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From Corporate governance to the Genesis of Cascade private equity governance: a theoretical analysis of the main research.

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Abstract: *The purpose of this research is to analyze the evolution of approaches to corporate governance in private equity firms. Our literature review is in line with the main disciplinary and strategic trends in governance. In this article, we study information asymmetry in private equity firms from the perspective of agency theory and the cognitive contribution of limited partners in these complex organizations. The results of the research work find lead to interesting deductions as to the nature of the governance system in private equity, namely the intersection of disciplinary and strategic approaches.*
Key Word*: Cognitive Contribution; Limited partners; Governance; Private equity.*

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I. Introduction

Private equity is distinguished not only by the way in which this industry offers specific financing tools for the creation and development of companies but also by the way in which this asset class is governed at the level of the investor portfolio (Alaoui and Bikhzazen , 2020). Although, the private equity includes a “downstream” part concerning the financing of target companies and a second “upstream” part offering private equity companies the funds necessary for this financing. This study of the private equity governance system requires the analysis first the governance of private equity companies and portfolio companies from a disciplinary perspective, then the governance of this cascade organization from a cognitive perspective.

Moreover, the partnership relationship between LPs and GPs within private equity companies (Pilar and al, 2020) gives rise to a close analysis of this partnership by identifying the mode of governance of these managerial companies in the framework of disciplinary and strategic approaches. Indeed, our research sheds light on the complexity of the governance of this type of organization according to the two aforementioned currents. As part of the disciplinary approach, our study highlights the informational asymmetry born of the relationship between the limited partner (shareholder in private equity companies) and the General partner (manager of private equity companies) on the one hand, and the relationship born between these same General partners (shareholder) who finances the target companies on the other hand. Moreover, our literature review is interested in these two levels of relations (LP-GP and GP-Target leader) within the framework of the strategic stream of governance.

II. The birth of cascading information asymmetry in private equity

According to Fontenay (2019), the definition of the mode of governance of private equity firms lies in the nature of the partnerships themselves and in the structure of the agreement of this partnership. The most common organizational structure in the private equity industry in the United States and in many European countries is the Limited Partnership, considered as an investment vehicle in the form of investment funds with a fixed life (Alaoui and Bikhzazen, 2020). The Limited Partnership is a legally defined structure and seen as an attractive vehicle for investors mainly because of liability and for tax reasons (Gompers and Lerner, 2001). Through this partnership, the investors (LPs) delegate to the fund manager (GP) the responsibilities of selecting, structuring, managing and liquidating investments in portfolio companies. However, LPs are vigilant with regard to management efficiency through which the manager should safeguard their interests (Brown and al, 2020).

Many authors (Sahlman, 1990; Weinberg, 1994; and Gompers and Lerner, 2001) find that among the most obvious situations where the manager could promote his own interests to the detriment of those of the investors are the monitoring and control efforts little provided to portfolio companies, the excessive burden of management fees, the high risk-taking of investments and the reserve of investment opportunities for himself and his associates . According to these authors, the resolution of these problems lies in the nature of the partnerships themselves and in the structure of the partnership agreement.

First, partnerships have a limited lifespan; to stay in business especially in this sector, managers in the private equity industry must regularly raise new funds, and fundraising should be less costly for the most reputable companies. Second, GP compensation should be closely linked to the performance of the investment fund (Brown and al, 2020). Admittedly, fund managers find themselves forced to establish a favorable balance sheet for investors and their advisers, but this does not eliminate potential conflicts between LPs and GPs.

According to the various studies of Sahlman (1990), Weinberg (1994), Gompers and Lerner (1995), and Brown and al (2020) the effectiveness of reputation as an incentive to preserve the interests of LPs is uncertain when GPs are near the start or the end of their careers. In the first case, a reputable PM is insufficient for him not to behave opportunistically. Therefore, a failure to raise funds by a GP could affect its reputation and market value.

According to Brown and al 2020, information asymmetry is one of the main reasons for the activism of Limited partners in private equity firms, mainly when it is a (target) company financed by one of its investment funds at an early stage of development. This informational asymmetry then becomes higher when this GP is the leader of this target and which suppose the control investors of the private equity firm (LPs). Regarding the large potential asymmetries of information, Gompers (1997) found in his study that Venture Capital contracts explicitly include important control rights to Venture Capital. The difference between Venture Capital and the "classic" financing of listed companies according to Brown and al (2020), lies in particular in the information asymmetry. From this fundamental specificity, it results most of the differences between venture capital and buy out and traditional corporate finance. To counteract the information imbalance, GPs directly assess the project to be financed (Brown et al, 2020) and set up appropriate control mechanisms that are easier and more radical than external shareholders can do (Debrières, 2001).

