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Power Between Entrepreneurs and Investors: A Case Study[‡]

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Introduction

Two main approaches have been utilized to explain the relationship between entrepreneurs and their investors. The first is based on the separation of ownership and management i.e. the so-called principal-agent approach. The second emphasizes trust and cooperation in the relationship. This article offers new perspectives from which to analyze the relationship by utilizing power constructs such as dependency, power balance/imbalance and different power sources in the setting. The data are based on the author's eighteen month period of observation as a business angel in one entrepreneurial venture.

The relationship between entrepreneurs and their equity investors (professional venture capital firms and wealthy individuals known as business angels) has attracted considerable research attention in the last twenty years (see e.g. Denis (2004); Wright and Robbie (1998)). It has been suggested that a co-operative relationship is an important precondition of the successful development of a venture (Cable and Shane (1997)). Extensive research has thus been devoted to increasing our understanding of the characteristics and conditions of co-operative relationships. From the investors' point of view, it is essential to invest in entrepreneurs who are the most likely to increase the valuation of the venture and eventually provide investors with an exit that is several times the initial investment (Macmillan et al. (1985)). Entrepreneurs often seek not only capital from investors but also nonfinancial benefits,

[‡] I wish to express my gratitude to Dr. Marjo-Riitta Parzefall for her comments and encouragement in earlier versions of this paper. In addition, I would like to thank the participants of the 17th AOEF conference in Pasadena L.A. and one anonymous referee for their valuable comments. Last but not least, my thanks go to the two entrepreneurs with whom I spent almost two years working on the project. Unfortunately, the business venture did not succeed but hopefully we can all learn from the project, both in an academic and practical sense. All errors and inconsistencies are mine.

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such as strategy consultation, access to networks and mental support, which can be equally important to their success (Sapienza et al. (1996)). Despite all efforts, the entrepreneurs' and investors' relationship is not, however, always successful and co-operative. Several reasons have been identified that have influenced the relationship such as asymmetric information, lack of trust, parties' opportunistic behavior and change in motivation i.e. one party decides to proceed with another project (Cable and Shane (1997)). Investors' detailed pre-investment analysis, efficient contracting and active post-investment communication are methods that are utilized to reduce these problems but are not always successful (Sahlman and Stevenson (1985)). Some authors have suggested that also entrepreneurs should analyze their investors in detail prior to the investment decision (Ehrlich et al. (1994)).

In this article, I shall examine power, which has previously been largely overlooked in this context, as a "theoretical tool" for understanding and explaining the relationship between entrepreneurs and their investors. Power has a very long history in organizational research and scholars such as Marx and Engels and Weber have already theorized the concept (Thye (2000)). Hundreds of articles have since been published in organizational research analyzing power from almost all possible viewpoints and concentrating on various aspects and antecedents of power. In section two, I shall go into more detail regarding some relevant conceptualizations of power, but the main determination remains still fairly similar. According to that power is ability to "*get others to do things they would not otherwise do*" (Baldwin (1980, p.501)).

As suggested, it may not be beneficial always to develop new tools and frameworks, for example, in entrepreneurship research but to "*use the theoretical tools already developed within psychology, sociology, economics, and various branches of business research*" (Davidsson (2003, p.52)). Accordingly, I will examine the applicability of power and more specifically the applicability of power and dependency, power balance/imbalance and sources of power i.e. coercive, reward, expert, legal/position and referent power in the context (French and Raven (1959); Emerson (1962); Casciaro and Piskorski (2005)).

The examination of power in the current research setting in particular seems relevant for the following reasons. First, power constructs have been very extensively studied in organizational research. For example, Pfeffer and Salancik's (1978) classic publication of resource dependency theory has yielded more than 2,300 citations as of spring 2002 (Pfeffer and Salancik (2003)). Consequently, this research tradition could potentially provide valuable insights into this special interfirm context: the relationship between entrepreneurs and their investors. In addition, for example, Santos and Eisenhardt (2005) suggest that power conception may be especially suitable in environments that are characterized by limited competition, which is common in entrepreneurial financing (Sahlman (1990)). Second, the power approach is very limitedly utilized in the entrepreneurial finance context. As far as I am aware, there is no study that has to date concentrated on power aspects in entrepreneurial finance. Considering the increasing importance of entrepreneurial firms for economies and job creation (Denis (2004)), it seems relevant to use all means available to increase our understanding of the phenomena. Third, previous theoretical approaches have provided important insights into the relationship but several critical questions remain unanswered. For example, different involvement levels of investors (i.e. hands-off vs. hands-on approach) have not shown a consistent correlation with the performance of ventures (Macmillan et al. (1989); Busenitz et al. (2004)). Another intriguing question is the very high emphasis investors (especially VCs) place, while making investment decisions, on entrepreneurs' personal

characteristics and experience. A common saying is that investors prefer investing in B-class business ideas with A-class management to A-class business ideas and B-class management. However, entrepreneurial research has found very little empirical support for the idea that a certain combination of characteristics and experience correlates with performance (Gustafsson (2004)) and, hence, I try to offer new insights that are needed to understand these critical issues better and eventually resolve them.

I shall base my analysis on the case data that I collected during a period of eighteen months as a business angel of one entrepreneurial venture in Finland, plus interviews and other qualitative material. However, where relevant, I shall link the discussion to both the formal venture capital and business angel contexts. When I discuss both groups together, I shall use the term “investor” and when the distinction is relevant I will use the terms business angel (BA) and venture capitalist (VC).

I. Entrepreneurial finance and power

Business angels and professional venture capitalists constitute two main sources of equity funding for entrepreneurs. Business angels usually concentrate on the very early stage investments while professional venture capitalists prefer to invest in more mature firms. One way to illustrate the investment propensities of the parties is as a continuum where business angels represent one end and professional venture capitalists the other (van Osnabrugge and Robinson (1999)). Venture capitalists and business angels have other relevant differences than just the stages of the firms that they invest in, such as the source of capital, motivation of the investment, involvement level and style, and contracting mechanisms. In short, business angels invest their own wealth; are motivated in addition to capital gains by personal benefits accruing from their involvement in entrepreneurial ventures; they prefer a more hands-on approach and style; and are not that demanding in drafting legal contracts. Professional venture capitalists, to the contrary, invest limited partners’ money (e.g. insurance companies and pension funds), are almost purely motivated by capital gains, and prefer tight legal contracting and a more hands-off approach (De Clerq et al. (2006)).

