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Ethics, corporate governance and venture partner entry and exit in entrepreneurial ventures

Prof. Yves Fassin, Department of Management, Innovation and Entrepreneurship
Ghent University, Belgium

ABSTRACT
The current paper investigates an important tension field in entrepreneurial ventures. It takes a closer look upon crucial stages in an entrepreneurial venture's lifecycle, i.e. the dynamic of entry and exit of one or more venture partners such as investors or entrepreneurs. Upon the entry of new partners, tension and conflicts may arise about exit in that current partners may be either forced to or blocked from exit. Alternatively, agreements may be reached while conflicts may nonetheless arise later on in the partnership, which if not carefully managed may still result in premature exit of one of the venture partners. Using illustrations from cases, we outline the nature of these conflicts resulting from these tensions between entrepreneurs and investors and propose governance remedies to prevent or solve these conflicts.

Keywords: business ethics, corporate governance, exit, conflict, venture capital, angel investors, entrepreneurs, codes of conduct

Questions for debate

How can we ameliorate the ethics and governance in entrepreneurial ventures ?

How balancing the rights of different shareholders of an entrepreneurial venture (and by extension other important stakeholders) in a fair and equitable manner, without impeding on the efficiency of the venture ?

How can the ethical codes of the VC associations be enforced in the marketplace ?

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INTRODUCTION

Entrepreneurs, especially start-up entrepreneurs, face a constant tension to secure the financing of their company, this at different stages of the life of their venture. It is widely recognized that small or young, high-growth companies generally face substantial difficulties in raising financing from traditional sources such as banks and public capital markets due to a lack of track record, profit generation and tangible assets, all of which result in high uncertainty for potential investors (Berger and Udell, 1998; Da Rin et al., 2006). Because of the need to finance the growth of their venture, entrepreneurs often need to turn to external sources of equity financing, i.e. angel investors or venture capitalists (VC). Whereas angel money is provided by private, individual investors who have no family or friend connection to their entrepreneurs, venture capital is provided by institutional, professional funds (Harrison and Mason, 1999; Van Osnabrugge, 2000). Both types of private equity investors are generally active investors who use multiple mechanisms, including contracting, board membership and relationship building with management to reduce agency problems (e.g., Fiet, 1995; Kelly and Hay, 2003; Landström, 1993; Van den Berghe and Levrau, 2002).

Recognizing the importance of corporate governance, it has become common practice for VC and angel investor associations to install a code of conduct. The European Venture Capital Association's members "shall deal fairly and honestly with all business concerns seeking its assistance" (EVCA, 2005). Angel investors are expected to abide similar rules of fair treatment (EBAN, 2009). As governments, scholars and practitioners are calling for more accountability for all parties involved, we believe it is crucial to study the conduct of entrepreneurs, angel investors and VCs in their relations with each other. To our knowledge, little empirical work has examined entrepreneurs' and investors' violations of installed codes of conduct and potential unethical behaviour towards each other. and even very little work has addressed the "darker" sides of their relationships in general and the tensions it occasions (see

Fassin (1993), Parhankangas and Landström (2006) and Brougham (2010) for some of this work). Given the central role of business ethics and corporate governance in today's business world, we aim to contribute to this literature by focusing on violations of corporate governance principles and unethical behaviour of entrepreneurs, angel investors and VCs. We thereby contribute to the call for more research on ethics and entrepreneurship (Hannafey, 2003; Fisscher et al. 2005; Harris, Sapienza & Bowie 2009).

While such misconduct can occur throughout the different stages of a start-up's lifecycle (Fassin, 2000), we will focus on one specific important milestone, i.e. entry and exit where one of the new venture partners enters or withdraws from the financial ownership of the venture concerned. Entry or exit, regardless of whether it refers to entrepreneurial or investor entry or exit, represents one of the key events in the investor-entrepreneur relationship and has profound implications for both the individual and portfolio company concerned. Regardless, most of this literature so far has failed to provide a contextualized view on investor and entrepreneurial entry and especially exit. In what circumstances can such exit occur? What are the issues involved? While probably most exits occur in mutual agreement, others are involuntary and may result from conflicts between venture partners. Therefore, using a multiple case method design, the paper outlines with vignettes of the cases the nature of entry and exit-related conflicts that may arise and proposes governance remedies to prevent or to solve such conflicts.

ENTRY AND EXIT-RELATED CONFLICTS AS A CONSEQUENCE OF VENTURE TEAM CHANGES

During an entrepreneurial venture's lifecycle, several new actors may appear; not only in terms of investors, but also in terms of actively involved people. Starting out with only the

founding team members, the new venture team gradually expands by hiring a number of key team members. Then, with successive rounds of angel or VC financing, experienced and hands-on board members may enter. Figure 1 illustrates the lifecycle of a venture with subsequent crucial phases of entry of new financiers, which also implies new partners and new board members with new rules and new agreements. The first line shows the successive capital rounds, with family, friends and fools (FFF), business angels and VC, to end eventually with an IPO and trade sale. The second line shows the entry and exits of actors in the venture: the financiers in the board, and in dotted lines, the entry of exit or the staff, key people and team, and in some cases the entrepreneur himself. Note that in both lines timing of entry and exit vary across each individual case. The figure illustrates an generalizing example. The cases in the vignettes described critical moments that coincide with one of these crucial events in the lifecycle of a venture.