Thus, these investors develop a monitoring system by installing formalized information flows (Van Den Berghe and Levrau, 2002). Several studies (Barney et al, 1994; Kaplan and Stromberg, 2003) on Venture Capital propose models based on the contract between the venture capitalist and the manager of the company financed. These contracts allocate control rights independently of financial rights (Gompers, 1998) and which, according to Stéphany (2001), allow them to assess managerial risks as well as the risks of opportunistic behavior.

According to Fontenay (2019), the financial intermediary presents the investor with information on the quality of the applicant and thus enables the exchange. This accentuates the development of information theory vis-à-vis the market failures it presents. Thus, the informational advantage is even more valuable as the demand comes from a fund investing in unlisted and therefore opaque companies (Fontenay, 2019). Limited Partners find themselves incentivized to produce effective oversight, which will be all the more important the greater the asymmetry of information. Investment funds generally evolve through investment in unlisted companies, i.e. little subject to legal constraints on the publication of information and their permanent monitoring remains a task carried out by the GP, (Brown and al 2020).

Thus, we evoke an important observation showing a double-edged sword which could lead to an opportunistic behavior on the part of the GP towards the LPs.

Moreover, even if the target companies do not identify with the organizational form that is at the origin of the contractual approach to governance, the disciplinary dimension is widely present in the governance system of this type of organization. Pouget and Stéphany (2002) argue that the allocation of control rights is all the more delicate in an unlisted company when the concentration of capital makes effective control, which is not the case for listed companies whose shareholders exercise control only partially. This applies perfectly to companies financed by private equity. Thus, several studies have tried to demonstrate the role of these financial investors in the monitoring and control of the company target. Once the investment is undertaken, Venture Capitalists become more involved in the companies they finance and adopt a more active and interventionist behavior than shareholders of listed firms (Sapienza et al, 1996).

According to Van Den Berghe and Levrau (2002), these investors develop contractual control through specific agreements as well as through differentiated rights. In addition, they play a decisive monitoring role as a member of the board of directors (Brown and al, 2020). Holding blocks of control in portfolio companies, Debrières (2001) notes in this regard that this holding is likely to represent a specific governance system compared to those traditionally found in large listed companies. Thus, an active investment strategy is required of companies financed by private equity (Brown and al, 2020). In addition, adopting a passive strategy would be appropriate when holding listed shares. Debrières (2001) also notes that venture capitalists are more likely to achieve the expected profitability, given the risk accepted and that they are specialists in controlling this type of business. This author underlines the highly risky, illiquid and poorly diversified nature of venture capital investments.

Bonnet (2005), for his part, argues that failure can occur through a significant or even total loss of invested capital, given the nature of the companies in the portfolio, often very young (in creation or post-creation) or highly indebted (LBO). Hence, the establishment of active monitoring in portfolio companies, which is essentially justified by the level of risk generated (Sapienza et al, 1996). Several reasons can explain the involvement of the General Partner (Van Den Berghe and Levrau, 2002). We find the premature nature of the companies financed (mainly Venture Capital), the technological innovation, the high level of entrepreneurial risk. Moreover, Brown and al (2020) find the high volatility of projects, the rapidly changing environment, periods of bubble and bankruptcy as well as the opacity or even the low degree of transparency and public communication. These criteria justify the high risk of this type of company and explain the active monitoring of the Managers of the funds of the companies constituting their portfolios (Fontenay, 2019).

III. Governance of the LP- GP - Target relationship from an agency theory perspective

The divergence of interests between the shareholder and the manager is at the origin of the agency theory. According to Jensen and Meckling (1976), it results from the situation where the manager wants to invest in projects that meet his ambitions even if they are not profitable which do not align with the interests of shareholders (Fontenay, 2019). Hence the establishment of an incentive / sanction system and means of monitoring to limit this divergence (Brown 2020).

In the context of portfolio firms, the principal and the agent (according to agency theory) may disagree about the direction of the leader's actions. Sapienza and Gupta (1994) underline that these disagreements will thus create agency problems for the investor, as long as neither party is always right or always wrong and that they keep significant shares of the capital. .

