Private Equity investment performance : Do social ties between venture capitalists and CEOs matter

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ABSTRACT

Our area of interest is the relationship between Private Equity professionals and the CEOs of companies. Building on previous research on board-CEO relationship and on venture capital and management buyout governance, we aim at complementing the frequently used agency theory perspective by way of a social and behavioural perspective.

Whereas agency theorists underline the role of independence between management and board, we think the success of private equity professionals lies in their ability to combine independence and control with trust, cooperation and support in their relationship with CEOs.

The existence of social ties between VCs and CEOs is expected to produce antagonistic consequences, fostering cooperation and support but hampering control. We propose an original model formalising the relations between VC-CEO social ties, board processes, VC's roles vis à vis CEOs, and investment performance.

KEY-WORDS: Private Equity, Venture Capital, Management buy-outs, corporate governance, board of directors, CEO, trust.

RESUME

Nous basant sur les travaux concernant la relation entre dirigeants et membres du conseil d'administration, et les modes de gouvernance des capital investisseurs, nous proposons de compléter la perspective de la théorie de l'agence par une perspective théorique de nature sociale et comportementale.

Alors que la théorie de l'agence souligne quasi-exclusivement l'importance de l'indépendance entre administrateurs et dirigeants, nous pensons que les capital investisseurs sont capables de concilier indépendance et confiance, coopération, support vis à vis des dirigeants.

Selon la perspective théorique choisie, l'existence de liens sociaux entre capital investisseurs et dirigeants peut produire des effets contradictoires, favorisant la coopération mais défavorisant le contrôle. Nous proposons un modèle visant à formaliser les relations entre (1) les liens sociaux entre capital investisseurs et dirigeants, (2) les processus et les rôles qui caractérisent leur relation, et (3) la performance des investissements.

MOTS-CLEFS : capital investissement, capital risque, LBO, gouvernement d'entreprises, conseil d'administration, dirigeant, confiance.

INTRODUCTION

The relationships between shareholders, board members, and managers are certainly the most frequently studied in the corporate governance literature. The last 20 years have seen the progressive adoption by companies in Europe and North America of corporate governance methods grounded on postulates issued from organizational economic theories (principally agency theory and transaction costs theory).

The main postulates of these methods are two fold:

(i) the main objective of a company is the creation of shareholder value, which is by consequence the essence of the mandate given to managers by shareholders.
(ii) given the opportunism of managers and the information asymmetry between them and shareholders, managerial control methods need to be used in order to incite and/or compel managers to act in the interest of shareholders.

Hence agency theorists tend to recommend[1] – amongst other features- a strong control by the board of top management, reward for performance systems, and equity participation by management (either directly or through stock option plans).

It is to be noted, however, that the impact of the above methods on company performance is not established by empirical research, which gives mixed and contingent results (see 2.1 below).

Michael Jensen (1989), an initiator of agency theory, argued that the traditional organisation form of the US public company may be replaced, mostly in mature sectors, by other types of organisations capable of handling more efficiently the conflicts between shareholders and managers. Management Buyouts (MBOs) specialists were mentioned as the main actors of this transformation through methods based on high financial leverage, reward for performance systems, equity participation for managers and board members (directly or through stock option plans), and contracts aiming at reducing the waste of cash flow.

As regards venture capital[2], numerous academic publications underline the governance methods adopted by venture capitalists in the post-investment phase: active participation in the board, strict control of management action plans and results, advice to management in many areas including strategy formulation, personal support given to management (MacMillan & al. 1988, Gorman & Sahlman 1989, Sapienza & Timmons 1989, Rosenstein & al. 1993, Fried & Hisrich 1995, Steier & Greenwood 1995).

The methods used by MBO and venture capital firms since the ‘80s have since spread in many public and private companies throughout modern economies. An illustration of this trend is given by *The Economist* (August 7, 1999 issue) report on the tremendous rise of stock options granted to top managers in the last decade, both in the US and in Europe.

[1] As Donaldson (1990) mentions, agency theory tends to be both of positive and normative nature.
[2] We use in this paper the terminology proposed by the European Venture Capital Association. Private Equity refers to equity investment in private companies and covers broadly two areas: Venture Capital, which concerns start ups and early stage financing, and MBO’s which generally concern mature companies. The term “venture capitalist” (VC) refers, unless otherwise indicated, to professionals being part of either venture capital firms or MBO firms.

We believe, therefore, that private equity, as a pioneer industry of many contemporary corporate governance methods, constitutes a fascinating field for the study of the relationship between managers and board members.