Insert figure 1 about here

Not only may new venture partners enter at different times during the entrepreneurial lifecycle, some may also leave (e.g, Ucbasaran et al., 2003). This dynamic in new venture teams may create tensions among venture partners given that each change often entails new rules and agreements.

In some cases such changes may immediately result in conflicts about exit. In situations where partners want the same thing, exiting or staying, there is generally no problem. If, upon the entry of a new partner, everyone agrees that old partners should remain, an agreement needs to be reached regarding the conditions under which this will occur and regarding the role of each party. If everyone agrees that a particular partner should quit, they

will need to agree on the price and conditions of the deal. Tensions that lead to problems or conflicts, however, may occur when partners involved want opposite things, i.e. some people may want to exit, but may be forced to stay (and thus blocked), while some may want to stay, but are asked to exit.

In addition to exit-related conflicts arising upon the entry of new venture partners, conflicts may also arise later on despite agreements being made upon entry. Conflicts may also derive from the asymmetric contractual agreements that are perceived as unfair by one party, especially when decisions are unilaterally imposed by the majority shareholders (Desssein, 2005; Collewaert and Fassin, 2012). Such tensions, if not carefully managed, may still result in the premature exit of one or more of the parties involved, or at worst in the failure of the venture. Prior to venture partner (e.g., new management team members, angel investors or VCs) entry, existing and potential new partners will exchange information and get to know each other. As such, trust and mutual liking is built (Forbes et al., 2006; Harrison et al., 1997). Upon actual entry, a number of agreements will be made and recorded in contracts, defining each other's obligations and rights (e.g., Kelly and Hay, 2003; Kaplan and Stromberg, 2001; Wright et al., 2009). These contracts include a number of covenants, conditions (e.g., milestones) and procedures to follow in case of, for instance, the sale of shares to third parties (Cumming, 2008; Desssein, 2005). Further, promises, explicit or implicit, will be made (Parhankangas and Landstrom, 2006). While promises and agreements may be made with the best intentions, problems may nonetheless arise later on (Parhankangas and Landstrom, 2006). Content-wise, agreements and promises may be made with regard to operations, strategy and governance. Operational agreements involve task descriptions, i.e. what is expected from each partner, while strategic agreements refer to how to transpose the vision into a growth path for the venture. With regard to governance, agreements will be made regarding which control mechanisms to implement to achieve the right balance between

shareholders and management (Jensen and Meckling, 1976; Van Osnabrugge, 2000; Wright et al., 2009). Expectations based on promises made may differ among the various parties involved, leading to discussions later on. Also perception on how one is treated will differ among parties (Collewaert and Fassin, 2012). We will discuss each of these in more detail below using illustrations from cases.

RESEARCH DESIGN

For this exploratory study on exit in entrepreneurial ventures, we selected examples of companies that received financing from angel and/or VC investors. These cases were obtained through referrals from entrepreneurs and from the business angel networks. Conflict situations are frequently used in business ethics studies to describe unethical standards or practices (Brinkmann and Ims, 2004). The multiple case study methodology presented with cases in vignette style will be used to provide an indicative illustration of different ways in which entry or exit can occur in start-ups and in VC- or angel-backed companies as well as of questionable practices leading up to or triggering exit. While this handful of selected cases has no claim of being representative, they do provide insight into a number of entry and exit-related ethical issues. A short description of the cases used is provided in vignettes in Appendix A. Table 1 briefly schematizes the problems, conflicts and results for the nine cases.

*** Insert Table 1 about here ***

The vignette cases cover a wide range in entry and exit scenarios: investors force an entrepreneur to resign as a CEO and to sell his (the entrepreneur's) shares at a loss (Case G), to buy back the investors' shares (Case C); another entrepreneur abandons the venture himself when he sees no other way out (Case E), while there have also been cases that an entrepreneur leaves the team after completion of his finance round for another venture. Investors may also be faced with the dilemma to decide whether it is the CEO or the inventor who has to to quit (case B); the entrepreneur can also agree with investors to step down as a CEO, to take on another function in the venture and keep his shares (H). A variation on the latter can be found in the famous Cisco Case where the entrepreneurs also agreed to quit as a CEO, but only wanted to stay on as passive shareholders (Case Cisco, in De Clercq et al. 2006).

Other cases highlight the potential for investor exits; while a VC generally tends to decide himself upon whether or not to exit (excluding the venture's financial situation), angel investors are in a somewhat different situation. While these investors may be needed in the start-up phases of a venture, their presence is generally not indispensable as soon as larger financial partners make their entry. Angel investors may then be asked to resign from the board and to become passive investors; they may be required to subscribe to new shares; they may be asked or forced to sell their shares to the new investor (case D) or, quite the contrary, may be blocked from exiting (case F and H); VCs may also be indifferent and accept that angel investors stay on as shareholders. But also exit through an external acquisition proposal can bring conflicting views amongst VCs who step in at different timing and different entry price, and consequently may have a different evaluation of the proposal (case I). We will analyze each of these cases as illustrations to highlight entry and exit-related conflicts and related key elements of corporate governance.

