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Entrepreneurs and the Truth

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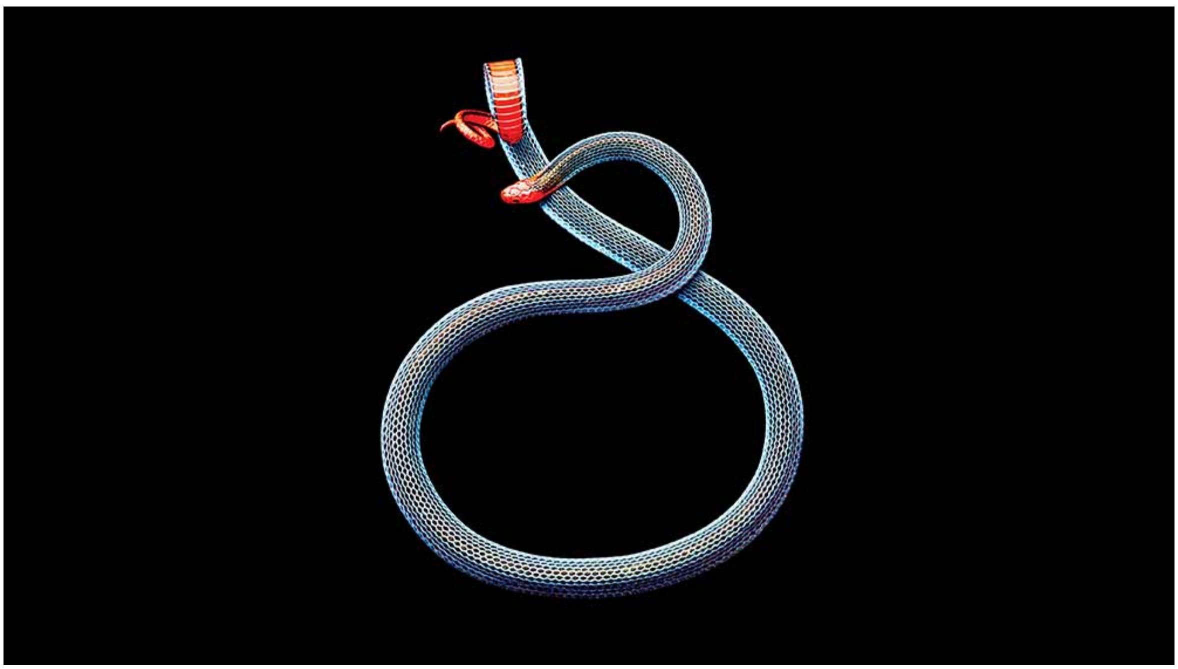

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Summary. Chicanery is common in the start-up world: With so much at stake, founders are apt to exaggerate, obfuscate, and otherwise stretch the truth when courting investors and other important stakeholders. Such deception locks up resources by prolonging the life of... **more**

In the early days of Vice Media, cofounder Shane Smith sent a few copies of the Montreal-based start-up's fledgling publication to a record store in Miami and a skate shop in Los Angeles so that the company could tell advertisers its readership was distributed across North America—an act befitting the monicker “Bullshitter Shane,” reportedly bestowed on him by a friend and colleague.

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Such chicanery is too common in the start-up world. The norms of entrepreneurship encourage founders to be hustlers and evangelists for their companies. Indeed, legendary founders are celebrated for their ability to inspire others, even if that means stretching the truth. Consider Steve Jobs, the quintessential start-up pitchman. Early Apple employees describe him as able to “convince anyone of practically anything.” In the words of engineer Andy Hertzfeld, Jobs had a “reality distortion field, a confounding mélange of a charismatic rhetorical style, an indomitable will, and an eagerness to bend any fact to fit the purpose at hand.”

That’s a vital skill for founders, who must persuade their audiences to temporarily suspend disbelief and see the opportunity the entrepreneur sees: a world that *could be* but is not now. However, reality distortion is a slippery slope. Enthusiasm can lead to exaggeration, exaggeration to falsity, and falsity to fraud. This descent is embodied in Elizabeth Holmes, the Theranos founder and Jobs devotee who allegedly deceived investors and customers by marketing bogus blood tests.

The Holmes case is rare; few entrepreneurs face criminal fraud charges, as Holmes did when this article went to press. But lesser indiscretions are common, including obfuscation, lies of omission, exaggeration, embellishment, evasion, bluffs, and half-truths. And they come at a cost. Deception results in market inefficiencies; it locks up resources by prolonging the lives of doomed ventures and making it difficult for VCs and employees to know where best to invest their money or labor. We believe it also takes a personal toll on founders, given the debilitating stress that often accompanies lying.

