

# **Conflicts between Entrepreneurs and Venture Capitalists: Explanations from Organizational Behavior Perspective**

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## **Abstract**

With rapid development of China's capital market, corporation between start-up firms and venture capitalists has entered a booming period. However, from 2001 to 2016, twenty two famous entrepreneurial ventures in China have experienced dramatic conflicts between entrepreneurs and venture capitalists, and as a result, sixteen firm founders had to leave their own ventures. In the current study, we take an organizational behavior perspective to address the question of why entrepreneurs-VC conflicts are inevitable in practice and how conflicts unfold over time. Case study analysis and semi-structured interviews are used to provide insights into the topic at hand. And by analyzing twenty two cases and interview results, it is found that three major reasons, among many, contribute most to entrepreneur-VC contradiction, and they are conflict between corporate culture and venture professionalization (process conflict), different or even contradictory preference of how to accomplish tasks (task conflict), and disputes in individual characteristics and behavior patterns (relationship conflict).

**JEL classification numbers:** G24

**Keywords:** entrepreneur, venture capitalist, intragroup conflict, organizational behavior.

## **1 Introduction**

Start-up firms are ventures with limited funds and high level of risks, and need capital to fuel their growth when expand to a certain size. It has been well documented that venture capital, as a financing source, is crucially important for the success of entrepreneurial ventures (Vanaker and Manigart 2010). However,

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for both entrepreneurs and VCs, much more efforts are required once the corporative relationship is established, i.e. during the post-investment period. Timmons and Bygrave (1986) find that the relationship between entrepreneurs and venture capitalists matters more than the capital itself. There is a lot of evidence suggesting that venture capitalists play roles over and beyond those of traditional financial intermediaries, which made conflicts between entrepreneurs and VCs common and to be expected (Thomas and Manju 2002, Higashide and Birley 2002).

Although the venture capital industry in China is still young, China's capital market develops rapidly, and corporation between start-up firms and venture capitalists has entered a booming period in China. However, from 2001 to 2016, twenty two famous start-ups in China have experienced dramatic conflicts between entrepreneurs and VCs, and among them sixteen firm founders were defeated and had to leave the company. Table 1 illustrates the basic information of the twenty two start-ups. Most research on venture capital in China is about VCs' influence on venture performance, such as on IPO pricing strategy (Chen et. al., 2011), on firms' investment behavior (Wu et. al., 2012; Liang and Wu, 2012), and on accounting information quality of listed companies (Hu, 2012). Very little research has been done concerning entrepreneur-VC conflicts, especially in post-investment period. The current study focuses on three types of intragroup conflicts between entrepreneurs and venture capitalists and aims to reveal how those conflicts unfold over time.

Table 1: basic information of the 22 companies

No	Company Name	Industry	Conflict Results
1	Sina.com	Internet information	firm founder exit
2	Robust	Manufacturing	firm founder exit
3	AsiaInfo	Information technology	firm founder exit
4	China H.R.	Internet information	firm founder exit
5	UT Starcom	Manufacturing	firm founder exit
6	Hong Haizi	Clothing retailing	firm founder exit
7	Taizi Milk	manufacturing	firm founder exit
8	Ku Xun	Internet information	firm founder exit
9	Zhongxuan Biochemistry	manufacturing	firm founder exit
10	China Health Media	advertising media	unknown
11	ZPIN	Internet information	firm founder exit
12	Dangdang.com	online retails	VC exit
13	Alibaba	internet business	reconciliation
14	South Beauty	catering	VC transferring share

15	NVC Lighting Holding Limited	manufacturing	firm founder exit
16	Twenty-four Coupons	Internet information	firm founder exit
17	Hougu Coffee	agriculture	VC transferring share
18	Zunku	Online retail	firm founder exit
19	Inhoerb	manufacturing	firm founder exit
20	Shanghai Jahwa Group	manufacturing	firm founder exit
21	Da Niang Dumpling	Manufacturing	firm founder exit
22	Vanke Co.	real estate	conflict ongoing

## 2 Preliminary Notes

The entrepreneur literature has long explored into entrepreneur-VC relationship (Cable and Shane 1997; Sapienza and Korsgaard 1996; Steier and Greenwood 1995), and finds that conflicts between the two parties, as well as conflicts within entrepreneurial team are somehow inevitable, and can be extremely detrimental to venture success even the two parties are joining together in good faith and with the same strategic objectives in the first place (Andrew et. al., 2010).