Dubocage and Rivaut Dauset (2006) suggest another reason for agency problems. This is the possibility that the leader is spendthrift or incompetent. Therefore, the General Partner focuses on the technical and scientific skills necessary for the success of the target but ignores a characteristic of the agent's personality that will influence the profitability of the company (Fontenay, 2019). This criterion corresponds to "managerial aptitude".

In order to ensure the quality and skills of the leader, Hisrich and Jankowicz (1990), show that Venture Capital funds devote considerable resources to this subject. These agency problems correspond to situations that make the agency relationship problematic but do not necessarily put forward its hypotheses, particularly the divergence of interests and the opportunistic behavior of the agent (Fontenay, 2020).

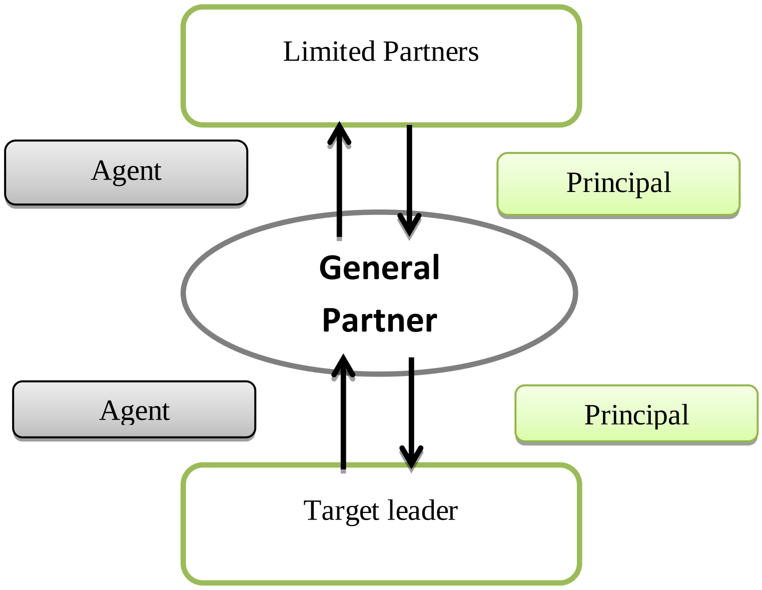
The GP has to deal not only with agency issues arising from its relationship with the manager of the holding company but also those arising from its relationship with LPs (Alaoui and Bikhzazen, 2020). Thus, the Private Equity process sheds light on a fundamental characteristic that is the double agency relationship.

Indeed, the GP has the status of principal with regard to the leader of the target and he is an agent with regard to the Limited partners of the investment fund (Alaoui and Bikhzazen, 2020). The GP's agent role probably affects his behavior as Principal towards the portfolio company (Alaoui and Bikhzazen, 2020).

According to this approach, Barry (1994) notes the involvement of the GP in his tasks of controlling and monitoring already existing funds would influence the investment decisions of potential LPs. On the other hand, Gompers (1994) presents a situation in which the GP would offer advice that goes against the interests of the executives with the aim of attracting more LPs.

The dual role played by the GP aroused the interest of Dubocage and Rivaud-Dauset (2006) who observed that Private Equity is an “original” illustration of the agency relationship through which the Principal can also behave opportunistic. We illustrate this dual role as follows:

Figure: Double agency relationship of the General partner



Therefore, several studies discuss the opportunistic behavior of the GP. In particular, the approach of Gomez et al (1990) who found that under the influence of the GP (Principal), the manager of the holding company (Agent) would reduce research and development costs in order to increase the target's short-term profits. In the same vein, the GP (Agent) will take advantage of a favorable stock market situation for an early resale of his holdings to enrich himself personally and / or strengthen his image (Grand Standing) with the Limited Partners (Principal). This undermines the long-term viability of the business (Gompers, 1996).

The degree of informational asymmetry is considerable between GPs who are active with respect to targets and LPs who do not have the ability to monitor the evolution of each individual investment (Fontenay, 2019). In this case, conflicts appear between the GP (agent) and the LP (Principal) that requires contracts and other mechanisms governing their relationship. Private equity thus raises agency issues that can be particularly delicate (Fontenay, 2019).

According to Debevoise (2018), the couple institutional investors and venture capitalists best illustrate how a contract solves agency problems. Thus, the LP is a poorly informed agent of the projects carried out by the GP. A well-constructed contract implementing an "incentive / surveillance / sanction" system would reduce agency problems, according to Dubocage and Rivaud-Dauset (2006). On the one hand, the GP is therefore encouraged to make a better effort since the contract presents him with incentives to realize capital gains. On the other hand, he undertakes to produce reports for Limited Partners (funders). According to the same authors, if the sanction incurred were not explicit, it would cause the GP to lose its notoriety in the financial community.

