterised by an underlying difference of interests whereby the agent is supposed to undertake expenditures that will bring him personal profits. These expenditures, supposed to be made to the detriment of the company or to be useless in value creation, decrease the amounts available to pay venture capitalists. Literature dedicated to the venture capital gives the example of the pleasure to lead certain activities rather than others (Shepherd & Zacharakis, 2001). In a venture-backed start-up, the founder may for example conduct scientific research that brings peer recognition for him, but no benefits for the company (Birley & Westhead, 1994; Scheinberg & MacMillan, 1988).

The hypothesis of asymmetry of information states that the agent possesses some information that the principal does not have. This information is then a private one. The notion of "hidden acts" or "hidden information" takes into account the following problem: the principal cannot know how much effort is supplied by the agent, while the level of effort of this agent increases the probability of a favorable result for the principal (Arrow, 1985). Asymmetry of information is particularly important in the case of venture-backed companies, given the innovative activity of these companies (Moore & Garnsey, 1992; Storey & Tether, 1996). The behaviour of the CEO is not observable for the VC. In particular, the VC does not know how the company will use the capital supplied and what effort is deployed by the founder (Bergemann & Hege, 1998).

In a strict definition of the AT the replacement occurring in a context of underlying conflict of interest and asymmetry of information is due to a lack of effort from the FC. The extended form of the AT introduces a lack of skills as a motive for VCs to replace the FC.

The central hypothesis is that there are underlying conflicts between the two parties in a context of asymmetry of information. One sign of opportunistic behaviour by the agent is his minimal level of effort. The AT focuses on conflict as an explanation for the replacement of the FC by the VC. Dismissing the CEO is known to be one of the mechanisms of control used by the principal to maximise shareholder wealth (Pitcher et al., 2000). According to Lerner (1995), investors increase their monitoring effort around the times of corporate crisis and take action by replacing the CEO.

However, the literature on this topic is mainly concerned with a lack of competence as a reason for replacement. Therefore, it takes some distance to the basic hypothesis and then introduces what we call an extended approach of the AT.

Walsh and Seward (1990) propose to extend the AT by taking into account the agent's lack of skills in addition to his lack of effort.⁴ In their view, the lack of managerial ability is one reason that can lead the principal to replace the CEO (the agent) as a result of an internal control procedure.⁵ They consider that principal – agent coordination issues are more than just a matter of opportunism. This extension of the AT is adopted in a large number of researches concerning venture-backed companies; a link is often sought between the practice of replacing the founder and the firm's performance. The two factors are positively associated in the US context (Ruhnka, Feldman, & Dean, 1992; Bruton et al., 1997) but negatively associ-

⁴ "Walsh and Seward (1990) began to extend agency theory when they suggested that agency problems arise not just from suboptimal effort but also from lack of agent ability" (Sapienza & Gupta, 1994, p. 1620).

⁵ "They suggest that agency problems may also arise from a lack of agent ability" (Bruton et al., 2000, p.70).

ated in France (Gerasymenko, 2008)⁶ and in the UK (Bains, 2007). This AT extension brings out the concept of “good faith”⁷ disagreements between VC and FC (Sapienza & Gupta, 1994). Bruton et al. (2000) re-examine all of this broader reading of the AT and establish a hierarchy of reasons why start-ups may dismiss their FCs: the lack of ability is followed by “good faith” disagreements, with managerial opportunism in last place. This extension of the AT allows us to look at the CEO's skills and to find a more advanced explanation of the reasons for replacing the FC.

From our point of view, the relevance of integrating the issue of the CEO's lack of competence into the AT analysis is debatable. Claiming to look further than opportunism while still being based on the AT is quite a step away from the founding hypotheses of the theory, and as such a disputable stance. Therefore if we consider the reason that motivates the replacement to be a lack of skills, another theoretical framework must be mobilised. A conflict originating in a lack of skills is not compatible with the AT's basic hypothesis (a lack of effort) and is no longer a conflict of interest.

Resource-based view: replacement originating in FC's lack of managerial skills

Penrose (1959), the pioneer of the RBV, highlights the key importance of the founder's skills: the founder is often the only person able to understand how and why his company might develop. His role is all the more central in a start-up company, since the founder generally has three types of knowledge: (1) he⁸ specifically knows the sector in which the new company will operate; (2) he is the only person aware of the opportunity for starting and developing this business; (3) he knows how to set up his company and get the business up and running. In this sense, he develops asymmetric knowledge of the real opportunities for his business (Wiklund & Shepherd, 2003). The FC can thus be considered as a human capital resource (Becker, 2009) thanks to his training, experience, judgment, intelligence, relationships and all his insights (see Grant's definition of human capital resources, 1991). The FC can thereby be the source of a sustained competitive advantage for his firm (Alvarez & Busenitz, 2001; Barney, 1991; Khanin et al., 2009; Penrose, 1959⁹). According to West and Noel (2009), the knowledge resource is a key factor in the expected development and performance of a start-up company. It plays a crucial role in some start-ups, for example in biotechnology firms, whose business is entirely built upon a radical innovation that is dependent on the founder's scientific knowledge. This knowledge possessed by start-up FCs is complex and tacit in nature (Zander & Kogut, 1995). It has been acquired through academic learning, but above all through subsequent informal interaction with other researchers in laboratories, by reading publications in scientific journals or by their own previous research. FCs are thus connected to external networks that generate tacit knowledge (Christman & McMullan, 2004). All this tacit, imperfectly

imitable knowledge is what convinces VCs to invest in start-ups. They choose their investments based not only on the innovative idea underlying the start-up, but also on the person leading the project. Thus, the founder's knowledge is considered as a guarantee that other resources (financial and technical) can be acquired (Brush, Greene, & Hart, 2001).

It would seem paradoxical at this stage to imagine the VC parting from an FC who holds these key-resources. Knowledge, training, experience,¹⁰ internal and external interpersonal relations can be said to possess the “VRIN” characteristics inasmuch as they can be qualified as “Valuable, Rare, Inimitable and Non-substitutable” (Barney, 1991). The high-tech start-ups¹¹ rely especially on the resources brought to the table by FCs (Brush et al., 2001) such as scientific expertise (in biotech companies) and a vision of potential innovations.

Finally, the RBV introduces the question of the CEOs' resources needed in order to sustain the competitive advantage of the firm. The role of VCs can be likened to that of the managers described in the RBV as they have to identify and to develop this human capital resource (Khanin et al., 2009). But if this theory puts the emphasis on the CEO and his resources, it does not offer a frame to analyse the kind of resources needed during the development of young innovative companies in an uncertain environment: “Finally, RBV misses the strategic role of time” (Eisenhardt & Martin, 2000, p. 1118). As Prévot, Brunhart, Gieu, and Maltese (2010) underline, in fast-changing environments, the key to success is the CEO's capacity to acquire or to develop as quickly as possible new manners to configure and to use resources. Again, for CEOs who seek to obtain VRIN resources and to develop an appropriate organisation, the RBV does not offer anything from which to draw practical orientations or know-how (Kraaijenbrink, Spender, & Groen, 2010).

Table 1 summarises the contributions and the limits of the theories used in classic literature: neither the AT nor the RBV seem to be completely satisfactory.