The remainder of this paper is organised in three sections. Section one discusses the nature of the relationship between board members and managers. Section two presents a review of the literature on venture capitalists governance. Section three presents a proposed model of the link between VC-CEO social ties and investment financial performance. We conclude the paper in the last section.

1. The relationship between board members and managers

1.1. Research on boards of directors: studying demographics or processes?

As mentioned by Forbes and Milliken (1999) a vast majority of the studies concerning boards of directors are based on agency theory and, unsurprisingly, focus on such demographic and economic characteristics of boards as size, composition (outside directors vs insiders), and compensation of board members. We consider this as being a very important limitation of existing research on boards in the managerial science literature. Only a very limited number of studies consider the way the board actually works, i.e. the processes used and the relationships existing between board members (Westphal, 1999).

The links between board demographics and economics on one side, company performance on the other are complex and indirect, and the above mentioned limitation may explain why the empirical results aiming at putting these links in evidence are so mixed (Charreaux 1997, Barkema & Gomez-Mejia 1998, Pochet 1998).

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In other words we believe that, a board being a group of individuals, the performance of the work it produces is not only dependant on demographic and economic features, but also on group dynamics, involving processes and relationships among members. A field of research, infrequently explored, exists here. Exploring this field requires, as a complement to the organisational economic theories, the use of social and behavioural theories. This is consistent with Eisenhardt (1989) who, taking into account the relative limitation of agency theory postulates on human behaviour, encourages scholars to use other theories as complement of agency theory,

As an introduction to our research project we describe below two alternative models of managers-board members relationship: the independent board model and the cooperative board model.

1.2. The independent board model

In this model, based on agency theory, the board's essential function is to control and monitor top management. In this regard the role of independent board members is crucial, particularly in public companies with a diffused capital. Independent board members –compared to board members dependent on management through personal or professional social ties- are supposed to be more efficient in the defence of shareholders interest vis à vis management opportunism, and more active in the control of management decisions and of company performance (Jensen & Meckling 1976, Charreaux 1997), as depicted below:

The independent board model:

board members independence → board control efficiency → company performance

The independent board model has been tested in numerous empirical studies on public companies, with mixed results (Charreaux 1997, Pochet 1998, Westphal 1999). The positive relation between board independence and board control efficiency is confirmed in a majority of studies, but this is not the case for the relation between board independence and company performance.

1.3. The cooperative board model

In this model, as illustrated below, the board is not limited to a controlling and monitoring device, but it is also considered as a decision making group, particularly in the field of company strategy (Forbes & Milliken, 1999, Westphal, 1999). Board members have a consulting and supporting role vis a vis top management, and the existence of an efficient cooperation between management and other board members is key to company performance. The board is considered as a social structure and the existence of trust and/or social ties between board members and managers is believed to foster cooperation between them.

The cooperative board model:

board members dependence (social ties) → board consulting efficiency → company performance

This model is consistent with numerous studies which stress the importance of the social aspect of business relationships (see for example Larson & Starr, 1993, who propose a model of company formation based on the personal social network of the founder).

It is grounded on two families of theories: the resource dependence theory (Pfeffer & Salancik, 1978) in which the role of the board in company strategy, and particularly as a means of securing key resources, is stressed, and the behavioural and social theories and models such as procedural justice theory (Sapienza & Koorsgard, 1996), the prisoner's dilemma model (Cable & Shane, 1997), social exchange theory (Barkema, 1995) and theories of trust (Morgan & Hunt, 1994, Lewicki & Bunker, 1996, Guibert, 1999, Wicks & al., 1999).

Westphal (1999) stresses the importance of social ties ("dependence") between board members and managers, as these tend to foster trust, openness, and cooperation, and hence to favour the strategic consulting role of the board. The survey he made on public US companies confirms the impact of social ties on the board consulting efficiency and on company performance.

1.4. Venture capitalists governance: combining independence and cooperation leads to success?

Venture capitalists and MBO specialists (VCs) seem to be able to combine the independent and cooperative models.

> <u>They can generally be considered as independent board members.</u> The funds which they manage hold large –and often controlling- shareholdings in companies, and they consequently have the power to appoint and dismiss top managers. The literature on VC governance shows that VCs are in most cases board members, and very active ones (Fried et al., 1998, Gorman & Sahlman, 1989). In addition, as mentioned in Sahlman (1990), their interest is not confounded with management interest. Their personal employment contracts include reward for performance systems generally based on the overall financial return of the funds they manage. In their decisions (for example to re-finance a distressed investee company), they unsurprisingly tend to favour their relationship with the investors who provide them with money rather than their relationship with the managers of a given company.
>
> <u>They can also be considered as cooperative board members</u>. The literature (see chapter 2.3 below) shows the great importance they grant to cooperation with managers, and to their own consulting and interpersonal roles, such as being mentors, coaches, sometimes friends, vis a vis managers.