Some researchers define entrepreneur-VC relationship as an agency relationship, in which conflicts are often studied through issues like control power and profit distribution (Zahra, S., H. Sapienze, & P. Davidsson, 2009). This relationship is all about taking control in order to prevent the partner from taking advantage of the other. However, one pitfall of this standpoint is that it does not fully cover entrepreneur perspective, because entrepreneurs start their business not only to make money, but also to gain personal reputation, self-value and exclusive human capital (Aghion and Bolton 1992). Another group of researchers studying entrepreneur-VC conflict, on the other hand, insist that only by putting their relationship in intragroup setting can their conflicts be effectively avoided, mitigated or solved (Thomas and Manju, 2002). Therefore, the current paper starts the analysis with the theory basis that entrepreneurs and venture capitalists are team members within an organization (Parhankangs and Landstrom 2006; Collewaert and Fassin 2013), and their conflicts are analyzed as intragroup conflicts.

### *Intragroup Conflict*

Conflict is a crisis situation or a state of discord caused by the actual or perceived opposition of needs, values and interests among individuals (Boulding, 1963, pp.5), and are originates from conditions such as goal incompatibilities, personal differences, interference in reaching goals, inefficient communication,

interdependency, and the alike (Bartos and Wehr 2002, pp.9). Researchers from multiple disciplines and streams, such as anthropologists, political science scholars, and sociologists, have also studied intragroup conflicts both at personal and group level, and have contributed to the view of conflicts as a negative organizational force (Dimoccio, 1998; Fry & Fry, 1997; Morrill, 1995).

Research on intragroup conflicts also has a long history in organizational behavior literature, and it has been agreed upon by majority of researchers in this field that, in long term and an overall context, intragroup conflicts damage group consensus, diminish confidence in cooperation, and decrease individual satisfaction and group productivity (Andrew et. al., 2010). Organizational behavior experts classified intragroup conflicts into three major types, namely relationship conflict, task conflict and process conflict (Jehn and Bendersky, 2003). Relationship conflict, as the first kind of intragroup conflict, was identified and studied in the earliest organizational behavior literature. Relationship conflict is caused by interpersonal incompatibilities among team members, such as personality differences, different preferences regarding non-task issues. It causes tension, annoyance and animosity, and shifts group members' attention and energy to other group members instead of tasks and missions at hand. In practice, relationship conflict increases group members' stress level and emotional instability, which decreases cognitive ability of anyone involved in and suffers from relationship conflict, and "encourages antagonistic or sinister attributions for other group members' behavior, which can create a self-fulfilling prophecy of mutual hostility and conflict escalation" (Jehn & Mannix, 2001; Baron, 1991; Janssen et al., 1999).

In late 1980s, task conflict was separated from relationship conflict as a new structure because the two have very different performance consequences (Amason & Sapienze, 1997; de Dreu, 1997). Task conflict exists when team members express different opinions about content of tasks and issues. In contrast to relationship conflict, task conflict focuses more on task content instead of non-task issues. Some researchers argue that task conflict is not necessarily negative, as appropriate level of task conflict can improve group decision quality when group members challenge each other's ideas, and can achieve affective acceptance of group decisions for it somehow gives group members a strong sense of participation (Amason 1996). However, task conflict does not exist alone in a situation. The mega-analysis conducted by Tony L. Simons and Randall S. Peterson (2000) showed that relationship conflict and task conflict are strongly correlated, and therefore, any efforts to stimulate potentially beneficial task conflict run a substantial risk of triggering detrimental relationship conflict. In other words, as relationship conflict escalates, group members with high level of interpersonal incompatibilities tend to encounter task conflicts, because they send ambiguous information, purposely propose different opinions for argument, and do not provide full cooperation. And these actions further damage intragroup trust, when trust is critically important to achieve high group performance. And when

trust is lost, group members lose their satisfaction and commitment to the group as a whole, which further intensify relationship conflict.

Process conflict, as the third type of intragroup conflict, only began to surface and was incorporated into conflict models by some organizational behavior researchers a little more than a decade ago (O'Reilly, Williams & Barsade, 1998). Process conflict takes place when different preferences of specific means/ways/methods to accomplish a task or a mission are presented by group members (Jehn 1997). Examples of process conflict can be about the composite of a team, group work distribution, resources allocation, and work scheduling (Andrew et. al., 2010). One of the most common process conflicts takes place when entrepreneurs believe that VCs should be responsible for introducing new financing while VCs may feel this should be entrepreneurs' responsibility. Although three types of conflicts often coexist in practice and positively interrelated with each other, it is believed that there is still an apparent distinction among them, and to accurately identify and distinguish among the conflict types is vitally important for solving them.