First, the above literature review shows that research in venture capital essentially adopts the AT framework to address the theme of replacing the FC and broadens the hypotheses of the theoretical corpus to include the lack of managerial skills issue. We consider that this posture is not acceptable inasmuch as a conflict originating in a lack of skills is not compatible with the basic hypothesis of the AT. Second, the RBV studies the strategic resources for the performance of companies and highlights the importance of the FCs managerial skills (which the AT does not), but it does not integrate the time factor and the evolution of start-ups and their actors.

Thus, limits of both AT and RBV lead us to investigate extensions of these theoretical frameworks and to question their potential contribution to the understanding of the practice under consideration here.

What potential contributions of AT and RBV extensions?

Entrenchment theory: CEO's reaction to replacement threats

According to the ET, the objectives of the leader are to make his replacement expensive for the company. The CEO's entrenchment increases his discretionary power (Alexandre & Paquerot, 2000; Schleifer & Vishny, 1989; Stiglitz & Edlin, 1992). To use Gomez' expression (1996, in Gharbi, 2004), he can react to the possibility of being replaced by emphasising his specific resources related to

⁶ Gerasymenko (2008), studying a sample of 122 French firms, shows that replacement of FCs is associated with poor business performance.

⁷ Sapienza and Gupta (1994) introduce a new type of agency problem: “good faith” disagreements between principal and agent concerning the choice of the agent's operating objectives: “It is our position that even if there were no question about managers' willingness to expend effort to maximize profits, the issue of the direction of effort would still exist. In contexts such as new ventures, in which task uncertainty is very high, signals regarding the best course of action are generally very weak. In such a situation, even if a principal and an agent are equally committed to the maximization of shareholder wealth, they might have recurring disagreements regarding how to prioritize operating goals” (p. 1620, cited in Bruton et al., 2000).

⁸ The authors wish the readers to know that the masculine pronoun “he” used throughout this article to refer to “founder, CEO, FC, VC and investor” may designate equally a man or a woman.

⁹ “Following the resource-based view of the firm (Alvarez & Busenitz, 2001; Barney, 1991), we assume that founders of new ventures may have heterogeneous talents and capabilities both in their professional activities and in the domain of management” (Khanin et al., 2009, p. 20).

¹⁰ Penrose (1959, p. 53) notes that “experience itself can never be transmitted; it produces a change – frequently a subtle change – in individuals and cannot be separated from them.”

¹¹ In 1981, Hambrick argues that top managers in R&D are especially critical in technologically intensive industries by providing an important and sustainable competitive advantage to such firms.

Table 1
Contributions and limits of the AT and the RBV.

	Contributions	Limits
AT	Case of FC replacement due to lack of effort in conflict of interest context <i>Viewpoint:</i> venture capitalist	'Lack of skills' not compatible with basic hypothesis of AT. Does not take into account FC's viewpoint
RBV	Case of CEO replacement due to lack of skills <i>Viewpoint:</i> company (competitive advantage)	Static perspective Does not elucidate nature of skills needed (no managerial implications)

his human capital or networks through two types of actions. First, the FC will hire close, loyal co-workers and take care to build up and develop his social networks. Second, he will maintain close relations with external partners: researchers, investors, political actors and, of course, other businesses. In this way, he makes his removal from the company difficult: investors run the risk of seeing certain key employees leave along with the manager, and of losing special links with other businesses, financial organisations and even customers. The CEO thus increases information asymmetry towards venture capitalists in an attempt to retain an advantage. This theory is in accordance with the empirical results of Wasserman (2003) or Bamford et al. (2006a, 2006b) inasmuch as they show that the FC has social capital that gives him influence over other employees.

The AT describes entrenchment as a process originating in the CEO's pursuing his personal interests to the detriment of the investors' interests. According to Gharbi (2004), there is also a "positive" aspect to such strategy. Indeed, this entrenchment may be beneficial to the company in that it leads to better employee commitment for instance or to new research partnerships or new commercial contracts. Furthermore, in start-up companies this entrenchment can be anticipated: from the earliest days of the company, the FC may focus on developing internal and external networks. In reaction, the VCs can negotiate with the founder in order to keep him in the company and maintain stability of the organisational networks. Both can try to cultivate a "chemistry" in this dyadic interaction and can expect having benefits for the boardroom dynamics and organisational performance (Kakabadse, Kakabadse, & Knyght, 2010). Indeed, integrating this framework in the replacement analysis may contribute to a less investor-focused analysis of CEO replacement.

Dynamic capabilities approach: role of managerial skills to sustain start-up development

As underlined before, the RBV does not offer a framework¹² to analyse the kind of resources needed during the development of young innovative start-ups in an uncertain environment (Kraaijenbrink et al., 2010). This dynamic dimension is even essential to study venture-backed companies which evolve in a "hypercompetition context" (D'Aveni, 1995) where the CEO's resources must constantly change and can lead to temporary advantages. The dynamic capabilities approach (DCA), an extension of the RBV, analyses an organisations' needs for sustaining competitive advantages in fast-moving business environments (Teece, 2007; Teece, Pisano, & Shuen, 1997). According to Teece (2011), these dynamic capabilities refer to three classes of activities and adjustments: (1) the identification and assessment of opportunities (sensing); (2) the mobilisation of resources to address opportunities and capture value (seizing); (3) a continued renewal (transforming). They correspond to meta-competences that transcend technical competences, in order to achieve not only "technical fitness" but also "evolutionary fitness"¹³ (accord-

ing to expressions used by Helfat et al. (2007)). Indeed, the issue for start-ups consists in both shaping their environment and adapting to it. The strategic role of management and especially of the top management team is akin to that of an orchestra conductor combining these three previous dimensions.¹⁴ Therefore, "these managers must cope not only with the external challenge of competition, but also with the internal challenge of potentially collapsing dynamic capabilities" (Eisenhardt & Martin, 2000, p. 1118).

This approach highlights that only some individuals possess those capabilities simultaneously: "Since all three classes are unlikely to be found in individual managers, they must be somewhere represented in top management [...] If the principal executive has depth in all three classes of capabilities, the organization has a better chance of success" (Teece, 2007, p. 1347). The DCA introduces top management's skills needed to achieve competitive advantage in changing environments as a new feature in the analysis. It shows that in some cases, the FC can gather evolutionary managerial capabilities. But most of the time, the replacement of the FC is more or less obvious: "The replacement of the CEO and other members of the top management team, if they demonstrate weak sensing, seizing, and reconfiguration capabilities, is important to effectuate" (Teece, 2007, p. 1340). Therefore, an important issue for investors is to control the dynamism of the CEO and to prevent his potential "strategic malfeasance" (Teece, 2007). The DCA attenuates the effects of the history or the past-dependency of a company, thereby showing that the business enterprise is shaped, but not necessarily trapped, by its past (Teece, 2007, p. 1341). From a certain point onwards, the FC's experience, while still important, is no longer crucial to the start-up's future. Following this, the FC's experience is not essential to the future of the start-up. Finally, the DCA introduces many variables that can be used to study the replacement of FCs: the specific context (changing and innovative environments), the kind of skills needed for top managers (Rodenbach & Brettel, 2012), and the links between dynamic capabilities and sustainable advantages of start-ups. The DCA focuses on the FC's managerial skills by integrating two key variables: time and the high velocity of the environment. It suggests the possibility of implementing "good practices" to help guide CEOs through acquiring and developing dynamic capabilities – said dynamic capabilities being acquired by "well-known learning mechanisms" (Eisenhardt & Martin, 2000). Following this, the DCA introduces the idea of common CEOs' resources to achieve effective dynamic capabilities, but it does not clarify how those "soft assets"¹⁵ possessed by the CEO will enable the start-up to sustain long-term competitive advantage. Empirical studies on dynamic capabilities focus on studying how managerial characteristics influence the dynamic capabilities of the firm (Rodenbach & Brettel, 2012).

