

RICH VERSUS KING: THE ENTREPRENEUR'S DILEMMA

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ABSTRACT

The two major motivations to start a new venture are the profit motive and the control motive. This paper examines how entrepreneurs' choices that increase their potential financial gains (i.e., achieve the profit motive) should conflict with their ability to achieve the control motive. In particular, it focuses on how attracting the external resources required to build value can conflict with entrepreneurs' abilities to keep control of their ventures at the CEO and board levels. It explores whether this tension exists both at the level of the individual entrepreneur's financial gains and at the level of the overall venture's value, and also whether entrepreneurs can avoid the tradeoff by building more human capital before founding the venture and by retaining more co-founders as the venture grows. It tests its hypotheses on a unique dataset of 457 private technology ventures, and finds strong support for each of its core propositions. Implications include the need for entrepreneurs to understand the small probability of achieving both the profit and control motives, and to examine their core motivation and proactively plan their strategic choices to achieve that motivation.

INTRODUCTION

Despite the importance of new ventures to economic development, such organizations suffer from a significant liability of newness that results in a high rate of failure (Stinchcombe 1965; Aldrich and Fiol 1994). The factor that underlies this heightened failure rate is a lack of resources (Stinchcombe 1965). Although an entrepreneur might already control some of the resources necessary to pursue an opportunity, critical resources must almost always be acquired from outside resource providers (Stevenson and Jarillo 1990). By acquiring these resources, entrepreneurs can build more valuable companies than if they only used those resources they already control.

The values of an organization's most powerful actors have a strong impact on the organization's strategic choices, particularly regarding the attraction and allocation of resources (Tagiuri 1965; Hambrick and Mason 1984:193). Consistent with upper echelons theory (Hambrick and Mason 1984), this study suggests that entrepreneurs' choices about resource acquisition will have fundamental implications for their organizations and for the financial value they can build. It focuses on the main two motivations, the profit motive and the control motive, that lead entrepreneurs to start new ventures (Sapienza, Korsgaard and Forbes 2003), how those motivations shape early choices about attracting human and financial resources, and how choices that increase the ability to achieve the profit motive should conflict with the ability to achieve the control motive (and vice versa). It uses a unique dataset comprised of data from 457 private technology start-ups, to test hypotheses about tradeoffs between financial gains and control.

THEORY AND HYPOTHESES

In new ventures, the entrepreneur is the critical actor shaping the firm (Hannan and Freeman 1989; Eisenhardt and Schoonhoven 1990), and entrepreneurs' early choices have a powerful "imprinting" effect on the evolution of the organization (Boeker 1989; Bettis and Prahalad 1995). New ventures are thus an excellent arena in which to study the impact of actors' strategic choices on them and their organizations. Entrepreneurs are attracted to take on the challenge of building new organizations by the profit motive (e.g., Schumpeter 1942; Kirzner 1973) and by the drive to control decision making within the company they started (e.g., Sapienza, Korsgaard et al. 2003). However, "Entrepreneurship is a process by which individuals pursue opportunities without regard to the resources they currently control." (Stevenson and Jarillo 1990:23) Because they are pursuing new opportunities, entrepreneurs usually lack key resources needed to build their organizations (Starr and MacMillan 1990). Assembling the necessary resources enables entrepreneurs both to increase their organizations' rates of growth and to reduce its risk of failure, potentially increasing dramatically the value of their companies.

For the entrepreneur, this introduces a fundamental tension, because the need to attract outside resources can conflict with the major factors, both tangible and intangible, that motivate people to become entrepreneurs. As detailed below, the entrepreneur will have to choose between attracting the resources that will help build a valuable company, in the process giving up a lot of equity and decision-making control, or else retain equity and control while not being able to build as valuable a company. These tradeoffs should exist both at the entrepreneur level and at the company level. (It is also suggested that one way that entrepreneurs can affect the tradeoff is by accumulating appropriate human capital prior to founding the venture.)

For instance, the founder of Steria, an information-technology systems and services company, faced such a tradeoff (Abetti 2005). In the end, the entrepreneur's desire "to remain independent and master of his own destiny" led him to refuse to accept capital from outside investors (relying instead on founder capital and bank loans), to maintain control of the company's equity, to not grant stock to Steria's employees, and to remain chief executive officer. As a result, the company's growth was slowed markedly (Abetti 2005). An alternate path for the entrepreneur would have been to take capital from outside investors and to allocate equity to others working for the company, thus potentially building a more valuable company. However, doing so would have conflicted with what motivated him to start Steria.

