

# Vice Capital

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*Academic and market interest in environmental, social, and governance (ESG) investing has grown markedly in recent years. Although less prominent, a substantial literature also explores whether “sin pays” in the public capital markets. This literature’s underlying theory is that social norms discourage the funding of businesses that promote vice. According to this theory, some investors—particularly institutions sensitive to social norms, such as pension funds and foundations—will shun vice investments. A consequence of this aversion is a “vice premium” for those investors who will invest in such companies. Largely unexplored, however, is what industries or business models qualify as “vice,” how this definition is constructed and changes, how vice aversion affects startup corporate governance and finance, and what consequences vice aversion holds for the real economy.*

*We address these gaps through a series of interviews with startup founders, venture-capital (VC) and angel investors, and legal and financial practitioners. Descriptive data from commercial VC databases supplement our interviews. We find that the definition of “vice” is nuanced and shifts over time as the subjective preferences of investors and their constituents adapt to changing regulatory environments and social mores. Our respondents report that vice startups face heightened regulatory and business-infrastructure hurdles compared to non-vice startups. This experience is especially true for women and other minoritized vice entrepreneurs and those serving minoritized customer bases. These challenges implicate entrepreneurship, society, and capital markets, including by complicating the concept of the vice premium in finance theory and by showing the potential for vice aversion to shape both the vice and non-vice sides of the real economy.*

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## INTRODUCTION

The environmental, social, and governance (ESG) movement has spurred reconsideration of how investors express normative values in their investment decisions in public markets and private startups.<sup>1</sup> Less examined is the mirror

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1. See, e.g., Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393 (2021); Michal Barzuza, Quinn Curtis & David H. Webber, *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV.

phenomenon—how startups in stigmatized industries access investment capital. In a move to fill that gap, this Article presents an interview-based study, supplemented with descriptive data, on the funding (and non-funding) of vice, or “sin,” startups.

Traditionally, “vice” or “sin” industries have been understood to include the adult, alcohol, tobacco, weapons, and gambling industries. As we explain in Part II, however, the definition of “vice” is more fluid and nuanced than the existing literature might suggest.<sup>2</sup> Vice businesses are, to varying degrees, stigmatized, prohibited, or heavily regulated, with restrictions designed to protect the safety, well-being, and even morality of customers and third parties.<sup>3</sup> Like other new businesses, vice startups need capital.<sup>4</sup> Although financial and other business considerations prototypically drive prospective startup investors’ decision-making,<sup>5</sup> whether to invest in vice also requires navigating their own moral, ethical, or aesthetic preferences as well as those of their constituents.<sup>6</sup>

To understand how vice interacts with startup investment, we conducted forty-two confidential, semi-structured interviews with vice founders and investors. Those investors included venture capitalists (VCs); the institutional investors that serve as limited partners (LPs) in VC funds; and high-net-worth individuals. Our interviews also included legal and financial practitioners whose work relates to the study. We supplement these interviews with descriptive data on startup fundraising, founder demographics, and exits.<sup>7</sup> Although in our ten-year, 236,012-startup sample, only 3.5% of firms were in vice industries (as we categorize them),<sup>8</sup> their associated stigma and regulatory environments provide a window into whether and

1243 (2020); Lin Lin, *Venture Capital in the Rise of Sustainable Investment*, 23 EUR. BUS. ORG. L. REV. 187 (2022); Antonia Botsari & Frank Lang, *ESG Considerations in Venture Capital and Business Angel Investment Decisions: Evidence from Two Pan-European Surveys* (Helmut Kraemer-Eis ed., European Inv. Fund, EIF Rsch. & Mkt. Analysis Working Paper No. 63, 2020).

2. See *infra* Section I.A (reviewing the literature on sin/vice stocks, including the definition of “vice”).

3. See generally Bernard E. Harcourt, *The Collapse of the Harm Principle*, 90 J. CRIM. L. & CRIMINOLOGY 109 (1999).

4. See generally Monika Dhochak & Anil Kumar Sharma, *Identification and Prioritization of Factors Affecting Venture Capitalists’ Investment Decision-Making Process: An Analytical Hierarchical Process (AHP) Approach*, 23 J. SMALL BUS. & ENT. DEV. 964 (2016) (presenting the financial and non-financial factors that influence startup investor decision-making).

5. These data were collected from two commercial VC databases, PitchBook and Crunchbase. See *PitchBook: Venture Capital, Private Equity and M&A Database*, PITCHBOOK, <https://pitchbook.com> [perma.cc/BJ4E-LSTL] (last visited Apr. 2, 2025); *Crunchbase: Discover Innovative Companies and the People Behind Them*, CRUNCHBASE, <https://www.crunchbase.com> [perma.cc/DH2V-MHY2] (last visited Apr. 2, 2025). Both databases are commonly used in academic research on venture capital, entrepreneurship, and related topics. See Shikha Sharma, *PitchBook*, 22 J. BUS. & FIN. LIBRARIANSHIP 244 (2017); Jean-Michel Dalle, Matthijs den Besten & Carlo Menon, *Using Crunchbase for Economic and Managerial Research* (OECD Sci., Tech. and Indus. Working Papers, Working Paper No. 08, 2017), [https://www.oecd.org/en/publications/using-crunchbase-for-economic-and-managerial-research\\_6c418d60-en.html](https://www.oecd.org/en/publications/using-crunchbase-for-economic-and-managerial-research_6c418d60-en.html) [perma.cc/FDK4-Q936].

6. George A. Akerlof, *A Theory of Social Custom, of Which Unemployment May Be One Consequence*, 94 Q.J. ECON. 749, 749 n.1 (1980) (defining such considerations as “act[s] whose utility to the agent performing it in some way depends on the beliefs or actions of other members of the community”).