ORIGINS OF POST-ENTRY CONFLICTS

As aforementioned, tensions and subsequent conflicts may arise later on in the venture partnership despite agreements being made upon entry. Specifically, various tensions may arise related to operations, strategy and governance.

On the operational side, entrepreneurs are generally expected to take the driver's seat, while investors are expected to act as board members with angel investors being somewhat more actively involved than VCs (Van den Berghe and Levrau, 2002; Van Osnabrugge, 2000). The way these roles are executed in reality, however, may be substantially different. For instance, investors' attempts to add value may sometimes result in excessive interference, which the entrepreneur may perceive more as a burden than a help. Indeed, entrepreneurs may not expect active participation from their financial partners and may see their VCs or angel investors much in the same way as banks, i.e. providers of only financial capital, not human and social capital. If this is the case, they will likely by surprised by actively intervening angel investors and VCs, which may cause friction. In some cases, however, intervention is necessary from the investors' standpoint because of the entrepreneur's lack of experience, professionalism or management capabilities (Parhankangas and Landstrom, 2006). Such interventions, if unanticipated, may require investors to alter their own role definitions, which again may serve as a source of frictions. Illustrations of such conflicts can be found in case B where angel investors and entrepreneurs do not agree on how to run the business; the investors want the entrepreneur to focus on sales rather than technological development, while the entrepreneur thinks the investors are meddling and only concerned about their financial goals. In case D, investors are put off by the longer than expected/promised development times. In case E, the entrepreneurs are dissatisfied when their VC starts imposing unexpected

additional costs, such as hiring a CFO. In sum, dissonance between expectations and actual executions of investors' and entrepreneurs' roles may cause conflict between them.

Changes in strategy may also cause conflicts between partners. The entrance of a new partner may imply drastic strategic changes, as illustrated in case F where the VC changed the original plan to a more aggressive one aimed at rapid growth. From the VC's perspective, a window of opportunity presented itself and had to be taken advantage of rapidly. However, this change in strategy did not only increase the venture's return potential, but also its risk. While this fits within a VC's overall strategy of portfolio diversification and risk spreading (i.e. over different investments), this is not traditionally the case for other partners involved such as entrepreneurs and angel investors who cannot achieve the same level of risk spreading. Hence, it should not be surprising that in case F strategic changes resulted in conflicts between old and new partners. Different is case G, where the VC carries out a strategic reorientation of its own fund and, as a consequence, refuses the follow-on investment he had previously approved for the company.

Finally, governance issues pertain to control over and sound management of the company. As control is generally in the hands of the VC, governance issues in our cases mainly reflect the latter and include ethical issues; in case A, it is the entrepreneur who plays on both deals and opportunistically drops his first agreement; in case C, the VC does not inform the entrepreneur of his investments in company C's competitor and in case F and H, the angel investors are not consulted when new deals are closed. With regard to control, the industrial investor in case D tries to eliminate the angel investors with all means possible, while angel investors are blocked from exiting by the VC in case F. In general, through contractual and relational monitoring, with venture capitalists relying more on the former and angel investors on the latter (Fiet, 1995; Van Osnabrugge, 2000), both types of investors try to dampen agency problems. They may, for instance, install mechanisms monitoring weekly

sales evolution. Such follow-ups presented by the investor as professional management instruments and intended as positive stimuli may in fact be experienced by the entrepreneur as unnecessary pressures that contribute to deteriorating the climate between investors and entrepreneurs. Different views on the use of control and on how this control may best be exercised may hence also provide fertile grounds for conflict. Despite the high cost of lawyers, litigation between entrepreneurs and VCs have been increasing in the US where litigation threatens the reputation of the VC (Atanasov, Ivanov and Litvak, 2008).

THE ROLE OF CORPORATE GOVERNANCE

So far, the discussion has highlighted the potential for conflicts among venture partners. Some conflicts may be specifically about exit, while others may be more general and present themselves during the entrepreneurial venture's lifecycle potentially leading to exit if not carefully managed. We believe that corporate governance has an important role to play in this process. Corporate governance focuses on devising incentive and control measures to ensure alignment of managers' and owners' interests. Mechanisms such as direct monitoring and incentive alignment reduce agency risks, caused by conflicts of interest between the owners and management of a firm (van Ees et al., 2009; Van Osnabrugge, 2000). Direct monitoring encompasses systems through which a board can observe, control and evaluate management behavior, such as budgets, accounting systems, executive remuneration and shareholder voting rights (Tosi and Gomez-Mejia, 1989; Wiseman and Gomez-Mejia, 1998). While entrepreneurs do not always welcome such measures, given that they are time consuming, we argue and want to emphasize that good corporate governance principles and codes of conducts may help to prevent and solve exit-related conflicts in entrepreneurial ventures. From this perspective, we will discuss some specific corporate governance elements that one may want

to take into account to achieve this goal: board representation, bylaws and covenants, other contractual issues, control and role definitions, and minority shareholders' rights. In addition, we will discuss the special case of forced and blocked exit, followed by a conclusion on the role of corporate governance. Table 2 summarizes where in our cases some of the corporate governance principles as proposed below were violated or offenced rather than respected.