Below I introduce two main theoretical approaches that have been utilized to explain the relationship of entrepreneurs and their investors. I then discuss the current literature on power in entrepreneurial finance. Finally, I shall discuss the more general literature related to power and present a summary at the end of the section, along with four propositions that I will test in the following section.

A. Two main approaches to explain the investor-entrepreneur relationship

The existing literature identifies at least two main approaches¹ to conceptualize entrepreneurs’ and their equity investors’ relationship. The first relies heavily on ideas about the separation of ownership and control and draws its insights from agency theory (Jensen and Meckling (1976)). The second approach emphasizes the relational aspects of the relationship such as trust, respect, fairness, justice, timely feedback, and communication (Sapienza et al. (2000)). The first approach is motivated by the idea that investors provide funding to entrepreneurs but are not able to control fully how entrepreneurs use that funding. Therefore, it is in investors’ interest both to post penalties and rewards that should influence entrepreneurs’ behavior, and to monitor entrepreneurs, and, hence, increase the chances that the entrepreneurs

¹ Other frameworks and approaches have also been utilized in entrepreneurial finance, such as resource based view, prisoner’s dilemma, incomplete contracting theory and transaction cost economics (Wright et al. (2003)).

behave according to investors' interests. Agency problems emerge for the following reasons. First, principals' (i.e. VCs) and agents' (i.e. entrepreneurs) goals are different. The VC is interested in maximizing the return of the investment portfolio whereas entrepreneurs might gain personal benefits from acting as company officers and may, therefore, not be as interested in increasing the value of the venture. Second, it is often difficult for principals to know what the agents are doing, which could in turn increase the uncertainty between partners and worsen the agency problem. Third, entrepreneurs and VCs have different attitudes towards risk, which may lead the partners into behaving differently in the same situation (De Clercq and Sapienza (2001); Eisenhardt (1989B)).

The second approach relies on the ideas of justice theories. The main suggestion of this approach is that when the less powerful party (usually the entrepreneur) is treated fairly and in a procedurally just manner, he or she is more likely to behave according to the decision makers' interests. This approach, therefore, provides insights into how the less powerful party (i.e. usually the entrepreneur) responds to the orders and commands of the other party. In addition, according to this approach, persons who are not able directly to influence the decision making might be interested in the fairness of decision making, and the process of decision making since it could provide them with a method to influence indirectly the decisions (Thibaut and Walker (1975)). Previous research has shown that a person's perception of fairness has a significant impact on their commitment to decisions, performance, behavior and attitudes across many different settings (Kim and Mauborgne (1991); (1993)). Three factors have also been identified that influence an actor's perceived procedural justice. First, standing is used to describe an actor's status in the relationship. For example, a VC that treats entrepreneurs with respect and does not force its views on the entrepreneur is more likely to earn high respect and perceived procedural justice from the entrepreneur. Second, neutrality implies that a party (i.e. a VC) who makes decisions behaves neutrally towards all actors (i.e. all portfolio companies of the VC) and is willing to change its view when new information becomes available. Third, trust relates to the assurance that the decision-making party behaves trustworthily and predictably. In the VC-entrepreneur context, a VC that does not exploit its position in order to gain short-term benefits is more likely to earn high trust and accordingly perceived procedural justice from the entrepreneur (Busenitz et al. (2004)).

Empirical studies have shown the applicability of the constructs of ownership and control in the entrepreneurial finance context. For example, Sapienza and Gupta (1994) demonstrated that VCs can reduce entrepreneurs' opportunistic behavior by monitoring entrepreneurs. Manigart et al. (2002) found evidence that monitoring should lead to a higher return from a portfolio company. Van Osnabrugge (2000) compared VCs' and business angels' investment processes. He utilized agency theory approach in his study and found strong support for agency theory's applicability in the VC-entrepreneur relationship. He found that a VC tends to emphasize actions, which decreases the information asymmetry by conducting detailed investment analysis and concentrating on writing comprehensive investment contracts.

Similarly, attempts have been made to explain relational aspects between VCs and entrepreneurs. For example, Sapienza and Korsgaard (1996) utilized procedural justice theory in order to explain entrepreneurs' and venture capitalists' relationship. According to the authors, considerations other than economic ones play an important role in explaining the relationship. Busenitz et al. (1997) suggested that when the VC-entrepreneur relationship is weak and is not based on trust, collaborative discussions are less likely occur. In addition, the

scholars showed that strict contract covenants utilized by VCs, and entrepreneurs' experience, decrease entrepreneurs' perceived fairness towards VCs.

In sum, both approaches have considerably advanced our knowledge and understanding of the investor-entrepreneur relationship and highlighted the importance of (1) contractual relationship, (2) post-investment monitoring and (3) trust and communication in the relationship. However, we still know very little of whether power that has been identified as a major attribute in other organizational contexts (Lee and Tiedens (2001)) has any implication in this context. In addition, the dynamic nature of the entrepreneur-VC relationship has attracted only a little attention. However, the relationship is usually in constant flux and, therefore, dynamic approaches are needed. For example, Cable and Shane (1997) have utilized the prisoner's dilemma² approach to explain entrepreneurs' and VCs' relationship. According to the authors, prisoner's dilemma relates to agency theory but contains more dynamic elements than static agency theory and takes into account the fact that also the principal (i.e. VC) can behave opportunistically. The nature of prisoner's dilemma (a multi-round setting) also covers the situation where a party's behavior reacts and responds to the other party's behavior and vice-versa. Similarly, in an entrepreneur-VC relationship, power can vary constantly and the dynamic analysis of power is well founded (e.g. longitudinal case study).