This combination of two models, which at first sight may seem antagonistic, triggered our interest for venture capitalist governance, and, more precisely, for the various aspects of the relationship between VCs and managers. Moreover, this suggests an interesting research question*: Does this ability to combine independence with trust and cooperation have an impact on the performance (in terms of financial returns) of venture capital and MBO investment*?

2. Venture capitalists governance: a review of the literature

In this section we first present the three areas of research which we have identified in the literature concerning venture capitalists and MBO specialists governance. We then suggest some possible tracks for future research.

The three areas of existing research are the following:

- the roles and value added of VCs: What are the roles of the VCs, in the post-investment phase, vis a vis the companies they finance and their managers? Which are the more important roles as perceived by VCs and managers? What is the impact of VCs actions, especially on company performance?

- the determinants of VCs roles: Do VCs adapt their roles to circumstances and as a function of which factors?

- the cooperation between VCs and top management: With which models can the relationship between VCs and managers be described? Which factors have an influence on the cooperation between them?

2.1. The roles and value-added of venture capitalists

2.1.1. A new typology of roles

MacMillan et al. (1998) and Sapienza & Timmons (1989) have proposed two typologies frequently used by other authors. However, they only partially recoup, that is why we propose a third, more complete, typology, regrouping VCs roles in three dimensions:

- consulting roles consist of strategic consulting roles (participation to strategy formulation and implementation), financial consulting roles (including for example assistance in the raising new funds from banks or shareholders), and operational consulting roles (for example assistance in the hiring of new people, in the identification of customers, suppliers, or advisors);

- controlling roles consist of the activities that enable VCs to control that managers act in line with the agreed upon strategy and the interest of shareholders. They consist of the review of plans, budgets, and of actual results, and the control on key decisions such as major investments or recruitments.

- interpersonal roles cover the social, and sometimes affective, roles of VCs with managers: mentor, coach, confident, provider of emotional and moral support, friend.

2.1.2. VCs perception of role importance: consulting roles come first

MacMillan et al. (1988) and Sapienza et al. (1996) have sought to establish a ranking of the roles by questioning VCs. Although the typologies used differ, we can draw some general conclusions from their work:

- two roles emerge as being the most important for VCs both as regards their perceived involvement and perceived efficiency. They are “consulting roles”: *sounding board* [3] and, in second place, *assistance in obtaining new sources of financing;*

- the strategic consulting roles are generally ranked above the operational consulting roles, which is consistent with the Fried et al. (1998) findings that VCs are much more involved in strategy formulation and evaluation than board members of public companies;

- national specificities seem to exist in the perception of role importance. According to the only multi-country study available (Sapienza et al., 1996), French and Dutch VCs seem to have a more “financial” profile than their Anglo-American colleagues, granting more importance to financial consulting roles and less importance to *sounding board* and to interpersonal roles;

- the studies available do not permit the direct comparison of the ranking of controlling roles and interpersonal roles.

2.1.3. Managers and VCs perception of VCs’ roles are broadly consistent

The two US studies available (Sapienza & Timmons, 1989 and Rosenstein et al.,1993) show a great proximity between managers and VC perceptions. However two differences are shown by Rosenstein et al.:

-first, managers give lower rankings than VCs to the strategic consulting roles. It therefore seems that VCs have a higher perception of their contribution to strategy than managers have.
- secondly, managers give a much higher importance (compared to VCs) to the role VCs have in assisting the company in its interactions with other equity investors (interfacing with investors group).

2.1.4. The value added by VCs: mixed evidence

Do VCs add value to the companies in which they invest? The literature gives mixed results and shows that value added is dependent on various factors.

A first way to attempt to answer this question is to study the link between the level of VC involvement in monitoring companies and the performance of these companies. MacMillan et al. (1988) fail to establish a relation: the performance of companies monitored by “laissez faire” VCs is not significantly different from that of companies monitored by VCs with a high degree of involvement.

Another way is to ask for the opinion of managers. Rosenstein et al. (1993) show that managers do not consider that VCs have a higher contribution than non VC external board members, except for VCs belonging to the top US VC firms. Moreover, the opinion of managers on VC’s contribution is not correlated to company performance, which is also the case in Barney et al. (1996).

[3] One can note that the *sounding board* role, described by Sapienza et al. (1996) as *“Listens, responds objectively, frankly, and truthfully”* may also be considered part of the “interpersonal” roles.