7. See generally *infra* Appendix.

8. See *infra* Appendix, Tables 1 and 2. This sample comprises U.S.-headquartered firms within the PitchBook database with founding dates from 2014 to 2023, inclusive. “Vice” startups are those tagged with at least one of the following industry categories in the database: alcohol, beer, wine, spirits, sex tech, pornography, adult content, cannabis, tobacco, vaping, firearms, ammunition, casino, or gambling.

how moral and reputational considerations shape entrepreneurship and capital markets.

At a high level, respondents report that (1) the definition of vice is nuanced and changes over time, yet it is also sticky; (2) vice aversion manifests in the subjective preferences of investors and their constituents and is unlikely to be fully reflected in limited partnership agreements (LPAs) (the core contract governing the relationship between VC funds and the LPs that provide them with capital) or side letters (bilateral agreements between an LP and a VC); (3) vice's funding barriers are exacerbated by vice-specific regulatory and business-infrastructure hurdles; and (4) vice aversion is further complicated in the case of women and other minoritized investors, founders, and customers.<sup>9</sup> In presenting these findings, the Article proceeds in three parts.

Part I provides background. We first briefly survey the existing literature on investing in virtue and vice.<sup>10</sup> We then provide background on startup funding, including the legal, economic, and decision-making structures of VC and angel investing.<sup>11</sup> We close the part by introducing our research methodology, which employs confidential, semi-structured interviews with vice and vice-adjacent entrepreneurs, VC and angel investors, LPs, and legal and financial practitioners.<sup>12</sup> Throughout the Article, we supplement interview data with descriptive statistics of historical startup information collected from the PitchBook and Crunchbase databases.<sup>13</sup>

In Part II, we present findings around what is a “vice” business.<sup>14</sup> This term has evaded a consensus definition in the scholarly literature,<sup>15</sup> and our study suggests that one might not be achievable. We show that what is and is not vice turns subjectively on judgments by heterogeneous economic agents. This subjectivity is nuanced even within vice industries.<sup>16</sup> Alcohol, for example, is widely understood as a traditional vice industry. But despite their common commerce in the ethanol molecule, vice judgments vary between businesses in the wine versus spirits versus beer subindustries.<sup>17</sup> Discrete agents' vice judgments collectively manifest, however, through their interactions within a capital ecosystem. This effect contributes to a thicket in which one investor's vice aversion serves to restrict an entire pool of capital, even if other investors in the pool do not share that aversion.<sup>18</sup> When vice aversions overlap within a capital pool, the resulting restrictions tend to

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9. Data available in these databases include founding dates, founder demographics, funding events, and exits. As indicated in Appendix, Table 5, minority founders make up a single-digit share of vice founders. This point contrasts with female founders, who are still substantially underrepresented in demographic terms but whose representation is an order of magnitude greater than that of founders of color. *See infra* Appendix, Table 5. As we note in Section III.C, all founders of color whom we interviewed were women, making it difficult to disentangle vice founders' experiences across gender and race.

10. *See infra* Section I.A.

11. *See infra* Section I.B.

12. *See infra* Section I.C.

13. *See supra* notes 5–7 and accompanying text.

14. *See infra* Sections II.A–B.

15. *Id.*

16. *See infra* Section II.E.

17. *Id.*

18. *See infra* Section II.C.

be mutually reinforcing.<sup>19</sup> As a result, vice restrictions can perpetuate throughout the market for startup equity. More, although views on vice *do* shift over time with changes in regulatory environments and social mores, legacy vice restrictions are sticky in that they replicate in successive funds raised by VC firms.<sup>20</sup>

In considering these definitional points, Part II contributes to the venture-capital and contracts literatures by showing that although some vice restrictions are expressed and enforced through formal contracts between LPs and VC funds, they are also often extracontractual in nature.<sup>21</sup> In respecting extracontractual restrictions, general partners (GPs) of VC funds anticipate LPs' vice aversions.<sup>22</sup> These extracontractual restrictions are further reinforced by a repeat-player dynamic between GPs and LPs.<sup>23</sup> GPs seek to raise successively larger funds over time.<sup>24</sup> Reinvestment from prior funds' LPs contributes to that goal, and GPs will thus engage in an investor-relations strategy that optimizes for repeat business. If anything, good investor relations precludes offending or embarrassing existing investors.<sup>25</sup>

An exception to these points is investment by angel investors (including family offices), who might reach idiosyncratic judgments about startups that other market actors avoid as vice.<sup>26</sup> Importantly, this latter kind of investor may freely invest in vice because it lacks agency commitments of the type borne by VC firms investing LPs' money.<sup>27</sup> Another exception is VC funds that specialize in vice and can do so because they have identified LPs indifferent toward or preferring of vice.<sup>28</sup> These two alternative capital sources will tend to be unsuitable for startups that will

19. *Id.*

20. *See infra* Section II.A.

21. *See infra* Sections II.B–C. GPs are the investment professionals who raise capital from LPs and make investment decisions for the funds.

22. *See infra* Section II.C.

23. *Id.*

24. *Cf.* Jason D. Rowley, *Rising Supergiant VC Funds Weigh on Smaller Counterparts*, CRUNCHBASE NEWS (Mar. 30, 2018), <https://news.crunchbase.com/venture/rising-supergiant-vc-funds-weigh-on-smaller-counterparts> [perma.cc/N2SA-X2XB] (“Just like the startup fundraising market is increasingly dominated by supergiant and other late-stage funding rounds, supergiant venture funds are accounting for an ever-larger chunk of the L.P. capital raised by general partners at VC funds.”).

25. *See infra* notes 171 and 176–178 and accompanying texts.

26. *See infra* Section I.B.

