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

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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.

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

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.

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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; Vallerie 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.

Takken 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 financiers 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’ preferred portfolio firms, the consequences of unethical behavior on the part of VCs are likely to be profound. We reason, then, that a VC’s ethical reputation is likely to be an important, yet presently overlooked consideration for entrepreneurs seeking VC investment offers. In the present study, we conceptualize the VC’s 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.
Empirically, we test our conceptual model by conducting two complementary experiments. Study 1 utilizes metric conjoint analysis to examine whether, ceteris paribus, a VC’s reputation for ethical behavior influences the entrepreneurs’ willingness to partner and how that reputation interacts with other reputational characteristics that have been influential in previous studies. The conjoint approach requires explicitly stating that the VC has a reputation for ethical or unethical behavior. Further, the conjoint design does not necessarily account for the degree to which investors’ ethical reputation has clear implications for the entrepreneur. Study 2 addresses these issues via a traditional scenario experiment where entrepreneurs develop their own perceptions of whether the behavior described is ethical or unethical, and we also manipulate the magnitude of the negative consequences if the funding offer is rejected. Further, study 2 extends the findings of study 1 by testing the degree to which individual differences (e.g., fear of failure) interact with the effects of ethical reputation on entrepreneurs’ investment partnership decisions. The net effect of our multi-study approach is that we offer theoretical insights and empirical evidence that responds to calls for more research exploring the investor–investee relationship (Collewaert and Fassin, 2013; Fisscher et al., 2005; Lockett et al., 2006; Parhankangas and Landstrom, 2006) and also for research linking ethics and entrepreneurship (Bucar et al., 2003; Hannafey, 2003; Harris et al., 2009).

3. Conceptual background

3.1. Business ethics and venture capital

There is little consensus regarding a formal definition of ethical behavior (Tenbrunsel and Smith-Crowe, 2008) but one widely recognized conceptualization is that ethical behavior is accepted morally as “good” and “right” as opposed to “bad” or “wrong” in a particular setting (Sims, 1992, p. 506). Because ethical or unethical behavior is contextual and perceptual, individuals form differing views of what constitutes ethical and unethical behaviors (Carlson and Kacmar, 1997). More formally, an individual’s evaluation and perception of ethical issues can be viewed through a combination of ethical lenses based on deontological and teleological perspectives (Morris et al., 2002). That is, evaluations by individuals may vary with regard to their reliance on inner-states and intrinsic characteristics (deontological) or situational cues and consequences (teleological) in their perceptions and behaviors (Hunt and Vitell, 1993; Morris et al., 2002). In that way, such perceptions are shaped by a variety of social factors and also individual differences (e.g., gender, nationality, and value orientation) and issues of moral intensity (e.g., personal impact, social consequences, etc.) (Cohen et al., 2001; Deshpande, 1997; Kelley et al., 1990; O’Fallon and Butterfield, 2005). While these insights have been applied to entrepreneurship writ large (cf. Hannafey, 2003; Harris et al., 2009; Morris et al., 2002), research at the intersection of ethics and VC investment is limited. Aside from a handful of books on ethics in finance (e.g., Boatright, 1999), there are only a few articles and case studies addressing the topic of ethics in VC (e.g., Fassin, 1993, 2000; Nanda, 2001; Useem, 2000)—thus remaining an intersection that stands largely unexplored.

Given the paucity of research applying business ethics to VC investment, we are left with an opaque understanding of how ethical or unethical behaviors might influence the dynamics and decisions that make up the VC investment cycle. Having said that, we do know that because ethics involve individual perceptions (Carlson and Kacmar, 1997), both sides of the investor–investee dyad can form differing views of what constitutes ethical or unethical behaviors. As such, entrepreneurs may well view certain actions of the VC as opportunistic and unethical; on the other hand, VCs may believe the same actions to be ethical and merely part of the VC investment game (Collewaert and Fassin, 2013). These opposing perspectives are evident as Utset (2002, p. 108) witnesses that entrepreneurs often refer to VCs as “vulture capitalists.” Thus, while the VC presumably views his or her behavior as ethical and a necessary course of action, the entrepreneur may interpret their actions as unethical—underscoring what is well-established in the ethics literature: ethical perceptions are often a gray area, subject to individual interpretation and contextual influences (O’Fallon and Butterfield, 2005; Sims, 1992).

In the present study we are less interested in differences between what VCs and investors perceive as ethical or unethical actions. Instead, we focus on how a reputation for perceived ethical or unethical behavior influences the entrepreneurs’ decisions to accept VC funding. Specifically, we reason that variations in reputation for perceived ethical behavior will play an important role in these decisions because when entrepreneurs decide to accept VC funding, they give up a measure of control over their business (Drover et al., 2013). In many ways, the VC becomes an agent of the venture because entrepreneurs assume that the VC will represent the best interest of their venture; however, VCs are multifaceted agents (Sappington, 1991) who are charged with balancing their own interests, those of their investors, and those of their investees. As such, VCs may take actions that do not seem unethical to them, but are perceived as unethical to other constituents. Given this, agency theory is a useful lens through which to view the role of ethics in the VC–entrepreneur relationship.

3.2. An agency view of venture capital investing

The entrepreneur’s choice to partner with a VC can—besides the financial means—provide advantages and added value, often coming in the form of strategic guidance, operational knowledge, or the recruiting of expert personnel (Busenitz et al., 2004; Shepherd and Zacharakis, 2001). These advantages, however, come at the expense of relinquishing control, and while VCs often have profound structural and strategic influences on the venture, these influences are sometimes at odds with the best interest of the entrepreneur. This phenomenon is well explained by agency theory (Jensen and Meckling, 1976), which emphasizes factors contributing to risks of opportunistic behavior and goal misalignment, where agency problems like moral hazard, adverse selection and hold up occur (cf. Amit et al., 1998; Hellmann, 1998; Kaplan and Stromberg, 2003). Because multiple principal—
agent relationships arise during VC investing (Barry, 1994), the VC investment process can be viewed from a multi-principal’
actions and post-investment behaviors (Barry, 1994; Sahlman, 1990). VCs can encounter problems when the entrepreneurs they
invest in do not behave in a preferable manner, but instead act opportunistically (even unethically) (Gorman and Sahlman, 1989;
Scarlata and Alemany, 2010); at the same time, entrepreneurs face agency problems when VCs are thought to exhibit such
behaviors (Cable and Shane, 1997; De Bettignies and Brander, 2007; Fassin, 2000; Fried and Ganor, 2006; Hellmann, 2006; Smith,
1998). Further, VCs may have conflicts of interests with the entrepreneurs, for instance regarding an exit strategy (Barry, 1994).
All of this suggests that agency problems arise across many facets of the principal–entrepreneur relation and how perceptions of ethical behavior influence that agency relationship from the perspective of the entrepreneur.

At the core of this relationship is the premise that agents (i.e., VCs in our case) often exhibit a proclivity to engage in individual
utility-maximizing behavior that may be misaligned with the goals of the principal (i.e., entrepreneurs in our case) (Bohren,
1998). As a mechanism by which to hedge against facing such behaviors, Meuleman et al. (2009, p. 1003) note that “reputation
plays an important role in resolving contractual incompleteness and problems of asymmetric knowledge in principal–agent
relationships.” In other words, knowledge of a party’s past behavior can serve as a proxy which informs the perceived risk of
potential agency issues. Thus, largely because of the extent of control and influence a VC often has, entrepreneurs are likely to be
sensitive to past behaviors which are perceived as opportunistnic or unethical, as such actions reflect the probability of incurring
future agency costs.