B. Power in investor-entrepreneur relationship

The power aspect between entrepreneurs and investors is rarely discussed in the entrepreneurial finance literature. One rare exception is Bowden's (1994) economic study of bargaining power, where he argues that venture capital funds' size influences the bargaining power of the investor. Cable and Shane (1997) have suggested in their conceptual paper utilizing prisoner's dilemma that venture capitalists and entrepreneurs are interdependent actors whose success depends on the other actor's behavior and vice-versa. Fried and Hisrich (1995) suggest that venture capitalists have three sources of power; money, personal relationships and formal power. In money power, the authors refer not to the capital that investors have put into the company, rather that which investors potentially may invest in the company in the future. The authors suggest that this source of power is strongest when the venture is performing poorly and the need for money is urgent and vice-versa. Relationship power is a result of investors' time and effort put into the entrepreneurs' venture, which in turn increases the entrepreneurs' trust in and respect for the investors. According to the authors, this kind of power is mostly preferred since it is more enjoyable to use but at the same time may be hard to attain. Formal power is based on, for example, board, voting and liquidation rights determined between entrepreneurs and investors in the investment negotiations (Kaplan and Strömberg (2003)). According to Fried and Hisrich (1995), it may be that investors are not that willing to use their formal power since it is highly confrontational. In addition, the authors suggest that formal power is often least important to VCs and especially to early stage investors due to the relatively higher importance of money power. The authors largely neglect entrepreneurs' power. Wright and Robbie (1998) present in their literature review article several examples of power in the relationship; for example, entrepreneurs' power while negotiating additional funding, entrepreneurs' power in VC backed MBOs, and the power of the parties in the exit decisions. Fiet et al. (1997) showed that the larger board size of VC backed ventures is less likely to lead to dismissal of management team members, suggesting that larger boards lack the cohesion that is needed for decisive actions such as dismissal. In addition, the authors showed,

² See a more detailed explanation of prisoner's dilemma in Grant (2004).

relating to power, that the increase of VC controlled board seats leads to increased propensity for dismissals. In sum, none of the above-mentioned studies have taken a more in-depth approach to power but have still implicitly suggested that investors have more power in the relationship. This leads to research question one:

Is it so that investors are more often the more powerful party in the relationship?

C. Power constructs in organization research

One way in which to conceptualize power is as “*a characteristic of interpersonal relationships*” (Lee and Tiedens (2001, p.45)). This relational perspective on power can be divided into two parts. The first perspective concentrates on the social aspects of power, while the second concentrates on the dependencies and interdependencies of the individuals (i.e. whose power is of interest). In the social network perspective, all individuals are organized in a network and one’s objective and observable position in the network determines one’s power over the other members of the network. The second perspective relates to individuals’ dependency on each other. An extensively quoted early article of Emerson (1962) explains power as follows: “*The power of A over B is equal, and based upon, the dependency of B upon A*” (p.33). In other words, the higher the dependency of an actor, the higher the power of the resource holder.

The constructs of power, dependency and interdependency seem especially relevant in entrepreneurial finance. Both investors and entrepreneurs have only a limited number of suitable exchange partners and high quality goods. From the investor’s point of view, once the investment has been made there is often no short-term substitute for the entrepreneur as an exchange partner, at least not without cost (Fiet et al. (1997)). The entrepreneur provides the investor with the possibility to participate in a high growth venture, and with future growth and revenue opportunities. In addition, the entrepreneur may provide for business angels the possibility to participate in an interesting business which provides personal benefits for the business angel. Investors’ “goods” that they exchange with entrepreneurs are not only funding but also nonfinancial advice and benefits that could help entrepreneurs to be successful and develop their business. Similarly, entrepreneurs do not have a broad supply of substitutes for the investor (Sahlman, 1990).

In addition to dependency, the concept of power balance and imbalance has attracted attention in organizational research and it has relevance in the entrepreneurial finance context³. Casciaro and Piskorski (2005) have discussed in detail the power balance and imbalance between firms. They have showed that power balance and imbalance are two distinct dimensions of interdependency. A high mutual dependency between partners creates an incentive for them to act in a co-operative manner (i.e. absorb constraints). In contrast, in a scenario of power imbalance, the less powerful party may have incentive but little leverage to negotiate a fair deal with a more powerful party, who in turn would have little incentive and high negotiating power. In the entrepreneurial finance setting, a practical implication could be that a mutually dependent entrepreneur and investor would have more incentive to negotiate a fair deal and behave co-operatively compared to a situation of power imbalance between partners. This leads to research question two:

³ For example, entrepreneurs’ low power and, in turn, investors’ high power may in the worst case lead to failure of the venture (see e.g. Steier and Greenwood (1995)). On the other hand, it has been suggested that entrepreneurs possess considerable power in operational issues of the venture (Cable and Shane (1997)).

How does power and power balance influence the transfer of nonfinancial benefits and co-operation between parties?

The final aspect of power that I shall discuss is different power sources. I will utilize the typology that was originally developed by French and Raven (1959). It includes five power sources: coercive, reward, expert, legal/position and referent, which are briefly discussed below.