Sapienza (1992) gives more positive conclusions on the value added by VCs, establishing a positive relation between VC's value added (as perceived by both managers and VCs) and, respectively, company performance, and the frequency and openness of VC-managers interactions.

All the above studies use a similar methodology (mail questionnaires). The mixed results may be partly caused by differences in the samples (for example Rosenstein & al. have questioned CEOs of high tech firms only whereas all sectors were included in the other studies), and in the operationalization of variables (for example the measure of performance is based on perception in MacMillan & al., in Rosenstein & al. and in Sapienza whereas it is based on accounting measures in Barney & al.).

2.2. Adaptation to risk: the determinants of venture capitalists roles

Some authors have tested the links existing between VCs roles and behaviour, and the characteristics of the companies and of the managers they monitor, especially as regards two kinds of potential risks: *agency risks* (risks of opportunistic behaviour of managers which may be adverse to shareholders interest), and *business risks* (risks linked to the nature of the company: industry, stage of financing, managers experience level,…).

These studies are based on the general hypothesis that VCs are conscious of these risks and try to adapt their behaviour in consequence. The results do not clearly confirm this assumption: when risk level is high, VCs tend to use contracts enabling a stronger control on management (Barney et al., 1989), to reinforce their presence on the board (Lerner, 1995), and to increase the frequency of interaction with managers (Sapienza & Gupta, 1994, Sapienza et al., 1996). But it is to be noted that the correlation coefficients are often low, and that some results do not show evidence of the expected links between risk and VC behaviour.

2.3. The necessary cooperation between venture capitalists and managers

In these studies cooperation is generally considered to be fostered by (1) agreed upon and respected information exchange procedures, (2) open and trustful interpersonal relationships.

Sapienza & Koorsgard (1996), using procedural justice theory, show the relation existing between the level of VC satisfaction with the information procedures used by companies and the level of trust and support they accord to managers. An interesting and paradoxical conclusion of their work is that managers can gain more freedom by simply fulfilling the information needs of their shareholders.

Using the prisoner's dilemma metaphor, Cable & Shane (1997) propose a model incorporating the main factors which can impact on the decision of VCs and managers to cooperate (on the prisoner's dilemma metaphor, see also Axelrod, 1992). The factors are:

personal similarity: prisoner's dilemma research has shown that cooperation is favoured if the other party is perceived as similar to oneself.

information exchange: cooperation is enhanced when information about the cooperative strategy of one party can be gathered easily by the other. Two factors that affect information transfer are communication and social relationships between the parties.

time pressure: the greater the time pressure to reach an agreement, the more likely parties are to reach a cooperative solution. Time is a component of financial returns, and is therefore important for VCs. In addition VCs have commitments towards their investors to invest and divest the funds they manage within a limited period of time.

payoff to cooperation: cooperation can be enhanced by increasing payoffs from cooperation. Most VC transactions occur because both parties are expecting high potential gains from cooperation.

transaction procedures: Prisoner's dilemma research has established that certain procedures can be implemented to increase the probability of cooperation, particularly in the early stages of the relation, when the parties generally do know and do not trust each other. Example s of such procedures in VC are non-compete clauses or antidilution clauses granted by management,

The high importance granted by VCs to social ties and mutual trust with managers is underlined by many authors, as illustrated by the following statements:

Fried & Hisrich, 1995 (p.106):
(quote of a VC interviewed)

> *« It's really the personal relationship that you develop with the guy running the company and his team and other directors. [You have influence] if they conclude that you are an interesting person committed to the success of the company, that you're going to work hard at it, that you're not going to try to run it, that you're going to be very open, and that you think clearly and communicate clearly and are just a valuable person to have around."*

Sapienza et al.,1994 (p.15):

> *« The fact that interpersonal involvement is accorded more importance than operational involvement […] is particularly fascinating. It suggests that functions such as energizing and motivating management, sharing psychological risk and trauma, and being a friend and confidant end up being more important than providing a network of contacts, a benefit so often mentioned by venture capital firms attempting to attract business. The apparent level of trust which must develop to make this succeed belies a now old image of venture capitalists as "vulture capitalists"*

Steier & Greenwood, 1995 (p.351):

> *"One venture capitalist flippantly described the value of the unique emotional support he was able to provide: "Who can an entrepreneur talk to about his problems? He can't talk to his wife – she'll leave. He can't talk to his employees – they'll quit". […] In many ways, supportive venture capitalists can provide the emotional as well as business support which independent entrepreneurs require".*

The “cooperative board” model, as described in paragraph 1.3 is particularly well illustrated by these statements. Dimensions such as cooperation, trust, and personal support, seem to be key in the relationship between managers and VCs. This confirms our view that considering the board of directors only as a controlling and monitoring device (as illustrated by the “independent board” model), which is the case of the vast majority of corporate governance literature on boards, is incomplete and misleading.