The contractual relationships between the LPs and the GP on the one hand, and the latter with the Executives of the portfolio companies share elements (Brown et al 2020). It is thus a question of the staggering of the financing while keeping the option of abundant, the limited life of the fund and the investment according to stages linked to the achievement by the target of the specific objectives. Added to this, the GP's incentives to create value illustrate the compensation schemes (Pilar et al, 2020) through carried-interests on one side and the receipt by the manager of a share of this value that he helped create, on the other. In addition, the establishment of mechanisms ensuring liquidity remains a common point, since LPs hold on to the distribution of investment returns and GPs hold the right to request the redemption of their convertible shares, for example. In the event of default, the leader will be denied access to capital and fundraising will be more costly and tricky for the PM, which would directly impact the reputation of both (PM and CEO) in the financial community. In any case, Barry (1994) assures us that this double agency relationship can play a determining role in the success or failure of private equity investment.

The contractual theories put forward the objective of reducing the losses in value generated by the GP and shed light on the controlling role of the LP to describe its involvement in the governance of Private Equity companies. Therefore, the contractual trend favors the disciplinary dimension of governance.

IV. The cognitive contribution in the governance of private equity companies.

The double agency role that the GP plays has sparked interest in approaching the governance mode of private equity organizations from a strategic perspective. In this view, Charreaux, 2000a notes the importance of the remarkable renewal of governance theory and the evolution of the economy. Thus, this theory evolve to adjust to new organizational forms and new patterns of value creation.

The new organizational configurations have been described by Zingales (2000) in three main characteristics:

- reduction of the importance linked to vertical integration and control of physical assets,
- strengthening the interest in innovation and quality encouraged by increased competition,
- The importance of human capital in the creation of value.

All of this data means that the competitiveness of private equity companies in general and that of investment funds in particular depend essentially on the capacity for innovation linked to the specific skills of human capital in these organizations. To this end, Wirtz (2008) sheds light on the role of knowledge and skills in the creation of innovation opportunities and in the exploitation of the competitive advantages that the strategic approach puts forward which makes them potential vectors of valuable creation. For a specific approach relating to Corporate Governance and a rather specific sector of finance, several researchers (Brown and al 2020; Pilar and al 2020) have been interested in the non-financial contributions of General Partners to the targets they finance.

Regarding the strategic perspective, we find from the study of Pilar et al (2020) two types of learning namely "Business Management Advice" which can be translated as management advice and operational assistance. Using the same approach, Fontenay (2019) reveals two aspects of support from General Partners. On the one hand, the strategic vision by means of a more formalized, systematic and regular influence allows an involvement in the investment policy and external growth strategies. On the other hand, Brown et al (2020) present the organization from an operational dimension, through the establishment of an information system and the recruitment of management teams.

Other authors such as Pouget and Stéphany (2002) highlight advice and network sharing based on formal inputs from the GP. This intervention can be carried out according to six fields of value creation, namely Finance, the Accounting Information System, Production, Marketing, Organization and Management (Pouget and Stéphany, 2002), even if the informal contributions of the GP constitute a guarantee of the potential of the target for this type of shareholder. The importance of the GP's partnership with the target lies in the identity of this investor and his specific skills in the different phases of financing, ranging from the process of selecting participations to the exit of capital, beyond the capital contributed (Fontenay, 2019). The degree of specialization of Venture Capital, the specific knowledge it may have on the industry and its target, largely determines the profitability of its investment decisions (Wright, 2007). For their part, Van Den Berghe and Levrau (2002) consider that a minimum knowledge is essential for an ex-ante examination of the proposed projects. Furthermore, they raise doubts about the need for specialization. Indeed, the General Partner may not be an expert or have knowledge of the target industry sector exceeding that of management.

V. Organizational learning and confidence in private equity

The complex nature of the partnership between the GP and the target entrepreneur has created an increasingly attractive field of research. Dowd (2016) qualifies the relationship between the venture capitalist and the manager as a cooperative relationship between the two, highlighting the financial and managerial skills of the latter. This alliance lift a voluntary inter-firm cooperation agreement, aimed at achieving a competitive advantage for the partners (Das and Teng, 2000).

