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ENTREPRENEUR - INVESTOR NEGOTIATIONS: INVESTIGATING THE POWER GAP

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Federal Securities laws are designed to ensure that investors are provided with sufficient information to make an informed investment. These laws presume that investors are relatively naïve and powerless compared to the relatively sophisticated and powerful sellers of securities. In the new venture arena, however, it is often the case that sellers, the entrepreneurs, are relatively naïve and powerless compared to the investors, who tend to be expert in venture finance. This paper explores these heretofore unexamined power imbalances and presents attributes of the entrepreneurs and their resources that may affect entrepreneurs' ability to negotiate with venture capitalists.

INTRODUCTION

The iconic perspective of modern entrepreneurship envisions a handful of bright, young entrepreneurs developing their product with minimal resources, sometimes literally in a garage, only to be "discovered" by venture capitalists who fund and nurture the fledgling enterprise until it becomes a public corporation and leader in its industry. The fairy tale includes the transformation of the young, idealistic entrepreneurs into captains of their industry.

Reality, however, does not always comport with this idyllic view. Anecdotal evidence suggests the entrepreneurs face a much harsher reality as they place confidence in venture capitalists whose business models are based on generating enormous returns on a small percentage of their many investments, rather than nurturing fledgling entrepreneurs (Holding and Carlsen, 1999). Nevertheless, some entrepreneurs do very well and receive deal terms that allow them to grow their companies with the appropriate amount of attention from the investors. The aim of this paper is to explore the heretofore unexamined power imbalances between entrepreneurs and investors and to postulate some sources of power that may enable entrepreneurs to negotiate effectively with investors.

Business Start-Ups and Venture Capital

Because a start-up business does not have an established product in the market, there are generally little or no revenues in the business' nascent years. A small, start-up business has a variety of sources from which it may draw operating capital: the savings of the owners; bank loans, particularly those guaranteed by the Small Business Association; friends and relatives; wealthy individuals - often referred to as "angels"; and

venture capitalists.

Loans to the business are limited to the extent of the collateral of the owners and create a repayment burden while the business is still developing. Selling part of the business to an investor offers a viable alternative, as the amount of invested funds is structured on the future income of the enterprise (rather than the current unencumbered assets of its owners), and there is no repayment burden.

Venture capitalists have become a significant source of new venture financing in recent years. By 2003, there were nearly 2,000 venture funds actively managing over \$250 billion in business investments (Leavitt, 2005). The typical venture capital process is for a venture capital firm to form a limited partnership, with itself as the general partner. Limited partners are then solicited to pledge funds to a particular venture fund. The limited partners are usually institutional investors and high-wealth individuals. The venture capital firm manages the fund, selecting which ventures to invest in. The venture capital firm collects a set management fee, as well as shares in positive returns earned by the fund (Bankman & Cole, 2001).

Angels, in contrast, are generally high-wealth individuals who invest directly in a business at a very early start-up phase. The availability of angels has progressed beyond just "friends and families." Angels have become more prominent and accessible, even banding together into organizations to share leads and information (Leavitt, 2005).

Whether the initial venture funding is provided by an angel or venture capitalists, it is expected that there will be subsequent rounds of financing as the business develops, often involving more than one venture capital fund (Gorman and Sahlman, 1989). The investors' goal is a liquidity event, usually in the form of an initial public

offering (IPO) of the stock of the venture. The IPO creates a market for the stock of the venture, allowing the investors to sell their ownership interest in the venture—theoretically for a substantial profit. Even where the investors and the entrepreneur are equally committed to maximizing shareholder wealth, they may have recurring disagreements regarding how to prioritize operating goals (Sapienza & Gupta, 1994). The entrepreneur's ultimate goal is to build a viable business. The investors' "long term" goal is a positive return on the investment portfolio, of which the entrepreneur's company is just one part, within 7-12 years, the typical life of a venture fund (Nesheim, 2000). As a result, investors and the entrepreneur have different, and possibly conflicting, priorities.

