Journal of Business Venturing xxx (2013) xxx–xxx

Contents lists available at ScienceDirect

Journal of Business Venturing

Take the money or run? Investors' ethical reputation and entrepreneurs' willingness to partner☆

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ARTICLE INFO

Article history:
Received 27 December 2012
Received in revised form 20 August 2013
Accepted 21 August 2013
Available online xxxx

Field Editor: G. Cassar

Keywords:
Venture Capital
Business Ethics
Investor Reputation
Investor Selection
Conjoint Analysis

ABSTRACT

Drawing on the multi-principal–agent perspective, this research models the influence of venture capitalists' reputation for ethical behavior on entrepreneurs' willingness to partner decisions. We test our model using a two-study design. Study one, a conjoint experiment, revealed that explicit knowledge of past unethical behavior negatively affects entrepreneurs' willingness to partner. Interaction effects revealed that factors previously shown to influence the entrepreneurs' evaluations—investor value-add and investment track record—become largely contingent upon and often subjugated by investors' ethical reputation. Study two, a traditional between-subjects scenario experiment, revealed that when entrepreneurs develop their own perceptions about the ethicality of an investor's prior behaviors, the ethical dimension remains highly influential. Further, we find that as the consequences of rejecting funding become more severe (e.g., possible bankruptcy), entrepreneurs become increasingly willing to partner with unethical investors. We also find that high fear of failure entrepreneurs are less willing to partner with unethical investors than their low fear of failure counterparts.

1. Executive summary

Strong traditions of research focus on the new venture financing process (Cassar, 2004; Fairchild, 2011; Petty and Gruber, 2011) and on the role of ethics in organizational contexts (Ferrell et al., 2012; Ford and Richardson, 1994); however, research linking venture financing and ethics is lacking (e.g., Harris et al., 2009). This means that we have a growing understanding of both domains, but lack an understanding of how the ethical dimension may manifest in the realm of venture financing. Representing one of the first attempts bridging the two areas of inquiry, this research examines the role an investor's ethical reputation plays in the entrepreneur's willingness to partner with the investor. Because venture capital (VC) investors are often at an asymmetric power advantage and can act opportunistically or unethically (e.g., Broughman, 2010; Collewaert and Fassin, 2013), we build on the multiple principal–agent characterization, to investigate how a VC's reputation for ethical behavior influences entrepreneurs' decisions to accept or reject funding.

☆ An earlier version of this paper was published in the 2013 Academy of Management Best Paper Proceedings, and was also presented at the 2013 Academy of Management Conference, Lake Buena Vista, Florida. The authors would like to thank Dr. Gavin Cassar, and the three anonymous reviewers for their insightful comments and suggestions that pushed us to improve this paper. Last, we gratefully acknowledge the financial support provided by the Hankamer School of Business at Baylor University.
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0883-9026/$ – see front matter
http://dx.doi.org/10.1016/j.jbusvent.2013.08.004

While a number of principal–agent relations exist in the VC cycle, our model focuses on a lesser-studied perspective by viewing the VC as an agent of the entrepreneur. This leads to the argument that knowledge of an investor's past behavior can lend toward predicting the odds of incurring future agency costs—thus becoming influential in the entrepreneurs' willingness to partner decision. We use a two-study approach to test this conceptualization empirically. Employing metric conjoint analysis, we begin in study one by decomposing the decisions of entrepreneurs pertaining to their willingness to partner with a prospective investor. Our analysis of 550 decisions reveals that knowledge of explicit ethical or unethical behavior profoundly shapes the entrepreneurs' willingness to partner. Interaction effects indicate that factors previously shown to drive entrepreneurial evaluations, such as investor value-added services and investment track record (Fairchild, 2011; Valliere and Peterson, 2007), become largely contingent upon and in some cases subjugated by an investor's ethical reputation.

Study two takes a complementary approach via utilization of a traditional between-subjects scenario experiment designed to examine further the influence of ethical reputation as well as delineate nuances of interactive relationships. We find that when entrepreneurs develop their own perceptions about the behaviors of investors (i.e., they are not overtly told whether a VC is ethical or unethical), the ethical dimension still emerges as a highly influential factor. Moreover, study two documents the extent to which contextual and individual-level differences influence the role of an investor's ethical reputation. Here, we find that as the consequences of rejecting the funding offer become more severe, entrepreneurs become increasingly tolerant of partnering with an unethical investor. We also find, somewhat counter-intuitively, that high fear of failure entrepreneurs is less willing to partner with unethical VCs than their low fear of failure counterparts.