- *Coercive power* refers to the more powerful actors' use of "stick" as a power source. In extreme cases, it could mean even a physical punishment but often it is a severe consequence for one who is not following the actor's lead. In the entrepreneurial finance setting, it could refer to investors' possibilities to punish entrepreneurs who are not following investors' suggestions. Examples of coercive power could be the possibility to dismiss an entrepreneur or the denial of additional funding.
- *Reward power* refers to the more powerful actors' possibilities to reward the other party. The reward can be either monetary or non-monetary. For example, a manager can offer bonuses or other incentives to well-performing employees. Reward power has a linkage to coercive power: depending on the actors' behavior, the more powerful party can use either coercive or reward power. In the entrepreneurial finance context, investors have several possibilities to "reward" their portfolio firms. For example, just allocating investors' time to help entrepreneurs can be a major reward for entrepreneurs (Sahlman (1990)).
- *Expert power* relates not to an actor's formal position and the power that it bestows, but to the actors' knowledge and expertise that others consider valuable. A good example is the increasing power of IT departments in firms. The more critical the IT systems become, the more power IT experts and system administrators gain. Entrepreneurs acquire equity funding for different reasons (Hellman and Puri (2002)). In some cases, the nonfinancial aspects are estimated to be even more important than the financial (Ehrlich et al. (1994)). This can be interpreted to lead to a situation where an entrepreneur who is seeking high nonfinancial benefits is more dependent and willing to follow the investor's lead, in order to ensure that she/he would gain those nonfinancial benefits from the investor. Examples of critical nonfinancial benefits that entrepreneurs may be seeking are access to networks, image improvement and strategy consultation. Consequently, an actor that provides high expertise also possesses high expert power over another party to the relationship.
- *Legal power* relates to an actor's legal position in the unit or group. For example, an investor often possesses considerable legal power that is determined in shareholder's agreements and other investment documents. In addition, entrepreneurs who are a venture's employees and co-owners possess legal rights.
- *Referent power* refers to the situation where a skilful user of such power gets people to do things without force, expertise and formal position, but just by being "such a nice guy".

The discussion of the different power sources above leads to the third and final research question:

What are parties' power sources and do they vary according to situation?

II. Methodology and data

The data for this article are based on my eighteen month period as an investor in one entrepreneurial venture in Finland. The involvement started during summer 2004 and ended in winter 2005. During that period, I systematically stored all the material that was distributed and produced. In addition, after the involvement, I conducted four interviews with the entrepreneurs. Below, I discuss in more detail the data sources, data collection, participant observation methodology and case study research that this article is based on.

Data collection for empirical research projects usually starts with random sampling, meaning that a sample of observations is collected from the population in which the characteristics are of interest. In case study research, it is often theoretical sampling that is being utilized (Glaser and Strauss (1967)). The purpose of theoretical sampling is not to choose observations randomly but to select cases that should represent the phenomena of interest well, and in which access deep under the surface is possible. The purpose is that by gaining such access it is possible to research complex constructs and, for example, causalities, better than in surveys. When studying complex constructs, such as power and the dynamics of power, a deep understanding is especially important.

A. Data sources

In entrepreneurial financing, the empirical studies are based on either one side of the relationship (e.g. surveys of entrepreneurs or investors) (see e.g. Van Osnabrugge (2000) or Barney et al. (1996)) or cover both sides of the relationship (see e.g. Sapienza (1992)) The third group of studies relies on secondary information such as data from Venture Economics or Venture One (see e.g. Gompers (1995)). The fourth category is in-depth case studies (see e.g. Sweeting and Wong (1997)). My approach follows the latter research tradition. The data cover, for example, over 300 e-mails, 15 discursive sessions (using Skype voIP software), 11 versions of business plans, six versions of the shareholder's agreement and investment agreement. In addition, I have conducted four interviews with the entrepreneurs. The interviews were mostly transcribed applying the "24-hours' rule" (Bourgeois and Eisenhardt (1988)).

B. Case study research and participant observation methodology

The purpose of the research project is to examine the applicability of power constructs in the entrepreneur-investor relationship. I have derived research questions from the theory and existing research, and answered them using case study methods such as pattern matching, the presentation of rival explanations, establishing a chain of evidence, and emphasizing quotes and narratives from the data. Data collection has been achieved, among other means, through participant observation methodology which, according to Yin (2003), is a special data collection method where a researcher can have at least four kinds of role: (1) a member of the setting, (2) a partially active member of the setting, (3) an active member of the setting and (4) a key member of the setting. My role in the setting most closely resembled that of a key member.

Case studies have been used in the entrepreneurial context before but participant observation methodology has rarely been employed in the entrepreneurial setting. I was able to find only one example in the entrepreneurial finance context, namely Silva's (2004) study of a Portuguese venture capital firm's investment strategy and process. However, several aspects

speak for using this kind of methodology. First, it is very difficult to obtain data on venture capital investments, especially in longitudinal form. The same applies to business angel investments. Angels often want to remain anonymous and acquire information about potential deals through intermediaries (van Osnabrugge (2000)). Second, it is not necessarily possible to get answers concerning complex issues such as power in the relations and the dynamic nature of power from interviewees in a few interviews or surveys. This viewpoint is supported by Beaver and Jennings (2005, p.21):

“Researching small business management competence and the quest for competitive advantage is fraught with difficulties. The relationship between enterprise performance and management action and inaction is extremely tenuous and very difficult, if not impossible, to demonstrate conclusively. Only those persons immediately affected by organizational events have sufficient knowledge of the precise circumstances to be able to suggest cause and effect relationships.”

Third, it is suggested that current venture capital research projects that are either based on surveys or secondary databases need additional data sources to increase our understanding of the phenomenon (such as observation studies) (Fenn and Liang (1998)).

C. Evaluation of the quality of the research

Key concerns promoted, for example, by Yin (2003) in case study research – reliability, construct validity, internal and external validities – were considered in detail when I designed, conducted and finally wrote the research project report. *Internal validity*, relating to cause-and-effect relationships, was increased by conducting multiple interviews, a careful analysis of different data sources, pattern matching and the presentation of rival explanations. The generalizability of the results outside of this data (i.e. external validity) was conducted by utilizing the existing literature and analytical generalization. The third concern promoted by Yin (2003), construct validity, was a major issue since I participated actively in the research setting. I have increased construct validity primarily through the extensive utilization of various data sources, key informants’ review of the report, and the establishment of a detailed chain of evidence between analysis, propositions and data. Reliability was increased using the case study process framework promoted by Eisenhardt (1989A). The same framework was used by Fried and Hisrich (1995) in their study of a rare example of power in the entrepreneurial finance context. In addition, I established a common database for all material and a “data room” where the data were analyzed in a consistent manner. I have summed up the four key concerns of the case study research, following the example of Sarker and Lee (2003, p.818), in Table I.