### 4. Hypotheses

If, as we have conceptualized, entrepreneurs are sensitive to past unethical behavior, and these actions create agency costs,
then these considerations should manifest in entrepreneurs' VC partnership decisions. This line of thinking is consistent with the
research that documents the influence of VC characteristics on an entrepreneur’s decisions. Specifically, the VC’s personal
compatibility, added value, and reputation for investment success have all proven influential (Fairchild, 2011; Saetre, 2003;
Smith, 2001; Valliere and Peterson, 2007; Zheng, 2011). In this spirit, we theorize that perceptions of ethical reputation will
influence entrepreneurs’ decisions to accept funding offers from investors primarily because of the agency risks associated with
accepting outside equity financing.

Moreover, due to the increasing connectivity of entrepreneurial networking groups and enhanced transparency from investor
review communities such as TheFunded.com (Zheng, 2011), entrepreneurs are likely to be cognizant of information regarding
the VC’s prior behavior and by extension his or her ethical reputation. In that regard, Zheng (2011) analyzed a set of post hoc
comments from entrepreneurs reviewing their former investors and noted that the ethical behavior of VCs surfaced as a recurring
theme. When viewed through the lenses of agency theory tenets, the prediction that emerges is that entrepreneurs are likely to
avoid the agency risks associated with a prospective investor whose post-investment behavior is perceived as unethical. Stated
differently, VCs’ reputation for perceived unethical actions sends signals to entrepreneurs about their future fate should they
decide to accept funding. This suggests that entrepreneurs will likely place considerable value on this aspect and the preceding
logic yields our first hypothesis:

**Hypothesis 1.** The greater the VCs’ reputation for ethical behavior, the greater the entrepreneurs’ willingness to partner with the
VC.

### 4.1. Interactive role of ethical reputation

The influence of reputation for ethical behavior does not occur in isolation and thus must be considered alongside other VC
characteristics known to influence entrepreneurial decision making. Specifically, prior research has documented the influential role of the value-add VCs bring to their relationships as well as the VCs’ past record for investment success (Smith, 2001; Valliere and Peterson, 2007). Given that value-adding services and reputation for success are readily established as influential considerations (Smith, 2001; Valliere and Peterson, 2007; Zheng, 2011), we do not formally hypothesize these direct relationships (see Haynie et al., 2009; Wood and Williams, 2013 as examples of this approach). Instead, we are interested in the interactive role ethical reputation plays as one concomitantly considers multiple VC characteristics. Exploring such effects contributes to delineating boundary conditions around these variables, thereby shedding new light on the role that perceptions of ethical reputation may play in this stage of the entrepreneurial process.

#### 4.1.1. VC value-add service

As previously noted, VCs generally offer a variety of value-added services in addition to a series of capital injections (Hellmann
and Puri, 2000; Sahlman, 1990; Sapienza, 1992). Specifically, such services may include the ability to recruit key executives,
strategic guidance, industry-specific expertise and operational assistance (Bygrave and Timmons, 1992; Large and Muegge,
2008). Value-adding activities are widely known to play a central role in assisting the growth and development of a VC’s portfolio
firms. In turn, these activities play an important role in explanations for why some VC-backed firms realize lower failure rates (Zacharakis and Meyer, 1998). They also assists in explaining why some VC-backed companies reach IPO faster than startups absent of VC involvement (Hellmann and Puri, 2000; Jain and Tabak, 2008; Shane and Stuart, 2002). Such services, therefore, can

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ultimately translate into a significant source of economic rents for an entrepreneur, and as a result this characteristic has surfaced as a fundamental evaluative factor that entrepreneurs highly value (Fairchild, 2011; Saetre, 2003; Smith, 2001; Zheng, 2011).

Moreover, if we then consider the impact of value-added services alongside the ethical reputation of a prospective VC, the role of the former is likely to differ. While a VC equipped with considerable value-added capabilities holds the potential to benefit a startup tremendously, perceptions of ethics-related behaviors may exert a moderating effect which can render the previously established role of value-added services less meaningful in the eyes of entrepreneurs. In this way, we argue that the prospect of steep agency costs accompanying a VC that has previously acted unethically in post-investment behaviors contributes to offsetting the potential upside of partnering with a VC offering extensive value-added capabilities. More formally:

Hypothesis 2. The relationship between VC value-added service and entrepreneurs willingness to partner is less positive when the VC has a reputation for unethical behavior.

4.1.2. VC prior investment success

The investment track record of a VC, which is a function of prior performance and experience (e.g., realized exits such as IPOs or M&As), is important for a number of reasons (Dimov et al., 2007). In fact, Lee et al. (2011) note that facilitating exits is a critical component of enhancing a VC firm’s reputation, as such exit activity sends signals indicative of the investor’s capabilities. In other words, the investment track record of VCs serves as a predictor of the likelihood of future investment success (Kaplan and Schoar, 2005). In this way, the greater the number of successful realized exits, the greater the acquired prominence and perceived capabilities.

From the entrepreneurs’ perspective, a VC who has taken a high volume of his or her investments public, or who has driven many exits through acquisition indicates that a prospective VC is equipped with the requisite skills and abilities to facilitate a successful outcome. As such, the investment success of a VC firm has rightfully been shown to be important to entrepreneurs in their evaluations of prospective investors, as Smith (2001) notes that the most important factor was a VC’s reputation for investing in successful startups. Given the importance of a VC’s investment history to entrepreneurs, the strength of this evaluative variable is likely to vary in the presence of prior ethical or unethical behavior. Consider the example of a VC who has made a number of successful investments, but is known to act opportunistically to succeed. We maintain that as such information becomes salient to an entrepreneur, the high potential for agency costs will contribute to counteracting the advantages the VC can potentially provide and will adversely impact the entrepreneurs’ willingness to partner. Thus:

Hypothesis 3. The relationship between VC prior investment success and entrepreneurs willingness to partner is less positive when the VC has a reputation for unethical behavior.

4.2. Magnitude of the consequences

To this point we have used agency theory principles to argue that entrepreneurs are less likely to partner with VCs when those investors have a poor reputation for behaving ethically. This conceptualization predicts that investment offers from less ethical VCs are likely to be rejected; however, as Morris et al. (2002) point out, entrepreneurs face a number of unique challenges such as time pressures and cash shortfalls that may lead to compromises when ethical issues arise. By extension, this means that there may be severe consequences and also compromises for entrepreneurs when considering rejecting the VC’s offer. Take for example that entrepreneurs typically take on substantial personal risk when they launch a new venture and thus are willing to go to great lengths to ensure venture survival. In that way, running out of operating cash is the worst-case scenario for most entrepreneurs, and this is important because we know that considerations of the worst-case scenario loom large in entrepreneur’s decisions (Wood and Williams, 2013). In this vein, prior research has shown that consequences of accepting or rejecting VC funding are salient factors in entrepreneurs’ decisions (cf. Hsu, 2004). In the context of our model, this is a key consideration because the VCs’ reputation for ethical behavior may play less of a role if the consequences of rejecting the funding are severe—such as entering bankruptcy if the investment offer is rejected.3 In other words, entrepreneurs with “their backs against the wall” may pay less attention to the VCs’ ethical reputation than under circumstances where less is at stake. This consideration suggests that the threat of agency costs associated with partnering with a VC known for questionable ethical behavior will be tempered when the consequences of rejecting the funding offer are severe (e.g., bankruptcy). This suggests the following interactive relationship:

Hypothesis 4. The consequences of rejecting a funding offer will interact with reputation for ethical behavior, such that entrepreneurs will be more willing to partner with a VC who has a questionable ethical reputation when the consequences of rejecting the offer are severe rather than mild.