2.4. Suggested research areas

The review of literature , in the previous sections, shows that the knowledge on VC governance is still incomplete in many areas, and that there are many interesting tracks for future research. In what follows, we propose four possible research areas.

Proposing and testing a comprehensive typology of VC’s roles

partial and do not permit a comparative ranking of the importance granted by VCs and by managers to controlling roles and to interpersonal roles.

Enriching knowledge on country specific governance methods

In the only international comparative study on VC’s governance available, Sapienza et al. (1996) mention the specificities of French and Dutch VCs. One may think that, with the progressive internationalisation of the private equity industry, mostly under the domination of Anglo-American firms, these specificities will fade out. However, further research may help to validate, detail, and explain these specificities.

Enriching knowledge on VCs’ value added and its determinants

The relations between VCs’ value added and their level of involvement, on one hand, and company performance, on the other hand, appear to be not consistently established by empirical research. Moreover these studies have only been conducted on US companies. A research field exists here, particularly in countries other than the US.

Exploring the role of trust and social ties in VCs-managers relationship

<u>Trust</u>
We mentioned above the importance granted to trust by VCs. Trust has been an area of considerable interest in managerial science in recent years, particularly in marketing (see the review of literature by Guibert, 1999) and in organization science (Lewicki & Bunker, 1996). The role of trust has been studied in various non hierarchical relationships (Burt & Knez, 1996, Shepard & Tuchinski, 1996), but not, as far as we know, in CEO-board relationship.

Two kinds of hypotheses can be made about the positive impact trust may have on CEO-board relationship:

on the cognitive side, the presence of trust may enhance the openness of communication, which could benefit both management (who can derive more value added from board advice) and other board members (whose controlling role is made easier);

on the interpersonal side: trust may favour the interpersonal roles of board members vis a vis managers.

Trust may be expected, thus, to have a positive impact on performance. But we also know that an overinvestment in trust ("blind" trust) can be dangerous and favour opportunistic behaviour. Therefore, building on Wicks et al. (1999) "optimal trust" model, further research could examine whether VCs adapt their investment in trust to circumstances (business risks, agency risks, level of dependence vis à vis management,…) and could help to establish whether the level of trust has an impact on investment performance.

Social ties

As mentioned above (1.2 and 1.3) VC-CEO social ties can be expected to have a negative impact on performance, according to the independent board model, or a positive one according to the cooperative board model.

The literature suggests that the impact of social ties on performance mediates through VC-CEO processes (for example information exchange procedures) and through VCs roles vis à vis CEOs (for example the level of controlling or consulting roles). Therefore, a model formalising the influence of social ties on investment performance through processes and roles could be proposed and tested.

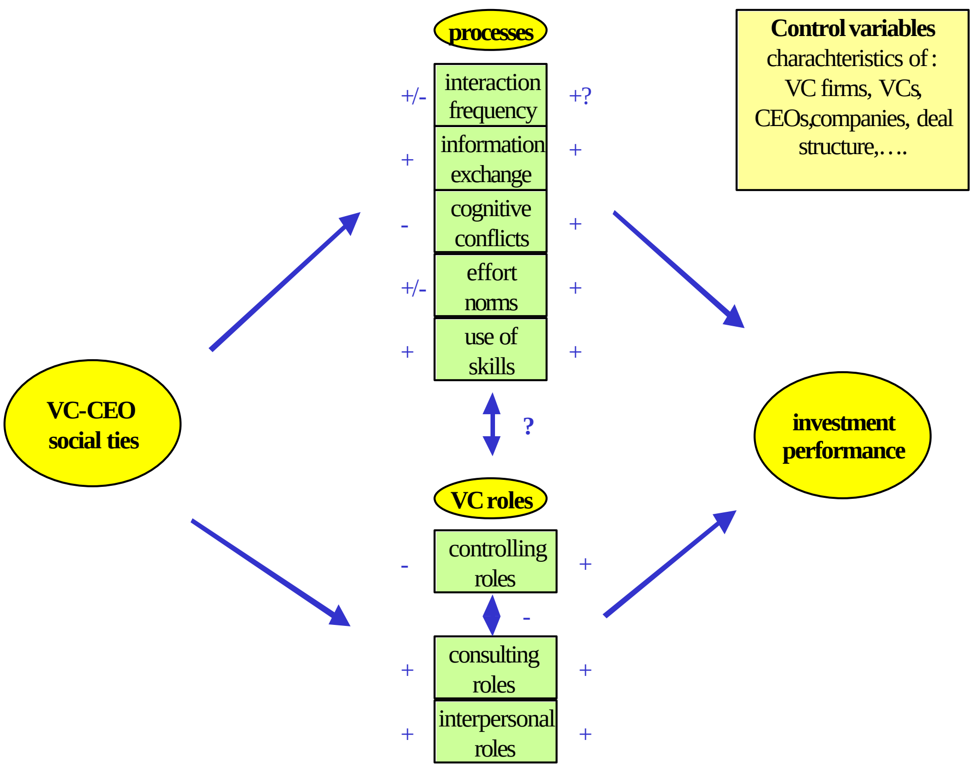
3. Proposal of a model linking VC-CEO social ties and investment performance