Resource-based theory aptly explains this type of partnership through the learning approach. The learning process begins before this alliance is operational (Dowd, 2016). La Sépale (2004) emphasizes the importance of combining confidence building and learning the trade of the other party in the overall learning vision and its role in reducing the risk of inefficiency.

In various fields of management research, the link between cooperation and trust fits in the context of alliances (Bebchuk et al, 2015). It emerges that the trust, which manifests itself in positive anticipations of the partner's behavior, leads to better quality information exchanges, to a stronger involvement of partners by promoting cooperative behavior (Bebchuk et al, 2015).

Coffee and Darius (2016) describes trust as a mechanism associated with all forms of transaction and cooperation that accompanies and complements the traditional economic mechanisms of the market and the hierarchy. It is therefore a natural part of corporate governance mechanisms. The notion of trust would thus encourage exchanges of information, the search for help and advice by the leaders and the common work to solve the problems posed (Coffee and Darius, 2016).

Beyond the explicit contract based on various legal and financial clauses, the concepts of trust and cooperation remains the system to an implicit contract. The Limited partners often maintain close relationships with their General Partners to continue to gain access to detailed information (Muller, 2008). The aim is to ensure better monitoring of the existing fund, to facilitate future reinvestment decisions and to develop personal relationships (Fontenay, 2019).

The results of Bonnet's study (2005) confirm the effect of trust on cognitive mechanisms. It encourages informed partners to express their views openly even if they disagree on the accomplished task or on the way to accomplish it. Although, the limited partners keep their active role in case, the Private Equity industry is still young but they do not interfere in the operational management of the investment fund. Thus, they prefer to keep the discretionary route of work when the General Partner takes full responsibility for the investments. Bonnet (2005) points out, on the one hand, that trust could have a negative impact on the exercise of managerial control. On the other hand, it might favorably influence their mutual willingness to cooperate. This would lead the GP to get involved in his cognitive functions (advisory roles) to the detriment of disciplinary ones. Furthermore, the results of Bonnet's study (2005) do not show evidence of a negative correlation between trust and control.

VI. Conclusion

The results of the studies cited in this article lead to interesting observations about the nature of the governance system in private equity. They demonstrate that improved trust between LP and GP seems to stimulate the LP's advisory role and promote the exploitation of detailed and specific information and the emergence of cognitive conflicts (Cognitive role of LP). However, these results do not go hand in hand with a decrease in the level of control exercised over the GP (disciplinary role) because the disciplinary vision of governance and the cognitive one can be two complementary approaches to the governance system of Private Equity companies. Thus, the alliance of contractual and cognitive theories may be the subject of future research work.

We find that these two visions of value creation are present in Private Equity companies. On the one hand, the various conflicts that may exist, resulting for example from the opportunism of actors with divergent interests and the strong informational asymmetry revealed the potential loss of efficiency. On the other hand, the role that innovation and knowledge play in the functioning of private equity firms and portfolio companies makes human capital and organizational learning potential factors that may reveal important opportunities for development, encouraging the use of employing the governance system in private equity companies.

These two visions of the role of the governance system in this sector can lead to better value creation through a system that targets the priorities of both disciplinary and contractual perspectives. As Pouget and Stéphany (2002) suggest that, "By actively monitoring participation, the investor reduces the risk incurred while structuring the development of the firm around the process of value creation".

Muller (2008) suggest three control grouping of the Limited Partner duty. These are control activities, which allow LPs to direct and control the actions of General Partners and thus constitute the disciplinary role. In addition, this author presents the value of advice relating to the cognitive role of LP in organizational learning; and the interpersonal roles arising from informal contacts between LPs and GPs.

Moreover, the plurality of criteria (disciplinary and cognitive) in the practice of governance is difficult to apply. To this end, Charreaux (2003) suggests a unified model integrating the two disciplinary and cognitive visions of governance by borrowing certain criteria and by ruling out others deemed incompatible. This model is valid for private equity firms.

This representation of the model can constitute a better response to the problem of control by integrating its cognitive dimension. Two levels can evaluate this approach. On the one hand, the limited rationality and cognitive constraints of General partners which can prevent optimal managerial decisions (which can result from the opportunism of the GP). On the other hand, the Limited Partners themselves obey their limited rationality and their own cognitive constraints in the exercise of their control and in the evaluation of this opportunism especially in the case of information deficit between the LP and the GP. This reveals that the issue of executive control can convoyed the intersection of the disciplinary and cognitive perspectives of the governance system of private equity companies.

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