III. The investment and power relationships

In this section, I will discuss my involvement with the entrepreneurs by concentrating on the power aspects. The venture had been operating as a part-time hobby of the two founders for approximately two years before my involvement. There were no additional employees. The venture sold DVD movies on the internet. The founders wanted to import a new movie rental concept from the U.S to Finland, where the venture was operating.. The concept had been very successful in the U.S. The business idea was fairly straightforward. Customers paid a fixed

monthly fee, selected movies online and the movies were then delivered to the customers by mail. The customers could keep the movies for as long as they wanted but they could not receive new movies prior to returning the previous ones by mail.

The initial contact between the entrepreneurs and myself was established in June 2004. I became interested in the business opportunity presented by entrepreneur ONE⁴. They were not actively looking for an investor but rather searching for different methods to finance their venture. I became interested mainly because the business concept had been extremely successful in the U.S., and because there were no competing businesses in Finland at that time. I also recognized an opportunity since the entrepreneurs needed additional finance and it was unlikely that they would be able to raise it without more experienced people committed in the venture. Consequently, I negotiated that I would get approximately 1/6 of the shares in return for a small capital installment and “sweat equity” that I was willing to put into the venture.

I did not have an official operational role in the venture. I acted in an advisory capacity and, in addition, helped to put together a business plan and raised some additional debt financing and grants from governmental sources. I also helped to launch the service and had a seat on the company’s board along with the entrepreneurs. There were no additional board members. My motivation for the investment was primarily to get involved in the entrepreneurial venture and secondarily for financial gain.

It took almost a year from the initial contact to launch the service. After only three months in operation, the entrepreneurs came to the final conclusion that the service was not going to succeed. The main reason for the termination of the project was the lack of customers resulting from the highly unprofessional graphic design of the service. Due to its successful launch, the concept was able to attract a considerable number of people to the website, but potential customers were not willing to sign up due to the image that the poor design created. The second reason was that the profit per customer was much lower than we had anticipated⁵.

Interviews with the entrepreneurs clearly showed that they were concerned about the control of the firm before they agreed to my investment. For example, they agreed beforehand that should problems arise they would always team up against me. This was presented by entrepreneur TWO in the following quote:

[E1]⁶; “We agreed beforehand that in case of disagreements we [the entrepreneurs] would discuss the issue together and decide the best course of action for ourselves [so that our interests would be protected].”

Prior to and after the investment we worked hard to develop the concept. During the development phase, I tried to offer my advice and, for example, made several suggestions about the content of the service. I also emphasized some aspects that I felt to be especially important, such as improved communication among us, and the image which the service created for the customers. Consequently, I made specific suggestions about how we could improve these

⁴ In order to preserve anonymity, I shall call the entrepreneurs ONE and TWO.

⁵ This was due to various reasons, such as: 1) customers returned movies sooner than what we expected which increased our postal fees 2) Finnish postal agency charged more postal fees than what they had originally quoted due to their own error, 3) more movies got broken and lost than what we had anticipated 4) movies cost more than what we had expected due to the reason that movie distributors added extra shipping fees that we had not anticipated when they delivered the movies. All these costs decreased our profit per customer considerably.

⁶ I will refer to these interviews and e-mail quotes later in Table II and the text and, hence, I have numbered them as evidence (E1, E2 etc.).

aspects and ensure that they would be sufficiently taken care of. For example, I suggested that in order to improve the quality of the graphic design and user interface of the software, we should consider recruiting additional resources. In addition, I pointed out that it is very risky for only one person to be responsible for all software development, which was highly critical to the business. I even suggested a suitable person to aid in the software development. However, the entrepreneurs turned these suggestions down as a quote from an e-mail on April 5th, 2005 illustrates:

[E2]; "I or [entrepreneur TWO] do not see that we need additional programming resources. Therefore we can forget this issue. Let's see if there is a need for that later but now there is none."

In addition, I made several suggestions as to how we could improve marketing. For example, I suggested that we should have a marketing plan where we would broadly define at a high level the targets of our marketing attempts. My suggestions were largely ignored.

Returning to the power sources presented by French and Raven (1959): coercive, reward, expert, legal and referent power, and the concept of power imbalance (see e.g. Casciaro and Piskorski (2005)), it seems that I had very limited power in the relationship. I did not have any coercive power or in fact any real interest in using coercive power. I did not possess any considerable reward power, since I was not in a position to provide any large-scale additional funding for the entrepreneurs. Neither did I possess any other resource that would have been valuable to the entrepreneurs. I may have had some expert and referent power but they were fast deteriorating. Entrepreneur TWO explained that at first they tried to follow and implement my suggestions in detail but soon decided that "there are more important matters". According to entrepreneur TWO, it seems that an investor with relevant experience and reputation would have possessed more power in the relationship, as the following quote shows:

[E3]; "If we would have had a person who would have been familiar with movie business as an investor, I believe that he would have been able to provide instantly ideas that would be aligned with business logic of that particular business area."

The following quote from an e-mail from entrepreneur ONE also implies that my referent power was very limited in the relationship (e-mail dated May 16th, 2005):

[E4]; "If we had a real venture capitalist as an investor, of course we would provide the information that he would require."

In other words, more relevant experience and reputation would have provided more power for the venture's investor. However, I did not possess the critical resources that the entrepreneurs assessed as valuable, nor did I manage to influence the entrepreneurs by using referent power or any other power source. Consequently, I maintained very little power in the relationship.

Due to my low power, I also had problems in getting information about what was going on in the venture. I, for example, sent correspondence saying that I would be interested in knowing what is going on in order to provide useful comments for and timely help to the entrepreneurs. However, due to time constraints, the entrepreneurs were not very concerned

about the information that I was getting, as entrepreneur ONE wrote in his e-mail of May 16th, 2005:

[E5]; “Of course information comes to you later [days or in some occasions weeks], but the main point is that we know what we are doing.”

The next two quotes from entrepreneur TWO after it was certain that the venture was going to fail illustrate the obvious dilemma (i.e. that my comments were actually considered valuable):

[E6]; “It was damn good that you scrutinized our plans in such detail... [it saved us from putting even more effort and resources on the failing project],” and:

[E7]; “Since you looked at the business from the outside you provided quite wild ideas, which might have been the answer if we would have executed them [i.e. the venture would not have failed].”