*** Insert Table 2 about here ***

Board representation

The composition of the board is an essential part of the shareholder agreement. Besides a strategic role, the board has a monitoring and control role. In case ventures have different shareholder groups, boards also fulfil an important information and communication role. Given that all important partners have a right to be represented in the board, new representatives will tend to be added to the board throughout consecutive financing rounds. However, there are limits to a board's size for reasons of efficiency. The traditional "solution" is that the number of representatives of older partners is decreased. For instance, as occurred in cases D and F, angel investors often make room for more professional board members. One should, however, not forget that some angel investors like to be actively involved in the venture. When the role of each partner evolves from being active and hands-on to passive, the role of governance accrues. Too many errors occur such as neglecting to inform older partners, not only formally, but also in informal ways. These information channels are, however, crucial to keeping inactive angel investors informed and connected to the venture.

Most codes of corporate governance consider the number of independent board directors as an important guarantee of board independence. While changing a board's composition upon entry of new investors by replacing old investors' representatives by those

of new ones is not necessarily problematic, one needs to pay careful attention to safeguarding the board's independence. In addition to their own representatives, VCs for instance often appoint new people out of their network as independent directors (as in case E). One may however question whether such directors can indeed be considered independent (Van den Berghe and Levrau, 2002). Independent board members, even if chosen by the major shareholder, should function in an independent way. In particular, the independent Chairman has the implicit responsibility to safeguard all shareholders' interests.

Bylaws and covenants

Bylaws and covenants may also help to prevent exit-related conflicts given that they can limit venture partners' decision latitude and can hence prevent some of the previously discussed issues related to unexpected or unilateral changes made (Cummings, 2008; Dessein, 2005). Specifically, these covenants determine the extent of control that is imposed on the entrepreneur; they can specify limitations in spending or other constraints that require the approval of the main shareholders. Other frequently used covenants specifically pertain to exit (Gompers and Lerner, 1996; Kelly and Hay, 2003). Some may restrict the purchase or sale of shares of the firm between venture partners, others oblige the entrepreneur to stay with the venture, precluding him to exit if he would choose to and even others allow investors to fire entrepreneurs if they would deem this necessary (for instance, in case entrepreneurs ignore the board's advice). Those covenants have been gradually introduced by investors to protect them from fraudulent behaviour on the entrepreneurs' part. Even if they are not meant to be used, they provide investors with all the legal possibilities to intervene (Cumming, 2008).

When including such covenants, it is fundamental that one establishes that all partners involved have a clear and correct understanding of the meaning and implications of these covenants. In some cases the lack of experience in legal and financial affairs makes that

entrepreneurs do not fully understand the impact of those covenants (e.g. case E), providing investors with an informational advantage. In negotiations, VCs are often one step ahead of the entrepreneur; their experience provides them with a longer-term and more realistic perspective than that of the traditionally overoptimistic entrepreneur. Exit provisions for VCs may hence result in a "sophisticated transfer of control from the entrepreneur to the venture capitalists as financial investments increase" (Smith, 2005). The entrepreneur often only realizes this when milestones are not met and the VC exercises his rights as stipulated by these covenants, which the entrepreneur then perceives as an abuse of power. One must also ensure that covenants are used in a fair manner, unlike in case F where VCs effectively use their right of first refusal to block the angel investors from exiting.

Other contractual issues: Valuation and dilution

In negotiations with investors, entrepreneurs are often in a weak position due to time pressures and long negotiation periods. Often, they have no real alternative than to accept the deal terms as proposed by the selected investor. Some investors make use of this advantage by proposing low valuations and/or high dilution for the existing shareholders, especially when a company is running out of money (e.g, cases B, D, E and F). VCs also frequently employ a staged financing approach which creates "tough provisions that ensure participation in the upside and minimize exposure to malfeasance", but may also cause entrepreneurs to lose ownership if their performance falls below target goals (De Clercq et al. 2006: 99). If milestones are not met: "either the VC cuts losses by simply not funding the next financing round or alternatively invests at a lower valuation" (De Clercq et al. 2006: 100). While trying to negotiate low valuations is part of the game for VCs, or any other investor for that matter, negotiations must occur in a fair manner without pressure, dirty tricks or abuse of power.

In case H and I, the asymmetry between the investors is illustrated. Following the agreements made, and the proposal of the majority shareholders to sell the company, all investors have different returns. What is a good deal for the one investor (in most cases the latest investor) does not mean a profitable deal for the original investors, those early days investors who have been diluted in a period of lower results, including the business angel and the entrepreneur. Even if this new investor saved the shares of the original investors, this does not mean that he should not consider the rights of the other investors of previous rounds. Even with contractual agreements, this investor who wants to realize a short time capital gain, could envisage to allow a better price for the business angel and the first VCs. Entrepreneurs placed in that case have more power than business angels: if they do not cooperate with the acquirer, often the venture has no future, making the deal vulnerable,