Resource Dependence Theory (RDT) is also applied in the current study to help identify different source of conflict because it examines how the external resources of organizations affect the behavior of the organization (Sapienza, Manigart, and Vermeir 1996). In studying any kind of relationship, it can be greatly helpful to understand who depend more than whom by examining reasons like the resource being provided, availability of substitutes to that resource and the existence of alternative suppliers (Gomez-Mejia, Balkin, and Welbourne 1990). Therefore, in order to gain a comprehensive insight into entrepreneur-VC conflicts, it is necessary to examine the dependencies of one party on the other. For start-up firms, finding external financing source can be extremely important but difficult because of their high risk of failure. On the other hand, venture capitalists do not rely on one single investment but diverse their capital into a portfolio of projects in order to balance their profit. In this sense, entrepreneurs are put in a disadvantageous position as they depend more on VCs than the other way around. However, because entrepreneurs know much better about the business itself than VCs, the latter do suffer from imbalance of information, and depend deeply on entrepreneurs for intact and accurate information about the company they invest in. In practice, VCs try to reduce this dependence by every means and to ensure entrepreneurs act in accordance with their wishes.

### **3 Research Method**

#### *Data Collection*

Considering that different industries or business sectors have varying types and

levels of conflicts, case study is employed for this research to provide diverse perspectives on the topic at hand (Eisenhardt and Graebner 2007). Variation is present in terms of case location, industry (ranging from information technology and manufacturing to real estate), and company size. Besides, perspectives of both entrepreneurs and VCs are considered and explored in the current study. Twenty two companies that received financing from VCs and experienced dramatic conflicts with VCs were selected using a theoretical sampling procedure based on data collected through previous researches (e.g. Zhou jianan et. al., 2015) on the nature and conflict evolvement path. The aforementioned conflict types and conditions are all found in the case companies.

In order to bring a richness of data together and contribute to the validity of the research (Yin 2003), publications and reports about the twenty two case companies were collected through various channels, such as VC companies, start-up firms, consulting institutions, government departments, and authorized publishers including news papers and magazines.

### *Interview Design*

Based on case analysis results, semi-structured face-to-face or telephone interviews were carried out with capital market analysts and researchers on the very topic. The five analysts are all with more than fifteen years of working experience in capital market both in China and abroad, and all have thorough understanding of the case companies in the current research. The two university scholars are both researchers with more than ten years of research experience in organizational behavior.

When designing interview questions, case study results provided the main reference. In measuring relationship conflict, interviews were developed based on the following three questions:

- a. How do the two parties perceive personalities of each other?
- b. Do you think the two parties have unethical actions?
- c. How do the two parties react to “people problem”?

In measuring task conflict, interviews were centered in the following two questions:

- a. How do the two parties evaluate the management capabilities of each other?
- b. How do the two parties perceive the operating capabilities of each other?

In measuring process conflict, interview questions are developed based on the three questions:

- a. Which do you think is more important? Corporate culture or firm professionalization?
- b. How do you think managerial team should be professionalized?

- c. What do you think is the main conflict/conflicts in the adjustment of organizational structure? And how do the two parties react to the conflict/conflicts?

## 4 Main Results

From the research, we draw the conclusion that three major reasons, from organizational behavior perspective, contribute most to entrepreneur-VC contradiction, and they are disputes between enterprise professionalization and corporate culture, different or even contradictory preference of methods to accomplish tasks, and conflicts in individual characteristics and behavior patterns. In this section, research findings are discussed concerning the three major conflict sources and how conflicts unfold them over time.

### *Process conflict: enterprise professionalization V.S. corporate culture*

Case analysis shows that culture-professionalization conflict is everywhere, and the follow-up interviews supported this observation with seven interviewees all believe that entrepreneurs and VCs argue over this issue as often as they argue over profit distribution.