At least two aspects emerge from these experiences. First, since my power was very limited and even though I saw serious shortcomings and tried to react to them, my suggestions and advice were largely disregarded. This was really problematic for me since my initial motivation to invest was to get involved in a new and exciting venture. The entrepreneurs' opinions illustrate well how they thought about the investors. First, a quote from entrepreneur ONE and then from TWO:

[E8]; “It is ok that an investor interacts and provides help but without question the entrepreneurs should always have the final say on any given issue. If, for example, it is not possible to reach a compromise then the entrepreneurs' opinion should win.”

[E9]; “When there was a conflict of opinions the majority decided [i.e. usually the entrepreneurs' opinion].”

The entrepreneurs' view of the investors' role is very different from that, for example, which professional venture capitalists favor (see e.g. Pratch (2005)), and also business angels tend to get involved more closely in the ventures they invest in (Van Osnabrugge (2000)). From my point of view, i.e. a person who wanted to be involved in an entrepreneurial venture, I soon learned that it was not that easy to influence an entrepreneurial venture and that I would not get the personal benefits from the investment that I had expected.

Second aspect that emerges from the mismatch between my attempt to provide advice and the entrepreneurs' reluctance to listen is *why* was the communication and advising so difficult? Especially since the entrepreneurs admitted later that they should have paid more attention to my propositions. Entrepreneur TWO's quotes shed some light on this aspect:

[E10]; “I think that we had some kind of a collision of cultures here. Your communication style is very aggressive [direct] and if one is not used to it one may end up denying everything that the other person is promoting. I know that it happened to me as well.”

In order to illustrate his point, entrepreneur TWO gives a short example about a board member of another firm:

[E11]; “This particular board member tells a story, who knows whether it is imaginary or not, with many illustrative examples and listeners usually discover themselves what he is suggesting. This style does not criticize anybody personally and could have worked well in our firm as well.”

In other words, the explanation offered by entrepreneur TWO was that the entrepreneurs were not willing to listen to the comments and advice since the communication method was wrong (too aggressive and direct) for them.⁷ According to Cousins (2002) and Casciaro and Piskorski (2005), given high power imbalance the more powerful party tends to place less emphasis on the less powerful party’s opinions and interests. Consequently, the entrepreneurs’ high power may have led to the situation where they did not want to put more effort into those issues that they did not see as useful.

We launched the service in July 2005 and got a lot of publicity in the Finnish press considering the size of the venture. However, after only one month entrepreneur ONE’s belief in the concept started to shake. He wrote in his e-mail of August 9th, 2005:

[E12]; “We have had visitors from 6000 different IP-addresses [meaning different customers had visited the service’s website] and we have gotten 40 customers... In addition our profit per customer is on average 1.5 euros per month... In sum my feeling of success on a scale 0-100 is pretty close to zero”

After that e-mail we started seriously to analyze our options. I suggested that we should try to intensify our efforts to attract customers and openly evaluate possibilities to co-operation with other players. We decided that we would wait one more month and meanwhile try to increase the number of customers considerably. Unfortunately, the results were not very encouraging and, hence, we started to look for an exit. I had used common stock when I invested in the venture and I did not have the protection of a liquidation preference clause. This put me in a very unfavorable situation in a low valuation trade sale or in liquidation. Therefore, I had an incentive to continue the venture even though the possibility for success was very low. However, the entrepreneurs disagreed and wanted to exit the business as soon as possible. After a few months of searching, the entrepreneurs found an owner of a video rental chain that wanted to expand into the mail rental business, and they agreed to sell the business to him at a lower valuation than that we had put into the venture.

The shareholder’s agreement stated that all board members should agree on major decisions including ownership restructurings and changes to board membership. This clause provided me with an effective method to veto unfavorable decisions that were considered “major”. Even though I was against the trade sale, I had very few options to make the entrepreneurs actually do something that they would not otherwise want to do i.e. to continue the venture’s business in one way or another. Due to my limited options, I offered the

⁷ It seems that the communication *style* was a major issue that caused a great many problems between us. Previous research has emphasized the importance of communication between investors and entrepreneurs (see e.g. Busenitz et al. (2004)). Interestingly, correct communication style has not received in-depth attention and could be a subject for future research. However, this research project does not concentrate on it.

entrepreneurs the possibility to buy back my shares at a lower valuation than I had initially paid for them, but still a higher valuation than what my share of the proceeds of the trade sale would have been. The entrepreneurs, who wanted to exit the firm as soon as possible, did not have any other realistic options than to agree to the proposition, and I sold my shares back to them before the venture's business was sold to the third party.

Based on the case description above, it is probably clear that the entrepreneurs held considerable power over me and the power was imbalanced in our relationship. Based on the interview data, it seems that the power imbalance had influenced the entrepreneurs' willingness to evaluate seriously the suggestions that I made. Based on the existing literature, it has been suggested that VCs in particular possess high power over entrepreneurs and their power bases are legal, expert, coercive and sometimes referent and reward power. Business angels, who prefer post-investment involvement, may consequently utilize more expert and referent power compared to the other power sources. In my case, the entrepreneurs held considerable power over the investor. This is particularly interesting since the existing research suggests that entrepreneurs' power may decrease when their venture is not developing according to plan (Fredriksen and Klofsten (2001)). In our case, the venture was developing poorly but still the entrepreneurs held considerable power and actually their power increased as a result of the poor development. In more detail, the entrepreneurs held considerable power relating to the day-to-day operations of the venture and the strategy of the venture, and they disregarded suggestions that I made. However, I would have been very reluctant to invest additional funds in the venture. Also, due to the high risk and fairly pessimistic outlook for the venture, it would have been difficult for me to dismiss the entrepreneurs (it was very unlikely that anybody would have been interested in starting to work in the venture on similar terms), and this provided them with considerable but only partial power. Utilizing the power dependency typology, I was more dependent on the entrepreneurs than they were on me. However, the power dependency was related to day-to-day activities and business strategy aspects.