Control and role definitions

As the cases illustrate, the need for additional funds remains a constant in the life of an entrepreneurial venture, whether for positive reasons - to finance growth - or for negative ones - running out of cash due to insufficient sales or delay in technological development. This constant quest and negotiations create tension for the entrepreneur. Entrants, injecting new funds, affect the relationship between the entrepreneurs and the prior investors, often angel investors. Entrepreneurs are generally the ones who negotiate with potential investors; angel investors do not tend to be involved in the early stages of the courting process. As we previously discussed, this may create tensions as the partnership between entrepreneurs and angel investors is replaced by a new alliance between entrepreneurs and VCs, as in cases D and F. Problems due to changing roles of prior investors may be avoided by involving them in the deal preparation and negotiation process. In some cases, angel investors may even fulfil a mediating role between entrepreneurs and VCs. Similar problems due to changing roles may

also present themselves between entrepreneurs and investor entrants as they start fighting over the control over the venture (e.g., cases C, E and G). Most of these problems could probably be prevented or solved by including the other partner in all deal discussions that he or she will be affected by as well as by making clearer agreements upfront in terms of role definitions.

The problem of firing the founder, inventor or CEO, is a more specific dilemma related to control, strategy and governance of the venture (Bruton, Fried & Hisrich, 1997). Even if the contracts confer these rights to layoff the founder-CEO at any time, it remains a delicate operation that should be realized in a decent and fair way.

Minority shareholders' rights

In situations of urgency, governance principles are not always respected. Even if the law foresees a procedure to protect the rights of the minority shareholders, urgency does not always allow for sufficient time to launch the procedure. For instance, when a company needs cash next week to pay its employees, a capital increase should be proceeded with as soon as possible. Launching the procedure for minority shareholders would imply the company not being able to pay its bills and the board having to apply for bankruptcy, which obviously cannot be the ultimate goal. In some cases, even "standard" principles of good governance, such as providing all information in advance (e.g., case F), are not adhered to. Some investors play it very hard and threaten minority shareholders with bankruptcy if they do not accept the deal as is. In case H, one angel investor is pressured to sign the procuration to allow the capital increase to be executed and hence agree with a serious dilution without having been consulted throughout the negotiations and without having received key documents, which the law requires. The entrepreneur and his colleague angel investors pressure him to accept. In case D, the industrial investor also uses threats and intimidation techniques to get rid of the angel investors, while in case E the VC threatens to sue the entrepreneur. To enable smooth

exits of venture partners, more attention should be paid to respecting minority shareholders' rights.

The special cases of forced and blocked exit

Turning our attention to conflicts about exit rather than conflicts potentially resulting in exit, we want to highlight the issue of forced or blocked exits. The VC market is renowned for being illiquid: VCs cannot sell their stock in a moment's notice (Cable and Shane, 1997). This statement holds even truer for minority shareholders; they do not have access to internal venture information, have no board seat and are bound by covenants. Given the right of first refusal and their small percentage of shares, angel investors thus generally have no other possibility for exit than being bought out by existing or new shareholders. Because entrepreneurs have little or no money, angel investors typically have to rely on the VC's goodwill to be bought out. Besides general governance issues, the case of new investors forcing angel investors to exit or blocking them from exiting is clearly problematic and poses the question of right and fair reward for angel investors.

Angel investors take most risk by investing in the seed phase of the venture and often spend much time advising and helping the entrepreneur without any remuneration. At some point, angel investors thus expect to be fairly rewarded for their work in the first difficult years of the venture and will generally not accept to exit at entrance price. In case of success, their work and investments have permitted the venture to arrive at the stage it has now reached; in less successful situations, angel investors want to get a piece of a possible beneficial exit later on, for instance through an IPO. Some angel investors may like to share in the success and may therefore refuse to exit (case D), others may choose to refuse high risk and should have the possibility of a fair exit (case F and H). New investors may however argue that success will only be realized thanks to their new aggressive strategy, thereby

refusing to buy the old investors out, and certainly not at a higher premium. From a VC's perspective, such an action would not make much sense given that it does not bring in any additional funds into the venture nor does it give them any additional control. This leads us to a serious question for corporate governance: Is it acceptable and fair that minority investors are blocked and have no exit possibility? Is it fair that minority investors can be forced into an uninteresting exit? Is it acceptable that one minority angel investor can block a deal for reasons of corporate governance and even for legal reasons, while the deal would benefit the company, but would harm his own interests? From an ethical point of view, the cases posit the issue of a fair price and exit for angel investors.

Some solutions could be proposed. A fair deal should acknowledge each partner's contributions and should try and meet each partner's goals. For instance, one may propose an exit at the angel investor's entrance price accrued with a normal interest, potentially combined with an increase up to half of the capital gain when VCs and entrepreneurs decide to sell their shares or when they launch an IPO. The latter may in turn be combined with a declining percentage depending on the duration between this exit operation and the final exit through trade sale or IPO. Such an elegant exit agreement will allow angel investors to recover their initial investment and will reward them with some upward potential in case the venture they helped to launch is successful. Furthermore, it also addresses the new investors' needs and goal because it leaves them (and the entrepreneur) with complete control. Finally, this solution will also allow angel investors to reinvest the capital gained into a new venture, which may subsequently offer new investment opportunities for VCs. An alternative could be the development of a specialized fund that buys shares of angel investors. In return, angel investors could be offered shares of the fund. Not only would it provide them an attractive exit route, it would also allow them to benefit from the fund which holds a wide range of

small participations in different companies and hence allows them to spread some of their risks like VCs.

