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Ethical Dilemmas in Hawaii's First Public-Private Venture Capital Fund

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Abstract. Are there any business decisions that do not have an ethical dimension? Who decides that a decision is unethical? What impact does ethics have in today's business environment? The case focuses on the development of Hawaii's first public-private venture capital fund by three very different entities: the State of Hawaii economic development corporation; a US mainland-based private equity investment firm; and a partnership of two serial entrepreneurs. The case uses a progressive disclosure format so students only read and analyze the actions and ethical issues that occur at a specific point in time: creation of the venture capital fund; selection of startups to be included in the fund's investment portfolio; and public reaction to decisions and actions by the fund. The case frames the issues confronted at each point as ethical dilemmas. Analysis includes answering questions and formulating recommendations or solutions to each dilemma.

Keywords: ethical dilemma, venture capital fund, public-private partnership, equity investment, early-stage startups, entrepreneurs.

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1. Introduction

Governments at all levels recognize that entrepreneurs and their innovations can have a positive impact on economic growth and development. This holds especially true for the State of Hawaii, a cluster of islands in the Pacific Ocean 2400 miles (4000 kilometres) from the US mainland. Its east/west placement makes Hawaii strategic for shipping, transportation, and US military purposes. Its tropical climate and location have benefitted agriculture and tourism. Hawaii's isolation, high cost of living and lack of local venture capital for tech startups, however, have had a negative impact on opportunities for entrepreneurs and the tech community. Government officials recognized the need to find ways to keep entrepreneurs and tech startups from leaving for the mainland. In 2013 the legislature funded and tasked a State agency to support Hawaii's innovation ecosystem and early-stage tech startups including the use of State funds to partner with private equity investors.

This case does not argue the pros and cons of a public-private venture capital fund or address the strategies and approaches for how this can be accomplished. Using an interrupted case methodology and a progressive disclosure format, it focuses on ethical dilemmas that occurred during the development of Hawaii's first early-stage venture capital fund. Three complex and challenging questions of ethics are examined at three critical points in time: creation of the venture capital fund; selection of the first startups to receive funding; and public reaction to the fund's decisions and actions.

2. Creation of Hawaii's First Venture Capital Fund (Part 1)

The impetus for creating a Hawaii-based venture capital fund came from two serial entrepreneurs, Arben Kryeziu and Nick Bicanic. Both had a record of bringing innovations from concept to commercialization. In 2013 they were looking for seed funding for two of their early-stage tech-based startups Flikdate (a mobile dating app with real-time video) and Ozolio (an HD webcam relay service). The ideal place to find investors for their startups was on the US mainland. Devon Archer, a New York-based private equity investor affiliated with Rosemont Seneca Technology Partners, LLC (Rosemont),[1] expressed an interest in both startups. Although Kryeziu and Bicanic's first priority was funding for their startups, they began to see the potential for a Hawaii-based venture capital fund.[2]

They met with the president of Hawaii Strategic Development Corporation (HSDC) Karl Fooks.[3] Although the State was prohibited from making a direct investment in a startup, he indicated that the State would support a Hawaii-based venture capital fund. The State had a newly enacted HI (Hawaii) Growth Investment Program that was established by the legislature to expand the innovation ecosystem with an emphasis on entrepreneurship development;

1. **Rosemont Seneca Technology Partners, LLC (Rosemont)**, is a private equity firm formed in 2011 with headquarters in San Francisco. It is an affiliate of **Rosemont Seneca Capital, LLC** with headquarters in Washington, DC. Rosemont Seneca Capital, LLC was founded in 2009 as a private equity investment firm.
2. **Venture capital fund** – a type of equity financing in which investors receivee ownership interest in a venture. It is generally used for early-stage or startup companies that have high growth potential. While every entrepreneur believes that their venture has high-growth prospects it is investors that decide and choose to back those they think hold the most promise of return and least risk of loss. Venture capital funding is not an equity loan or a secured debt loan. See Zider, B. (1998), "How venture capital works", *Harvard Business Review*, 76(6): pp. 131-139.
3. HSDC was an agency of the State of Hawaii established in 1990 to promote economic development and economic diversification in Hawaii. HSDC operated as a fund of funds and could not invest directly in ownership of private companies.

research commercialization; and mobilization of startup investment capital.[4] Fooks believed that if HSDC provided funding for a venture capital fund it would bring private equity investment capital from outside Hawaii. If Kryeziu and Bicanic created a venture capital fund the State would commit $5 million but ***only if*** it was matched with private funds, a legislative requirement for the use of HI Growth Initiative funds.

Kryeziu and Bicanic began the work of developing a venture capital fund by first establishing a venture capital firm. They filed articles of organization with the State to incorporate mbloom Ventures LLC as a domestic limited liability company[5] on November 20, 2013. Based on HSDC's expressed interest in a venture capital fund, the next task was to recruit private equity investors that would help fund mbloom Fund I. They contacted Devon Archer who had expressed a strong interest in Kryeziu and Bicanic's two startups. Archer affirmed that Rosemont would be willing to match the State's $5 million in a Hawaii-based venture capital fund but only if Flikdate and Ozolio were included in the fund's investment portfolio. These conditions for providing funding each created a classic *quid pro quo*.[6] At that point Kryeziu and Bicanic moved ahead with plans for mbloom Fund I. The legal, organizational and operational structure of mbloom Fund I is shown in Diagram 1 on the following page. It shows the flow of money, authority and responsibility in the fund.