Relating to the second research question of transfer of nonfinancial benefits and co-operation, the entrepreneurs disregarded suggestions that were not attractive from their point of view or they gave them "*two seconds*" before they did so, as confessed by entrepreneur TWO. However, entrepreneur TWO confirmed in the interviews that this led to a situation where most of the ideas, even good ones, were rejected since the entrepreneurs used their power and decided to do things their way. This suggests that power balance influences the transfer of nonfinancial benefits and co-operation. A similar aspect was identified by Casciaro and Piskorski (2005).

I was not entirely powerless in the relationship, and, due to my legal power, I was able to negotiate a fairly good exit from the unprofitable business. I also had some power when we started our relationship, but soon the entrepreneurs started to disregard my suggestions and requests (my referent power was decreasing). The entrepreneurs also admitted that if they had had an experienced venture capitalist as an investor, they would have behaved differently (suggesting that a professional venture capitalist would have possessed more referent power). Finally, I had some expert power while I negotiated additional financing from the government. In turn, the entrepreneurs had high power that was mainly based on their formal position as company executives (legal power) and on my limited possibilities to find replacements for the entrepreneurs (partly expert power).

In Table II, I present the summary of the research questions and case study evidence.

IV. Discussion

In this paper, I have examined power in the relationship between investors and entrepreneurs. I have employed the case study approach and participant observation method. I have been able to document and analyze in depth one entrepreneurial venture's interactions based on actual decisions and behavior. In addition, I have interviewed the entrepreneurs afterwards to examine their perceptions of power in even more detail.

As my data and the power literature suggest, it seems that power constructs are constantly present in the relationship and they influence actors' behavior. It also seems clear that power is a more complex construct in the entrepreneurial finance context than Fried and Hisrich (1995) have suggested. Contrary to their propositions, this study suggests that it is not always the investor who has the power. Entrepreneurs have power that is drawn from different power sources, such as legal and expertise power. Constructs such as dependency, power balance/imbalance, and different power sources, contain all important issues that could help us understand the relationship between entrepreneurs and investors better, and also in an optimal situation to influence the actors' behavior.

Further studies on power could first benefit by making a distinction between different power sources. For example, Pfeffer (1992) suggests that acknowledging various power sources is in itself a major power source. From the investors' point of view, it may be crucial to build different power sources. For example, VCs' high emphasis on extensive ex-ante contracting (referring mainly to coercive, reward and legal power sources) seems somewhat limitative. VCs' own interest and that of their limited partners requires them to ensure that the capital is invested as efficiently as possible. Based on my analysis, the development of additional power sources could help to reach that goal. It may also be the case that the importance of different power sources depends on the development phase of the portfolio firm. For example, Fried and Hisrich (1995) have suggested that formal power is more important at the later stages of ventures. Similarly, the importance of fairness and trust in the entrepreneur-VC relationship (Busenitz et al. (1997)) can be interpreted to support the recommendation of additional power sources such as referent power.

The typical business angel strategy of extensive ex-post involvement is not ideal either. By concentrating on building a relationship, referent and expert power may be sufficient on some occasions but probably situations arise when legal power, for example, is needed. My agreement with the entrepreneurs illustrates this. Due to the lack of a liquidation preference clause or usage of convertible preferred shares, I was at risk of losing almost all my investment. But the clause in the shareholders' agreement that provided me with a veto on any changes in the ownership structure gave me a good negotiating position that eventually made the entrepreneurs buy back my shares. The second important insight into power constructs relates to business angels' high need to get involved in the venture's business. With low power this may be impossible, and, therefore, the development of various power bases may be essential for business angels.

The identification of and building different power sources is also important for entrepreneurs. For example, one major concern for entrepreneurs who are acquiring equity financing is the loss of control of their firm (Shepherd and Zacharakis (2001)). Also, my data (see E1) revealed a similar fear among the entrepreneurs. However, the skilful utilization of different power sources may help entrepreneurs to stay in better control of their firms. In sum, different power sources all play an important, partially complementary and partially overlapping, role in the investor-entrepreneur relationship. Their importance may vary

depending on the situation and stage of the firm's development. In order for the parties to manage their relationships successfully, all power sources may be needed, not necessarily constantly but occasionally during the relationship.

Another interesting aspect that emerges from the research data and previous power literature is the question of the amount of power between parties and power balance. It has practical implications and could be a target for further academic research. For example, in my case data the (powerful) entrepreneurs agreed afterwards that they should have considered some of the suggestions more carefully during the relationship. On the other hand, there are also illustrative examples of where the investor's decisions are argued to have destroyed the entire venture or at least seriously delayed its development (see e.g. Steier and Greenwood (1995)). Without high investor power it is less likely to happen. Therefore, the question of what is the correct amount of power and power balance between entrepreneurs and their investors becomes significant. One way to illustrate this question is to consider three scenarios: first, power imbalance between a powerful investor and powerless entrepreneur; second, the opposite scenario; and a third scenario of power balance. The obvious question is whether one of the scenarios would be optimal compared with the others for the co-operative relationship or is it so that the venture's industry or stage could have implications for optimal/suboptimal power between partners.

My data and previous research give some indicative answers. In scenario one, regarding high power imbalance in favor of entrepreneurs, it could mean that nonfinancial contributions potentially provided by the investor are less likely to be adapted by the entrepreneur (as happened in our case). In addition, it may be that the business angel is not going to gain the personal benefits that he/she expected from the investment. The opposite scenario of high power imbalance in favor of investors could mean that entrepreneurs, who often have a high need for independence (Brandstätter (1997)), will lose their motivation to work on behalf of the venture. On the other hand, sometimes investors will replace the entrepreneur who they perceive to be performing inadequately, and, on these occasions, the low motivation of entrepreneurs is not a problem for investors, due to the fact that investors believe that dismissals increase the performance of the firms (Bruton et al. (1997)). In sum, it is likely that both parties would prefer as high power as possible, but if the interest lies on the transfer of nonfinancial benefits and co-operation between partners, which should in turn increase the performance of the venture, then a more balanced distribution of power may be preferable as illustrated in scenario 2 (Casciaro and Piskorski (2005)). The three scenarios are presented in Figure 1.