Conflicting Motives, Founder Backgrounds, and Organizational Value

Both Adam Smith (1991 ed.) and Joseph Schumpeter (1942) emphasized that the personal *profit motive* drives private enterprise. More specifically, entrepreneurs want to build personal wealth by owning equity in a valuable venture (Schumpeter 1942; Kirzner 1973). Supporting this, a recent study found that many founders of new high-technology ventures believe that their chances of becoming wealthy are much greater if they were to start a venture than if they were to pursue non-venture options (Amit, MacCrimmon, Zietsma and Oesch 2000:120). These "opportunistic" entrepreneurs are more motivated by financial gains than are "craftsman" entrepreneurs, who are more motivated by the need for autonomy (Chell, Haworth and Brearley 1991).

The more resources that a new venture can gain control of, and the quicker it can do so, the better the venture's competitive position (Romanelli 1989:375). In particular, the major types

of resources required by entrepreneurs are human resources and financial resources (Sapienza, Korsgaard et al. 2003). However, gaining the resources to build valuable companies can also come at a steep cost to the entrepreneur. In order to acquire control of critical resources, organizations have to give up things that are of high value to their resource providers (Emerson 1962; Pfeffer and Salancik 1978). This is particularly true in new ventures, for the high rates of growth of such ventures often require a very high percentage of resources not controlled initially by the entrepreneur (Venkataraman 1997) and the most valuable resources are in limited supply (Peteraf 1993:181). Entrepreneurs will have to give up a share of the venture's control and its future rents in order to attract valuable co-founders, hires, and investors (Collis and Montgomery 1995; Coff 1999). High-quality co-founders and non-founding hires will demand more equity than will lesser co-founders and hires. The same is true of investors who can add the most value, compared to lower-value investors (Amit, Glosten and Muller 1990; Hsu 2004). If the entrepreneur refuses to give up such control, he will fail to attract the best resource providers and thus will build less value.

The central problem is that giving up control of the venture conflicts with the second core motivation for entrepreneurs, *the control motive*. Not all entrepreneurs start ventures to get wealthy (Amit, MacCrimmon et al. 2000:120). In fact, recent empirical studies have found that entrepreneurs earn lower financial returns (Moskowitz and Vissing-Jorgensen 2002) and income (Hamilton 2000) than would be expected. The major explanation offered by each study is that this results from a willingness to forego economic benefits in order to gain the intangible benefits of increased professional autonomy and personal control. In particular, entrepreneurs are motivated by the chance to play a central role in driving and controlling the growth of the company they founded (e.g., Carland, Hoy, Boulton and Carland 1984; Begley and Boyd 1987). Because of this control motive, entrepreneurs want to maintain control of decision making within the firm by retaining control of the CEO position (Wasserman 2003) or by retaining control of the board of directors (Wasserman and Boeker 2005). Therefore, there is an inherent tension between the profit motive and the control motive, for the resource-attraction choices that help increase financial gains endanger the entrepreneur's control of the venture, and vice versa.

There are two major levels on which the entrepreneur can keep or give up control of decision making: controlling whether the entrepreneur remains CEO (Hellman 1998; Wasserman 2003) and whether outsiders or insiders control the board of directors (Sahlman 1990; Lerner 1995). First, investors who want to grow a more valuable company will often push to bring in a new CEO to replace the entrepreneur. However, such actions run counter to the wishes of an entrepreneur whose primary motivation is being able to control the development of the organization he or she has founded. Entrepreneurs who do not want to give up the CEO position will be less attractive to investors who want to be able to change CEOs as the company grows, thus hurting the entrepreneurs' abilities to gain resources from outsiders.

Hypothesis 1: If the entrepreneur still holds the CEO position, the value of the entrepreneur's equity stake will be lower.

The second level where entrepreneurs want to control decision making within their firms is within the board of directors. The board of directors controls most major decisions within modern companies (Mace 1971), and maintaining control of more than half of the board can give entrepreneurs powerful influence over those decisions. Within new ventures, for most corporate decisions, board control is critical (Lerner 1995; Kaplan and Stromberg 2004). Such decisions

can have fundamental implications for the founders of the company, making it very important to entrepreneurs that they retain control of the board as long as possible (Wasserman and Boeker 2005). However, given the money and other resources they contribute to the company, investors also want to control key decisions as much as possible. Entrepreneurs who resist giving such investors control at the board level may thus harm their own ability to attract the resources of such outsiders, reducing their ability to grow the value of their companies.

Hypothesis 2: If the entrepreneur still controls the board of directors, the value of the entrepreneur's equity stake will be lower.