27. *See id.*

28. *See, e.g., Vice Ventures*, VICE VENTURES, <https://viceventures.com> [perma.cc/VM28-LSC7] (last visited Apr. 2, 2025) (“Vice Ventures is an early stage venture capital fund conquering stigmas and striving towards superior returns by investing in good companies operating in superficially ‘bad’ industries.”); *Funding and Support for Startup Drinks Brands: Distill Ventures*, DISTILL VENTURES, <https://www.distillventures.com> [https://perma.cc/AMW3-LFPT] (last visited Apr. 2, 2025) (offering “Funding & Support for Startup Drinks Brands”); *Proven Cannabis Investors: Casa Verde*, CASA VERDE CAP., <https://casaverdecapital.com> [https://perma.cc/2VG9-KA86] (last visited Apr. 2, 2025) (promising to “Help[] Founders Build the Future of Cannabis”).

eventually require successive fundraising rounds, however, due to their size<sup>29</sup> or diversification requirements.<sup>30</sup>

In Part III, we show that investors' own vice aversion is not the only funding barrier that distinguishes vice from non-vice startups. Intertwined with the effects examined in Part II, vice startups also face regulatory and business-infrastructure hurdles.<sup>31</sup> Public regulation that prohibits, restricts, or otherwise burdens a vice business might dissuade investors who are unwilling to bear incremental legal or regulatory risk, compared to a non-vice business.<sup>32</sup> For example, is an investor in a cannabis business—to the extent that such a business is illegal—exposed to criminal liability, perhaps under an aiding-and-abetting theory?<sup>33</sup> Or even if the investor avoids direct liability, is the possibility the company will be shut down by law enforcement simply too high a business risk to bear?

Beyond regulatory hurdles, vice and vice-adjacent<sup>34</sup> businesses often lack access to—or bear greater costs to access—essential business infrastructure that non-vice startups take for granted.<sup>35</sup> A startup in the sexual-wellness space, for instance, might run afoul of “no adult” policies of payment processors or advertising channels.<sup>36</sup> Challenged by lack of payment processing to sell products, or advertising channels to market them, it might appear an unattractive investment, even absent regulatory burdens or adult-industry aversion on the part of investors.<sup>37</sup>

Part III also contributes to the corporate-governance and finance literatures by theorizing vice distortions in the market for startup equity.<sup>38</sup> First, it shows that vice aversion within a VC/startup relationship risks generating less investor engagement in corporate governance.<sup>39</sup> Residual risk or reputational concerns might cause VC investors to eschew traditional governance rights, like designating

29. Vice-specializing VC firms have less investment capacity than mainstream VC funds. *Generalist vs. Thematic Investment Strategies: Does One Approach Yield Higher Returns?*, ASCEND VENTURE CAP., <https://www.ascendstl.com/press/generalist-vs-thematic-investing> [perma.cc/S8LV-EB EK] (last visited Apr. 2, 2025) (noting that “[e]merging managers and micro-venture capitalists” are more likely to follow thematic investment strategies, whereas generalist firms are more likely to have at least \$250 million in assets under management).

30. Individual and family-office investors must diversify their portfolios, whereas VC funds allocate to just one asset class, venture capital. *See Goldman Sachs Releases 2023 Family Office Investment Insight Report*, GOLDMAN SACHS & CO. (May 8, 2023), <https://www.goldmansachs.com/press-room/press-releases/2023/announcement-08-may-2023.html> [perma.cc/5YVG-TX46] (reporting that in 2023, the average family office allocated 26% of its assets under management to “private equity,” which includes venture capital).

31. *See infra* Section III.A.

32. *See infra* Section III.A.1.

33. *Id.*

34. By “vice-adjacent” we mean businesses that offer products or services that are not squarely within a vice category but that are still stigmatized and have some proximity to vice businesses. For example, products designed to create sexual pleasure or appeal to prurient interests would fit squarely within the “adult” vice. In contrast, products designed for sexual health or function, although perhaps not prurient in nature, would be adjacent to the “adult” vice. They might also bear some of the same stigma as “adult” products. *See infra* Section III.B for further discussion of the vice/vice-adjacent distinction.

35. *See infra* Section III.A.2.

36. *Id.*

37. *Id.*

38. *See infra* Section III.B.

39. *See infra* Section III.B.1.

directors, to which they are contractually entitled.<sup>40</sup> They might also prompt investors to insist on, and enforce, onerous negative covenants that undermine a startup's commercial and financial prospects. Governance distortions around vice startups also point to vice as having, all equal, higher cost of capital.<sup>41</sup> This higher cost appears on both the VC/startup and the LP/VC sides of the startup-equity market. It owes in part to high search and opportunity costs from efforts that both vice entrepreneurs and vice-specializing VCs must bear to overcome mainstream aversions.<sup>42</sup>

Part III also raises the possibilities that investor, entrepreneur, and customer demographics impose additional hurdles to funding vice.<sup>43</sup> For example, women founders of vice or vice-adjacent startups face heightened skepticism when they seek VC funding, especially for businesses that primarily serve minoritized customers.<sup>44</sup>

In the Conclusion, we argue that our study focused on vice aversion in the market for startup equity more broadly advances understanding of vice aversion in other capital markets. Further, the Conclusion reaches two key implications that follow from the Article's earlier findings. First, our study complicates existing theory around the "vice premium."<sup>45</sup>

Second, we observe that private-investor value judgments embed in the earliest stages of capital formation, long before public investors have an opportunity to weigh in. This point implies that vice aversion helps shape the real economy in terms of available products and services.<sup>46</sup> These effects include not only products and services for consumption, but they also limit investment options available downstream in public markets. After all, a vice startup that fails to obtain adequate early funding won't make it to an initial public offering (IPO).<sup>47</sup>

But, perhaps unexpectedly, vice aversion also influences the *non-vice side* of the real economy.<sup>48</sup> For example, products that intersect with women's sexual health, despite being quite unrelated to the sex industry, might nevertheless effectively be treated as such.<sup>49</sup> In that light, even a non-vice firm can encounter the sorts of funding barriers associated with vice aversion, suggesting that normative investment aversion affects the non-vice real economy, too. This implication captures a broader observation that carries throughout our study: Although vice lacks a shared social meaning, aversion to it nevertheless shapes our capital markets and real economy in subtle, systemic, and unexpected ways.