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How can we drive deception out of the start-up culture while also encouraging entrepreneurs to take risks and dream big? We have spent decades researching this question, and we bring a multidisciplinary approach to answering it. One of us (Kyle) is a successful founder turned academic; one (Jon) teaches business and philosophy; and two (Tom and Laura) hold academic appointments focused on ethical entrepreneurship. In this article we first explore why deception is so prevalent among entrepreneurs and then explain why common justifications for it are invalid. Finally, we suggest guidelines for behavior that can help entrepreneurs be both successful and honest—to the benefit of all.

Why Entrepreneurs Lie

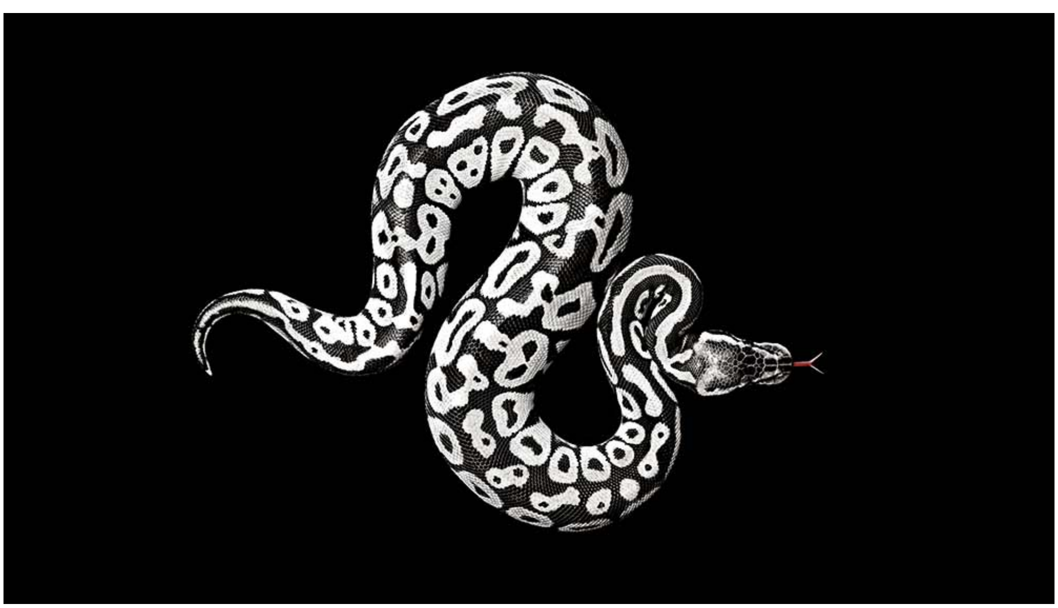
The Chicago economist Frank Knight was one of the first scholars to study the role of entrepreneurs in the modern capitalist system. In his 1921 book *Risk, Uncertainty, and Profit,* he distinguishes entrepreneurs from other businesspeople by their willingness to act in the face of uncertainty. Of course, established businesses face uncertainty too—but start-ups must navigate through a particularly dense fog. Entrepreneurs often don't know whether their product will work, how it will be manufactured, who the customers will be, or how they can be reached. For Knight, an entrepreneur is someone who, facing all this uncertainty, acts while others dither.

But action alone is insufficient. An entrepreneur needs others' help and must therefore be a persuasive cheerleader—when pitching VCs for funding, wooing prospective employees away from cushy jobs, persuading customers to take a chance on a new product, and instilling confidence in the team amid the start-up's vacillating fortunes.

That's the first reason some entrepreneurs are less than truthful: They transgress because they have many opportunities to do so. More than most other businesspeople, they are always "on."

The second reason is that entrepreneurs have a lot on the line. As a group they stand to gain great wealth, but it's unevenly distributed. Research shows that the median entrepreneur has poor risk-adjusted returns—statistically, founders would be better off working at an established company or holding a diversified index fund than holding their own equity. But what the median lacks, the maximum makes up for. A small percentage of entrepreneurs become enormously wealthy. Indeed, entrepreneurs dominate the ranks of the world's richest people.

A thousand things must go right to earn such outsize rewards, and in any one meeting, a founder's fortunes might balance on a knife's edge. Failure can mean not just missing an enormous windfall but also letting down friends, family, employees, and investors. With stakes that high, it can be tempting to bend the truth.