Investing in small, start-up ventures involve significant risk (Sapienza & Gupta, 1994; Utset, 2002). Risk can have its rewards: venture funds collectively reported returns of 150% in 1999. But risk also sometimes means loss: as venture funds collectively reported returns worse than *negative* 25% in 2002 (Cumming & MacIntosh, 2004). One study has indicated that approximately 7% of investments account for more than 60% of venture capitalists' profits, while one-third of investments result in (sometimes total) losses (Bhide, 1992).

There are significant unknown variables associated with start-up ventures. By definition, the business model of a start-up has not been tested against an actual market. Most start-ups do not yet even have a product. It is unknown whether the idea can be converted to a marketable product, whether a competitive product is about to be introduced in the market, or whether the entrepreneur can manage an operational and growing business (Sapienza & Gupta, 1994). In addition, each party's self-interest may increase the risk of failure. Venture capitalists are only willing to provide the minimum funds necessary for the venture to meet discrete milestones, thereby minimizing the venture capitalists' risk if the venture appears unsuccessful in its early stages. At the same time, the entrepreneur is loath to give up too much ownership and control in the business. "Thus both venture capitalists and entrepreneurs willingly conspire to impose stringent limits on the resiliency of their enterprises" (Gorman & Sahlman, 1989:238). While venture capitalists and entrepreneurs may initially believe they have common goals and are a partnership, when things go badly, their interests diverge (Gorman & Sahlman, 1989).

Venture capitalists attempt to control risk through governance procedures. Studies indicate that venture

capitalists pursue less industry and geographic diversification when investment risk is high; therefore they manage risk through monitoring and involvement rather than through diversification (Sapienza & Gupta, 1994). When deciding whether to fund a new venture, venture capitalists must consider more than the potential success of the venture, and hence the positive return on investment. Venture capitalists must also decide how best to structure the financing to protect their own interests while simultaneously enhancing the likelihood that the new venture will succeed. The foundation of this structure is governance and control (Barney et al., 1989; Utset, 2002).

Although venture capitalists do not usually purchase a majority of the venture's stock, they often purchase enough to control the company's board of directors, which has the ultimate responsibility of managing the company. In addition, venture capitalists provide financing in stages, replenishing capital only if the venture remains a potentially viable investment. Finally, the venture capitalists will require disincentives for the entrepreneur to exit from the venture, particularly by requiring that entrepreneurs sell their interest in the company should they leave (Utset, 2002).

With this level of control, venture capitalists can exert power in a number of ways. They can terminate the entrepreneur if they believe more competent senior management is needed and the entrepreneur is no longer necessary for the viability of the venture. According to venture capitalists, the most significant reason new ventures fail is because of ineffective senior management, meaning that venture capitalists will "frequently" fire the original senior management (Gorman & Sahlman, 1989). Indeed, some entrepreneurs have thought their dreams of a successful start-up were realized when venture capitalists agreed to invest, only to find that they were left with nothing (Holding and Carlsen, 1999). Ultimately, if the venture capitalists believe the venture is no longer viable, they can liquidate it, which includes having the company buy back the venture capitalists' stock (if there are assets to pay for the redemption) (Utset, 2002).

The entrepreneur, understandably, will more than likely fight any termination or liquidation decision by the venture capitalists. The entrepreneur is also not necessarily powerless, particularly if the entrepreneur holds the knowledge necessary to make the venture viable. This may set up a conflict between the entrepreneur and the venture capitalists that ultimately may be destructive to the venture. If the venture capitalists are at odds with the entrepreneur, but the

entrepreneur is too valuable to the venture to terminate, the result may be retaliation.

Many of these issues are covered by the term sheets negotiated by the parties at the time of the investment. The extent to which these terms favor either the entrepreneur or the investor depends on the relative power of the parties.

Power

Most definitions of power take as their root Weber's (1947) classic definition of power as the probability that a person can carry out his or her will despite resistance. French and Raven (1959) rarefied Weber's definition by determining five bases of power: (1) reward power; (2) coercive power; (3) expert power; (4) legitimate power; and (5) referent power. Emerson (1962:32) argued that "power is a property of the social relation; it is not an attribute of an actor." Thus, power only arises within a particular context between two or more actors.