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40. *Id.*

41. *See infra* Section III.B.2.

42. *See infra* Section III.B.3.

43. *See infra* Section III.C.

44. *See infra* Section III.C.3.

45. *See infra* Conclusion.

46. *Id.*

47. Joseph C. Picken, *From Startup to Scalable Enterprise: Laying the Foundation*, 60 BUS. HORIZONS 587, 588 (2017).

48. *See infra* Conclusion.

49. *See infra* Sections III.A.2.b and III.C.3.

## I. BACKGROUND

This Part sets the stage for the interview data and conclusions that follow in subsequent sections. Part I.A introduces the substantial literature in vice and virtue investing in the public capital markets. Part I.B introduces the funding environment for startup companies, with a focus on the structure of VC and angel investment. Part I.C describes our research methodology.

*A. Investing in Virtue, Investing in Vice*

A substantial literature explores whether “sin pays” in the public capital markets. The underlying theory is that social norms discourage the funding of businesses that promote vice and that some investors, particularly institutions sensitive to social norms—such as pension funds and foundations—will shun those investments.<sup>50</sup> This shunning will in turn result in a “vice premium” for those who *do* purchase the securities of vice companies. A standard explanation for the vice premium is a demand-and-supply mechanism in which muted demand caused by norm-constrained investors bids up the returns necessary to attract investment from unconstrained investors.<sup>51</sup> Researchers have described these results as “consistent with the ‘doing good but not well’ hypothesis, whereby the expected returns of socially responsible stocks are lower than those of conventional stocks.”<sup>52</sup>

Much, though not all, of the empirical research supports this theory. Hong and Kacperczyk, for example, study publicly traded stocks in the alcohol, tobacco, and gambling industries and find that these investments are less often held by institutional investors, are less covered by analysts, and have higher expected returns than comparable stocks in non-sin industries.<sup>53</sup> Similarly, Kim and Venkatachalam study the gambling, tobacco, alcohol, and adult industries and find that, although these stocks provide superior returns and higher financial-reporting quality, investors nonetheless are willing to bear a financial cost by excluding these industries from their portfolios.<sup>54</sup> Finally, Fabozzi, Ma, and Oliphant study stock returns in the alcohol, tobacco, defense, biotech, gambling, and adult industries, concluding that these stocks have outperformed the broader stock market on a risk-adjusted basis.<sup>55</sup> In contrast, Blitz and Fabozzi attribute the overperformance of sin

50. Harrison Hong & Marcin Kacperczyk, *The Price of Sin: The Effects of Social Norms on Markets*, 93 J. FIN. ECON. 15 (2009); see also, e.g., Andreas G. F. Hoepner & Lisa Schopohl, *On the Price of Morals in Markets: An Empirical Study of the Swedish AP-Funds and the Norwegian Government Pension Fund*, 151 J. BUS. ETHICS 665 (2018); Greg M. Richey, *Fewer Reasons to Sin: A Five-Factor Investigation of Vice Stocks*, 43 MANAGERIAL FIN. 1016 (2017); Pieter Jan Trinks & Bert Scholtens, *The Opportunity Cost of Negative Screening in Socially Responsible Investing*, 140 J. BUS. ETHICS 193 (2017); Jacquelyn E. Humphrey & David T. Tan, *Does it Really Hurt to Be Responsible?*, 122 J. BUS. ETHICS 375 (2014); Matthew Hood, John R. Nofsinger & Abhishek Varma, *Conservation, Discrimination, and Salvation: Investors’ Social Concerns in the Stock Market*, 45 J. FIN. SERVS. RSCH. 5 (2014).

51. *Supra* note 50.

52. Meir Statman & Denys Glushkov, *The Wages of Social Responsibility*, 65 FIN. ANALYSTS J. 33, 44 (2009).

53. *Id.* See also Xing Han, Youwei Li & Olena Onishchenko, *Shunned Stocks and Market States*, 28 EUR. J. FIN. 705 (2022) (updating Hong & Kacperczyk with a more recent sample and supporting their results).

54. Irene Kim & Mohan Venkatachalam, *Are Sin Stocks Paying the Price for Accounting Sins?*, 26 J. ACCT., AUDITING & FIN. 415 (2011).

55. Frank J. Fabozzi, K.C. Ma & Becky J. Oliphant, *Sin Stock Returns*, 35 J. PORTFOLIO MGMT. 82 (2008).

stocks to factors unrelated to their sin status.<sup>56</sup> Consistent with these results, at least some research supports the flip side—that firms with a credible ESG commitment bear a lower cost of capital and provide lower returns to investors, particularly in the environmental space.<sup>57</sup> We expand on this existing literature by focusing our study on the earliest stage of capital formation, which has to this point been a less scrutable setting given the lack of objective, comparable, and public financial data on startups.

### B. Startups and Venture Capital

We use a definition of “startup” that centers on a new business’s product or service offering, its financing needs, and its temporal trajectory.<sup>58</sup> Elizabeth Pollman observes that “[s]tartups are typically started by entrepreneurs and backed by outside investment with the goal of developing an innovative product or service, creating high growth, and exiting through a trade sale of the company or . . . IPO.”<sup>59</sup>

This definition distinguishes startups from other new businesses. Unlike startups, the latter would typically not offer innovative products or services, would have comparatively modest financing needs, and would be expected to provide investment returns to their owners via wages from employment or distributions from profits.<sup>60</sup> A few examples can draw out the difference in the Article’s context. Entrepreneurs who seek to launch an adult-content platform or a spirits brand might be startups within the Article’s scope.<sup>61</sup> That is, their business models would require some innovation and large amounts of capital, and their investment returns would tend to come through an acquisition or IPO.<sup>62</sup> In contrast, entrepreneurs who wish to open an adult-products or liquor store are outside our scope because their stores are unlikely to innovate product or services offerings, can get off the ground with more modest financing (such as through personal funds or bank loans),<sup>63</sup> and likely will realize any return through wages or profit distributions.