We think that a distinctive feature of private equity specialists is their ability to combine, as board members, the independent and cooperative models described above in part 1. In an attempt to help understand how this combination works and what are its consequences, we propose the model described below.

This model constitutes an attempt to formalise the influence of social ties between VCs and CEOs on the *processes* which characterise their relationship, on the *roles* that VCs play vis a vis CEOs, and, through processes and roles, on *investment performance*.

3.1. Proposed model

Model linking social ties, processes, VC roles, and performance



3.2. Model variables and hypotheses

3.2.1. Variables

We consider in the model **social ties between VCs and CEOs as the independent variable**. Based on the theoretical background and review of literature exposed above, our proposal is that VC-CEO social ties have an influence on investment performance through two types of **mediating variables**:

a-**the processes between VCs and CEOs**, particularly as the board is concerned. Building on the literature on boards and on VC-CEO relationship, we have identified 5 process variables (see Sapienza & Koorsgard, 1996, Cable & Shane, 1997, Forbes & Milliken,1999):

frequency of contacts between VCs and CEOs,

quality of information transmission procedures: are VCs and CEOs satisfied with the way they exchange information (for example VCs are often dissatisfied with the timeliness and content of the reporting made by investee companies),

effort norms, which refer to the group's shared beliefs regarding the level of effort each individual is expected to put forward a task,

cognitive conflicts, which consist of task-oriented differences in judgement among group members about the content of a task or the way to handle it,

use of board member skills, which refers to the board's ability to use the knowledge and skills of its members and to apply them to its tasks.

b-**the roles of VCs vis a vis CEOs.** Our review of literature on VCs governance leads to the identification of three types of roles (see 2.1.1 above):

- <u>consulting roles</u> consist of strategic consulting roles (participation to strategy formulation and implementation), financial consulting roles (including for example assistance in the raising new funds from banks or shareholders), and operational consulting roles (for example assistance in the hiring of new people, in the identification of customers, suppliers, or advisors);

- <u>controlling roles</u> consist of the activities that enable VCs to control that managers act in line with the agreed upon strategy and the interest of shareholders. They consist of the review of plans, budgets, and of actual results, and the control on key decisions such as major investments or recruitments.

- <u>interpersonal roles</u> cover the social, and sometimes affective, roles of VCs with managers: mentor, coach, confident, provider of emotional and moral support, friend.

The dependent variable is investment performance, i.e. the absolute (or relative to plan) internal rate of return of the VC investment.

Control variables: as investment performance is obviously dependent on many different factors, a number of control variables need to be measured. They include data on private equity firms (size, type, country of origin), VCs (age, country of origin, previous experience, reward system), CEOs (age, country of origin, previous experience, reward system), VC-CEO previous social ties, portfolio companies (size, industry, technological intensity, agency risk, business risk, financial risk), deal characteristics (size, date of execution, equity structure, board composition).

The main hypotheses underlying the model are detailed below.

3.2.2. Links between social ties and processes

H1a *Strong social ties are positively associated with the frequency of interaction*
One can assume that individuals linked by strong social ties will meet more frequently, and that shared experience and frequent contacts may help to develop trust and social ties inside an organisation (Powell, 1996).

H1b *Strong social ties are negatively associated with the frequency of interaction*
Agency theory suggests that independent board members, aiming at exerting an intense control on managers, tend to meet them more often than "dependent" board members (Charreaux, 1997). As shown in the literature, VCs tend to adapt their behaviour to the risk they perceive, by meeting managers more often when risk increases (Sapienza & Amazon, 1993, Sapienza & Gupta, 1994).