To recapitulate, this theoretical framework, focused on the FC, allows us to analyse the expectations of VCs regarding FCs' re-

¹² If Penrose (1959) or Wernerfelt (1984) mention the dynamism of the RBV, Barney (1991), Barney (2001) offers a more static view of resources.

¹³ "Evolutionary fitness concerns how well a dynamic capability enables an organization to make a living by creating, extending or modifying its resource base" (Helfat et al., 2007, p. 7).

¹⁴ "Top management leadership skills are required to sustain dynamic capabilities. An important managerial function is achieving semi-continuous asset orchestration and corporate renewal, including the redesign of routines" (Teece, 2007, p. 1335).

¹⁵ Teece et al. (1997, p. 528) define "soft assets" as: "values, culture, and organizational experience, distinctive competences and capabilities (that) generally cannot be acquired; they must be built. This sometimes takes years – possibly decades".

sources from a dynamic angle, and to integrate the role of VCs in developing the top manager's skills.

Cognitive governance perspective: cognitive dimension of conflict

As explained hereabove, when the conflict originates in a lack of effort, the AT is appropriate to explain replacement of FCs by VCs. But another theoretical explanation should be proposed when the conflict is due to a lack of skills. A perspective in terms of cognitive governance proposed by Charreaux and Wirtz (2006) can be fruitful to better define the concept of conflict between FCs and VCs in this case. These authors distinguish two perspectives: the “disciplinary governance”, which is based on the AT, and the “cognitive governance”, which is in line with the RBV. The cognitive governance perspective (CGP) seems to be particularly suitable for venture-backed companies. Indeed, Charreaux and Wirtz (2006) consider that cognitive dimensions play a major role in innovative start-ups. Moreover, inasmuch as they provide “smart money”,¹⁶ VCs are not only simple financial investors: they are able to produce “cognitive gains” when their skills help the company to develop growth opportunities. In the disciplinary governance perspective, conflicts are based on a difference of interest whereas in the cognitive governance perspective, they are caused by divergent mental patterns. Cognitive conflicts come from a mutual incomprehension originating in divergent and subjective representations of strategic opportunities of the company between investor and CEO. They do not have the same appraisal of strategic opportunities and this difference of viewpoint is distinct from a conflict of interest. In order to take into account a lack of skills as a motive for FC replacement, it may be fruitful to integrate the cognitive dimension of governance into the analysis.

What are the motives for replacement? Is there always a conflict? What is the nature of the conflict? What theoretical frameworks can explain all practices of FC replacement by VCs? Can we go further than classic academic literature based on the AT and the RBV to deepen our understanding of this phenomenon? Our empirical study sets out to find answers to these questions.

Data analysis: diversity of FC replacement scenarii

Empirical context and methodology

The issue of CEOs leaving has been widely investigated in large listed groups in the French context (Allemand, 2009; Mard & Marsat, 2008) but not much in venture-backed start-ups. In this section, we begin with a presentation of this specific empirical context. We then describe our methodology.

Empirical context

Our research is focused on French venture-backed companies.¹⁷ This field comprises a heterogeneous group of businesses, from young biotechnology research firms built on radical innovations to e-commerce businesses. The former category of start-ups employs skilled personnel and the venture capital is used to fund R&D expenses. Indeed, biotech companies are often portrayed as engaging in a series of “races” to win (Baum & Silverman, 2004) and to obtain the financial resources necessary to support

technology management (Amburgey, Dacin, & Singh, 1996).¹⁸ The latter category, e-commerce businesses with low technological content, needs significant capital input to grow and to acquire market share, and the funding provided by VCs is used for marketing expenses. The founders of these various venture-backed companies have different profiles as well. In biotechnology, they can be “star-scientists” (Darby, Liu, & Zucker, 1999) and their human capital is considered as less fungible than in other sectors (Baum & Silverman, 2004), whereas in Internet start-ups they can have more managerial backgrounds. Our field of analysis allows us to take into account this diversity of FCs.

Methodology

To decode the process and to identify the various possible scenarii, we designed an exploratory methodology based on qualitative data. In line with Eisenhardt (1989), we conducted an iterative process of qualitative data collection, analysis and theory-building. Thus, our research is positioned in a practical middle ground between a theory-laden view and an “unfettered empiricism” (Suddaby, 2006).

Venture capitalists form a closed professional community that does not open up easily. Their professional practices require each VC to keep some of the information he holds to himself, and this does not encourage disclosure of either VCs' knowledge or of their analysis.

Moreover, replacement of FCs by VCs is considered as a confidential practice: “The current CEO is often unaware [that he is to be replaced], we do it on the quiet” (a headhunter). In this context, this phenomenon is difficult to capture since the actors have a tendency to rewrite history: “Be careful about the account they may give you after the event. It's storytelling” (FC8). Our field research took place in this context. So, the difficulty is to accept storytelling as a necessary first step, and in a second step to build case studies with methodological rigour in order to elaborate a “good theory” (Eisenhardt, 1991).

These constraints led us to contact VCs and FCs from our own networks¹⁹ so as to collect data in confidence. Indeed, confidence was crucial, for example in distinguishing between the voluntary and involuntary dimensions of FC succession. Afterwards, these first contacts brought us new opportunities for interviews with FCs and VCs outside of our networks.

As the population of French VCs is small and heterogeneous, our aim was to have a diversity of profiles rather than a large number of interviewees. We selected them based on theoretical sampling considerations (Glaser & Strauss, 1967), the objective being to cover as many situations identified in the literature as possible. Thus, we were careful to select some VCs who had replaced their FCs, and others who had not. Indeed, in order to understand the reasons that lead to FC replacement, we must also analyse the reasons that lead to a non-replacement. Moreover, we interviewed as many “stars of the profession” of venture capital in France as new entrants in the business (see appendix A for more details).

In order to gather the viewpoints of all actors concerned by FC replacement, between 2009 and 2012 we also carried out eight semi-structured 2-hour interviews with single FCs who have remained or not in their position. The 8 FCs and the 8 VCs interviewed do not belong to the same dyadic relationship except

¹⁸ We have no global data on the importance of starting capitals needed by companies according to their sector, and hence, we do not make the assumption that biotech start-ups require more capital than e-commerce ones. VC1 confirms this feature: “Biotech firms need more capital than e-commerce. In a biotech, there are around four financing rounds from €M 2 to €M 10 along 8–10 years. In comparison, e-commerce firms need around 2 financing rounds (from €M 1 to €M 5) along 3 years.”

¹⁹ These networks refer to the contacts we built during our previous research conducted since 1998.

¹⁶ VCs are recognised for providing advice and other value-adding services.