In the context of transactions, power can determine the allocation of rewards of any agreement (Kim, 1997; Mannix, 1993; Pinkley et al., 1994). Consequently, the greater one party's power relative to the other party's, the more resources the more powerful party can claim (Kim et al., 2005). Bacharach and Lawler's (1981) comprehensive review of the relevant literature suggests that negotiators who are perceived as having greater bargaining power than their opponents can enforce their will. Further, negotiators with lower perceived power generally cannot and do not resist the demands of more powerful opponents (Horai & Tedeschi, 1969; Michener, Lawler, & Bacharach, 1973). Conversely, when the power of two parties is equal, each side is better able to resist the domineering behavior of the other (cf. Pinkley, Neale, & Bennett, 1994).

Thus, when an entrepreneur is negotiating with potential investors, the relative power of the entrepreneurs and investor largely determine who receives the greater benefit from the investment. Nevertheless, the entrepreneurs' personal and resource attributes can enhance their power relative to the investor. In this paper, we generate eleven propositions regarding potential sources of power to entrepreneurs with respect to investors.

Sources of Entrepreneurs' Power

Certainly many venture finance deals conclude with terms that are favorable to both parties. We contend that entrepreneurs that engage in such positive deals have more power with respect to investors than entrepreneurs

who accept less advantageous terms. From whence does this power derive? We develop eleven propositions setting forth attributes of entrepreneurs or their resources that may contribute to the entrepreneurs' power. In the context of the propositions that follow, the "entrepreneur" includes all founders involved in the management decisions of the startup.

Attributes of the Entrepreneur

Entrepreneurs vary in terms of financial and technical expertise and experience. We believe four of these factors may be particularly important in affecting entrepreneurs' power vis-a-vis the investor: (1) experience in new venture finance; (2) general financial experience; (3) expertise in the entrepreneur's industry; (4) negotiating experience; and (5) skin in the game.

Experience in New Venture Finance

While many entrepreneurs are new to the market for venture financing, other entrepreneurs have repeated experience. Westhead, Ucbasaran, and Wright (2005) describe entrepreneurs as "novice" entrepreneurs, who have no prior business ownership experience; "serial" entrepreneurs, who have sold or closed a business in which they had an ownership stake and who currently have an ownership stake in new, independent business; and "portfolio" entrepreneurs, who have concurrent ownership stakes in two or more independent businesses. The latter two categories suggest that experience in entrepreneurship increase the entrepreneur's power for three reasons. First, experience provides the entrepreneur with a basis for comparison when negotiating with investors (Babcock et al., 2005). Second, an experience curve effect may enable the entrepreneur to capitalize on his or her existing knowledge base and internal infrastructure, thereby reducing costs of capital (Reagans et al., 2005). Third, experience is likely to generate credibility on the part of the entrepreneur (cf. Brokaw & McDevitt, 1994). As Westhead and Wright (1999) and MacMillan, Siegal, and SubbaNarasimha (1985) found, the entrepreneur's experience is used by potential investors to screen applications for assistance. Thus, not only will experience help the entrepreneur to see the relationship with the investor and the actual terms in a more sophisticated light, experience will also allow the entrepreneur to be seen by the investor as more capable and credible.

Proposition 1: Entrepreneurs with more entrepreneurial experience will have more power

relative to investors than entrepreneurs with less entrepreneurial experience.

Financial Expertise

Expert power is demonstrated when an individual has knowledge or expertise relevant to others (French and Raven, 1959). Fiske (1961) suggests that the hallmark of expertise is the ability to adjust one's skills to be adaptive and successful even in the face of changes in situational demands. In venture finance situations, it can generally be assumed that the investor has more financial knowledge and expertise than most entrepreneurs. However, to the extent that the entrepreneurs have their own financial expertise, the entrepreneurs' power relative to the investor will be enhanced.

Proposition 2: Entrepreneurs with financial expertise will have more power relative to investors than entrepreneurs without financial expertise.

Rare Substantive Expertise

Rare substantive expertise in the entrepreneurs' field may also enhance the entrepreneurs' power, particularly when the field is a popular one for venture capital. Where the value of the enterprise lies within the entrepreneur, then it is less likely that the investor will jeopardize the relationship with the entrepreneur than if the value lay within physical assets or intellectual property.