IMPLICATIONS AND CONCLUSIONS

The discussion on governance issues related to exit in entrepreneurial ventures highlights the need for the establishment and application of good corporate governance principles. Most national and international venture capital and business angel associations have promulgated codes of good conduct (e.g., EVCA, 2005; EBAN, 2009). The cases in this paper, however, clearly illustrate that the implementation of such codes needs to be enforced.

For instance, it seems as though at times investors have used corporate governance rules against the entrepreneur. Additionally, good corporate governance practices often seem to be absent in investors' dealings with entrepreneurial companies. In entrepreneurial ventures with different partners, clear agreements should describe which involvement is expected from each partner and how information will be distributed among all partners, especially so towards passive and previously active partners. Acknowledging and respecting every partner's objectives, roles and contributions over the different phases of a venture's lifecycle is crucial. One must strive for an alignment of goals and rewards, resulting in a win-win situation for all parties involved. Partners should accept that the company's interest will take priority over the individual interests of investors and founders. Angel investors must also accept that their roles may change over a venture's lifetime; the entry of (more professional) venture capitalists may mean the end of the angel investors' active role. However, a change of structure following a substantial capital increase with new partners should involve open and fair discussion on the deal structure and board representation, and this with involvement of all actors (Utset, 2002). The deal structure should be realized in an equitable manner and should not be imposed unilaterally, even if supported by the contract. Indeed, many restrictions are perceived as

harsh and even unfair (De Clercq et al. 2006: 99). Good corporate governance should respect minority stakeholders. Decent corporate governance also implies – besides matters of compliance to the law - an ethical attitude from all partners involved.

This paper addresses the lack of research on tensions and dysfunctional relationships in entrepreneurial ventures, especially during key moments such as entry and exit of new venture partners. It illustrates the tensions experienced by the entrepreneur to maintain ownership and control in growth stages. This explorative study adds to the entrepreneurship literature by shedding more light on the dynamics in the relationship between entrepreneurs, angel investors and venture capitalists. It illustrates the difficulty to balance family ownership and professional management and to confront rational and emotional dimensions in the decision-making of entrepreneurial ventures. It allows us to gain an insight into some of the issues that may arise throughout a venture's lifecycle leading up to the exit of investors or entrepreneurs. Furthermore, we propose some corporate governance principles to help prevent and solve exit-related conflicts in entrepreneurial ventures. This paper therefore also contributes to the overlooked areas of corporate governance and business ethics literature applied to entrepreneurial ventures. Finally, it also sheds a more practical light on the important issue of blocked or forced exit of a venture partner.

Our analysis has several important practical implications. By gaining a better insight into (1) the issues that may arise during an entrepreneurial venture's lifecycle and (2) the specific roles, goals and contributions of each party, venture capitalists, angel investors and entrepreneurs may learn how to prevent or solve their potential exit-related conflicts and, as such, how to make the transition that goes along with exit a smoother one. We also offer some practical suggestions for a fair exit agreement. Responsible and ethical behaviour are essential for good corporate governance practices. The paper pleads for the thorough implementation of

existing codes of corporate governance and principles of good conduct of the various associations in the practice of entrepreneurial ventures.

APPENDIX A: Case descriptions

Case A

A successful serial entrepreneur presents a business plan for a IT company at the local business angel network meeting. Two business angels are interested and a deal is proposed to the entrepreneur, who confirms by mail that he accepts the offer. Two weeks later, when parties have to finalize the contract, the entrepreneur sends a mail to the angel investors that he cancels the deal. In the meantime, the entrepreneur had negotiated a better deal with an industrial partner. Reaction of one of the business angels: "It is better to know now how opportunistically this guy operates, than after having invested in his company".

Case B

A mechanical engineer of a university laboratory invents a new electronic device for a new type of electric motor with applications in different industries. He files a patent and founds a company with two business angels in order to develop the prototype. One year later, a marketing expert joins the company; he invests additional money and becomes CEO of the company. He quickly experiences some difficulties to sell the product as the first series shows some flaws, that need time and money to be corrected. In the meantime, the engineer is developing other applications of the patented technology, that also need additional money. As the sales do not take off, the company is coming under cash pressure. Tensions grow between the inventor and the CEO. The inventor blames the CEO for costing too much to the company while not being able to sell, whereas the CEO blames the inventor for dispersing his efforts to new applications rather than focusing on a right technical solution for the first application. The angel investors in the board had repeatedly warned to focus on one product first. In order to save the company, they propose that one of the two guys should quit, which would jeopardize the company's future, or that an additional capital increase should be sought on short terms, while both guys should find some modus of cooperation. The inventor admits he took time to realize that sales are key for a new company and to understand he has moved from a research job to one of developer with more pressure on timing and cost imperatives.