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3 In the realm of VC investment, many early-stage ventures are cash flow negative for an extended period of time. Thus, the inability to secure funding often results in insolvency. That is, the threat of bankruptcy is often not a reflection of a venture’s prospects, but rather a reflection of the capital-intensive nature of high risk/high reward ventures.
4.3. Fear of failure

In addition to magnitude of the consequences, we suspect that the influence of an investor’s ethical reputation may be contingent upon individual differences. While one can imagine a host of individual differences that might be in play, we consider fear of failure in our model. Fear of failure is the “capacity for experiencing shame or humiliation as a consequence of failure” (Atkinson, 1966, p. 13), and we selected fear of failure because it has been well researched in the context of entrepreneurial cognition and decision making (cf. Mitchell and Shepherd, 2010; Wood et al., 2013). As such, we know that fear of failure influences entrepreneurs’ decisions, but it has not been considered in terms of the ethical behavior and the agency concerns associated with partnering with an investor of questionable ethics, for example. Our theory explicitly considers fear of failure as an influential individual difference in this context.

Prior research on fear of failure has surmised that those with high fear of failure view failure as an unacceptable event that carries negative implications for their self-worth and relational security. If we consider this in light of agency theory logic, it suggests that entrepreneurs who have a high fear of failure will be more willing to bear the agency risk of partnering with an investor who has a questionable reputation for ethical behavior because they cannot bear the thought that failure might ensue if they pass on the investment offer. In other words, a high fear of failure entrepreneur is looking for circumstances where the odds of failure can be minimized and in some cases this means that taking a chance on a VC with a questionable ethical reputation is the best option for avoiding failure, at least in the near term. In sum, higher levels of fear of failure may lead those entrepreneurs to take actions, like partnering with less ethical VCs, that others may not. This reasoning leads to our final hypothesis:

**Hypothesis 5.** Entrepreneurs fear of failure will interact with reputation for ethical behavior, such that entrepreneurs will be more willing to partner with a VC who has a questionable ethical reputation when fear of failure is high rather than low.

Because our conceptual model involves a number of hypothesized relationships, as well as some conformity relationships from extant research that are not formally hypothesized, we illustrate the sum of these relationships in Fig. 1. Further, as discussed in the Introduction section, we take a multi-study approach to testing these relationships. Study one is a conjoint experiment that tests Hypotheses 1–3, while study two is a scenario experiment designed to provide confirmatory evidence for Hypothesis 1 and then test Hypotheses 4 and 5. These approaches are discussed in detail below and are noted for illustration purposes in Fig. 1.

5. Study one: a conjoint approach

Study one explores the relationships posited in Hypotheses 1–3 by leveraging metric conjoint analysis—a technique for analyzing decision processes (Shepherd, 2011) that has proven especially useful for studying the decision policies of entrepreneurs (e.g., Haynie et al., 2009; Mitchell and Shepherd, 2010; Wood et al., 2013). Conjoint analysis involves developing a series of theory-driven profiles (outlined in detail below) where participants make assessments of each profile and those assessments are used to decompose the underlying structure of respondents’ decisions (Aiman-Smith et al., 2002; Hitt et al., 2004; Shepherd and Zacharakis, 1997). Conjoint analysis allows researchers to capture entrepreneurs’ decision-making policies as they make action-based decisions regarding their willingness to partner with investors given a specific set of circumstances (detailed below). The key advantage of this approach is that it captures entrepreneurs’ decision policies while they are ‘in use’ and thus overcomes many of the limitations associated with post hoc techniques that require introspection (Aiman-Smith et al., 2002; Green and Srinivasan, 1990).

5.1. Sample

Participants were active entrepreneurs who belong to a large entrepreneurship association in the midwestern United States. Using a membership list, we sent a participation request via email to 240 entrepreneurs with two reminders sent at one-week intervals. The profiles used in the conjoint experiment are as follows:

- **Study One**:
  - VC Prior Investment Success
  - VC Value Added
  - Ethical Reputation of VC

- **Study Two**:
  - Magnitude of Consequences
  - Fear of Failure

**Fig. 1.** Model of investors’ ethical reputation and entrepreneurs’ willingness to partner.

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intervals (Dillman, 2000). The conjoint experiment was completed by 65 entrepreneurs (27% response rate). This sample size is on par with recently published conjoint studies in entrepreneurship (c.f., Murnieks et al., 2011; Wood and Williams, 2013). All 65 respondents indicated that they were entrepreneurs and 61% had experience with equity financing. 73% were male, while 27% were female and the average age was 46 years old. With respect to education, 4 entrepreneurs held a high school diploma at minimum, 7 held an associate’s degree, 27 had earned a bachelor’s degree, 24 held master’s degrees and 3 earned their doctorate. Years of entrepreneurial experience varied from 1 to 35 years, with a mean of 13 years. In addition, 72% of respondents have were female and the average age was 46 years old. With respect to education, 4 entrepreneurs held a high school diploma at minimum, 7 held an associate’s degree, 27 had earned a bachelor’s degree, 24 held master’s degrees and 3 earned their doctorate.

5.2. Instrument

Our experiment and instrument were based on the established traditions of a number of well-regarded conjoint analysis studies (e.g., Aiman-Smith et al., 2002; Choi and Shepherd, 2004; Haynie et al., 2009). Participants accessed the experiment online, where the instructions outlined the completion of the experiment, followed by variable descriptions, profiles to be evaluated, and finally a post-experiment questionnaire. The primary task involved assessments of a VC funding offer where the VC was described by different combinations of ethical reputation, value-add, and prior investment success. Respondents were asked on 1–7 Likert scale: “What is the probability you would partner with this investor?” and “How favorable do you view this prospective investor?” Orthogonal full factorial design was used in the profile design (2 levels of ethical reputation × 2 prior investment success × 2 value add) resulting in 8 full profiles (see Appendix A). In addition, one warm-up profile and two repeat profiles were included as reliability checks (Warden and Chen, 2009). The presentation of the profiles and variable was randomized to reduce the probability of capturing order effects.

Before viewing the profiles, respondents were told that each VC was to be evaluated separately, independent from the others. Participants were also instructed to put themselves in the context of each scenario, responding as if they were in the situation. Participants were then introduced to the investment scenario (see Appendix A). The context provided follows the traditions of other conjoint studies (cf. Murnieks et al., 2011), where limited information beyond profile attributes is provided; this is intentional, as detailed information may confound the effects of the profile attributes. The definitions of each of the three attributes were provided (see Appendix A). The instrument was validated by a number of entrepreneurs, who indicated each attribute and level to be relevant to their “real world” evaluations of prospective investors. Finally, we captured respondent’s demographic data, such as age, gender, education, entrepreneurial experience and encounters with unethical investors.

5.3. Dependent variable

The entrepreneur’s willingness to partner with a VC served as the dependent variable. We followed Murnieks et al. (2011) using a multi-item measure and subjects were asked of their probability of partnering (1—low probability to 7—high probability) and how favorable they viewed each investor (1—unfavorable to 7—highly favorable). The resultant scores were summed to form an overall measure of willingness to partner (α = .87).4

5.4. Independent variables

We manipulated three independent variables using two levels of each variable. Prior investment success was articulated as “proven,” where the VC had been successful in prior investment activity (e.g., achieving IPOs) versus “developing,” which indicated a lack of prior success. Value add was conceptualized as delineating the degree to which the VC offers value-added services to the entrepreneur (e.g., networks, recruiting, or strategic guidance) and was presented as “many” versus “limited.” Finally, ethical reputation reflected the levels of prior ethical or unethical behavior in prior post-investment activities—high vs. low—as evidenced by various sources. Hence, we articulated specific actions of prior VC behavior indicative of ethical or unethical behavior (exemplar profile provided in Appendices A and B).