Proposition 3: Entrepreneurs with rare expertise in their fields will have more power relative to investors than entrepreneurs without rare expertise in their fields.

Negotiating Experience

Specific experience or training in negotiations should also give entrepreneurs power in their negotiations with investors. Neale and Northcraft (1986) found that while both expert and amateur negotiators were able to reach integrative ("win-win") solutions over time, expert negotiators were more integrative early in the negotiations and tended to secure higher average outcomes than amateur negotiators. Thompson (1990) found that experienced negotiators made more accurate judgments about the other party's priorities and were more likely to negotiate more favorable agreements.

We can expect, then, that entrepreneurs who are experienced negotiators will be able to negotiate more favorable terms than will novice negotiators.

Proposition 4: Entrepreneurs with specific training or experience in negotiations will have more power relative to investors than entrepreneurs without training or experience in negotiations.

Skin in the Game

"Skin in the game" is a term coined by billionaire investor Warren Buffet to refer to personal investment in an enterprise (Morring & Taverna, 2005). Scholars and commentators alike have suggested that a party's skin in the game increases personal commitment to a successful venture (Tennant, 2005; Koehn, 2005; Gray, 2004; Bischel, 2004). Anecdotal evidence suggests that venture capitalists are conginizant of this concept. As entrepreneur Glenn Cornett explained, venture capitalists discounted the value of his business at an early stage because so little money had been put into it (Cornett, 2005). Accordingly, a greater personal investment by the entrepreneurs can be expected to improve the entrepreneurs' negotiating position.

Proposition 5: Entrepreneurs with more personal financial investment in the start up will have more power relative to investors than entrepreneurs with less personal financial investment in the start up.

Attributes of the Entrepreneur's Resources

Even where an entrepreneur has some personal attributes that may be advantageous in negotiations with investors, entrepreneurs likely to strengthen their power through the accumulation of certain resources that are also likely to enhance power. These include (1) strong intellectual property, (2) loyal board members, (3) high status alliance partners, (4) high status legal counsel, (5) an advisory board, and (6) the length of time the start up has been in business.

Strong Intellectual Property

Holding and Carlsen (1999) report an incident that occurred in 1991: It was every entrepreneur's worst nightmare.

One day EP Technologies was seeking venture capital financing to expand its medical equipment business. The next day an entirely new company - financed by the same venture capitalists - arose to make exactly the same product for exactly the same market.

Theft of intellectual property, euphemistically called "competitive intelligence," is an important concern for every entrepreneur. Legitimate investors are acutely concerned with the protectability of entrepreneurs'

intellectual property (Klein, 2005; Schneider, 2002)); the stronger the protection, the more valuable is the property. Less legitimate investors will be concerned for other reasons; the weaker the protection, the easier it is to appropriate. In either event, strong intellectual property protection should provide more power to entrepreneurs than weak intellectual property protection

Proposition 6: Entrepreneurs who have strong intellectual property protection will have more power relative to investors than entrepreneurs with weak intellectual property protection.

Loyal Board Members

Holding and Carlsen (1999) report another incident that highlights the importance of loyalty: In June 1997, Shyam Das sat down for sodas with venture capitalist Jeffrey Drazan at the Peppermill Restaurant in Cupertino. Drazan and his firm, Sierra Ventures, had put about \$7 million into the company Das founded the year before, and after a few minutes of small talk, Drazan said he wanted another Sierra director on the board. Das was wary. For years, he had worked alone to perfect the company's product - an ingenious device capable of storing more data on a computer disk than anyone thought possible. And he could feel Drazan prying it away. But Drazan assured him they would "always be together," so Das relented. It was a critical mistake.

Two months later, Das was out, fired from his own company - with Drazan's new director casting the deciding vote. And although Das still held millions of shares of company stock, he said the directors eventually found a way to betray him one more time. "When I handed over this company," Das said, "it was just like losing a child." Das' experience illustrates the importance of personal loyalty on the board. While it is often the case that investors will insist on board seats, and even board control, loyal board members provide at least some buffer to this power.

Proposition 7: Entrepreneurs with loyal board members on the board will have more power relative to investors than entrepreneurs without loyal board members on the board.