¹⁷ 342 French companies received a total M€399 of funding from venture capitalists during the first half of 2012 (Chausson Finance Index). 23% of this total was invested in e-commerce start-ups, 20% in the health sector, 15% in cleantech companies and 13% in software ventures.

in one case (cf. appendices A and B). These FCs are sometimes well known in their sector and they belong to professional associations (see appendix B for more detail). Additionally, this field research was complemented by a semi-structured interview with a headhunter who specialises in hiring managers for biotechnology firms. This sample constitutes an originality of our approach in that VCs' viewpoint is not favoured over that of FCs. The interview guide we designed asked the interviewees to tell us about FC replacement issues and, in line with the exploratory approach adopted, left room as well for the emergence of different scenarii. For example, interviewees were asked to describe if they had taken part in a replacement process, the steps of the process they had observed, the results of this process, the respective roles of the two key actors (VC and FC), the nature of relationships between them, and where appropriate, interviewees were questioned about the non-replacement practice. In order to better capture the nature of the process, we also decided to interview these actors with open questions and to react to what they said. Finally, we tried to gather different viewpoints in order to identify the cases of replacement and non-replacement.

In addition to this primary data, we used several secondary data sources for triangulation. Specific cases were investigated concerning start-up companies in which the VCs' replacement of their FCs attracted media coverage. We have sought to collect all the information on the cases concerned in both the general and specialist press (*Biotech Finance* newsletter, *Journal du Net*, a French online magazine for business and high-tech news, etc). These cases were also related with some of our primary data, or are considered as exemplifying (or not) FC replacement. Finally, we also added information collected from blogs kept by entrepreneurs or actors in the sector.²⁰

Interviews were transcribed and analysed by both authors. For cross-analysis interview transcripts were coded separately using the same grid, then exchanged. Coding used the following themes: FC or VC profiles, FC replacement (or not), motives of replacement, roles of each actor during the process of replacement, consequences of replacement. We have then grouped interview results according to the reasons for replacement given by the interviewees.

The four scenarii of replacement observed in french vc-backed companies

"Venture capitalists who say they invested in people are liars. Because they say that right up until they replace the people concerned. We operate in a world of execution. So I boot out and replace the CEOs of the start-ups in my portfolio. I'm not a naive admirer of entrepreneurs and if they don't meet the forecasts in the business plan, then I let them go." (VC4).

The words of this venture capitalist appear to confirm the unilateral and often conflictual nature of the departure of a FC. Analysis of the primary and secondary data suggests that the reality is more complex, and brings out four scenarii.

Scenario 1: replacement originating in a conflict of interests between FC and VC

This first scenario is the best-known one, and is often reported in the media. Venture capitalists have the power to "kick out"²¹ FCs when they are no longer considered to satisfy their financial interests. Several quotations from the interviews describe this process:

"There you are, we disagreed... they fired me... I fell into the trap... Without me, the company wouldn't exist and they know that very well" (FC1).

"I was CEO of firm X until 2008. At which date, after a strategic disagreement that was fundamental to the management of the company, I was induced to leave- effectively I was kicked out" (FC2).

"It's very rare to have the founder as the company's CEO until the end. [...] When replacement of the CEO happens during the early stages, that generally means there's a conflict. The CEO doesn't keep his promises [...]" (VC7).

The terms used by parties on both sides of such cases are particularly vivid and forceful. Conflict of interest is seen as unavoidable, as illustrated in the case of Parenzo (cf. Case 1).

Case 1 The Parenzo²² case

This online shoe retailer was set up in late 2005 by three partners, one of whom, Francis Dupont, was appointed CEO of the start-up. But the €4 million funding provided for the venture in 2006 was not followed by the results venture capitalists had expected. They therefore commissioned an audit conducted by Stéphane Dubois (former CEO of a wellknown multimedia start-up in France), who was appointed Parenzo's CEO immediately afterwards. Francis Dupont's dismissal thus took place in conflict and received extensive media coverage.²³ In press releases and on his own blog, he complained of "disgraceful practices" and sued two of the company's investors. These investors were dissatisfied with their CEO for not doing everything possible to achieve the business plan objectives. They complained that "sales were 50% below target and margins were catastrophic". The VC5, who has financed Parenzo, criticises the FC for not making enough efforts to create value and because his actions followed his own interest and not those of his VCs: *"He just blows money like crazy. He pays out advisers and lawyers"*.

In the first scenario, the CEO is "kicked out" because he is not taking optimal care of financiers' interests. The main reason of replacement is therefore the conflict of interest between FC and VC: *"Sometimes, replacement is just obvious. Some FCs do not understand VCs' objectives. FCs spend money and forgot to reach VCs goals"* (FC6).

Scenario 2: replacement in case of conflict related to FC's lack of managerial skills

Venture capitalists may give reasons other than divergent interests for replacing the FC. The lack of ability to make the transition from a scientist's role to a manager's role is often presented as the reason for replacing the CEO. In the biotechnology sector, this is a very common scenario since many of these firms are set up by former scientists who have little connection with management and finance culture. The following quotation is telling:

"We got by for a long time on the myth of the researcher-entrepreneur. But there aren't many of them. In most cases the business is an extension of a laboratory. You have a star-scientist who sets up his own business. It never works! (...) A business with no prospects of earning money isn't viable. Sooner or later, you have to think

²² All names of companies and of persons have been modified in order to preserve confidentiality.

²³ Several press articles covered the situation with very direct titles: "Stéphane Dubois prend les rênes de Parenzo dans un climat tendu" (Stéphane Dubois takes over the reins of Parenzo in a tense climate), *Les Echos*, n°19879, March 16, 2007; "Rififi chez Parenzo.com" (Fisticuffs at Parenzo.com), *NetEco*, March 16, 2007.

²⁰ Interviewees' names and/or companies are withheld to preserve confidentiality.

²¹ This expression was used by our interviewees.

about making a profit. That's the kind of thing that 90% of the guys who set up this type of company don't get. It's pretty fascinating." (FC1).

The case of Datis Pharma (case 2) is a typical example of this scenario.

Case 2 The Datis Pharma case

This biotech start-up was created in February 2003 by three researchers. Only one of them, David Martin, was holding the CEO position. A venture capital fund, Innova Partners, took part in the first round of funding in June 2005, to the tune of €4 million.²⁴ Then, the company went through a difficult period in terms of top management. Despite the dual profile of David Martin, both a scientist (PhD) and a manager (MBA from HEC), he was dismissed by his chief investor after 6 months. While acknowledging that "it's a risk you sometimes have to accept in this sector",²⁵ the former FC explicitly criticised the way he had been ousted from management with his two partners, and above all how they were then "expropriated" of their shares. His removal was the subject of an open dispute between Martin and the famous venture capital fund. "These venture capital funds that hold capital in the vast majority of start-ups capable of becoming the leaders of tomorrow can sometimes behave unethically, with absolutely no respect for entrepreneurs or business angels" (David Martin). A new CEO was chosen by the VC and appointed head of Datis Pharma in June 2007. The new CEO's profile – with his long managerial experience in big companies – suggests that the venture capitalist considered Mr. Martin no longer had the managerial skills required to develop the company, particularly as regards signing a partnership with an industrial operator in the pharmacy sector and conducting a large-scale second round of financing.

Scenario 3: replacement by mutual agreement originating in FC's lack of managerial skills

Another scenario emerges from our field study: the replacement of the FC by the venture capitalist can result from a mutual agreement. First of all, it can be accepted by the two parties as a possibility covered contractually in the shareholder agreement: "That's often the case nowadays, people ask for golden parachute clauses" (a headhunter). The quotations from the interviews show that the replacement sometimes corresponds to the FC's aspirations. Some start-up founders do not want to become managers and want to keep concentrating on their core scientific skills. As a result, there is no conflict in this scenario:

"Today, when I invest in a start-up I make no promises to anyone. The CEO knows the rules. There's only one company in my portfolio that still has the same CEO today as in the beginning. It [the replacement] doesn't take place in a conflict, because the CEO hands over his position to someone else. I have replaced a CEO then called on his services afterwards for another firm. I took him out of firm [X] and hired him for firm [Y]. There's nothing personal about this setup. In plenty of cases I've remained on good terms with the CEOs who were kicked out" (VC4).