H2 *Strong social ties are positively associated with satisfaction with information exchange procedures*
The mutual trust associated with strong social ties may encourage CEOs to be more open as regards information exchange (Westphal, 1999), and consequently to follow the agreed upon procedures as regards board information timing and content. The fact that VCs are satisfied with the information procedures can, in addition, increase their trust in the CEO (Sapienza & Koorsgard, 1996).

H3 *Strong social ties are negatively associated with cognitive conflicts*
Forbes & Milliken (1999) show that the existence of cognitive conflicts inside the board can increase the board efficiency in strategic decision making, by encouraging the review and assessment of various possible actions. But they mention that cognitive conflicts may have a negative impact on board cohesion and on board members satisfaction.
Therefore, we can expect that the existence of strong social ties may encourage board members to reduce the frequency and the intensity of cognitive conflicts, in order to preserve the quality of their relationship with the CEO, whereas independent board members may be less reluctant to provoke cognitive conflicts if they consider it necessary.

H4a *Strong social ties are positively associated with board effort level*
Strong social ties are believed to encourage, through mutual trust and openness, an active cooperation between board members and CEOs, particularly as strategic decisions are concerned (Westphal, 1999), which may foster a high effort level in the board.

H4b *Strong social ties are negatively associated with board effort level*
Agency theory suggests that independent board members will tend to be more active and more involved in the board tasks (particularly as monitoring and control are concerned) than dependent ones (Charreaux, 1997).

H5 *Strong social ties are positively associated with an efficient use of board member skills and talents*
The ability of a group to cooperate and to learn collectively , which we may assume to be favoured by the existence of strong social ties between members, has a positive impact on the expression and use of the skills and talents of its members (Forbes & Milliken, 1999).

3.2.3. Links between social ties and VC roles

H6 *Strong social ties are negatively associated with the controlling roles of VCs*
This is a fundamental hypothesis of agency theorists. As Charreaux wrote: «…the efficiency of the control from the board [on top management] is supposed to lie upon the mutual oversight by managers one hand, and on the presence of external board members (non affiliated with management) on the other hand» (Charreaux, 1997, p.150)[4].

H7 *Strong social ties are positively associated with the consulting roles of VCs*
This hypothesis is largely developed and empirically confirmed by Westphal (1999): strong social ties foster the cooperation between board members and CEOs and demand by CEOs of advice from board members.

H8 *Strong social ties are positively associated with the interpersonal roles of VCs*
We can assume that roles such as mentor, coach, confident (and, evidently, friend) may be favoured by the existence of strong social ties. These ties are expected to contribute to the establishment of the mutual knowledge and trust that may favour interpersonal roles.

H9 *Controlling roles are negatively associated with consulting and interpersonal roles*
Using social exchange theory, Barkema (1995) shows that, when principal and agent are characterised by frequent contacts, which is generally the case between VCs and CEOs, a high level of control by the principal on the agent may be counter productive. If control is excessive, the agent may consider that the social exchange contact which links him to the principal is broken, and, therefore, may reduce his effort level and his openness to cooperation. We may also expect that a high level of control by VCs is incompatible with the development of interpersonal roles.

[4] The original French text is: « …l'efficacité du contrôle du conseil d'administration [sur les principaux dirigeants] est censée reposer d'une part, sur la surveillance mutuelle entre dirigeants présents au conseil, et d'autre part, sur la présence d'administrateurs externes (non affiliés au management) ». English translation by the author of the present paper.

3.2.4. Links between processes and investment performance

H10 *The frequency of interaction is positively associated with performance*

This hypotheses is cautiously proposed, as the literature shows mixed evidence on this association (see2.1.4). Contrary to expectations derived from agency theory, Mac Millan et al. (1988) failed to establish a link between monitoring intensity by VCs and performance.
An explanation of these findings may lie with causality: if one can expect that a high monitoring level has a positive effect on performance, one can also suspect that increased risks and difficulties (which may produce, "in fine", lower performance) met by investee companies tend to encourage VCs to increase their monitoring level (Barney & al., 1994).

H11 *The quality of information exchange is positively associated with performance*
We can assume that the board will be able to produce a better work, and particularly to take better strategic decisions, if board members are correctly informed on the company and on its environment by management.

Hypotheses 12, 13, and 14 are derived from group dynamics and board efficiency literature (Guzzo & Shea, 1992, Forbes & Milliken, 1999). They are:

H12 *Cognitive conflicts are positively associated with performance*
Cognitive conflicts between the members of the board are expected to contribute to the quality of strategic decision making, because they result in the consideration and careful evaluation of different alternatives before any decision is taken. In addition, the presence of disagreement in the board require CEOs to explain, and sometimes modify his proposals.