5.5. Reliability analysis

To assure that our experiment was conducted in a reliable manner, we asked respondents whether they had understood the instructions and whether they fully understood the various attribute definitions. All respondents indicated that they fully understood both. We then followed Warden and Chen (2009) by conducting paired T-tests between responses on the original and repeat profiles. Means for our summed dependent variable were 2.6 vs. 2.4, and 13.5 vs. 13.4. Both differences failed to reach statistical significance (T = 1.7, p > .05; T = .435, p > .05, respectively). Because there was no significant difference between original and repeat profiles, we concluded that participants responded in a reliable fashion.

4 We also ran the results separately for each of the dependent variable questions used in the scale. Similar results were obtained.
5.6. Empirical model

Conjoint data is multilevel, and Hierarchical Linear Modeling (HLM) has proven a worthy analytic technique for modeling such effects (Heck et al., 2010) and hence is the technique of choice in conjoint studies (e.g., Haynie et al., 2009; Mitchell and Shepherd, 2010; Murnieks et al., 2011). As such, we used HLM to model and analyze our data. In HLM, parameter estimates are generated, and the t-values associated with those parameters indicate the significance of the conjoint attribute or the interaction between attributes. The parameter estimates can be interpreted as unstandardized regression coefficients and indicate the amount of change in the dependent variable as a function of a one-unit change in the independent variable (e.g., a move from the low to high condition).

5.7. Results for study one

The estimated marginal means for each level of the variable are reported in Table 1, while the results of the HLM analyses are reported in Table 2.

As noted in Table 2, all three main effects were positive and significant. While the main effects for prior investment success and value-added were not hypothesized directly, we note that entrepreneurs more favorably evaluate investors who have a successful historical investment track record, \( \beta = 2.32, p < .001 \) and investors who possess extensive value-added capabilities, \( \beta = 2.97, p < .001 \). Our results further substantiate extant research on these relationships.

The third main effect of ethical reputation is of particular interest mainly because existing research has yet to consider how perceptions of ethics-related behavior may influence the entrepreneur’s evaluation of investors. Because of the prospect of agency-related issues, we argued that an investor’s ethical reputation in prior post-investment behaviors would have such a significant impact on the willingness to partner that entrepreneurs would become less willing to partner with an investor as perceptions of prior unethical behavior become salient. Results illustrated a significant main effect for ethical reputation, \( \beta = 9.20, p < .001 \). Further, Table 1 sheds more light on this relationship, where we see the willingness to partner was considerably lower in the presence of a lower ethical reputation (\( M = 3.41 \)) than when the VC was known to operate with a high degree of ethical behavior (\( M = 10.33 \)). As such, these findings offer support for our first hypothesis. In addition, we can glean some insight into the respective importance of each variable by observing the coefficient size of the variables. Interestingly, we note the role of ethical reputation to be the most important factor, followed by value-added services and then by prior investment success.

While the examination of our hypothesized main effect contributes to our understanding of how ethical-related variables may manifest in the evaluation process, Hypotheses 2 and 3 offer deeper insights into the interactions. Hypothesis 2 examined the interaction effect between ethical-related behavior and value-added services. The existing literature reveals that entrepreneurs highly value such capabilities; thus, it was important to test the hypothesis that perceptions of prior unethical behavior will prove to counter its influence. Our findings confirmed this interaction effect between ethical reputation and value-added services, \( \beta = 2.35, p < .001 \). Table 1 reveals that an entrepreneur is considerably more willing to partner with a VC equipped with value-added potential when this investor has a reputation for ethical behavior (\( M = 12.27 \)), versus unethical behavior (\( M = 3.70 \)). Further, we see that value-added services alone resulted in a lower conditional mean of 5.75 and a high conditional mean of 7.96, but considered jointly, when a VC has acted ethically in prior post-investment behaviors, the means become 8.39 and 12.27, respectively. Conversely, when a reputation for unethical behavior was present, the willingness to partner fell significantly to 3.12 and 3.70, respectively. Therefore, we observe a strong interaction effect in which value-added services are reinforced by ethical reputation on the part of the VC, yet the importance of value-added services is sharply mitigated by the presence of an unethical reputation. Thus, these findings support Hypothesis 2.

In a similar manner, Hypothesis 3 examined the interaction effect between ethical reputation and prior investment success. Extant literature also informs that a VC’s historical investment history is a primary driver of entrepreneurs’ investor assessment. As such, we sought to explore how ethical-related behavior may impact the strength of this previously established variable, and as a result, we hypothesized that a reputation for prior unethical behavior would prove to offset its positive influence. Our analyses

<table>
<thead>
<tr>
<th>Variable</th>
<th>Level</th>
<th>Mean</th>
<th>Standard error</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment success</td>
<td>Low</td>
<td>5.80</td>
<td>.136</td>
</tr>
<tr>
<td></td>
<td>High</td>
<td>7.94</td>
<td>.134</td>
</tr>
<tr>
<td>Value-added</td>
<td>Low</td>
<td>5.73</td>
<td>.133</td>
</tr>
<tr>
<td></td>
<td>High</td>
<td>7.96</td>
<td>.124</td>
</tr>
<tr>
<td>Ethical reputation</td>
<td>Low</td>
<td>3.41</td>
<td>.176</td>
</tr>
<tr>
<td></td>
<td>High</td>
<td>10.33</td>
<td>.156</td>
</tr>
<tr>
<td>Investment success × ethical reputation</td>
<td>Low–low</td>
<td>2.90</td>
<td>.137</td>
</tr>
<tr>
<td></td>
<td>Low–high</td>
<td>8.71</td>
<td>.225</td>
</tr>
<tr>
<td></td>
<td>High–low</td>
<td>3.92</td>
<td>.253</td>
</tr>
<tr>
<td></td>
<td>High–high</td>
<td>11.95</td>
<td>.160</td>
</tr>
<tr>
<td>Value-added × ethical reputation</td>
<td>Low–low</td>
<td>3.12</td>
<td>.158</td>
</tr>
<tr>
<td></td>
<td>Low–high</td>
<td>8.39</td>
<td>.220</td>
</tr>
<tr>
<td></td>
<td>High–low</td>
<td>3.70</td>
<td>.212</td>
</tr>
<tr>
<td></td>
<td>High–high</td>
<td>12.27</td>
<td>.165</td>
</tr>
</tbody>
</table>

Please cite this article as: Drover, W., et al., Take the money or run? Investors’ ethical reputation and entrepreneurs’ willingness to partner, J. Bus. Venturing (2013), http://dx.doi.org/10.1016/j.jbusvent.2013.08.004
support this interaction effect between ethical reputation and prior investment success, (β = 1.26, p < .01). Turning to Table 1, we see that an entrepreneur becomes considerably less willing to partner with a VC reflecting a favorable investment track record when this investor also has a reputation for unethical behavior (M = 3.92), versus ethical behavior (M = 11.95). Viewing the estimated marginal means, we observe that prior investment success alone yielded a low conditional mean of 5.80 and a high conditional mean of 7.94; however, when we consider this variable in the presence of ethical reputation, the willingness to partner becomes 8.71 and 11.95, respectively. On the other hand, the willingness to partner drops to 2.90 and 3.92, respectively, when a VC reflects a reputation for acting unethically in prior post-investment behaviors. Thus, we observe a significant interaction effect where the influence of prior investment success is mitigated by the presence of prior unethical behavior and is reinforced by a reputation for ethical behavior. These findings provide support for our third hypothesis.