"In the venture capital firm I used to work in, deals were on a European scale: there were Nobel prize-winners who had absolutely no interest in managing a business." (VC1).

Once replaced, the FC (with the approval of his investors) may choose one of three options:

- Scenario 3.a: he stays in the firm as head of research (CSO – chief scientific officer) for example.

"The standard case is when there's no conflict. It isn't a conflict situation because the founders are forewarned: they don't know how to manage development of the business and keeping the company running well is in their interest because they own shares in it. So the replacement happens when the company expands. The founder had the required skills for creating the company, we needed him to complete preparation of the new product. But once the firm grew, he had to be replaced. Generally, we ask him to remain on board. He has a position as scientific director" (VC6).

"He can stay in the start-up to carry on managing R&D, but someone else is needed to manage the company" (a headhunter).

- Scenario 3.b: he leaves the company to join a research organisation (private or public) but remains a consultant for his former company.

"He [a VC] arranged things so I could carry on as a scientific advisor to my old company for 4 years. I had the impression I could preserve a few things and the shareholders felt I could contribute things on a scientific level, and they preferred that solution" (FC2).

- Scenario 3.c: he can leave the company to work in another innovative start-up and thus, he may become a serial entrepreneur.

"I didn't want to get into business. Science is what interests me. So we agreed on the financial terms and I handed over control. And that's fine. I'm doing what I like [...], I'm about to embark on a new start-up adventure." (FC4).

The CEO may even prepare for his own departure, by taking part in the succession planning:

"I know an FC who decided to set up a continuity plan over 6–9 months with a CEO he got on well with" (FC5).

Our research brings out this third option, in which the replacement may be instigated by the FC himself, in contrast to the first two, which often result from prior negotiation initiated by VCs.

Scenario 4: non-replacement of start-up's FC

Another scenario emerges from our field study: the non-replacement of the FC by the venture capitalist. This is confirmed by several investors' accounts:

"If you replace a CEO you're heading straight for failure (...) My greatest success is company A, where the CEO is the person who remains from the beginning [...]" (VC2).

"The most successful ventures are the ones where the FC has stayed" (VC5).

"In my experience, you shouldn't change the CEO! When you look at it all in detail, you can see that most of the companies that are doing well are the ones that have the same CEO from the start [...]" (VC8).

"I consider that as investors, we're visitors in a company: when we're invited and things don't go well, we leave. (...) I don't replace CEOs." (VC3)

If we analyse these cases with a longitudinal approach, it's interesting to distinguish two sub-cases.

²⁴ Les Echos n°1944, 29 June 2005, p 30.

²⁵ "Constructing respect between investment funds and entrepreneurs/business angels in forming/developing innovative businesses" (<http://www.agoravox.fr/tri-bune-libre/article/fonds-d-investissement-et-19929>, Martin, website accessed on 28/07/2007).

– Scenario 4.a:

A CEO interviewed describes his non-replacement as the result of his reaction to his potential replacement. Off the record, he mentions that as he realised that the VC could replace him, he decided to form strong bonds with his employees and to build new ones with academic research laboratories. This case shows that the CEO can act to prevent his potential “layoff”.

“You cut off its head, empty the firm of its substance, and afterwards it's hard to put the pieces back together” (VC2).

“Replacement can lead to an employee revolt” (VC1).

“The change of CEO is complicated for venture capital, because it's difficult to put someone new into a team that has a shared history” (VC8).

– Scenario 4.b:

America's most famous success stories such as Microsoft, Google and Facebook all belong to this scenario, as do certain French high-tech companies. For instance, the FC of Soilec (created in 1992) is still the CEO and chairman of the board of his company. A former researcher at the CEA (French Atomic Energy Authority), he is presented as someone who was able to adapt to managerial functions: *“he uses his talents as an industrialist and an entrepreneur to convey a vision and a plan for his company” (FC5).* The start-up was initially funded by venture capital, and its FC succeeded in moving forward in step with the financial actors until the company's IPO in 1999. Biotechnology is another sector in which replacement is not automatic, as reflected in the case of Cell (case 3).

“If I have one example to give you of a researcher who's been very successful, it's the CEO of Cell, Chairman of France Biotech. Who's a born researcher, loves science and research, but is also a businessman. That's an admirable success” (a headhunter).

Case 3 The cell case

Biotech company cell was founded in 1999 by a researcher (A.C.) at the Institut Pasteur and Harvard Medical School, and by a postgraduate student. The transition from science to business was natural for both these researchers. *“I always wanted to start a business. I've been doing research on molecular scissors²⁶ for 8 years now with that aim in mind” (the FC in 2000).* He has been the company's general manager since 1999 and even became Chairman of France Biotech, the French association of biotechnology companies. All the venture capitalists and CEOs interviewed cited him as an example of a scientific founder's capacity to acquire managerial skills: *“There aren't many who can evolve from a scientist into a manager. He is one” (a former biotech CEO).* He is considered to have *“successfully turned himself into a skilful manager”²⁷* and attracts media coverage beyond his own sector.²⁸ Cell is even one of the few French companies to be listed on the stock market (since 2007). In June 2011, A.C. was appointed Chairman and CEO of Cell. He even seems to be on positive terms with venture capital: *“Venture capital is not dead”* he was pleased to comment in March 2011 as Chairman of France Biotech.²⁹

Some FCs do succeed in developing managerial skills in addition to their initial scientific skills. In such cases venture capitalists choose to keep them on as CEOs, in order to retain their combined range of knowledge dual expertise (case of FC7). Both types of actor become partners on the long term.

Towards a theoretical framework to encompass all FC replacement scenarii

A typology of scenarii emerges from our empirical data (Diagram 1). This typology refers to an original combination of the theories described above. This study leads us to nurture a reflexion about the nature of conflicts and to underline the importance of a dynamic perspective.

Proposition of replacement scenarii typology

This exploratory research brings out a typology of scenarii for FC replacement more elaborate than that which we have identified in the literature. In Diagram 1, each scenario is embedded in a theoretical framework. We mobilise the AT and the RBV but also the ET, the DCA and the CGP.

The AT is suitable to account for the well-known replacement originating in a conflict of interest (scenario 1). This scenario corresponds to the “separating turnover” of Hellmann and Puri (2002) in which the arrival of the new CEO implies the departure of the founder and where the investors play a controlling role. The RBV and its dynamic extension, the DCA, allow us to explain different scenarii: the case of replacement in conflict when the motive is a lack of managerial resources (scenario 2). This theoretical positioning is different from those adopted in the AT-based literature. The RBV and the DCA are also relevant to account for non-conflictual situations of replacement (scenario 3) or for non-replacement (scenario 4-b).