Case C

The entrepreneur of company C had run his business successfully for quite some years but needed funding in order to grow and therefore turned to venture capitalists. Within two months after the entry of the venture capitalist, he learned that they had also – prior to the investment in company C – invested in his biggest competitor. Not only was this investment much older, it also concerned substantially larger amounts. However, company C had the competitive advantage of having developed a much more advanced technology. Through an e-mail from the venture capitalists sent to the entrepreneur by mistake (but directed to the competitor), he discovered that their plan was to integrate his company into his competitor's. After having discovered this, he was afraid to undertake any legal actions as this would imply having an external expert value his company, which would entail the risk of being faced with such a high value that he could not (financially) afford to buy back the venture capitalist's

shares. Related, he quickly learned that the initial amount provided by the venture capitalist was (intentionally) too low compared to what he really needed to achieve his goals. This implied having to secure a second round within one year, resulting in having his ownership diluted. In the end, the entrepreneur succeeded in buying out the venture capitalist, albeit at a high cost.

Case D

The entrepreneur of a start-up in the plant distribution sector convinces four angel investors through a business angels network to invest in his business. Quite quickly the angel investors realize that the project is far less advanced than expected: whereas they thought they had invested in a start-up ready to market its technology, in fact neither the technology nor software was ready. Additional cash is needed, for which the entrepreneur finds an industrial partner willing to invest 25 % of the total capital. Two angel investors can stay on the board and one observer is added for the new industrial investor. Soon problems arise: the industrial partner wants venture D to pursue a more aggressive strategy, requiring more capital, and also wants a larger stake in the company. A new financing round is organized: two angel investors quit at entry value, two others want to stay on but do not want to participate in the round. Due to their refusal to invest, the industrial partner threatens the angel investors to sue them in case of bankruptcy. After debating for a few months, the two angel investors accept to sell their shares, at entry price, to avoid further conflict and discussion, which immobilize the company. The industrial partner invests substantial additional amounts into the company, without success as within two years company D goes bankrupt.

Case E

After having bootstrapped their venture at start-up, two entrepreneurs raise venture capital funding (we will call the venture capitalist VC1). A year later, further contacts with the venture capital community reveal international interest. A consulting firm working in conjunction with a bank proposes to raise the 5- to 10-fold of the initial venture capital investment funds necessary for marketing in exchange for a fee and commission. Another venture capitalist, VC2 proposes an alternative: they will invest the same amount as VC1 and will use their network to raise the tenfold. Negotiation with VC2 is tough; they impose a new shareholders agreement, with a number of complex covenants, but give in on valuation, a very sensitive element for the founders. The entrepreneurs accept the offer. Then gradually, VC2 starts imposing additional costs on the venture such as hiring a CFO and recruiting external board members from VC2's network. They also propose to hire a high level CEO to give the company more visibility, which they argue to be necessary to attract international investors. Entrepreneurs manage to postpone some of these proposals, but board relations quickly deteriorate. Meanwhile, VC2 does not live up to its promise and fails to bring in new international investors. The entrepreneurs decides to go out and start looking for new venture capital money himself, but all of them seem to have been informed by VC2 that the company is in bad shape (despite the fact that the company had just received a high valuation). Finally, only one alternative remains: a wipe-out from VC2. But VC2 dawdles and requires successive cost reductions. When, finally, the company runs out of money, the entrepreneur announces he has to file for bankruptcy. As VC2 threatens to sue him, entrepreneurs and VC1 resign. VC2 tries to save what is left by bringing in an additional amount as urgency financing. It was however too little too late and VC2 filed for bankruptcy for company E.

Case F

A biotech entrepreneur founds his start-up F in 2004. After a few months, three angel investors provide seed funding. To finance the international expansion strategy of the

company, additional funding is sought and found from a large venture capitalist (VC). After some market research by this VC, they suggest a change of strategy, requiring more funding and implying a higher risk as no customer revenue is foreseen within two years. When the company runs out of cash (as foreseen by the new business plan), the VC decides to waive the milestones set in the initial investment agreement and reinvests without consulting the angel investors. The latter refuse to reinvest their committed portion and two of them offer their shares for sale to the VC, at a 30% discount. The VC refuses to buy the shares, stating "we do not need to buy the shares, we have control. But you can sell them to another party and at that time we still have a right of first refusal". Furthermore, the VC wants to fire the angel investors' board representative. In the following months, the company repeatedly runs into cash problems. Rather than going for a capital increase, the VC provides several convertible loans. Later, by converting their loans with a new capital increase, they forcefully dilute entrepreneurs and business angels.

Case G

To help a European textile company realize its growth ambitions, two venture capital companies invest and join the Board of Directors. Several investment projects are successfully completed, including a first foreign acquisition in Asia. The board pushes the entrepreneur to make additional foreign investments and acquisitions to accelerate the growth, promising to deliver additional funds when and if necessary. A few months later, after several new projects have been launched, the entrepreneur appeals to the promised additional capital. However, the private equity investors renege on their promise. To make matters worse, the Asian market collapses due to SARS and one of the private equity investors indicates they want to exit. In reaction to this increased uncertainty, company B's bank (to whom one of the private equity investors is related as a captive fund) reduces credit lines and converts securities without informing the entrepreneur and in contrast to previous oral agreements from the bank director. Chinese walls within the bank that forbid transfer of information between departments, such as the credit and private equity department, are not respected. The private equity investors fight to take the control over the company and decline several takeover proposals for the company. Finally, they end up forcing the entrepreneur to sell his business at a low price to a competitor group with good connections to the bank. Rather than cooperating with the entrepreneur, the private equity investors set their lawyers the task to ensure that no responsibility from their side can be invoked.