Because most startups fail, when early-stage entrepreneurs seek capital to finance development of their products and services, the sources of that capital must be risk-preferring.<sup>64</sup> Those sources might include personal funds of the

56. David Blitz & Frank J. Fabozzi, *Sin Stocks Revisited: Resolving the Sin Stock Anomaly*, 44 J. PORTFOLIO MGMT. 105 (2017).

57. Statman & Glushkov, *supra* note 52; Malcolm Baker, Daniel Bergstresser, George Serafeim & Jeffrey Wurgler, *The Pricing and Ownership of US Green Bonds*, 14 ANN. REV. FIN. ECON. 415 (2022); Stuart L. Gillan, Andrew Koch & Laura T. Starks, *Firms and Social Responsibility: A Review of ESG and CSR Research in Corporate Finance*, 33 J. CORP. FIN. 101889 (2021) (summarizing this research).

58. Elizabeth Pollman, *Startup Governance*, 168 U. PA. L. REV. 155, 164 (2019).

59. *Id.*

60. *See generally* Manuel G. Flores-Romero, *Survival of the Small Firm and the Entrepreneur Under Demand and Efficiency Uncertainty* (Warwick Econ. Rsch. Papers, Paper No. 700, 2004), <http://warwick.ac.uk/fac/soc/economics/research/workingpapers/2008/twerp700.pdf> [perma.cc/3RK3-K3RF] (theorizing how small-firm entrepreneurs survive and earn returns from their businesses).

61. *See* Interview BGG; *see also* Nicole Fallon, *Drunk on Money? Why Alcohol Is the Celebrity Investment Du Jour*, BUS. (Oct. 6, 2023), <https://www.business.com/articles/celebrity-investment> [perma.cc/B5Z8-PY3Y].

62. *See* Picken, *supra* note 47.

63. *But cf.* 13 C.F.R. § 120.110 (excluding, among other things, gambling and adult businesses from receiving U.S. Small Business Administration loans).

64. Brian J. Broughman & Matthew T. Wansley, *Risk-Seeking Governance*, 76 VAND. L. REV. 1299, 1303–04 (2023).

entrepreneurs (who, after all, have unusual confidence in their ability to build a new company);<sup>65</sup> funds from friends, family, and colleagues (who might have cognitive biases in favor of the entrepreneurs and thus fail to appreciate the risk or, appreciating the risk, nevertheless invest out of loyalty to them);<sup>66</sup> or risk-preferring third parties. Those risk-preferring parties are subjects in this Article. At a high level, they include two kinds of investors: angels (typically wealthy individuals or family offices who invest for their own accounts)<sup>67</sup> and VCs (investment professionals who invest funds committed by others).<sup>68</sup>

Angel and VC investors invest in new firms that they believe could grow to significant scale and profitability, despite that possibility being quite speculative early on.<sup>69</sup> These investors apply professional judgment and fundamental business analyses in predicting which startup firms are most likely to achieve meaningful success.<sup>70</sup> But it remains a reality of the market for startup equity that even after passing investor screens, most startups will at best be modest successes, if not total losses, for investors.<sup>71</sup> This investing model is rational, and can be quite profitable, however, because a small number of fabulously successful companies can produce significant investment returns for an angel or VC investors' overall portfolio.<sup>72</sup> "Success" in this market generally means "exit": that a startup enters the public markets via an IPO of its stock (thus allowing its current investors to sell their shares to new, public investors) or it is acquired by another company (thus liquidating current investors' stock).<sup>73</sup>

On the path to exit, startups typically raise capital in multiple rounds.<sup>74</sup> This approach has two key implications. First, it mitigates agency costs by aligning an entrepreneur's management decisions with investors' interests: Unless the entrepreneur can show satisfactory progress, she will not be able to obtain future capital.<sup>75</sup> Second, as a startup matures toward exit, its prospects become less speculative and thus investment in it becomes less risky.<sup>76</sup> Later-stage investors, who have lower risk preferences than earlier investors, will thus enter a startup's capital

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65. See Craig R. Everett & Richard J. Fairchild, *A Theory of Entrepreneurial Overconfidence, Effort, and Firm Outcomes*, 17 J. ENTREPRENEURIAL FIN. 1, 20 (2015).

66. See Samuel Lee & Petra Persson, *Financing from Family and Friends*, 29 REV. FIN. STUD. 2341, 2343–44 (2016).

67. *Early-Stage Investors*, U.S. SEC. & EXCH. COMM'N (Dec 23, 2024), <https://www.sec.gov/education/capitalraising/building-blocks/investor-types> [perma.cc/6U9H-74Z3].

68. *Id.*

69. PAUL GOMPERS & JOSH LERNER, *THE VENTURE CAPITAL CYCLE* 183–87 (2nd ed. 2004).

70. See Paul Gompers & Josh Lerner, *The Venture Capital Revolution*, 15 J. ECON. PERSPS. 145, 155 (2001).

71. See generally Elizabeth Pollman, *Startup Failure*, 73 DUKE L.J. 327 (2023) (theorizing how the VC/startup ecosystem generates and manages the failure of large numbers of startup firms).

72. Chris Dixon, *Performance Data and the 'Babe Ruth' Effect in Venture Capital*, ANDREESSEN HOROWITZ (June 8, 2015), <https://a16z.com/performance-data-and-the-babe-ruth-effect-in-venture-capital/> [perma.cc/KVV5-DEFM].

73. See Picken, *supra* note 47.

74. Xuan Tian, *The Causes and Consequences of Venture Capital Stage Financing*, 101 J. FIN. ECON. 132 (2011).

75. See Anat R. Admati & Paul Pfleiderer, *Robust Financial Contracting and the Role of Venture Capitalists*, 49 J. FIN. 371, 374 (1994).