The mutual agreement (scenario 3) can be linked to the “accommodating turnover”³⁰ (Hellmann & Puri, 2002), which points towards a situation where the founders are willing to work with an outside CEO, and the investors willing to play a supporting role consisting in facilitating the transition. The explanation lies in the “myopia about science”³¹ affecting certain founders, and/or in their disregard for managerial skills (Meyer & Dean, 1990). In this third scenario, what matters are the capabilities of both FC and VC to identify the skills needed during the development of the company. We have underlined the limits of the AT, which does not consider the scenario of replacement in a non-conflictual setting. A FC may accept (or even anticipate) his replacement for several reasons: (1) he is aware of his lack of managerial skills and is as keen as the venture capitalists to see the company succeed; (2) he is not interested in being a businessman, and he wants a job that uses his core skills; (3) the rules of the game were clear from the beginning, and replacement is financially to his advantage. The ET is relevant to consider the non-replacement in an underlying conflict of interest environment (scenario 4-a).

³⁰ These scenarii emerge from our empirical analysis, while the distinction between separating and accommodating turnovers constitutes a starting point for Hellman and Puri. Their objective is to study the venture capitalist's role of control and support. These concepts not being directly observable, Hellman and Puri use the two types of turnover as proxy. They speak of an ‘accommodating turnover’ if the founder retains some position in the start-up and of a ‘separating turnover’ if the founder severs all ties with the company.

³¹ This expression describes some scientist FCs who are focusing so much on their scientific R&D that they are unable to take some distance and comprehend the managerial challenges faced by a company.

²⁶ DNA enzymes.

²⁷ “A. C., Un président tout feu tout flamme pour France Biotech” (A. C., a chairman burning with enthusiasm for France Biotech), *Les Echos* n°20495 August 26, 2009.

²⁸ “Génie génétique” (Genetic engineering), *Le Nouvel Observateur*, 27/10/2011.

²⁹ “Les biotechs attirent à nouveau les capitaux” (Biotech companies attract capital once again), *LeFigaro.fr*, 30/03/2011.

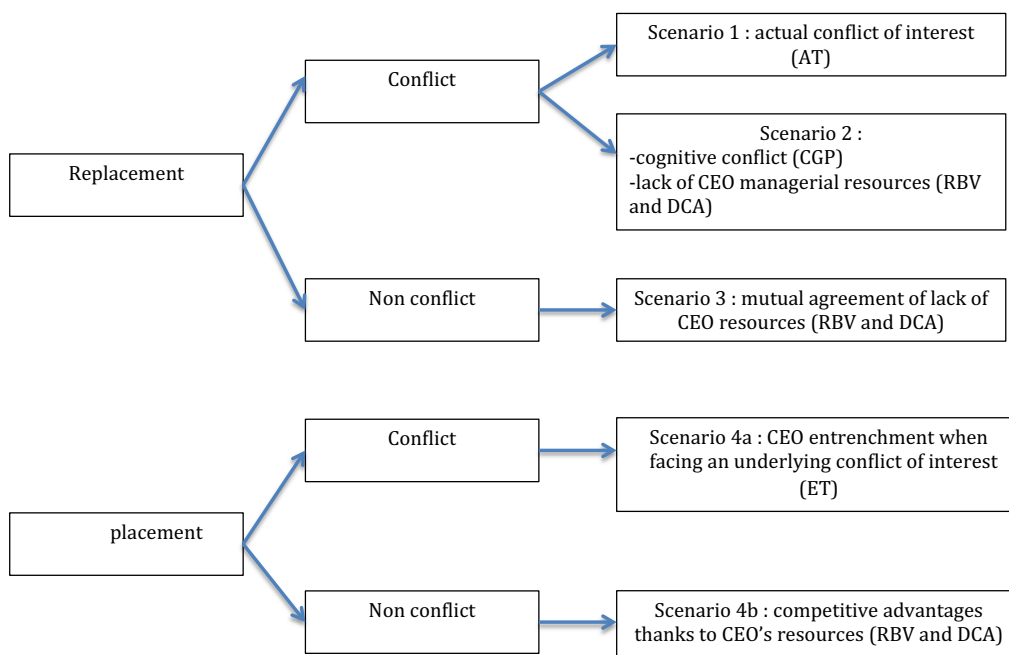


Diagram 1. A typology of CEO-replacement scenarios explained by combining theories.

Finally, scenario 2 deserves special attention. This case of replacement is usually considered by scholars in light of the extended approach of the AT and in light of the RBV. We propose to analyse it by combining insights of the CGP and of the DCA. Resources expected by VCs can differ from those implemented by FCs. This difference could be more a matter of cognitive perceptions, as introduced by the CGP.

Two key factors to analysis: nature of conflict and time

A more accurate analysis of conflicts

Our empirical study leads us to analyse more in-depth than literature does the nature of conflicts. The conflict of interest between VCs and FCs can either explode (scenario 1) or remain underlying (scenario 4-a). In the latter case, FCs can make their replacement expensive for VCs. We consider that a conflict originating in a lack of managerial skills is not a conflict of interest and thus cannot be analysed through the AT (as some researchers do). We propose to qualify this type of conflict as a “cognitive conflict” in accordance with the CGP. The case of a biotech venture-backed company illustrates this viewpoint: the VC criticises the fact that the FC lacks managerial skills whereas the latter blames the investor’s misunderstanding of his scientific concerns.

“VCs say to me that I didn’t understand managerial issues, that I have to be aware of the fact that the company has to earn money. My viewpoint was that they had to understand that what they propose could never work. The main problem was that they didn’t understand the scientific issues we face.” (FC2)

Let us precise that both types of conflict may coexist in a same situation. We consider that they are not exclusive of one another but most often one in particular constitutes the main motive for replacement.

Moreover, our field analysis gives rise to more complex relationships between conflict and replacement than those taken into account in the literature. We show, with reference to the RBV and

the DCA, that the CEO’s departure from the company is not always synonymous with conflict (as for Hellmann & Puri, 2002). He may leave of his own free will to move onto new start-up ventures (case of the serial entrepreneur). On the contrary, an underlying conflict of interest can exist without the departure of the FC, who is “entrenched” in the start-up.

Finally, conflicts can have negative or positive consequences. They can be seen as a source of perturbation for the start-up itself but also for each employee. This is the classical point of view explained by Desbrières (2005) amongst others: power struggles can be destructive, as they threaten the firm’s base of cognitive resources (existing networks, knowledge, skills, corporate culture).

“Conflict is never a good thing. You have to try and convince the CEO that it’s not a good idea for him to carry on in the job. You avoid conflict because you’re in a situation that means you have to find a compromise with the existing team. You try to convince them to change direction, offer the CEO jobs that are attractive to him.” (VC4).

“It’s not in the investor’s interest to turn everyone in the firm against him. It’s in his interest to avoid conflict, because that’s bad for the quality of the firm.” (VC7).

But conflict can also be a source of positive change for both FC and VC. Indeed, they can try to negotiate, to redefine new rules for management or for their relation. This can be an opportunity to prevent future difficulties.

Finally, the nature of conflict may have an impact on the time it takes to replace a FC. The replacement may be faster in the case of a conflict of interest than when the conflict is a cognitive one. Indeed, a lack of skills, at the root of a cognitive conflict, needs more time to be apprehended. This leads us to question the role of time.