The hypotheses above focused on how the need to attract resources should increase the chances that the entrepreneur will have to give up control of the venture. However, past work on strategic choices (e.g., Hitt and Tyler 1991) has found significant impacts of an executive's prior work experience and functional experience on organizational outcomes, with specific applications to entrepreneurial contexts. This prior experience should have an important impact on the entrepreneur's ability to build the venture, in ways that may help the entrepreneur achieve his or her motivations beyond what would be expected from the tradeoff described above. Most centrally, entrepreneurs' having general management (GM) experience influences the strategies adopted by new firms (Boeker 1988) and the thresholds with which entrepreneurs evaluate firm performance and whether to exit (Gimeno, Folta, Cooper and Woo 1997). Furthermore, in contrast to managers with narrower functional backgrounds, managers who have GM experience consistently lead their business units to higher levels of performance (Govindarajan 1989). Therefore, we would expect founders who have GM experience to have built greater value than founders who do not have GM experience.

Hypothesis 3: Entrepreneurs who had general management experience before founding the venture will have more valuable equity stakes in their venture.

The first three hypotheses capture the tradeoff between the founder's retaining control of the venture and the value of the founder's personal equity stake. However, does the founder's choice to retain control affect the value of the overall venture? Especially during the early stages of venture growth (Wasserman 2006), when founders are more likely to act like organizational "stewards" (Davis, Schoorman and Donaldson 1997), the key consideration for entrepreneurs may be how their choices will affect the overall value of the venture itself. For instance, entrepreneurs may be more willing to give up control if it means that the venture will benefit, even at the expense of the entrepreneur's financial gain. If so, we should see a negative relationship between the control retained by the entrepreneur and the value of the venture itself.

Hypothesis 4: If the entrepreneur has been replaced as CEO or if outsiders control the board of directors, the company's valuation will be higher.

CONCEPTUAL INTEGRATION: THE RICH VS. KING TRADEOFF

We can integrate these factors into a matrix that summarizes the "Rich vs. King" tradeoff. On the horizontal axis is the value of the entrepreneur's financial stake. The vertical axis shows

the degree to which the entrepreneur has kept control at the CEO and board levels, varying from keeping little control (being a “minor player”) to keeping a lot of control (“major player”).

Value of Stake

| | | Substantially lower than potential value | Close to potential value |
|--|--------------|--|--------------------------|
| Control Kept - CEO position - Board control | Minor player | Flop | Rich |
| | Major player | King | Rich & Regal |

For many founders, the “ideal” entrepreneurial outcome would be one where the entrepreneur both grows a valuable company and remains a big player in it (“Rich & Regal” in the matrix). However, within a particular type of business, most entrepreneurs will face a tradeoff between building value and keeping decision-making control – i.e., between being “Rich” (a minor player with a valuable stake) and being “King” (a major player holding a much less valuable stake). At the same time, entrepreneurs who have a general management background should have a higher likelihood of becoming Rich & Regal.

DATA, METHODS, AND RESULTS

The data used in this study was collected in annual surveys of private American firms. To reduce the chance that the results are sensitive to the year in which the data were collected, this study uses data from the 2000, 2001, and 2002 surveys, while controlling for the year of collection. The full dataset includes 457 private technology companies.

The first *dependent variable*, the current value of the entrepreneur’s equity holdings, is computed by multiplying the company’s “pre-money” valuation times the entrepreneur’s percentage of equity held (e.g., Lerner 1994; Kaplan and Stromberg 2004), logarithmically transformed. (Auxiliary models were run using the logarithm of the amount of capital raised, with similar results.) To test Hypothesis 4 regarding the value of the company, the logarithm of the company’s pre-money valuation was used as the dependent variable. The core *independent variables* included three dummy variables: whether the entrepreneur still held the CEO position (Hypothesis 1), whether founders still controlled the board of directors (Hypothesis 2), and whether the entrepreneur had a general management background from prior work experience (Hypothesis 3). To test Hypothesis 4, the organization-level models used as dependent variables the company’s valuation and its total capital raised. The control variables included human capital controls, company controls, and segment and year dummies.

In summary, all four hypotheses are supported. Most centrally, entrepreneurs who give up the CEO position ($p < .01$) and board control ($p < .005$) hold more valuable equity stakes. At the same time, when the entrepreneur has a general-management background ($p < .05$), the entrepreneur’s stake is more valuable. The results also hold for the core organization-level model: company valuation is greater if the entrepreneur has given up the CEO position ($p < .01$) and if the entrepreneur has given up control of the board ($p < .005$). Thus, there appears to be a strong tradeoff between value created and control retained, but that entrepreneurs who have prior general management backgrounds may be able to build more value than strictly implied by the Rich vs. King tradeoff.

DISCUSSION

This study has examined the conflict between entrepreneurs' two major motivations, the profit motive and the control motive. People are motivated to become entrepreneurs by potential economic benefits and by the ability to control and shape the companies they start.