6. Study two: a scenario approach

Study two compliments study one by providing an additional test of the VC ethical reputation and willingness to partner relationship. This is important, largely because study 1 overtly stated that the VC has a reputation for ethical or unethical behavior instead of describing certain behaviors and allowing the entrepreneur to discern the degree to which that behavior is ethical or unethical. In addition, the conjoint experiment does not account for the degree to which ethical reputation has clear implications for the entrepreneur. Bearing these points in mind, our objective in study 2 was to explore whether or not similar results would be obtained if we did not overtly tell participants that the behavior was ethical or unethical and instead allowed them to make their own inferences about whether the behavior described was ethical or unethical. In addition, study one did not consider the magnitude of the consequence for the entrepreneur if the funding was rejected (Hypothesis 4), nor did it consider the possibility that individual differences such as fear of failure (Hypothesis 5) might influence the effects of ethical reputation on an entrepreneur’s partnership decisions. Study two investigates these relationships via a between subjects scenario experiment, an approach well established in cognition and decision making studies broadly (e.g., Kahneman and Tversky, 1972; Meindl et al., 1985; Wood and Karau, 2009) and in entrepreneurship specifically (e.g., Burmeister and Schade, 2007; Grégoire et al., 2010).

6.1. Instrument and variables

We used a 3 (ethical reputation: unethical, neutral, or ethical) by 2 (magnitude of consequences: mild or severe) between-subject’s factorial design. All participants received identical instructions and background information that provided the basics of the situation (see Appendix B). Each individual then faced one of six versions of the VC investment offer scenario. All versions contained common information designed to hold influential factors constant at the average (e.g., ownership stake, board position, investor track record and value add5). Once this information had been provided, each scenario contained one of the six possible combinations of the manipulation (e.g., experimental treatments). For ethical reputation, we drew on the literature that suggests when dealing with investors, entrepreneurs perceive that ethical problems often arise around exit timing decisions (Broughman, 2010; Collewaert and Fassin, 2013). Broughman (2010), for instance, pointed out that VCs may have incentives to facilitate a venture’s exit on terms or at a time which benefits the VC at the expense of other stakeholders. For magnitude of consequences, we drew on research that documents the key role cash flow plays in venture survival and the ability to pursue opportunities to grow the business (Chandler and Hanks, 1998; Cooper et al., 1994). Thus, the insights gleaned from the literature and our first experiment provided the foundation for the manipulation language we developed for the scenario experiment. The full language used is provided in Appendices A and B. Finally, the experiment was pretested by a group of active entrepreneurs, professors and doctoral candidates in an effort to validate the research instrument. The results confirmed the design of our instrument and provided evidence that the language was clear and that the scenario reflected a “real world” situation.

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5 Value add and prior investment success were both influential in study one. As such, we used the background information and language in the investment offer to hold both of these constant in study two.

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We administered the scenario experiment by randomly providing each participant one and only one of the six treatments. After receiving his or her scenario, each individual responded to the following three questions: What is the likelihood that you would partner with this investor? (1—unlikely to 7—very likely); How favorably do you view this prospective investor? (1—unfavorable to 7—highly favorable); How likely are you to accept the present investment offer from the VC? (1—unlikely to 7—very likely). The resultant scores for these three items were averaged to form an overall measure of “willingness to partner” ($\alpha = .86$), which serves as the dependent variable.

The dependent variable questions were followed by manipulation check questions (discussed below) designed to ensure the effectiveness of experimental treatments. These questions were followed by our measures of fear of failure, the five-item short form of the Performance Failure Appraisal Inventory (PFAI). The PFAI was developed by Conroy et al. (2002) and assesses beliefs that failure is associated with negative consequences ($\alpha = .81$). The fear of failure items were followed by a series of demographic questions (responses outlined below), and a number of these were used as control variables. Specifically, prior research has documented that education and entrepreneurial experience are influential in entrepreneurs’ decisions (Baron and Ensley, 2006; Haynie et al., 2009) and that in the context of investment, the entrepreneurs’ experience with investment dynamics is likely to play a role in future investment-related decisions. Therefore the control variables included in our analysis were the entrepreneurs’ age, level of education, years of experience as an entrepreneur, and experience with equity investments.

6.2. Sample

Participants were active entrepreneurs who either belonged to a large entrepreneurship association or were clients of a university business development outreach program, both located in the midwestern United States. Using a contact list, participation requests were emailed to 341 entrepreneurs with two reminders sent at one-week intervals (Dillman, 2000). The scenario experiment was completed by 79 entrepreneurs (23% response rate). To ensure that our sample size provided adequate power to detect a meaningful effect (Cohen, 1992), we conducted a power analysis (see Table 4). Results indicate that power for each effect or interaction is at or above the .80 threshold commonly used as a sufficiency guide, indicating that our sample of 79 entrepreneurs is adequate (Cohen, 1992). All 79 respondents indicated that they were active entrepreneurs; 68.3% had experience with equity financing while 48% had experience with VC financing. The average years of entrepreneurial experience were 13. Of the respondents, 77% were male while 23% were female, and the average age was 50 years old. With respect to education, 14 entrepreneurs held a high school diploma at minimum; 17 held an associate’s degree; 39 had earned a bachelor’s degree; 8 held master’s degrees, and 1 held a doctorate. In sum, our participants are experienced entrepreneurs with the requisite knowledge and skills to evaluate VC investment offers.

Because the motivation for study two is partially derived from study one findings, the samples need to be sufficiently similar to one another. The concern is that differences between the samples could influence our results. To ensure that was not the case we used recruitment techniques that mirrored those used in study one and we solicited entrepreneurs from the same geographic region as study one. This approach proved effective as evidenced by a comparison of representative characteristics for the participants in study one and study two. Specifically, the comparison revealed an average age of 46 versus 50, experience with equity investments was 61% versus 68%, gender was 73% versus 77% male, and both samples had an average of 13 years of entrepreneurship experience. Based on this evidence we concluded that the two samples were sufficiently similar to one another.

Table 3
Estimated marginal means by factor and level (study two).

<table>
<thead>
<tr>
<th>Variable</th>
<th>Level</th>
<th>D.V. Mean (S.E.)</th>
<th>Condition N</th>
</tr>
</thead>
<tbody>
<tr>
<td>Magnitude of consequences</td>
<td>Moderate</td>
<td>4.55 (.16)</td>
<td>43</td>
</tr>
<tr>
<td></td>
<td>Severe</td>
<td>5.41 (.18)</td>
<td>36</td>
</tr>
<tr>
<td>Ethical behavior</td>
<td>Unethical</td>
<td>4.15 (.20)</td>
<td>28</td>
</tr>
<tr>
<td></td>
<td>Neutral</td>
<td>5.28 (.22)</td>
<td>24</td>
</tr>
<tr>
<td></td>
<td>Ethical</td>
<td>5.51 (.21)</td>
<td>27</td>
</tr>
<tr>
<td>Consequences × ethical behavior</td>
<td>Moderate-unethical</td>
<td>3.25 (.29)</td>
<td>71</td>
</tr>
<tr>
<td></td>
<td>Neutral</td>
<td>4.96 (.27)</td>
<td>67</td>
</tr>
<tr>
<td></td>
<td>Ethical</td>
<td>5.42 (.26)</td>
<td>70</td>
</tr>
<tr>
<td></td>
<td>Severe-unethical</td>
<td>5.04 (.27)</td>
<td>64</td>
</tr>
<tr>
<td></td>
<td>Neutral</td>
<td>5.59 (.31)</td>
<td>60</td>
</tr>
<tr>
<td></td>
<td>Ethical</td>
<td>5.61 (.31)</td>
<td>63</td>
</tr>
<tr>
<td>Fear of failure × ethical behavior</td>
<td>Low-unethical</td>
<td>4.17 (.35)</td>
<td>15</td>
</tr>
<tr>
<td></td>
<td>Neutral</td>
<td>4.93 (.34)</td>
<td>14</td>
</tr>
<tr>
<td></td>
<td>Ethical</td>
<td>5.67 (.43)</td>
<td>13</td>
</tr>
<tr>
<td></td>
<td>High-unethical</td>
<td>3.91 (.26)</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>Neutral</td>
<td>5.18 (.29)</td>
<td>11</td>
</tr>
<tr>
<td></td>
<td>Ethical</td>
<td>6.62 (.20)</td>
<td>14</td>
</tr>
</tbody>
</table>

Fear of failure based on median sample split (low fear of failure N = 37; high fear of failure = 42).