Key role of time in high velocity environment

Our empirical study emphasises the role of time in understanding FC replacement. Greiner (1998) underlines that founders do not

actually make good managers, especially when the start-up grows and the founders may remain focused on scientific aspects of the business and neglect its managerial aspects, which can lead the company to failure. Furthermore, the initial “honeymoon period”³² between the CEO and the investor is particularly short in early-stage companies. Wasserman (2003) introduces a dynamic approach, explaining that the first major task for a start-up is the development of its products. The skills needed by the CEO at this stage stretch most founders’ abilities beyond their limits. A technology-oriented FC will be able to lead a company through its early stages but as the company grows, it will need someone with different competences.

The DCA helps us to reposition the replacement process at a theoretical level from a dynamic standpoint: it shows that the skills required of an FC necessarily change as the start-up develops. The stages in the life of a young company (filing a patent, receiving full market approval, marketing and selling its products) all involve challenges for founders whose initial skills are often not highly commercial or financial. When the company is first created, the entrepreneur contributes to the technological knowledge that makes up the core of the start-up (sensing and seizing in Teece’s typology (2007)). Until the innovation becomes an actual product, VCs cannot afford to lose a CEO who brings the company rare, complex resources that cannot be found on the market. In those early stages, the founder has tacit knowledge about the company that cannot be codified or transferred to a new CEO. Once the product’s feasibility has been demonstrated, the (technical and/or scientific) resources contributed by the FC are less precious. VCs can then replace him and put a manager or business developer at the top, with the managerial skills that the founder lacked. In this way, they “reconfigure capabilities” following Teece’s expression.

Time could play a role in the learning process of both actors. On one hand, the FC can learn on the job and then develop managerial capabilities. He may also come to realise with time that he has to face tough “dilemmas” between retaining control of his CEO position or making profit (cf. Wasserman’s “Rich vs. King trade-off”, 2006, 2008). The founder has to choose between giving up his position in order to grow a more valuable venture and to cash financial gains, and remaining as the CEO. On the other hand, a VC can become more competent in deciding to replace the FC or not and in knowing when it is more effective to do so.³³ For example, in the long term, “kicking out” the FC can be bad for the VC’s reputation. One of the VCs interviewed (VC5) revised his practices following a bad experience after replacing an FC. This relationship between both stakeholders can evolve. They can learn to know each other and thereby contribute to attenuating any cognitive conflict. Thus, the time factor may both increase or decrease the probability of FC replacement.

Finally, the dynamic angle introduces a new result: these scenarios can be simultaneous or sequential. For example, one of the FCs interviewed described that he first tried to develop his networks (with his employees, research laboratories) when he noticed that he could be replaced by the VCs (scenario 4.a). But in a second step, a conflict of interest (on the start-up’s objectives) arose with the VC and led to his replacement (scenario 1). Sometimes, the origins of the replacement can be plural: the replacement can be the

consequence of both a conflict of interest (scenario 1) and a conflict due to the FC’s lack of resources (scenario 2).

Conclusion/discussion

Main contributions of the research

Theoretical results

In this paper, our objective is: “to gain a better understanding of what occurs within the “black box” of founder replacement” (Wasserman, 2003, p. 151). Even if our research is an extension of Wasserman’s work, we introduce a theoretical understanding of this phenomenon. First, we propose a critical analysis of literature: the extended AT approach is not relevant as the motive of lack of skills is not compatible with the basis hypothesis of the AT. By means of a reference to the ET, this study also restores a more even balance of power between FC and VC, showing that the CEO can have an active role in response to investors, which are traditionally considered as being all-powerful. Our findings suggest that it is time to rethink relationships between VCs and FCs. Indeed, the literature often presents the VC as central to decisions,³⁴ but we propose a more balanced view in which a CEO has the power to become entrenched, or to leave on his own initiative in order to launch new start-up businesses.

Finally, we propose an integrated approach in which theories described in the first section are complementary. The combination of these various analytical frameworks allows us to examine the diversity of relations between financial actors and start-up FCs.

Managerial implications

The accusatory discourses of CEOs paint a storybook picture of a researcher robbed of his invention by financiers. If the research community sees that venture capital is that closely associated with FC replacement, people with start-up projects may be put off seeking such funding for fear of being “kicked out” of the company they founded themselves, and this could seal the company’s fate. In a conflict-based scenario, as generally admitted, the venture capitalist’s primary aim is to improve corporate performance. The personal accounts collected in our research show that this can be a counterproductive attitude, since eliminating the founder can weaken the company. The entrenchment of the CEO increases the damage caused by the change of leadership. As Guéry-Stévenot (2006) remarks, removing the FC can be more costly than keeping him on, in view of his particularly important role in the company and relations with external partners.

We thus have several managerial recommendations. VCs may want to avoid FC replacement in certain situations. In line with Wasserman (2003), we think that replacement is not always properly thought out and discussed³⁵ and it is sometimes operated as a “rationalised myth” (Meyer & Rowan, 1977). In the French context and more widely in the European context, the venture capital market fails to reach a critical size.³⁶ Indeed, VCs and FCs of innovative start-

³⁴ There are some exceptions: for instance, Schrader and Lütje (1995) distinguish between voluntary and un-voluntary turnover. They adopt the point of view of founders: the desirability expressed in this typology is related to the founder’s viewpoint.

³⁵ More precisely, this practice follows taken-for-granted assumptions, beliefs and rules of thumb about FCs.

³⁶ In 2011, the weight of VC investments in GDP is around seven times smaller in the whole of Europe than in the USA. Indeed, according to the European Venture Capital Association, VC investments account around for 0.03% of GDP in Europe. According to the National Venture Capital Association (NVCA) and our own calculations, VC investments account for 0.21% in the USA.

³² “The existing literature suggests that company founders usually have a ‘honeymoon period’ (Choi & Shanley, 2000) during which new shareholders – such as investors – assess the company’s performance against expectations” (Wasserman, 2003, p. 154).

³³ Khanin et al. (2009) hypothesise that VCs might exhibit heterogeneity in their approaches toward this practice and mention the role of experience by mobilising RBV.

ups evolve in a very “small world” and the FC replacement practice could be especially risky because the pool of CEOs available to choose a new CEO from is particularly diminutive. Hence, our results could be generalised to any other developed country with a small VC market. Moreover, VC industry is more recent in European countries than in the USA.³⁷ Therefore European VCs are less experienced and their reputation is less established on average than that of their American counterparts. A systematic FC replacement practice could be harmful to their reputation and scare away founders. For these reasons, it would be in VCs’ best interest to integrate a possible development of FCs’ managerial capabilities in their decisions. Indeed, investors could play a supportive role, described by [Hellmann and Puri \(2002\)](#), in preventing the CEO’s departure and all the strategic resources associated to this entrepreneur. VCs would be wise to develop their own resources and skills in order to be able to manage the development of FCs’ managerial competences. Additionally, when the replacement is after all unavoidable, rather than removing the FC completely, VCs would be well advised to keep him in the company (as a CSO for example).

Finally, our research confirms that FC replacement is a usual practice in start-ups. Instead of ignoring it, it could be advantageous to both VCs and FCs to make arrangements prior to the beginning of the venture and to define the conditions of the replacement and the future role of the founder.

Some limitations to this exploratory research

Our typology (illustrated in the [Diagram 1](#)) proposes schematic explanations to the four empirical cases, but of course, things can be far more complex than this. For example, keeping the FC can be simultaneously the result of the development of new managerial skills (DCA) and of the entrenchment of the founder (ET). We wish to feature the main links that we have established but we are well aware that there exist other possible links.