High Status Alliance Partners

A number of scholars have argued that if an individual's partners possess considerable legitimacy or status, then the individual may derive legitimacy or status through that affiliation. This borrowed legitimacy or

status has been shown to have a number of positive economic benefits for the actor, ranging from survival to organizational growth and profitability (Baum & Oliver, 1992; Podolny & Phillips, 1996; Podolny 1993). In one of the more compelling demonstrations of the economic value of ties to high-status actors, Stuart and his colleagues (1997) examined the economic effects of interorganizational networks of privately held biotechnology firms. Stuart and his colleagues found that an affiliation with a prominent alliance partner increased the market value of the biotechnology firm. Consistent with an interpretation of these ties as carriers of legitimacy, Stuart and his associates found that the effect of affiliations varies inversely with the age of the start-up. In other words, young start-ups benefit more from the status of their network partners than do older start-ups.

Proposition 8: Entrepreneurs with high status alliance partners will have more power relative to investors than entrepreneurs without high status alliance partners.

High Status Legal Counsel

Just as high status alliance partners may be a signal of quality and hence give an entrepreneur more bargaining power, so too may the status of the entrepreneur's general counsel. Some law firms are known in the venture finance industry as higher status and more connected, knowledgeable, and capable than other law firms (Phillips & Zuckerman, 2002; Phillips, 2001). Thus, such law firms may provide the entrepreneur with power relative to the investors in at least two ways. First, these law firms may suggest a certain sophistication on the part of the entrepreneur that will translate into more respect. Second, the expertise of the law firms themselves in the domain of venture capital should inure to the benefit of the entrepreneurs through good legal advice.

Proposition 9: Entrepreneurs with high status legal counsel will have more power relative to investors than entrepreneurs with low status legal counsel.

Advisory Board

Fox (1982), in the Harvard Business Review, recommended that entrepreneurs create "quasi-boards of directors" or advisory boards to allow the entrepreneurs to gather expert advice without the imposing on the advisors the legal or fiduciary burdens of being board members. These advisors can offer advice without

becoming embroiled in operations or politics. Such advice can benefit the entrepreneur in two ways when negotiating with investors. First, the existence of the board of advisors signals that the entrepreneur is willing to listen to independent, outside advice. Second, the advisors can provide invaluable advice with respect to the negotiations themselves.

Proposition 10: Entrepreneurs with an advisory board will have more power relative to investors than entrepreneurs with no advisory board.

Length of Time in Business

In his classic essay introducing the concept of "liability of newness," Stinchcombe (1965) argued that new organizations in new economic sectors are at a disadvantage with respect to older, established firms. In other words, start ups are more likely to fail than older companies for a variety of reasons bundled under the concept of liability of newness (Gruber & Henkel, 2006; Aspelund, Berg-Utby & Skjevda, 2005; Fowler, S.W., Lawrence, T.B., & Morse, E.A. 2004; Deeds & Rothaermel, 2003). It is reasonable to suppose, entrepreneurs that have been operating their companies longer will not only have a greater chance of survival, but will also be able to leverage the longevity into negotiating power. Thus, though not a resource that can be purchased or otherwise acquired except by the passage of time, the longevity of the business may also be an important attribute of the entrepreneurial venture.

Proposition 11: A startup's length of time in business is positively correlated with the entrepreneur's power relative to investors.

CONCLUSION

Contrary to the assumptions of federal and state Blue Sky laws, investors in new ventures tend to be sophisticated and experienced and can use their sophistication and experience to take advantage of relatively naïve entrepreneurs. Not all venture finance deals are bad for entrepreneurs, however, suggesting that the attractiveness of the deal for the entrepreneur is contingent on a variety of factors. In this paper, we have identified nine possible contingencies based upon the attributes of the entrepreneur and the entrepreneur's resources. Specifically, we have suggested that the entrepreneur's experience in new venture finance, financial expertise, expertise in his or her field, and negotiating experience will positively affect the

entrepreneur's ability to negotiate positive deals. We have further suggested that the strength of the entrepreneur's resources will positively benefit entrepreneurs in their negotiations with investors. These resources include protectable intellectual property, loyal board members, high status alliance partners and legal counsel, and an advisory board.

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