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6.3. Manipulation check

Following the entrepreneur’s evaluation and decision to partner, we used several questions to discern the effectiveness of our manipulations. For ethical reputation, we asked, “According to the information in the scenario, would you say that the VC making the investment offer is” 1 (unethical) to 7 (ethical). There was a strong significant main effect for ethical reputation, \( F(2,77) = 21.53, p < .001 \), such that participants reported higher ratings in the ethical conditions (M = 6.03) as opposed to the unethical conditions (M = 4.33). For magnitude of the consequences, we asked, “According to the information in the scenario, would you say that the consequences of rejecting the funding from Innovative Venture Financing are” 1 (moderate) to 7 (severe). There was a strong significant main effect for consequences, \( F(1.78) = 51.29, p < .001 \), such that participants reported higher ratings in the severe conditions (M = 5.69) as opposed to the mild conditions (M = 3.53). These findings suggest that the experimental manipulations for ethical reputation and magnitude of consequences were successful.

6.4. Results for study two

Table 3 presents means and standard errors for each of the main effect conditions as well as the various combinations of the interaction effects (3 levels of ethical by 2 levels of magnitude of consequences), and Table 4 presents the ANOVA results on willingness to partner.

We followed a long line of scenario experiment research (cf., Burmeister and Schade, 2007; Grégoire et al., 2010; Kahneman and Tversky, 1972; Meindl et al., 1985; Wood and Karau, 2009) and analyzed our data using between-subjects ANOVA. Where required, we used Fisher’s least significant difference post hoc contrasts on the ethical reputation variable to determine which cells were driving statically significant effects. As discussed above, study two complements study one by investigating whether or not results for Hypothesis 1 are consistent if we allowed entrepreneurs to make their own inferences about whether the behavior described was ethical or unethical. Our results confirm study one findings as we document that when ethical behavior was inferred, there was a main effect for ethical reputation, \( F(2.69) = 12.39, p < .001 \), with entrepreneurs more willing to partner with VCs who have a reputation for behavior consistent with ethical (M = 5.54) as opposed to neutral (M = 5.22) or unethical behavior (M = 4.15). Taken together, the findings from study one and study two provide robust evidence that entrepreneurs greatly prefer to partner with VCs who are perceived to have behaved ethically in the past.

The second objective of study two was to test the influence of the magnitude of the consequence for rejecting funding as stated in Hypothesis 4. This hypothesis is about an interaction between consequences and ethical reputation, but before testing this relationship we first established that there was a significant main effect for magnitude of consequences, \( F(1.69) = 8.87, p < .001 \), with entrepreneurs more willing to partner with VCs when the magnitude of the consequences are severe (M = 5.33) as opposed to when they are mild (M = 4.61). In terms of the interaction, we found a significant effect for the consequences by ethical reputation interaction, \( F(2.69) = 4.78, p < .01 \). We used the condition means to graph the interactions in order to more fully interpret the relationships (Fig. 2). The graph reveals that as one moves from a mild to severe consequences environment, the slope of the line is greater for the unethical reputation condition than for the neutral condition. This finding provides support for Hypothesis 4 as it indicates that entrepreneurs are less reluctant to partner with a VC who has a reputation for unethical behavior when the consequences of rejecting the funding are severe. These findings suggest that the negative effects of unethical behavior on willingness to partner are contingent upon the severity of the consequences if the investment partnership offer is rejected.

The final goal of study two was to investigate the possibility that individual differences such as fear of failure might influence the effects of ethical reputation on entrepreneurs’ partnership decisions. Specifically, Hypothesis 5 argued entrepreneurs high in fear of failure will be more willing to partner with a VC who has a questionable ethical reputation. To explore this, we first added the fear of failure variable to the ANOVA as a random factor, and this resulted in significant interaction between fear of failure and unethical conditions. For magnitude of the consequences, we asked, “According to the information in the scenario, would you say that the consequences of rejecting the funding from Innovative Venture Financing are” 1 (moderate) to 7 (severe). There was a strong significant main effect for consequences, \( F(1.78) = 51.29, p < .001 \), such that participants reported higher ratings in the severe conditions (M = 5.69) as opposed to the mild conditions (M = 3.53). These findings suggest that the experimental manipulations for ethical reputation and magnitude of consequences were successful.

Table 4

<table>
<thead>
<tr>
<th>Variables</th>
<th>F-value</th>
<th>Observed power</th>
</tr>
</thead>
<tbody>
<tr>
<td>Controls</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Age</td>
<td>1.581</td>
<td></td>
</tr>
<tr>
<td>Education</td>
<td>1.773</td>
<td></td>
</tr>
<tr>
<td>Experience w/entrepreneurship</td>
<td>2.314*</td>
<td></td>
</tr>
<tr>
<td>Experience w/equity finance</td>
<td>1.497</td>
<td></td>
</tr>
<tr>
<td>Main effects</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Magnitude of consequences</td>
<td>9.082***</td>
<td>.844</td>
</tr>
<tr>
<td>Ethical reputation</td>
<td>12.391***</td>
<td>.975</td>
</tr>
<tr>
<td>Interactions</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Consequences × ethical reputation</td>
<td>4.779**</td>
<td>.791</td>
</tr>
<tr>
<td>Fear of failure × ethical reputation</td>
<td>2.705*</td>
<td>.836</td>
</tr>
</tbody>
</table>

N = 79 entrepreneurs.
* p < .05.
** p < .01.
*** p < .001.

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ethical reputation, $F(18, 27) = 2.71, p < .05$. We then employed the median split technique used by Mitchell et al. (2004), Dietz et al. (2004) and others where the sample is divided into high and low groups based on the median value from our data, which for fear of failure was 3.2 on a 5 point scale. We then calculated separate ANOVAs for the high ($N = 37$) and low ($N = 42$) fear of failure groups and found stark differences between the groups for the main effect of reputation for ethical behavior. Specifically, for the low fear of failure group ethical reputation had a much smaller effect, $F(2,40) = 3.37, p < .05$ on willingness to partner than it did for the high fear of failure group, $F(2,35) = 13.51, p < .001$. These findings indicate that entrepreneurs who are high in fear of failure react more strongly to the VCs reputation for ethical behavior than do those who are low in fear of failure. However, a graph constructed using condition means (see Fig. 3) unexpectedly revealed that high fear of failure entrepreneurs was less willing to partner with unethical VCs than low fear of failure entrepreneurs. As such, there is an important relationship, but it is in the opposite direction of our hypothesis and therefore Hypothesis 5 is not supported.

7. Discussion

This study represents one of the first attempts (to the authors’ knowledge) to investigate the role of ethical reputation in the VC–entrepreneur relationship, thereby answering calls for research connecting ethics and entrepreneurship (Hannafey, 2003; Harris et al., 2009) and on the dynamics of the investor–investee relationship (Collewaert and Fassin, 2013; Parhankangas and Landström, 2006). In that vein, we conducted two complementary studies that provide robust and comprehensive evidence that the VCs’ reputation for ethical behavior is a salient consideration in entrepreneurs’ partnership decisions. Specifically, we find that entrepreneurs are more willing to partner with ethical VCs and that ethical reputation plays an influential, interactive role when considered alongside an investor’s value-adding capabilities and investment track record. We also find that the direct effect of ethical reputation is conditioned by the magnitude of the consequences if the funding offer is rejected, to the extent that entrepreneurs are more willing to partner with VCs who have a negative ethical reputation when the consequences of not doing so are severe (e.g., bankruptcy). Alternatively, entrepreneurs who are high in fear of failure are less likely to partner with VCs who have a questionable ethical reputation. Taken together, the results of our multi-study investigation provide new understanding of the role of investor ethical reputation as well as insights on the conditions under which ethical reputation may be more or less influential. These findings have a number of implications for theory, practice, and future research on the investor–entrepreneur relationship.