H13 *High effort norms are positively associated with performance*
If high effort norms prevail in the board, one can expect that board meetings will be regularly attended and well prepared by members, which should lead to better quality meetings and to better decisions.

H14 *The use of board members' knowledge and skills is positively associated with performance*
One may expect that better collective decisions will be reached if each member brings on the table his specific knowledge and skills, in a cooperative way, within the board, when various alternatives are exposed and debated.

3.2.5. Links between VC roles and investment performance

H15 *VC controlling roles are positively associated with performance*
Agency theorists have largely developed, and empirically tested, the hypothesis that a high level of monitoring by board members has a positive impact on company performance (see Fama & Jensen, 1983, Charreaux, 1997). The rationale behind this hypothesis is that independent board members are supposed to exert a stronger oversight and monitoring on management than "dependent" board members.

H16 *VC consulting roles are positively associated with performance*
Many authors in the organisational and corporate governance literature have underlined the value of the advice which board members give to managers, particularly as regards the information and control of the corporate environment (Pfeffer & Salancik, 1978), and the strategy formulation (see Westphal, 1999, and his review of literature on the "cooperative board" model).

H17 *VC interpersonal roles are positively associated with performance*
The importance that VCs and managers grant to these roles clearly appears in VC governance literature (Sapienza & al., 1994, Steier & Greenwood, 1995). For example Sapienza & al. (p.15) mention the importance for VCs of *"…functions such as energizing and motivating management, sharing psychological risk and trauma, and being a friend and confident…"*. We would expect that they grant importance to these roles because they think they are key to performance. Our personal experience in private equity showed us that support from board members can be key to CEOs, particularly in medium and small size companies.

Conclusion

Building on the existing literature, we propose to complement the agency theory perspective, which is largely dominant in corporate governance research, by social and behavioural theories, which have the merit of shedding light on the way the board actually works as a group composed of individuals who have tasks to meet, and who establish processes and interpersonal relationships between them.

We propose to apply our approach to the case of private equity, as private equity specialists seem to have been the pioneers of some very successful governance methods, and as they seem to be able to successfully combine independence and cooperation with CEOs.

An important limit of our model may lie in the causality issue. Both on a theoretical and intuitive basis, many associations between the model variables can be doubled sided (for example strong social ties are expected to favour a high frequency of interaction, but a high frequency of interaction may be expected to favour the emergence of trust and of strong social ties). We need to assess further the theoretical and practical consequences of this issue.

Trust (i.e. interpersonal trust between VC and CEO) is indirectly present in the model as it underlies many of the hypotheses. However, trust does not appear explicitly as a variable. We need to consider more deeply if and how trust could be incorporated in the model, or if another model could be built using trust as the independent variable.

The future research that we intend to pursue is the empirical test of the model. We propose to operationalize the model variables and to measure them through a questionnaire to French VC-CEO dyads. Our research design is briefly described in Appendix.

APPENDIX

Summary of proposed research design

Research issues

Do social ties between VCs and managers influence:

-the processes of their relationship, particularly as the board is concerned: frequency of contacts, information transmission procedures, effort norms, cognitive conflicts, use of board members skills;

-the roles of VCs vis a vis managers: compared importance of controlling, consulting and interpersonal roles;

-via processes and roles, the performance of VC's investments in companies?

Theoretical framework

Agency theory, in which the board appears essentially as a control device, particularly through the action of independent board members.

Resource dependence theory, which underlines the role of the board in company strategy, particularly as a mean of securing key resources.

Social and behavioural theories and models (procedural justice, prisoner's dilemma, theories of trust, social exchange theory) which can help to study the board processes, the behaviours and the mutual relationships of board members, and the factors influencing board-management cooperation.

Methodology

Test of an original model formalising the relations between VCs-management social ties, processes, VC's roles, and investment performance.

Operationalisation of variables

Investment performance (explained variable):	-absolute and/or relative (to initial plan) IRRs
	-VCs and CEOs perception
Processes, VC's roles (mediating variables):	-questions to VCs and CEOs
VC-CEO social ties (explaining variable):	-questions to VCs and CEOs

A number of control variables will also be gathered through the questionnaire and using secondary data (characteristics of private equity firms, of MBOed companies, of VCs, of CEOs).

Data gathering

Questionnaire of VC-CEO dyads, members of the board of the same company.

Company population: all French companies on which a MBO was initiated in 1998 and 1999 (approx. 600).

Data analysis methods

Correlations between variables, Interrater analysis, Multiple Linear Regression, Structural Equation Modelling

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