76. See GOMPERS & LERNER, *supra* note 69.

structure at a higher price (given lower risk) than could have been obtained in earlier rounds.<sup>77</sup>

This Article highlights two critical early funding rounds: the seed round and the subsequent Series A round.<sup>78</sup> These rounds signal that a startup has moved beyond mere conceptualization and early research and development and now needs substantial capital for growth toward its commercial potential.<sup>79</sup> The average seed round in 2023 was \$3.6 million, whereas the average Series A round was \$18.7 million.<sup>80</sup>

The vice aversion presented in this Article occurs in the context of the legal, economic, and decision-making structure of VC—and, to a lesser extent, of angel—investing. At a high level, a VC firm comprises partners and other professionals with varying economic claims on the profits of the firm and roles in investment decision-making.<sup>81</sup> The VC firm organizes funds—pools of committed capital available for making VC investments—structured as limited partnerships.<sup>82</sup> The VC firm serves as the general partner (GP) of the funds, and it secures capital commitments from limited partners (LPs).<sup>83</sup> Typical LPs are large institutions that allocate part of their own capital to private asset classes, like startup equity. They include public and private pension funds, insurance companies, university endowments, wealthy individuals/family offices, and other institutions.<sup>84</sup>

The VC firm, as GP, is responsible for making decisions about how a fund's committed capital will be invested. This power is constrained, however, by a limited partnership agreement (LPA), a multilateral contract between the GP and its LPs that governs the fund.<sup>85</sup> It is further restricted by bilateral agreements between the GP and individual LPs known as side letters.<sup>86</sup> In return for managing a fund, the GP will receive an annual fee and a share of the fund's investment returns over a specified hurdle rate (the carry).<sup>87</sup> A typical fee/carry structure is “2 and 20,” that is, 2% of a fund's committed capital per year as a fee plus 20% of over-hurdle returns as carried interest.<sup>88</sup>

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77. *Id.*

78. Cf. Ofer Eldar & Jillian Grennan, *Common Venture Capital Investors and Startup Growth*, 37 REV. FIN. STUDS. 549, 562 (2024) (drawing a sample from all startups that “reach[ed] at least a Series A round or receive[d] at least \$10 million in VC funding?”).

79. See Ryan Choi, *Stages of Startups*, Y COMBINATOR, <https://www.ycombinator.com/library/Ek-stages-of-startups> [perma.cc/CTS8-VQK2] (last visited Apr. 2, 2025).

80. Matt Preuss, *The Ultimate Guide to Startup Funding Stages*, VISIBLE (Feb. 24, 2024), <https://visible.vc/blog/startup-funding-stages> [perma.cc/QVG5-QD4M].

81. See GOMPERS & LERNER, *supra* note 69, at 65.

82. *Id.* at 8–11.

83. *Id.*

84. *Id.*

85. *Id.* at 65–77.

86. See Elisabeth De Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907, 916–17 (2023).

87. Haje Jan Kamps, *All Venture Funds Use the ‘2 and 20’ Fee Structure, Right? Not Really*, TECHCRUNCH (Sept. 27, 2023, 11:10 AM), <https://techcrunch.com/2023/09/27/venture-fund-2-and-20> [perma.cc/TG7E-F2NY].

88. *But see id.*

Each VC fund is durationally limited and seeks to liquidate its holdings within a certain period—say, ten years—after the fund’s inception.<sup>89</sup> As a result, a successful VC firm will raise new funds every few years.<sup>90</sup> For the VC firm, each fund will ideally have more capital committed than the prior fund, and one way to grow fund size over time is repeat relationships with existing LPs.<sup>91</sup> The following figure illustrates the key actors in a VC fund, as well as their temporal relationship across funds formed by the same firm.

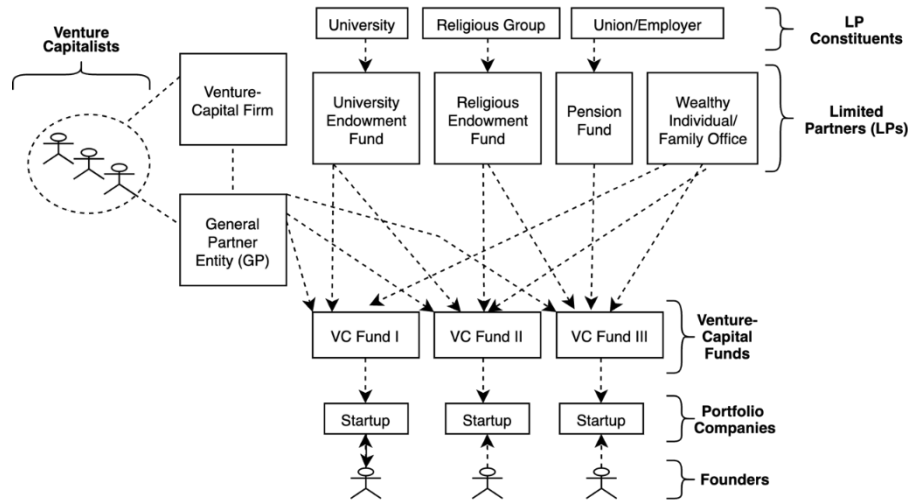


Fig. 1. A venture-capital firm’s fundraising lifecycle.

In comparison, angel investors—who might be individuals or family offices, which manage assets for very wealthy individuals and families—might also invest in startup equity.<sup>92</sup> That investment happens especially at early stages.<sup>93</sup> For angel investors, the legal, economic, and decision-making structures of their investments are simpler than those of VC firms and funds. That is because angel investors invest their own capital and thus need not worry about fiduciary or contractual obligations

89. Diane Mulcahy, *Six Myths About Venture Capitalists*, HARV. BUS. REV. (May 2013), <https://hbr.org/2013/05/six-myths-about-venture-capitalists> [perma.cc/GT3C-NBN8] [hereinafter *Six Myths*] (“[T]he standard VC fund charges an annual fee of 2% on committed capital over the life of the fund—usually 10 years—plus a percentage of the profits when firms successfully exit, usually by being acquired or going public.”). *But see* Diane Mulcahy, *The New Reality of the 14-Year Venture Capital Fund*, INSTITUTIONAL INV. (Feb. 19, 2015), <https://www.institutionalinvestor.com/article/2bsv31916hb46dpp501ds/portfolio/the-new-reality-of-the-14-year-venture-capital-fund> [perma.cc/46XZ-M9WK].