7.1. Implications for theory

When it comes to the entrepreneur–investor dyad, the research to date is largely focused on how investors select the entrepreneurs and firms they back. This has been a worthy endeavor because it leads to theories that articulate the criteria investors use as they make their investment decisions (Drover et al., 2013; Murnieks et al., 2011; Petty and Gruber, 2011;
What it does not account for, however, is how entrepreneurs evaluate and select potential investors. There is some research on this side of the dyad, but it focuses almost exclusively on the positive characteristics of investors, such as the value-add investors bring to the table. This helps explain why entrepreneurs might partner with given investors, but it does not explain why entrepreneurs might reject partnership opportunities. As noted at the outset, we know that it is not entirely uncommon for entrepreneurs to turn down VC financing offers (Smith, 2001), but to date, we have little understanding of the drivers of those choices. Our findings provide insight on some of the specific reasons and contexts that drive the decision to turn down funding, thereby adding empirical evidence to this under-researched aspect. Specifically, our study sheds light on this consideration as we find that holding other factors constant, entrepreneurs are far more likely to reject partnering (i.e., funding offers) from investors who have a negative reputation for ethical behavior. This suggests that entrepreneurs do not necessarily act as utility maximizers (e.g., taking a known immediate gain via accepting the investment offer over risking a possible unknown loss in the future via investors unethical behavior), as advocated by classic decision theory (March, 1994), if it means partnering with someone who has a reputation for unethical behavior. The implication, then, is that there is a need for “theory elaboration” (Lee et al., 1999) where extant theory on entrepreneur–investor partnership decisions is reevaluated and expanded to include the consideration that investors develop ethical reputations and these reputations have not only positive, but also negative aspects that are influential in partnership decisions.

If we continue in the spirit of theory elaboration, it is not enough simply to show that ethical reputation matters as entrepreneurs decide whether or not to partner with a VC investor. Rather, what are required are insights on when ethical reputation carries more or less weight in these decisions. Hence, we considered ethical reputation alongside the broader set of decision determinants known to influence entrepreneurs’ partnership decisions. Specifically, we considered value-add and prior investment success because these factors provide tremendous advantages to a startup. We find, however, that entrepreneurs are not willing to gain these benefits at “all costs” by overlooking the VC’s reputation for questionable ethical behavior. In short, we provide evidence that this is not a trade-off entrepreneurs are willing to consider, as the willingness to partner is favorable for each factor when considered alone, yet sharply declines when prior unethical behavior is added to the equation. We suggest that prior unethical behavior represents a threat of future agency costs and potential conflict (Collewaert and Fassin, 2013) that become too high to trade off for the upside of such benefits.

We also find in study two that while entrepreneurs are not willing to put aside past unethical behavior for the benefits the VC might bring, they are willing to put it aside when they face severe negative consequences if they reject the partnership offer. Specifically, we find that entrepreneurs are much more willing to partner with a VC who has a reputation for unethical behavior when the consequences of not doing so will result in negative outcomes such as running out of operating cash. This finding has implications for the use of agency theory in explaining investor–entrepreneur partnership decisions.

Specifically, our findings challenge the traditional agency theory approach to investor–entrepreneur partnerships because it is generally assumed that entrepreneurs act as agents for investors (cf. Arthurs and Busenitz, 2003). In other words, though there are multiple principle–agent relations comprising the investment cycle, this is not widely recognized and we advance theoretically one of the lesser-studied principal–agent relations. Do so addresses a theoretical deficiency in existing research on the VC–entrepreneur relationship, where the entrepreneurs’ goals and interests are rarely considered in research at the expense of the VCs’ (Arthurs and Busenitz, 2003). As such, our conceptual model and empirical findings explore the agency perspective where VCs can act as agents for entrepreneurs because they represent the firm and have substantial power over firm activities and ultimately the exit strategy. Still, the fact of the matter is that it is difficult for entrepreneurs to monitor closely the actions of VCs (Barry, 1994; Sahlman, 1990), and thus the threat of opportunistic behavior, such as forcing a premature exit, is a serious concern. Our findings suggest that ethical reputation is one indicator entrepreneurs use to mitigate this threat, but when the negative consequences of rejecting the funding are severe, this indicator may be assigned less weight. In sum, this suggests that agency theory’s (Jensen and Meckling, 1976) argument that a principal’s primary concern is the risks of opportunistic behavior (e.g., moral hazard, adverse selection and hold-up) may break down when there are other risks that are more immediate. This suggests future research could explore immediacy as a boundary of agency theory tenets within the VC investment context.

Another implication of our findings stems from the results for the interactive effects of fear of failure. It is well established that individual differences influence entrepreneur’s decisions (c.f. Cassar and Friedman, 2009; Mitchell and Shepherd, 2010; Wood et al., 2013), and we add to that evidence as we find that the entrepreneurs’ fear of failure interacts with ethical reputation such that high fear of failure entrepreneurs are less likely to partner with an unethical VC. These findings are counter to our hypothesized relationship and represent a seemingly counterintuitive outcome. One possible explanation for this is that entrepreneurs are aware of the agency risks that partnering with an unethical investor entail, and because those high in fear of failure have defined business failure as an unbearably negative event, they are resolute in their unwillingness to partner with a VC who has questionable ethics. In the case of high fear of failure entrepreneurs, it appears that these individuals are worried that adverse selection by unethical VCs could directly lead to failure and this decreases their willingness to partner. In other words, it is possible that high fear of failure entrepreneurs perceive partnering with an unethical VC as a road to eventual failure. This dynamic is not well explained by extant theory and while our study is a first look into the role of individual differences in entrepreneur–investor partnership decisions, our findings for fear of failure suggest that the role of individual differences warrant consideration in future conceptual and empirical research.

Another theoretical implication to be considered is that while ethical reputation is influential in entrepreneurs’ willingness to partner with investors, ethical behavior is subjective. This means that the same behavior may be seen as ethical or unethical by those who observe or learn about the behavior. As such, VCs may take actions that do not seem unethical to them—as conforming to the legal terms of the contract—but are perceived as unethical to other constituents. Study two accounts for these perceptual
differences among entrepreneurs, but is silent on the degree to which the perceptions of VCs and entrepreneurs differ in terms of the degree to which a given behavior is deemed ethical or unethical by parties on both sides of the dyad. If these differences do exist, new theory will be required to explain why these perceptual differences exist and the consequences that flow from them.

7.2. Implications for practice

Our study has implications for investors and entrepreneurs in the field. Specifically, we find that the ethical reputation of investors plays a crucial role in entrepreneurs’ willingness to partner decisions. As such, VCs and other investors should be aware that the “sins of the past” may influence their ability to partner with high quality entrepreneurs in the future. Entrepreneurs are typically good at doing their homework (Gupta, 2000), and the rise of online investor feedback communities such as “TheFunded.com” is making one’s ethical reputation much more transparent. As such, VCs should be aware of the profound positive or negative implications of ethics-related behaviors and would do well to build and protect their reputation for ethical behavior via ethical dealings with entrepreneurs and by making it known that they apply the codes of ethics of their professional associations. Likewise, entrepreneurs would do well to take heed of information that indicates the ethical reputation of the investor they are considering partnering with. Further, our findings suggest that entrepreneurs should be especially vigilant when they are in a situation where there are severe negative consequences for rejecting funding offers because in these situations they will be more willing to partner with unethical investors. This is likely trading short-term gain for a long-term loss, and one must carefully consider the agency cost that will eventually have to be paid.