This research is focused on the French context, which has few venture-backed companies compared with US context. Because of this small scale, we had to include venture-backed companies from different sectors to get a critical size for our sample: from biotech to e-commerce companies. This heterogeneity can create some bias, especially where CEOs’ profiles are concerned, since we chose to use the same methodology for all despite this heterogeneity. Following the examples of [Wasserman \(2003\)](#) or [Boeker and Karichalil \(2002\)](#), another choice would have been to concentrate on a homogeneous sub-sector, such as biotechnology. We decided to study all start-ups financed by VCs, whatever their sector, in order to have the opportunity to explore a wider array of situations.

Moreover, considering that the phenomenon we study is FC (non-) replacement, an explicit focus on specific cases of (non-) replacement would have been more appropriate, for example by interviewing both sides of the FC–VC dyad involved in these particular cases. Unfortunately, it has been quite impossible to do so (except in one case, see appendices) given the degree of difficulty to obtain interviews in the French context where this topic is particularly sensitive. Finally, our empirical context is the French one whereas many papers on these issues are focused on the US or UK. However, this choice brings forth the question of the generalisation to other contexts.

Perspectives of research

We have broadened the range of theories that can be used as references to analyse the replacement of FCs by VCs in innovative start-ups. Nonetheless, the mobilisation of these different theories may not be exhaustive. For instance, [Heibel \(2008\)](#) argues that job matching theory and organisational psychology may provide explanations for the factors leading to founder replacement and for the impact of this practice on firm performance. The sensemaking theory ([Weick, Sutcliffe, & Obstfeld, 2005](#)) could also be relevant to study the process by which FCs or VCs fashion an understanding of the FC replacement through “the iterative testing of plausible explanations” ([Weick et al., 2005](#)). This theory could also deepen our understanding of cognitive divergence between FCs and VCs about the management of the company – analysed in this paper with the CGP of [Charreaux and Wirtz \(2006\)](#).

At the empirical level, we are considering further investigation on the nature of the managerial skills likely to persuade VCs to keep FCs in the organisation. It would also be interesting to formally show that some features of FCs’ and VCs’ profiles can determine which of the four scenarii identified will apply. First, we could consider entrepreneurial founding teams rather than single founders, and the corresponding venture capitalists’ decisions and behaviours.³⁸ Second, we could analyse how VCs’ policy may increase the probability of following one scenario rather than another; for example a VC who rarely uses FC replacement may make more efforts to attenuate cognitive conflicts than a counterpart who sees replacement as a remedy.

Other fertile areas for research include the analysis of the frequency of each scenario according to the start-up’s sector. For example, it would be interesting to know whether FC replacement is more or less likely to be observed in the biotech sector than in the e-commerce one.

Another possible direction for future research could link each scenario to a performance outcome. According to our first investigation, this link between replacement and better performance seems not to be obvious in venture-backed companies. This research agenda about the potential link between replacement and performance gives rise to a crucial issue in venture capital research: the availability of financial performance data,³⁹ and as a corollary, the issue of measuring and quantifying performance.⁴⁰ Despite these obstacles, one of our future research goals is to analyse the link between replacement and performance – that is performance from the VC’s point of view on one hand, and from the company’s point of view on the other hand – using a multi-criteria approach to measure both types of performance.

Thus, this exploratory research opens up many new perspectives for future research.

³⁸ In line with [Patzelt \(2010, p. 142\)](#) “The results of our study emphasize that investors see the human capital of the CEO not independent of the TMT surrounding her or him”.

³⁹ Access to performance data is extremely difficult as venture capital funds and their investors have no obligation to disclose information on internal return rates ([Phalippou, 2011; Phalippou & Gotschal, 2009](#)).

⁴⁰ Given the difficulty of obtaining financial performance data, scholars generally choose other criteria to quantify performance. For instance, they use a unique accounting indicator such as turnover growth rate ([Gerasymenko, 2008](#)). Company performance is even assessed thanks to qualitative data sometimes (e.g., the capacity to attract new capital) and estimated by the VCs themselves ([Bruton et al., 1997](#)). From our viewpoint, such methodological choices may incur important biases.

³⁷ The VC industry emerges after the Second World War in the USA and only at the end of the 1990s in Europe ([Kenney, 2000](#)).

Appendix A. Features of VCs of our sample

	Type	Professional experience	Position/replacement
VC 1	Senior VC	Pioneer of venture capital in France Previous chairman of AFIC ^a and FPCR ^b	Has replaced CEO as a remedy Partner in venture capital funds where some companies had CEO turnover
VC 2	Senior VC	Not a sectorial specialist Proven track record An authority among his peers thanks to a famous success story Specialised in semi-conductor field	Has never replaced a CEO Has invested in a success story where CEO has not been replaced
VC 3	Junior VC	Newcomer Reputation still to build	Does not want to replace CEO
VC 4	Senior VC	Proven track record Partner in most famous and oldest venture capital company in France Specialised in information technology	Has replaced CEO Partner in venture capital company with “ad interim management” ^c rules
VC 5	Junior VC	Newcomer Already a promising track record	Had an unfortunate experience with CEO replacement (harmful effect on VCs reputation) Intends to practice CEO replacement exceptionally in future
VC 6	Junior VC	Specialised in information technology Newcomer	Wants to follow American model where replacement is more usual. Replacement as a remedy
VC 7	Senior VC	Specialised in information technology One of pioneers of venture capital in France Senior member of AFIC	Has replaced CEO Partner in venture capital funds where some companies had CEO's turnover.
VC 8	Junior VC	Not a sectorial specialist Newcomer Specialised in biotechnology	Does not want to replace CEO Use in very rare exceptional cases Invested in two biotech firms created by FC n°4

^a AFIC: Association française des investisseurs en capital (French National Venture Capital Association).

^b FPCR: Fonds Public du Capital-Risque (Public Fund of Venture Capital).

^c “Interim management” is the temporary provision of management resources and skills. Interim management can be seen as the short-term assignment of a proven interim executive manager to manage a period of transition, crisis or change within an organisation, such as the replacement of CEO.

Appendix B. Features of the FCs of our sample

	Type	Professional experience	Position / replacement
FC 1	Senior CEO/CFO	Previous CEO of biotech start-up CFO of big French biotech firm	Has been replaced by VCs Now CFO in a biotech where FC never been replaced
FC 2	Senior CEO	Has created biotech start-up Managed post-replacement start-ups (specialises in transition between founders and new CEOs)	Has been replaced by VCs Missions in companies where replacement just happened
FC 3	Senior CEO	Has created biotech start-up seen as success story	Never been replaced (15 years)
FC 4	Senior CEO	Previously FC of biotech start-up Now FC again of another biotech start-up	Has been replaced by VCs “Serial entrepreneur” profile VC n°8 investor in both his former and new biotech start-ups
FC 5	Senior CEO	Previous FC of biotech start-up Now CEO of another FC's biotech start-up	Has been replaced by VCs Has worked in business incubator Has been recruited as CEO in replace other FC
FC 6	Junior CEO	FC of Internet start-up	Never been replaced (6 years)
FC 7	Senior CEO	Serial entrepreneur Now FC again of Internet start-up	Never been replaced by VCs Holds CEO position in 2 start-ups and delegates his position in another 1
FC 8	Junior CEO	FC of high-tech start-up	Never been replaced by VCs (9 years)

CFO = Chief Financial Officer.

We also interviewed one headhunter specialised in handling CEO profiles for biotech companies.

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