Based on published accounts in the media (December 2013), Kryeziu stated that mbloom Ventures LLC had secured investors to fully fund mbloom Fund I. This indicates that key people from the three entities (HSDC, Rosemont, and mbloom Ventures LLC) had fruitful discussion and reached an understanding to achieve a contractual agreement.[7] It can be assumed that HDSC, Rosemont, and mbloom Ventures LLC entered into mbloom Fund I with eyes open. They would have exercised due diligence during the process of developing mbloom Fund I. This would include investigating, vetting, and studying the proposed relationship

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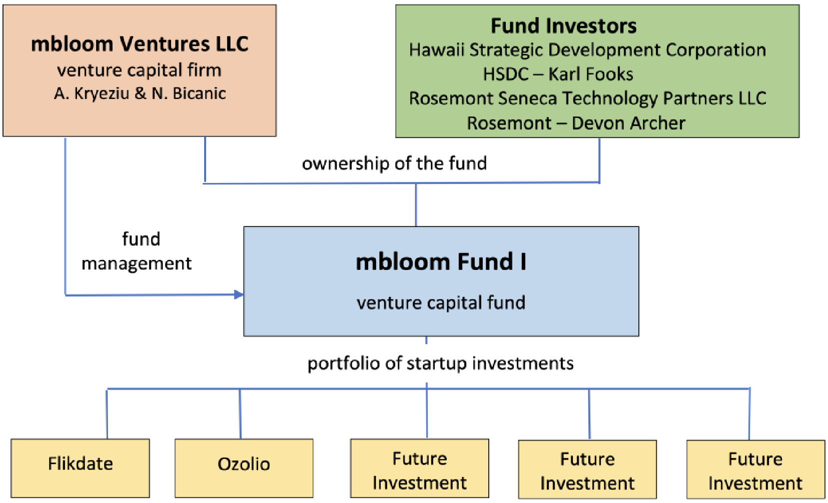
4. Hawaii Strategic Development Corporation 2014 Annual Report, https://hsdc.hawaii.gov/wp-content/uploads/2014/10/2014-HSDC-Annual-Report.pdf
5. **Limited liability company (LLC)** – a legal business entity created by filing documents with a state government. The words "limited liability" refer to the fact that LLC members/owners cannot be held personally responsible for business debts. In a dispute with a business creditor, members may lose the money invested in the company but their personal assets are not at risk. An LLC combines the pass-through taxation of a partnership or sole proprietorship with the limited liability of a corporation, https://cca.hawaii.gov/breg/registration/dllc/
6. ***Quid pro quo*** – Latin for "something for something." It describes an agreement between two or more parties where there is a reciprocal exchange of goods, services or money. This mutual consideration or exchange of something of value indicates the sincerity of the parties' intent to adhere to the contract between them. The term *quid pro quo* itself is generic and does not specify if the activity is legal or illegal. This depends on what are the "something for something". See for example: Lewinsohn, J. (2019), "Paid on both sides: Quid pro quo exchange and the doctrine of consideration", *Yale Law Journal*, (129): pp. 690-772.
7. Star Advertiser (2014), "Maui-based venture capital fund raises $10M for startups", (January 21), https://www.staradvertiser.com/2014/01/21/breaking-news/maui-based-venture-capital-fund-raises-10m-for-startups/

from all perspectives. The parties were aware that the $5 million commitment from HSDC included state and federal funds so there would be oversight by federal and state agencies. The media and public would be watching for any mishandling of public funds. To ensure that risk was spread around, and sound decisions were made, both legislation and Fooks had stipulated that State funds must be matched dollar for dollar with private investment funds.

Diagram 1. Legal, Organizational and Operational Structure of mbloom Fund I



From the perspective of a private equity firm, Rosemont would want to ensure that the money of its investors was protected, especially since a high percentage of startup ventures fail.[8] In order to leverage its investment and reduce the risk of loss, Rosemont would have wanted startups with a solid business plan, good management team, commitment/passion from the founders, and the potential to exit the investment with a positive return before the end of its funding cycle. Based on Rosemont's assessment, it was stipulated upfront that funding for Flikdate and Ozolio must be included. In fact, both HSDC's Fooks and Rosemont's Archer must have been sufficiently impressed with Kryeziu and Bicanic's track record as founders of successful startups. This included ventures funded by Silicon Valley luminaries like Google Ventures, BullPen Capital, and Don Dodge. Among their innovative startups was development of remote desktop virtualization access protocol software for Apple Inc. products.

8. Gage, D. (2012), "The venture capital secret: 3 out of 4 start-ups fail", *Wall Street Journal*, (September 20), https://www.wsj.com/articles/SB10000872396390443720204578004980476429190. According to research by Shikhar Ghosh, a senior lecturer at Harvard Business School, about three-quarters of venture-backed firms in the U.S. don't return the capital that investors provided.