7.3. Limitations and future research

Our study has potential limitations that create opportunities for future research. First, the scenario experiment in study two provides more context and richness than the conjoint approach but does not fully replicate real life investment contexts. To minimize concerns over this issue we developed our scenarios using extant literature as well as a series of interviews with entrepreneurs and VCs to ensure that the decision-making scenario reflected real world circumstances. Even with these steps taken, entrepreneurs in the field may be influenced by factors that we were unable to tap into our experiment. In our description of unethical behavior, for example, we focused on the timing of the exit but there are many other behaviors that might be perceived by entrepreneurs as unethical and some of these may overlap with the “value-add” that investors are thought to bring to the table. As such, there is an opportunity for future research that considers a broader range of unethical behavior and explores the possible dichotomy that may exist between VC value-add and unethical behavior.

Another potential limitation of our research is that our study assumes that the ethical reputation of the VC will be at its primacy during the investment offer stage. Of course, it is possible that entrepreneurs learn about prior unethical behavior on the part of VC much earlier in the process and choose to walk away well before an offer is tendered. We focused on the offer stage because it represents the part of the process where walking away is the most difficult for the entrepreneur and thereby reflects circumstances where one’s attitude toward ethical behavior is quite resolute. Clearly, our research is not designed to address the question of when in the process entrepreneurs are most likely to learn about potential partners’ ethical reputation and how they react to that information contingent on their location in the investment lifecycle. We are unaware of research that addresses these considerations and this is an opportunity for future research that builds on our findings.

A final possible limitation of our study is that we considered only fear of failure in our model. Because we found that fear of failure influences how entrepreneurs evaluate prospective investors, our results open fertile ground for future research examining additional individual-level differences that may come into play. Self efficacy, for example, has proven influential in decision making (Cassar and Friedman, 2009), and one can imagine that entrepreneurs high in self efficacy may be willing to partner with a less ethical investor because they simply believe they can achieve despite the inherent challenges of such a partnership. Additionally, the ethical orientation (or moral philosophy) of individuals has been shown to influence decision making processes in a wide variety of contexts (cf. Forsyth et al., 2008). By extension, examining how the ethical ideologies of entrepreneurs interact with their evaluation of investors is another potential area of future research. One could reason that each entrepreneur’s ideological classification would impact the way investors are assessed. As such, conceptually and empirically exploring the role of self-efficacy, ethical ideology and other individual differences may provide new insights that help inform why entrepreneurs accept or reject funding offers.

8. Conclusion

The net effect of our multi-study approach is that we fulfill the stated purpose of our research by providing comprehensive evidence and insight into the link between VCs’ reputation for ethical behavior and entrepreneurs’ willingness to partner. In short, entrepreneurs are sensitive to investors associated with questionable ethics in their evaluations, but how such reputations influence entrepreneurial evaluations is impacted by individual-level and contextual factors. This confirms the hunch that the relationship between investors and entrepreneurs is just as important to the success of the deal as the actual capital provided (Payne et al., 2009) and that where the money comes from is a critical consideration (Bygrave and Timmons, 1992). In that way, our investigation leads to a better practical and scholarly understanding of the role played by ethics within
the investor–entrepreneur dyad, and we look forward to joining others in future investigations of the dynamics of business ethics in entrepreneurship.

Appendix A. Study one conjoint experiment materials

**Investment Scenario:** Assume you are the founding entrepreneur of a start up in the technology industry. In order to achieve previously established growth goals, and to enhance the probability of a lucrative exit, you have deemed it necessary to arrange a first round investment from venture capitalists. For an amount of capital that is perceived as fair by both parties, venture capitalist X has offered to take a 35% ownership stake in your company (consistent with the average VC investment, the VC firm will assume 40% of total board seats, you as the founder will retain 40% and outsiders will consume 20% of the board seats). Presently, this is the only outstanding offer; although additional VCs may be interested if pitched, no other offers are certain.6

This investment opportunity is characterized as (combinations of the following were used):

- **Prior Investment Success: Proven.** Investor X has proven highly successful in the past start ups he has invested in and subsequently worked alongside, which is evidenced by minimal failed partnerships and an impressive history of taking his backed start-ups public.

- **Prior Investment Success: Developing.** Investor X has a limited track record of prior successful investments.

- **Value Added: Many.** Investor X has the potential to offer numerous value added services that will likely benefit your startup, such as an extensive network for recruiting and the capabilities to offer a high level of strategic guidance.

- **Value Added: Limited.** Investor X has minimal value added services to offer your startup, where such benefits as an extensive network for recruiting and the capability to offer a high level of strategic guidance will not be present with this investor.

- **Ethical Reputation: High.** Various source(s) indicate that Investor X has a reputation for operating with a high degree of ethical behavior in prior investment activity.

- **Ethical Reputation: Low.** Various source(s) indicate that Investor X has a reputation for lacking ethical behavior in prior investment activity.

Appendix B. Study two scenario experiment

**Background Information:** You are the founding entrepreneur and current CEO of RXP Enterprises, Inc., a venture in a high technology industry. Your company has a number of dedicated employees and is operating in a growing market space. Like most startups, your venture has had its ups and downs, but you remain optimistic about the venture's potential and future prospects. To this point, you have not sought outside equity funding but to achieve your goals you are now seriously considering outside equity financing. Given the high risk of your venture, traditional financing such as a bank loan is not a viable option. To that end, you are presently considering a first round investment offer from a venture capitalist (VC) at Innovative Venture Financing, Inc. The company is well established and the VC investor you are working with has a favorable track record of investment success.

**The Offer:** The VC at Innovative Venture Financing will give you an amount of capital that is considered fair by both you and the VC, in exchange for a minority ownership stake in your company (i.e., consistent with a typical first round equity stake of 32%). In line with VC investment norms the VC will assume a position on your board. In addition to the investment of capital,
the VC also has many value-adding capabilities, such as extensive knowledge of the market, which may benefit you and your company. Presently, this is the only VC interested in making an investment with your firm.

**Ethical Reputation: Unethical** You should know that achieving a high volume of exits (i.e., merger, sale, IPO) is an important measure of success in VC investment community. Your research indicates that the VC investor extending the offer has a reputation for using his position of power within his investment relationships to facilitate the sale of his backed companies prematurely. When this happens, the VC benefits tremendously, but he does so at the expense of the firm and entrepreneur because the investor chooses not to wait until the maximum financial return can be realized for the firm/entrepreneur he has invested in.

**Ethical Reputation: Neutral** You should know that achieving a high volume of exits (i.e., merger, sale, IPO) is an important measure of success across the VC investment community. Your research indicates that this VC investor does not have a reputation for using his position of power to prematurely facilitate the sale of his backed companies and instead is known for exiting in a way that takes into account the benefit of the firm and entrepreneur. As such, the VC is known to base his exit decision on the situation and sometimes that situation benefits the VC more than the firm and sometimes it does not.

**Ethical Reputation: Ethical** You should know that achieving a high volume of exits (i.e., merger, sale, IPO) is an important measure of success across the VC investment community. Your research indicates that this VC investor does not have a reputation for using his position of power to prematurely facilitate the sale of his backed companies in order to benefit him at the expense of entrepreneur, nor does he have a reputation for waiting to exit in order to maximize the benefit for the entrepreneur. As such, the VC is known to wait to exit until the maximum financial return can be realized by the VC and the firm/entrepreneur he has invested in.

**Magnitude of the Consequences: Mild** Finally, your accountant has informed you that if you do not secure outside financing, you will be able to meet your financial obligations—but your venture will be unable to grow.

**Magnitude of the Consequences: Severe** Finally, your accountant has informed you that if you do not secure outside financing, you will not be able to meet your financial obligations and your venture will soon go into bankruptcy.

References