Case H

A biotech company has worked for a few years with business angels and venture capital financing. The VC who has 49 % of the shares, and controls the board, refuses a trade sale as insufficient as the VC would loose on the deal, while there was a decent exit for the business angels. The business angels who were not represented on the board were not informed of this possibility. A few months later, in need of new finance, another VC is looked for and found; the original VC keeps 49% of the shares, while the angel investors and entrepreneur lose 80% of their investment. The angel investors were not consulted in the deal and are asked to sign the shareholder agreement without any documents nor business plan. They refuse and want to be bought out at their entrance price, which the VC refuses. Through the entrepreneur and the angel representative on the Board, the angel investors are made clear that, if they do not accept this deal, the VC will abandon its support for the company, which will then have to file for bankruptcy. The angel investors surrender, except for one who proposes a partial sale of his shares. The angel representative tries to convince the last angel not to block the deal.

Pressured with what he considers as intimidation and even blackmail tactics, the angel finally reluctantly accepts. The next morning, the closing is signed at the VC's place.

Case I

A French IT company has successive investments from business angels, a venture capital company and a second venture capital company, at different entry prices. An external industrial company offers to acquire 100 % of the shares of the company. The second venture capital who had entered one year ago, makes a profit of 40 %, and is willing to accept; but the first VC who had been there for 5 years, has hardly no return on investment, The business angels who have been there for 7 years can make a yearly return of around 10 %, while the entrepreneur makes 10 times his original investment. The second VC pushes to accept the deal, while the first VC refuses. With the contracts and the bylaws of the company, neither the entrepreneur nor the business angels can provide the majority to force any decision.

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FIGURE 1

Entry and exit in the life cycle of a venture

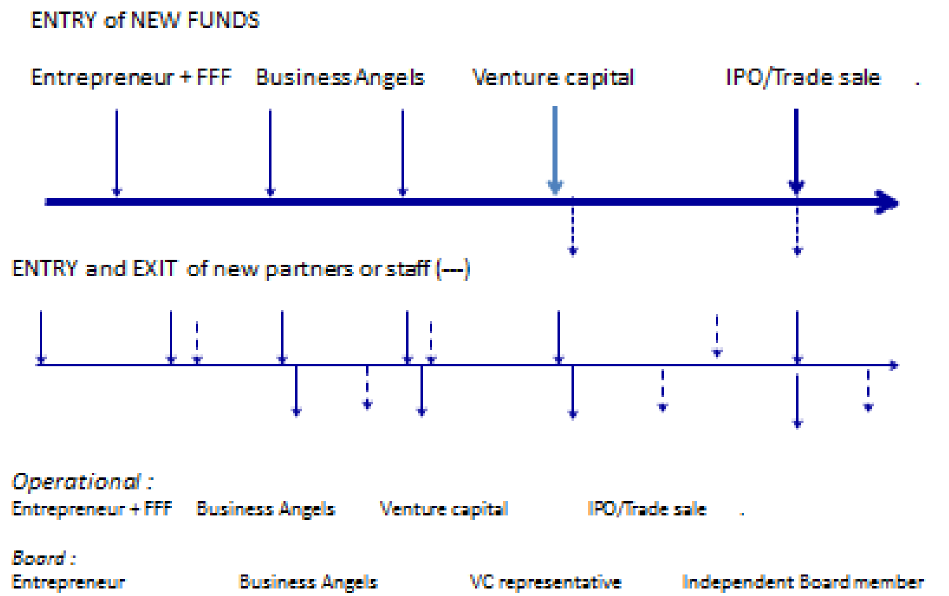

TABLE 1

Overview of problems, conflicts and results

case	Problem	Area of problem	Conflict	Result
A	entrepreneur breaks his word and changes investor	strategy and governance	BAs expulsed from deal	loss of deal for BA
B	typical operational problem	operational + relational	conflict between R&D and sales	dilemma : who should quit, founder or CEO ?
C	VC invests in competing company	governance	conflict of interest and governance	ENT forced to buyback his shares
D	change of majority	governance	new industrial partner wants to impose his view	industrial partner forces exit of BA
E	VC impose dilution and excessive costs	governance	ENT diluted and threatened	ENT forced to quit
F	VC impose change of strategy and dilution	strategy and governance	BAs marginalized	BAs want exit but are blocked
G	VC changes its internal strategy and key representative	strategy and relational	ENT abandoned	ENT forced to quit
H	VC imposes force dilution threatening with bankruptcy	governance	BAs marginalzed	BAs blocked
I	VC wants to sell company	strategy	differnt rewards and objectives	possibility of adjustment

TABLE 2

Violations or offenses of corporate governance principles presented in the cases

Violations or offense	Case	A	B	C	D	E	F	G	H	I
Board representation				*		*	*		*	
Bylaws and covenants				*		*	*		*	
Other contractual issues: Valuation and dilution						*	*	*	*	*
Control and roles			*	*	*	*	*	*	*	
Minority shareholders' rights					*	*	*	*	*	*
Other unethical behaviour		*		*		*				