90. *See Six Myths*, *supra* note 89 (“VC firms raise new funds about every three or four years . . .”).

91. Henry Lahr & Timothy E. Trombley, *Early Indicators of Fundraising Success by Venture Capital Firms*, 65 J. CORP. FIN. 1, 4 (2020).

92. Christian Camerota, *The Rise of the Angel Investor*, HBS NEWSROOM (Oct. 1, 2015), <http://www.hbs.edu/news/articles/Pages/angel-investing-lerner.aspx> [perma.cc/J6MM-RFSG].

93. Individuals and family offices are more apt to participate in early stages given the comparatively smaller amounts of capital invested at those stages. Although those investors might have greater wealth than a VC fund (for example, a billionaire versus a \$100 million VC fund), they diversify their investments across asset classes, whereas a VC fund exclusively invests in startup equity.

to LPs or fostering repeat-investor relationships with them. The following figure illustrates that simpler structure.

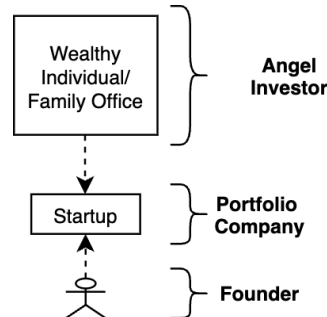


Fig. 2. Investment from an angel investor.

### C. Research Methodology

Beginning in summer 2022, we conducted a series of confidential, semi-structured interviews with individuals who represent the three actors at the center of the study: vice (and vice-adjacent) startup founders, investors/non-investors (including VCs and angels) in vice startups, and LPs who provide capital to VCs. We also interviewed legal and financial practitioners whose work is relevant to the study. Potential respondents were identified via (1) startup database queries of firms matching our interview criteria; (2) referrals from respondents themselves (snowball sampling);<sup>94</sup> and (3) our personal and professional networks. Per our Institutional Review Board protocol, prospective respondents were provided with an introductory email and information/disclosure document.<sup>95</sup> All interviews were conducted on a confidential basis, with interview notes kept separate from respondent identities.

We completed forty-two interviews before reaching theoretical saturation in winter 2023.<sup>96</sup> To promote candidness, we provided respondents with confidentiality around their identities and those of other persons or businesses identified in their interviews or other communications with us. As a result, in footnotes we mask references to interviews so as to balance providing concrete details and direct quotes against the risk that such details and quotes, when combined, de-anonymize a respondent.<sup>97</sup>

94. Chaim Noy, *Sampling Knowledge: The Hermeneutics of Snowball Sampling in Qualitative Research*, 11 INT'L J. SOC. RSCH. METHODOLOGY 327, 330 (2008).

95. University of Virginia IRB-SBS #5207 (on file with authors).

96. Jacqueline Low, *A Pragmatic Definition of the Concept of Theoretical Saturation*, 52 SOCIO. FOCUS 131 (2019).

97. For example, a single interview might be cited in different places as Interview AXU, Interview TCE, and so on. Through this masking, we can provide contextual details relevant to the quoted material but without providing so much information that the respondent is identifiable through a combination of quotes.

In addition, we collected descriptive data using the PitchBook and Crunchbase databases to add further context to qualitative interview data.<sup>98</sup> Those data are set out in the Appendix and referenced throughout the Article.<sup>99</sup>

## II. VENTURE CAPITAL AND VICE AVERSION

In this Part we present our main findings on a threshold question—what is “vice”? We conclude that the definition of “vice” is complex, subjective, and changes over time, yet it is also sticky. When we refer to “vice” industries, we do so without any normative characterization on our part. Rather “vice” or “sin” is the traditional label attached to industries that are frequently excluded from investment portfolios because the product or service is controversial or viewed as immoral, unethical, or aesthetically objectionable by large segments of society.<sup>100</sup> Indeed, in a ten-year sample from the PitchBook database of private companies, 9.6% of vice companies received a seed round and 4.2% received a Series A round, compared to 12.3% and 5.4% for all startups.<sup>101</sup> Although the Pitchbook data do not permit controlling for fundamental business factors (such as financial performance), they do reflect a funding gap between vice and non-vice startups. Indeed, the gap might be understated if vice aversion deters entrepreneurs from founding vice businesses or seeking VC investment for the ones they do start.<sup>102</sup>

Traditionally, vice has included the adult, alcohol, tobacco, gambling, and weapons industries, but researchers have employed different definitions.<sup>103</sup> Although the subjectiveness of this determination is recognized in the literature,<sup>104</sup> the full extent of the difficulties involved in defining “vice” highlighted by our respondents was revealing and has potential implications for empirical research on the returns from vice investment.<sup>105</sup> Defining vice is rendered more difficult by a few factors: (1) It changes over time, yet it is also sticky;<sup>106</sup> (2) it is highly subjective among economic agents;<sup>107</sup> and (3) there are “hard cases” and distinctions in stigma levels, even within a single vice industry.<sup>108</sup> Given these definitional issues, it is not surprising that many empirical studies reach different answers about whether there are superior returns to investing in vice and, if so, to what extent.<sup>109</sup> Although

98. See *supra* note 5.

99. See *infra* Appendix.

100. See Fabozzi, Ma & Oliphant, *supra* note 55, at 82.

101. See *infra* Appendix, Tables 1 and 2. The sample included companies founded between 2014 and 2023, inclusive. “Vice” companies were those tagged in the PitchBook database as being in the alcohol, beer, wine, spirits, sex tech, pornography, adult content, cannabis, tobacco, vaping, firearms, ammunition, casino, or gambling industries.