Case study reflects that, in practice, entrepreneurs are emotionally attached to their ventures and emphasize corporate culture in venture's development. As quoted from one of the interviewees that "for entrepreneurs, corporate culture is as important as management capabilities of the entrepreneurial team, and a dispensable pillar to sustain a firm's development in the long run". However, in seventeen cases of the current research, entrepreneurs had expressed strong opinion that venture capitalists do not fit into their corporate culture that has been built along venture growth, and this is one of major problems with venture capitalists. The research shows that VCs do not attach importance to corporate culture of the ventures they invest in as much as the entrepreneurs, and if VCs find that the corporate culture is not in conformity with the professionalized venture system they want to establish, they would, without hesitation, revise or even abandon corporate culture, which triggers greater conflict between them and entrepreneurs. On contrast, VCs display great attempt to professionalize the start-ups by measures like establishing professionalized human resource policies and adopting stock option plans. For VCs, professionalization is one of the best methods to restrain entrepreneurs and secure their control power.

Besides, it is interesting to notice that two analysts with abroad working experience have claimed that culture-professionalization conflict is more obvious and dramatic in China because of the immature nature of the entrepreneurial industry itself. It is believed that this can be an interesting as well as important

topic to investigate in for future research on entrepreneur-VC conflict in Oriental countries.

*Task conflict: different opinions about how to accomplish tasks*

Both case analysis and follow-up interviews revealed a lot of task conflict between entrepreneurs and VCs, and inter-dependency between the two parties greatly influences how they react to task conflict respectively.

In the twenty two cases, the best illustration of task conflict is found in Case 6 (Hong Haizi). When the company met with market constrains, one of the two venture founders (founder A) insisted to maintain the focus in the maternal and infant market to find the breakthrough, while the other founder (founder B) proposed the idea of increasing product variety and changing their marketing strategy to explore into B2C market. VCs of this company supported the latter. Task conflict soon triggered relationship conflict. Not only VCs and founder A were put into very intense relation, the two founders became no longer intimate like when they first started the business together. The situation became worse when employees began to take sides, and intragroup conflict gradually spread and took control of the whole venture.

It can also be concluded from the research that when encountering task conflict, entrepreneurs are more likely to compromise than VCs. Analysts and researchers interviewed in the research explain this phenomenon with dependency theory as entrepreneurs depend on venture capitalists not only for capital input, but also for making strategic decisions, introducing new financing resource and networking to important industry contact, which are all critical for venture success.

*Relationship conflict: individual characteristics and behavior patterns*

In most of the twenty two cases, VCs often accuse entrepreneurs of being “not sociable”, such as “being extremely difficult to communicate”, “not responding emails in time”, “being too arrogant and self-centered to be professional manager”, and “appointing people at his own will”. Twelve cases show dramatic entrepreneur-VC conflicts of this type, with Case 15 and 22 being the best examples. The venture founder of NVC Lighting Holding Limited (NVC) were expelled from the venture three times only for the reason that “he did not go alone well with the VC” according to two interviewees who had made deliberate efforts in investigating this case. The conflict situation in Case 22 (Vanke) presents other features. As the largest real estate corporation in China, Vanke is still undergoing drastic entrepreneur-VC conflict when the current research is conducted. One outstanding feature about this case is that Vanke’s entrepreneurial team, who displayed remarkable managerial capabilities, never contended with VCs for control power. Entrepreneurs of Vanke are well known as individuals with very



strong personalities. In post-investment period, they often criticized VCs in public for their personal incompatibilities and even unethical behavior, which pushed relationship conflict to a high level between them and VCs.

All twenty two cases confirmed the theory that relationship conflict interfere with task-related effort. Except for Case 22, the other case companies showed unsatisfactory business performance during and after the conflicts between entrepreneurs and VCs. Case Company 1, 2, 5 and 12, as once the leading companies in their respective industries, began to decline and even struggle to survive in the market. As pointed out by one interviewees that “if conflict, especially relationship conflict, between entrepreneurs and VCs is not carefully dealt with in time, ventures can not avoid the fate of going down in business”.

## **5 Conclusion and Further Research**

As does every research, this study has its limitations. First of all, very little direct contact was able to be made with people in the twenty two case companies due to research resource limitation. Secondly, due to time and information constrains, how entrepreneur-VC conflict interacts with conflict on the entrepreneurial team has not been studied as the researchers wished to in the first place. When conflicts arise between VCs and entrepreneurs, entrepreneurial team will have to decide how to react, which may cause conflicts within entrepreneurial team. In other words, how entrepreneur-VC conflict and conflicts within entrepreneurial team interact should be further studied in future research.

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