The third reason entrepreneurs are prone to deception is that it's relatively easy for them to get away with it. Entrepreneurship has a great deal of what economists call "information asymmetry." Typically, founders lead private, closely held companies and possess lots of information that others—investors, customers, employees—don't have. The leaders of public companies have extensive transparency requirements and are under intense scrutiny; if they tell a lie, many people are in a position to discover it. But even in a venture-backed start-up with board oversight, only a tiny circle of people are privy to the company's internal workings, so deceptions can easily evade detection or go unchallenged. And because start-ups are, on average, staying private longer than they used to, such opacity is increasingly common and persistent.

None of this is to say that entrepreneurs are less ethical than other businesspeople. What little research is available suggests that on average, they have *higher* moral standards than corporate managers do. But the pressures that might tempt them to be less than completely truthful are enormous—and decades of psychological study have shown that even people with high moral standards are likely to transgress in contexts in which ethical lapses are common and tolerated.

How Entrepreneurs Rationalize Their Lies

Most founders who shade the truth under such pressures probably don't see themselves in a poor light. They often justify their actions through some combination of three rationalizations that are closely related to common ethical theories about what makes actions right or wrong. But each falls apart under even casual philosophical scrutiny.

"It's for the greater good." In 2018 *Entrepreneur* interviewed Gary Hirshberg, who built Stonyfield Farm from a two-person (and seven-cow) side hustle into one of the world's leading purveyors of organic yogurt. Stonyfield's success didn't always seem destined. Hirshberg recounted a series of dire moments and the deceptions that saved the company, including lies to vendors and a loan officer at the Small Business Administration. He offered several rationales, all common among entrepreneurs and related to well-known theories of ethics.

"I think lying, if we want to call it that, which I guess is what it should be called, for the common good, because in the end it didn't help the vendors for me to go under either, is OK as long as you ultimately do deliver," Hirshberg explained. This "ends justify the means" rationalization harks back to the utilitarianism of Jeremy Bentham and John Stuart Mill, according to which an action should be judged solely on the basis of its consequences. "[I]t is the greatest happiness of the greatest number that is the measure of right and wrong," Bentham wrote.

"I'm protecting my people." A variant of the "ends justify the means" rationalization, this was invoked by Hirshberg as well. "You do whatever the heck you have to do to make it," he said. "We were fighting for employees' jobs and our mothers' and mothers-in-laws' and friends' investments. Fighting for our lives. And I think anything goes, as long as you're not injuring anybody." Friends, family, and early equity investors and employees are often prioritized over stakeholders appearing on the scene later and at a further remove—in Hirshberg's case, the SBA and his vendors.

Of course, entrepreneurs can't know whether their lying will lead to better outcomes for their stakeholders or result in the greatest happiness for the greatest number. They are subject to forces beyond their control, and many who lie "for the common good" will see their ventures fail. When that happens, it comes at the expense of stakeholders who were tricked into supporting them or harmed by risks they weren't given full and honest knowledge of.

"Everybody does it." Hirshberg said of his vendors, "It's not like they haven't seen it before." According to this view, reality distortion is merely part of the game, like "puffery" in advertising and bluffing in poker; it's not prohibited by the rules, and each person playing is responsible for knowing those rules. Sometimes the obfuscation is vague: During tech bubbles, some start-ups with only a small IT component tried to classify themselves as tech companies, because that would boost their valuation. Other times the fudging is more explicit, as when founders exaggerate anticipated revenue because they expect that investors will discount their numbers. In that scenario, a founder might reason, *I have to say we will generate $50 million a year, because investors are going to discount the figure and hear $5 million a year; everybody knows that.* Founders might also massage their financial models to produce outcomes they think VCs expect: a 10x return, a multibillion-dollar market. Those who don't exaggerate may rightly fear putting themselves at a disadvantage.

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Hirshberg is a successful entrepreneur, a prolific philanthropist, and no doubt a well-meaning soul. His comments capture the pressures all entrepreneurs feel and the rationales that can lead them to shade the truth. But they ultimately fail to hold water; they are excuses rather than sound arguments. They shift the responsibility for decision-making onto the supposedly uncontrollable and sometimes immoral norms of abstract institutions. "Business is business," founders might say, absolving themselves of murky choices. But in our view, the business and start-up domains are no different from the rest of life, and they should be governed by the same ethics.

The Honest Entrepreneur

Most entrepreneurs want to engender trust in others and prove themselves worthy of that trust. Few *aspire* to be scoundrels. Evidence suggests that for the vast majority of people, lying and deception cause considerable stress. For example, studies have shown that stress related to ongoing ethical dilemmas decreases job satisfaction and is a leading cause of burnout.

