Teaching Module: Ethics in Venture Capital

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Objectives

– Understand the underlying problems in the financing of startups

– How these problems and nature of startups result in ethical issues.

– Mechanisms to solve these problems

Major Issues

- High risk field – Majority of startups fail

- Was the failure due to entrepreneur's lack of effort – ethical issue- or bad decisions or luck? How to entangle the three?

- The problem is compounded by the lack of tangible numbers and evidence. Most startups have scant financial and market information – severe information asymmetry

Investor Point of View

- Two main issues:
  - Hidden information problem. Will an entrepreneur ethically disclose all material information?
  - Hidden action problem –agency theory/moral hazard.

Investor Point of View- Hidden Information Problem

- First issue:

  -the nature of startups and associated information asymmetry lead to incomplete information. Did the entrepreneur disclose everything when they accepted funding?

Investor Point of View- Hidden Action Problem

- Second issue:
  - Hidden action problem
    - agency theory – Entrepreneur is an agent of the investor. How to keep the interests of the entrepreneur and the startup aligned with the investor interests?
    - moral hazard - Will entrepreneur take unnecessary risks given that investors money is at stake?

Resolution-I

  - – Staged financing
  - – Syndicate investments
  - – Incentive compensation to entrepreneurs
  - – Seats in board of directors
- – Desired outcome: Best startups get the most funding and most VC backing

Resolution -II

- Staged financing – Set goals or milestones for a startup and provide funding as they are met.

- Syndicate investments – Reduce startup specific risk by having a group of investors- a syndicate- invest instead of just one. This will also provide better networking and mentoring opportunities for the startup.

Resolution-III

- Incentive compensation to entrepreneurs – To align the interests of the entrepreneur and the investor design entrepreneur compensation that rewards an entrepreneur when the investor goals are met.

- Seats in board of directors – To ameliorate principle agent problem and reduce information asymmetry investors typically take seats in the startup's board.

Entrepreneur Point of View I

- Two main issues:
  - Asymmetric information – Investors such as VCs or angels have much greater knowledge of the industry than the entrepreneur.
  - Lack of bargaining power – First time entrepreneurs lack skills, experience and knowledge to bargain effectively with a seasoned investor.

Entrepreneur Point of View II

- Asymmetric information – who does VC know, what companies are they backing
  - Disclosure of sensitive information
  - Backing multiple horses in a race
    - Conflict of interest

Entrepreneur Point of View III

- Lack of bargaining power
  - VC as provider of funds often has the last say

Entrepreneur Point of View III

- Lack of bargaining power
  - Entrepreneur is in VC's turf when they ask VC for a funding. VCs have invested in hundreds of startups while entrepreneur is probably going through the funding process for the first time.
  - VCs specialize in an industry and have specialized knowledge about it.
  - VCs have much better handle on how to value a startup since they have databases of private companies and other startups in that industry.
  - VC as provider of funds often has the last say

Resolution I

– Chinese walls

– Nondisclosure contracts

– Reputation – repeat players

– Limitations of Reputation

Resolution II

- Chinese walls:
- To avoid information spillover among a VCs different and possibly competing investments in other startups it has been proposed to set firewalls between different startup investments.
  - Impractical for small firms

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- Nondisclosure contracts
  - VC's skim hundreds of business plans every month
  - Entrepreneur has no information about the Other plans the VC is reviewing

- Reputation – repeat players

Resolution III

- Nondisclosure contracts
- Have VCs sign non disclosure contract that promises that the VC will not share startups trade secrets and other specialized knowledge with other competing startups.
  - VC's skim hundreds of business plans every month. Is it possible for them to ensure no spill over?
  - Verifiability: Entrepreneur has no information about the Other plans the VC is reviewing

Resolution IV – Market Forces

- Reputation – VCs are repeat players in the funding market. The funding cycle consist of VCs asking limited partners for funds to invest in startups and at exit of startups they return the money to the limited partners minus their fees. This cycle is repeated every 5-8 years.
- A VC that will take advantage of a startup in one cycle will have difficult time attracting a good startup in the next cycle. Eventually such VC will only be able to invest in riskier startups and have high probability of not returning the limited partners money at exits. Such VC will not be able to launch another fund because of lack of interest from the limited partners. The market weeds out the VC.

- Limitations of Reputation

Macro Effects

- Desired outcome: Best startups get the most funding and most VC backing
- However, in absence of clear resolution of the issues discussed what is the macro effect:

- Entrepreneurs less willing to seek VC funding. Promising projects not brought to fruition.
  - Effects:
    - Venture starvation, Venture shelving, Arranged marriages, Business stealing

- Sources:
- Denis, D. J. (2004). Entrepreneurial finance: an overview of the issues and evidence. *Journal of Corporate Finance*, 10, issue 2, p. 301-326.

- Nanda, A. (2001). Ethics in Venture Capital. *Harvard Business School (Case 9 902 028)*.