One aspect that speaks for the utilization of power constructs in entrepreneurial finance is that power is virtually always needed when getting things done involves more than an actors own efforts. When we want to get things done, we virtually always need to influence people who are not in our chain of command. In other words, we depend on the people we cannot influence officially or at the very least our power is very limited compared to our responsibilities (Pfeffer (1992)). One method to influence the actors that are outside our sphere of (official) influence could be the skilful utilization of power. In the entrepreneurial finance setting, this phenomenon is very well presented.

Another intriguing fact that speaks for using power constructs in the entrepreneurial setting is that the power research tradition is much more developed than the entrepreneurship or entrepreneurial finance research tradition. Consequently, and following for example Davidsson's (2003) suggestion concerning the utilization of previously tested

operationalizations of variables in entrepreneurial research, we could find more empirically validated constructs that we could then test in the entrepreneur-investor context.

This study is based on the data of one relationship (i.e. a single case study) and, therefore, caution is needed when interpreting the results (Yin (2003)). In addition, I have employed a rather unorthodox approach by being an active participant in the research setting, even though it has been suggested that this is “within the limits” of participant observation methodology (Yin (2003)). The biggest concern the approach raises is the question of objectivity. I have attempted to limit the problem of construct validity (Yin (2003)) by extensively documenting and presenting the data. In addition, I have linked my arguments and insights to the existing literature on power and entrepreneurship, which should further increase objectivity. Moreover, to argue on behalf of the data collection method, without my active involvement it would have been impossible to obtain as detailed data as I was able to collect during my 18 months period of involvement with the entrepreneurs.

The second important issue to be noted is that previous power research outside the investor-entrepreneur setting is very broad and established. However, I have concentrated on only a very small portion of aspects within the notion of power, and at the same time have excluded other interesting and without doubt relevant concepts and constructs that most likely would have equally advanced the understanding of the relationship. For example, by choosing to examine power sources originally presented by French and Raven (1959), I have also disregarded some other sources of power (Morgan (1986)). Therefore, a more in-depth analysis of power in the entrepreneur-investor context could be of interest than can be conducted in one academic article.

The final limitation, and at the same time a suggestion for future research, is the depth of various contract covenants and other agreement structures between entrepreneurs and investors. In our relationship, my right of veto on changes in the ownership structure provided me with a fairly good negotiating position and power that made the entrepreneurs buy back my shares. However, there are various other contract covenants. Kaplan and Strömberg (2003) have divided them into cash-flow rights, board rights, voting rights, liquidation rights and other control rights. In addition, an effective method to control entrepreneurs is the staged financing which VCs commonly use (Gompers (1995)). It could be very interesting to analyze in more detail the association between various contract covenants and power between partners. In my relationship, I had some power based on the investment agreement but the entrepreneurs neglected that by disregarding my suggestions for the best strategy for the firm. Since I had no effective methods to discipline the entrepreneurs for their behavior, I had to agree with them against my will and my power was low. The interesting question remains as to whether this is a common phenomenon or just an isolated incident.

Despite its limitations, my article sheds light on the role of power in the investor-entrepreneur relationship. I suggest that power constructs in entrepreneurial financing could provide several interesting research avenues and could even help us to understand what the optimal building block for a co-operative relationship between entrepreneurs and their investors would be. Going back to the one determination of power, “*get others to do things they would not otherwise do*” (Baldwin (1980, p.501)), is something that both entrepreneurs and their investors try to do continuously in their relationships, and therefore a more detailed academic analysis of that determinant would be well founded.

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Table I
Key concerns in case study research

Key concern in case study Research	Suggestions from the literature (Yin, 2003; Eisenhardt, 1989A)	Notes
Internal validity	Pattern matching	Research questions derived from the literature were matched with empirical patterns.
External validity	Address rival explanations Use of theory/existing literature	Rival explanations were presented. Existing literature was used to make connections between research data and the formal venture capital context.
	Analytical generalization	The data were generalized to power theories.
Construct validity	Using multiple sources of evidence	1) Participant observations during a period of 18 months, 2) multiple interviews with both informants, 3) over 300 e-mail and other documents and material.
	Having key informants review the case study report Establishing a chain of evidence	Both entrepreneurs have reviewed an earlier version of this report. Extensive linkage to interviews and other data in analysis.
Reliability	Developing a case study protocol	Protocol was developed utilizing Eisenhardt's (1989A) suggestions including literature review, proposals, semi-structured questionnaires etc.
	Creating/maintaining a case study database	All data were stored in digital form on a hard drive. In addition, a "data room" was established where data were analyzed in a consistent manner.

Table II**Three research questions and links to data.**

Research question	Notes	Links to evidence
RQ1: Is it so that investors are more often the more powerful party in the relationship?	It seems that the investor's power was very limited in this case. I had some referent power but it decreased when the relationship developed. My main power source was legal power during exit negotiations.	E1, E2, E3, E4, E5, E8 and E9
RQ2: How does power and power balance influence the transfer of nonfinancial benefits and co-operation between parties?	Based on the data, the entrepreneurs' high power enabled them to disregard suggestions. In other words, power imbalance decreases co-operation and transfer of nonfinancial benefits. However, a rival explanation could be that the communication method was wrong.	E5, E6 and E7. See also E10 and E11 which suggest that a wrong communication style may have been the reason for the rejection of nonfinancial contributions.
RQ3: What are parties' power sources and do they vary according to situation?	The entrepreneurs' power was based on legal and partly expert power. The investor's power was based first on referent power but later mainly on legal power. In sum, power is based on various sources and it changes according to situation.	E1, E3, E4, E8 and E9

Figure 1.**Three different scenarios of power balance and imbalance
between an entrepreneur and an investor**

(Inspired by Buvik and Reve (2002, p.267) and Casciaro and Piskorski (2005, p.171))