There is a better way, and it involves fostering virtue in all aspects of life, including the professional realm. In this Aristotelian worldview, actions are right if they are what a good (virtuous) person would do. In what follows we offer two practices from exemplary entrepreneurs whom we've had the pleasure of teaching, hosting, or collaborating with.

Show your evidence and assumptions. When entrepreneurs paint a picture of what could be, that picture is not fabricated wholesale; it's an evidence-based guess. The evidence consists of the entrepreneurs' experiences, primary data collected through experiments, traction gained, and third-party data—in short, things they know. The guesses are things they don't yet know but believe or hope to be true.

Not everyone draws the same conclusions from such inputs. Entrepreneurs owe transparency and truthfulness to those being asked to commit themselves or their resources to the venture. Of course, they should present a compelling vision. But they should also present the evidence and assumptions that support that vision. The principle is similar to the instructions given by eighth-grade algebra teachers: Show your work. A good venture capitalist will question a founder's assumptions at pitch meetings—but not all VCs do, especially if they're courting a start-up that's in high demand. And prospective employees, partners, and other stakeholders often aren't given an opportunity to closely examine the evidence and assumptions and form their own conclusions about the company, team, or product they're being asked to support.

Being compelling and being forthright can seem at odds with each other. In some contexts, caveats and discussions of risks are inappropriate. A founder who lucks into an elevator ride with an investor simply conveys the compelling story. And in casual conversation, what's relevant is the vision. Leaving out the risks and the downside potential is expected and not in any way deceptive.

But in a context where analysis and evaluation of the opportunity are the focus, such as a formal pitch or a conversation with a potential hire, entrepreneurs must articulate evidence and assumptions and yet still be persuasive. We propose a "conclusion sandwich." The best entrepreneurs begin and end with their conclusion—the extrapolation — and place their evidence and assumptions in the middle. A founder might say, "We'll make about $X million next year in gross revenue. Let me show you the evidence we have and the assumptions that support this." After running through the calculations, the founder might finish by asserting, "Therefore, we believe $X million is a reasonable estimate." Listeners won't miss the takeaway but are free to reach their own conclusions.

Surround yourself with people who will help you be your best. A mountain of psychology research shows that our social circles influence our morality. Acts that those around us commit or condone become acceptable to us over time, while acts they condemn become unacceptable. So wise entrepreneurs surround themselves with cofounders, mentors, board members, and investors who will help them become their best selves.

Investors are particularly important in this regard. An entrepreneur might launch a handful of ventures in a lifetime, but the most experienced investors participate in hundreds. They witness the ordeals of many founders in many markets over many years and accumulate wisdom that founders can't replicate. A good investor is able to "pattern match," is sensitive to the moral dimensions of particular ordeals, and knows what courses of action are "right" and have the best outcomes. The best investors help entrepreneurs heed the better angels of their nature.

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The wrong investors can be a disaster. This is especially apparent among those who prioritize growth above all else. Consider the pairing of WeWork cofounder Adam Neumann with SoftBank's Masayoshi Son. In their first meeting, Son is said to have expressed dissatisfaction with Neumann's level of intensity and urged him to be even crazier. Neumann obliged. The ensuing SoftBank-funded expansion of WeWork was outlandish, to say the least; it included self-dealing (Neumann trademarked the word "We" and sold it to the company for nearly $6 million) and extravagant expenditures (a $60 million private jet). WeWork became the United States' most valuable unicorn, fueled in part by Neumann's messianic charisma and powerful reality distortion field. It reportedly took just moments for him to persuade investors to fund his vision. He was known, and is now lampooned, for over-the-top claims about the company (for example, framing it not as a real estate subletter but as a "state of consciousness") and what it could accomplish (solving the problem of orphaned children, for one). Still, Neumann's WeWork nearly reached its IPO before imploding. (As of this writing, a far more modest incarnation of the firm, under new leadership, was preparing to go public in a merger with a special-purpose acquisitions company.)

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It may be tempting to think that departures from the truth are just part of doing business—that we operate in a no-holds-barred capitalist arena in which all contestants are responsible for their own welfare and know the rules of the game. Unfortunately, such cynicism feeds on itself; when we encounter dishonesty or scandal, we become disillusioned and are more likely to engage in such behavior ourselves.

Entrepreneurs face particular pressures to lie. Vying for a fixed pool of VC money, often working to secure returns for friends and family, and chasing dreams of greatness, they may feel they will be disadvantaged if they pursue their ventures with a vigorous dedication to the truth. Understanding the forces that tempt them to lie and the tactics that may help them remain virtuous can reduce the deception that's all too common in this crucial part of the economy.

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