Taken together, our multi-study approach connects business ethics and entrepreneurship by advancing our understanding of the role ethics plays as entrepreneurs evaluate and select potential equity investors. Our findings also offer new insights regarding the conditions under which ethical reputation may be more or less impactful. Collectively, these findings make a number of contributions to theory and practice while also setting the stage for important avenues of future research.

2. Introduction

The prevalence of equity financing in entrepreneurship has stimulated much scholarly research on the topic of Venture Capital (VC) investment. Much of the work to date has focused on how VCs evaluate entrepreneurs and their ventures in attempts to make effective investment decisions (e.g., Petty and Gruber, 2011; Zacharakis and Shepherd, 2007). What is missing, however, is research that considers VC investment from the entrepreneur's perspective. That is, we lack insight regarding the criteria entrepreneurs utilize in their evaluations of potential investment partners. While there are a few studies on this topic, they are largely restricted to factors such as the added value investors bring or the investors' track record of success (Valliere and Peterson, 2007; Zheng, 2011). These studies are insightful because they suggest that VCs bequest important substantive and affiliative advantages on the firms in which they invest, but they also implicitly assume that if VC money is offered, entrepreneurs will take it. This is not, however, entirely true; many entrepreneurs spend considerable time evaluating potential financers and in turn elect not to accept funding from certain VCs. Smith (2001), for example, reported that in their survey of 136 firms, over 70% of the entrepreneurs received more than one offer, while 54% had three or more offers. This suggests that entrepreneurs in mature VC markets often have options when it comes to VC financing. Hence, if researchers continue to focus solely on the VCs' perspective and positive characteristics of VCs, then they cannot account for possible reasons why entrepreneurs might reject VC investment offers. In the present study, we conceptualize the VCs' ethical reputation as one possible reason.

Justification for focusing on the role of VCs ethical reputation rests on ample research documenting the frequency of VCs asymmetric power advantage and the corresponding fact that VCs are often perceived as acting opportunistically or unethically (e.g., Broughman, 2010; Collewaert and Fassin, 2013; De Clercq and Manigart, 2007; Fassin, 1993, 2000; Fried and Ganor, 2006; Shepherd and Zacharakis, 2001; Smith, 1998). Further, because VCs typically have considerable control and influence in their portfolio firms, the consequences of unethical behavior on the part of VCs are likely to be profound. We reason, then, that a VC's reputation for ethical behavior is likely to be an important, yet presently overlooked consideration for entrepreneurs seeking financing. The purpose of our study is to explore the link between VCs' reputation for ethical behavior and entrepreneurs' willingness to partner. By recognizing and examining the role of ethics in this context, we set out to advance a nascent body of research on how entrepreneurs evaluate and select potential investors.

Our investigation of ethics in VC investment begins with the development of a conceptual model based on inferences from agency theory (Jensen and Meckling, 1976). Specifically, we draw on the multi-principal–agent characterization, where agency conflicts, such as divergent objectives, self-interest and unethical behavior, arise within a number of relations throughout the VC investment cycle (Barry, 1994). This perspective provides the basis for the introduction of a unique conceptualization where the VC is considered an “agent” of the entrepreneur whose prior ethical behavior must be considered as part of an investment offer acceptance decision. The influence of reputation for ethical behavior, however, does not happen in a vacuum and must be considered in conjunction with other factors known to influence investment acceptance decisions. Specifically, we draw on previous research findings to explore how the VCs' prior investment success (Smith, 2001), the value added VCs bring to the firm (Fairchild, 2011), and the magnitude of the consequences associated with rejecting the offer (Weber, 1996) interact with the ethical reputation–willingness to partner relationship. Further, we consider the literature that suggests stable individual differences, such as fear of failure, augment the degree to which ethics influence entrepreneurs' investment partnership decisions. Such contingency relationships are important because they help identify the conditions under which ethical reputations play a greater or lesser role as entrepreneurs decide if they should take the money or run.