Entrepreneurs who want to build valuable companies must attract the outside resources that can help them do so, by attracting co-founders, non-founding executives, and investors. However, to attract these outside resources, entrepreneurs have to give up something that may have motivated them to begin with: control of decision making. This requires them to choose between attracting resources that can help grow their companies and keeping those core benefits that are their main motivations for becoming entrepreneurs.

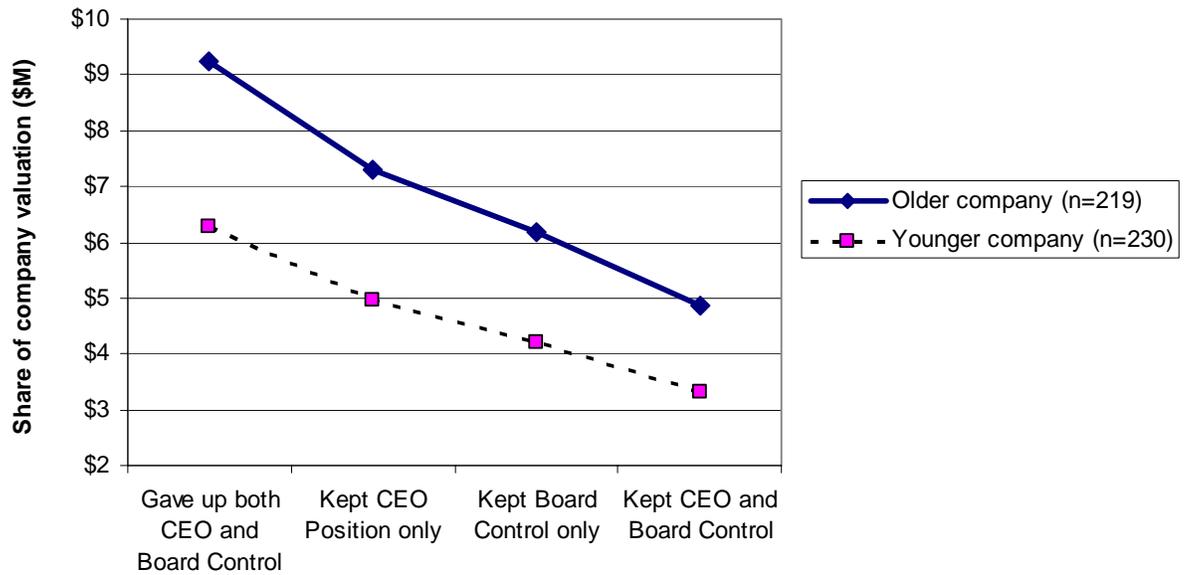
Hypotheses about this tradeoff were tested on a unique dataset of 457 private ventures in the technology industry. The results show that the more decision-making control kept (at both the CEO and board levels), the lower the value of the entrepreneur's equity stake. Thus, entrepreneurs are more likely to grow a more valuable venture if they are willing to give up control, or they can keep control, not attract the best resources (people, capital) to the venture, and be more likely to end up with less-valuable stakes. These results were found in both older and younger start-ups. At the organization level, this study also found that entrepreneurs' choices about retaining control also affect the valuation of the overall venture.

For entrepreneurs with simple motivations – for instance, entrepreneurs driven primarily by the profit motive and very little by the control motive, or vice versa – the set of choices they face should be more straightforward than if they are driven by both motives.¹ However, entrepreneurs driven by both major motives face a more complex series of choices (Sapienza, Korsgaard et al. 2003). These are the entrepreneurs who face tougher “dilemmas” in their strategic choices. Ideally, it would make sense for these entrepreneurs to try to achieve the entrepreneurial ideal of being both “Rich & Regal.” However, much as moves to “claim value” harm a person's ability to “create value” (Lax and Sebenius 1986), attempts by entrepreneurs to achieve one goal should harm their ability to achieve the other goal. This is why, despite prominent Rich & Regal entrepreneurs like Michael Dell and Bill Gates, most entrepreneurs are not like these exception cases and instead have to sacrifice one goal or risk achieving neither.

The tradeoff examined here mirrors examinations in the strategy literature (e.g., Coff 1999) of the relationship between rent generation and rent appropriation, and in the overall resource dependency literature on top management's ability to attract critical resources from the external environment (Pfeffer and Salancik 1978). Further research can help us understand how entrepreneurs may be able to reduce the drastic “liabilities of newness” that come from a lack of resources, further increasing the impact of entrepreneurs on capitalist economies.

¹ To the extent that entrepreneurs are motivated by other motivations beyond the two examined here, and to the extent that their corresponding strategic choices are unrelated or even conflicting with the Rich versus King tradeoff, the existence of such other motivations should make this study's empirical conclusions more conservative.

The Rich-versus-King Tradeoff



REFERENCES AVAILABLE FROM THE AUTHOR