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When do investors forgive entrepreneurs for lying?

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ABSTRACT

A growing literature suggests that some entrepreneurs lie to investors in order to improve the likelihood of acquiring resources needed for firm survival and growth. We propose a framework outlining the conditions that may enable an investor who has been told a lie by an entrepreneur to respond with forgiveness rather than by withdrawing from the relationship. Integrating the literatures on evolutionary psychology, forgiveness, and stakeholder theory we argue that investor's appraisals of expected relationship value and expected exploitation risk are the key antecedents to an investor's decision to forgive an entrepreneur's lie.

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1. Executive summary

Investors—defined as people who provide financial resources with an expectation of return on their investment—are critically important stakeholders for entrepreneurs whose most pressing task is to acquire resources needed for firm survival and growth. Accordingly, we would expect entrepreneurs to treat investors with respect and to provide an honest and accurate picture of the venture. However, in contrast to what we would expect, a growing literature suggests that entrepreneurs do not always share accurate representations of their venture. Put simply, some entrepreneurs present selected misinformation to prospective investors or deliberately use ambiguity to avoid disclosing aspects of a business that may create an unfavorable impression (Martens, Jennings, and Jennings, 2007).

This phenomenon of entrepreneurs deceiving their investors is evident in academic studies on the inaccurate stories and intentionally misleading information entrepreneurs provide (Lounsbury and Glynn, 2001; Rutherford et al., 2009) as well as practitioner reports (Kawasaki, 2008: 44) cataloging lies commonly told by entrepreneurs (e.g., "Our projections are conservative," "No one else is doing what we are doing," and "Hurry, because other venture capital firms are interested"). This line of research also coincides with emerging work noting the propensity of entrepreneurs to break rules, ignore guidelines, and pursue venture-related goals irrespective of moral virtue (for a review see Brenkert, 2009).

As an explanation, researchers note that these entrepreneurs may lie or engage in morally questionable behavior because they have not yet reached a point at which the firm is seen by potential investors as both understandable and permanent. Before reaching this point, investors are less likely to engage with the venture (Rutherford and Buller, 2007; Singh et al., 1986; Steverson et al., 2013; Zimmerman and Zeitz, 2002). This puts entrepreneurs in a quandary: lie to access the necessary resources or treat potential investors honestly and risk their refusal to invest.

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Stakeholder theory provides an argument that entrepreneurs could substantially benefit by establishing trusting and cooperative ties (Freeman, 1984). Firms that manage for stakeholders can create more value by getting their stakeholders to put forth greater effort and provide more nuanced information about their preferences (Harrison et al., 2010). In contrast, poor stakeholder treatment can destroy value and hurt the firm. For example, lying to an investor (a crucial stakeholder) can provoke moral outrage that results in retaliation, revenge, or avoidance. It follows that entrepreneurs who lie to investors should receive reduced value from the relationship and risk venture failure.

Interestingly, entrepreneurs who choose to lie may still build effective investor relationships (Rutherford et al., 2009) despite the violation of social norms (Steverson et al., 2013) and despite what stakeholder theory predicts (Freeman et al., 2010). This suggests that the entrepreneur–investor dyad is a context where the core propositions of stakeholder theory deserve closer scrutiny. The present conceptual contribution examines this topic and asks the question: Under what conditions will investors who could withdraw from the relationship, instead, choose to respond with forgiveness after suffering an entrepreneur's lie?

We submit that the present work is of interest to researchers and practitioners alike. From a theoretical perspective, we extend the logic of stakeholder theory by integrating the psychological conditions that facilitate forgiveness with specific types of organizational justice that may motivate investor behavior. From a practical perspective, this work outlines why entrepreneurs may lie as well as the processes through which forgiveness from investors for such a transgression may be achieved. Specifically, we note how, even after an investor learns of a lie, entrepreneurs can act to recover without suffering the expected negative effects. This research takes an important step towards a more complete understanding of the applicability of stakeholder theory in entrepreneurship as it relates to perceptions of justice and forgiveness.

2. Introduction

> "*An experienced VC fund manager I have known for years told me recently that if a person does not know how to seriously twist the truth from time to time, he (she) cannot be an entrepreneur*".
>
> [*Isenberg, 2010*]

> "*In Silicon Valley, you can tell that a person is pitching because her lips are moving*".
>
> [*Kawasaki, 2008*]

> "*Nearly every entrepreneur exaggerates his or her company's size to impress clients*".
>
> [*Fried, 2011*]

The task of acquiring resources is one of the defining roles of an entrepreneur (Pollack et al., 2012). It is only through establishing relationships that the entrepreneur can entice investors—defined as people who provide financial resources with an expectation of return on their investment—to provide the resources that are needed for a venture's survival and growth (Nagy et al., 2012; Sapienza and Korsgaard, 1996). The primary way in which entrepreneurs entice investors to provide resources is a business pitch—a cohesive narrative woven together from written and verbally communicated information that helps an investor to understand the entrepreneur's business (Pollack et al., 2012). This entrepreneur–investor interaction helps clarify, in the mind of the investor, the viability of a venture.

Stakeholder theory suggests that the way to foster beneficial relationships is to establish trusting and cooperative ties. In turn, firms that deal with investors "on the basis of mutual trust and cooperation" gain a competitive advantage relative to firms that do not (Jones, 1995: 422). From this perspective we would expect entrepreneurs to act respectfully, honestly, and ethically when presenting written and verbally delivered information to investors. In contrast to what we expect, however, a growing literature points to a phenomenon in which some entrepreneurs deceive investors (e.g., Martens et al., 2007; Rutherford et al., 2009).

Entrepreneurs present selected information to prospective investors and sometimes deliberately use ambiguity to avoid disclosing aspects of a business that may create an unfavorable impression. For example, "…the narratives contained phrases suggesting that a firm was an established leader even though, in our opinion, insufficient factual information was presented to support such a claim" (Martens et al., 2007: 1111). Recent studies support the existence of this phenomenon: that some entrepreneurs lie to investors by sharing inaccurate stories and intentionally misleading information (e.g., Aerts and Cheng, 2012; Herzenstein et al., 2011; Lounsbury and Glynn, 2001). In describing the state of the practice, Guy Kawasaki cataloged the top eleven lies entrepreneurs tell investors—he notes that, "… just about every entrepreneur who pitches me tells at least four of these eleven lies" (Kawasaki, 2008: 44). Examples of lies Kawasaki (2008) describes are: "Our projections are conservative," "No one else is doing what we are doing," and "Hurry, because other venture capital firms are interested" (Sherman, 2012).

One motivation for such lies is clear—these entrepreneurs have not yet reached a point at which the firm begins authentically sending credible signals to prospective investors that the firm is acceptable, appropriate, and desirable (Rutherford and Buller, 2007; Singh et al., 1986). Accordingly, investors are less likely to engage with the venture (Zimmerman and Zeitz, 2002). To compensate, entrepreneurs may lie to prospective investors. For example:

> "*Some years ago I worked with an entrepreneur who was raising his first $10 million of VC investment ("Series A"), without which the company could not proceed. One key element in the investment pitch was a strategic relationship with a multinational*

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