102. Cf. Nick A. Mmbaga, *Inglorious Industries: Assessing Why Founders Enter Stigmatized Industries*, 39 FRONTIERS ENTREPRENEURSHIP RSCH., 2019, Ch. 3, at 1, <https://digitalcollections.babson.edu/digital/collection/ferpapers/id/1344> [perma.cc/G5Y2-3S76] (investigating why some entrepreneurs are willing to enter stigmatized industries, like payday lending).

103. See *supra* notes 50–56 and accompanying text.

104. See Blitz & Fabozzi, *supra* note 56, at 106; see also Richey, *supra* note 50, at 1018 (“For my vice portfolio selection, I understand that the definition of ‘sin’ may be ambiguous or subjective at best, depending on one’s . . . cultural values . . .”).

105. See *infra* Conclusion.

106. See *infra* Section II.A.

107. See *infra* Sections II.B–C.

108. See *infra* Section II.D.

109. See *supra* notes 50–56 and accompanying text (discussing the empirical literature on returns to vice).

commenters have attributed these competing results to differences in which vice categories are included in empirical studies, what time period is studied, and what controls are employed, our research shows that—even within a particular vice industry—all investments are not equally problematic.<sup>110</sup>

#### A. Vice Changes Over Time, Yet is Sticky

As already noted, adult, alcohol, tobacco, weapons, and gambling constitute the core traditional vice industries. Yet the literature acknowledges the cultural, legal, and time dependence of this categorization.<sup>111</sup> Our interview data support that conclusion.

According to our respondents, vice exclusions in LPAs and side letters—that is, contractual restrictions on GPs' ability to invest in certain kinds of companies—change over time. For example, firearms (especially semiautomatic weapons) and fossil fuels (especially coal) were mentioned by respondents as industries for which they have noticed an uptick in vice exclusions.<sup>112</sup> Even industries without long vice provenance can take on such connotations. For example, one respondent, a senior decision-maker at a large, established VC firm, noted that many LPs—especially public LPs—have questioned cryptocurrency investments for some time.<sup>113</sup> Other respondents observed that crypto aversion has been increasing among LPs after a series of fraud and other scandals in that industry.<sup>114</sup>

Potential mechanisms for changing notions around vice include evolution in social mores and regulatory change. For example, the CEO of a joint venture between publicly traded brewer Molson Coors and cannabis startup Hexo framed the changing stigma around cannabis in generational terms: “It’s almost like a different time and world, so much has changed. If you have conversations with a young person today they cannot contemplate a time when people would go through that inner struggle [around cannabis-related business].”<sup>115</sup> But the changing status of cannabis has a legal component as well—before recent state-level legalization, there were no legitimate investment cannabis opportunities that would need to be excluded from VC portfolios.<sup>116</sup> That is to say, whatever their normative views on particular businesses, LPs and VC firms will generally not invest in outright illegal ones.<sup>117</sup>

110. *See id.*

111. *See* Fabozzi, Ma & Oliphant, *supra* note 55, at 85 (“Because the standard for what constitutes vice changes over time and among societies, the definition of what constitutes a controversial industry is itself controversial.”); Julie Salaber, *Religion and Returns in Europe*, 32 EUR. J. POL. ECON. 149 (2013).

112. *See, e.g.*, Interview QDO; *see also* Emily Flitter, *Activist Investing Has Come for Fossil Fuels. What About Guns?*, N.Y. TIMES (May 28, 2022), <https://www.nytimes.com/2022/05/28/business/gun-companies-activist-shareholders.html> [perma.cc/MV6R-PZDU].

113. Interview AEC.

114. Interviews NXJ, NLE, and ZHU.

115. Patricia Nilsson, *Cannabis Reignites Corporate Interest as It Edges Towards Mainstream*, FIN. TIMES (Apr. 3, 2021), <https://www.ft.com/content/f52b8bd9-867a-46ad-9808-d5d3afce739e> [perma.cc/DAB4-WX4N].

116. *See infra* note 249 and accompanying text.

117. *But see generally* Elizabeth Pollman & Jordan M. Barry, *Regulatory Entrepreneurship*, 90 S. CAL. L. REV. 383 (2017) (examining the practice of some venture-backed startups adopting business models that flout law but gain a loyal consumer base, which, in turn, enables lobbying for legalization).

Changing social attitudes toward gambling offer another instructive example. A number of respondents mentioned gambling as being a formerly disreputable industry that many investors now embrace.<sup>118</sup> One respondent attributed this change to the relaxing of regulatory restrictions that enabled gambling to outgrow Las Vegas and Atlantic City and their associations with organized crime:

Gaming is a good example because . . . there was a time twenty years ago where gaming was Vegas and Atlantic City and banned countrywide and a duopoly in the U.S. . . . Gaming, there was a time when venture, in my experience, would not touch it because it was associated with a niche industry in only two geographies and it sometimes had a link to organized crime. Then it moved into Indian reservations, then in the last few years it has exploded. . . . Now it is mainstream. . . . It became very significant, that it is national and global. No funds have an aversion to this space anymore.<sup>119</sup>

Another respondent—although less certain that “[n]o funds have an aversion to this space anymore”<sup>120</sup>—attributed reduced aversion toward gambling as driven by the Supreme Court’s decision in *Murphy v. NCAA*, which freed states to expand sports betting:<sup>121</sup>

[G]aming has its own challenges, especially [when I started]. Back then, and to some extent now, there were a lot of fundraising options that were closed off. Since the 2018 *Murphy* ruling, it has softened a bit. However, for many VCs, while the partners have no objection, many LPs don’t want to touch gambling, cannabis, or alcohol, so they exclude themselves.

Another respondent agreed that gambling is no longer a vice industry but attributed the change to the gambling industry successfully rebranding itself as “entertainment,” consistent with other our discussion below around communication, euphemism, and vice:<sup>122</sup>

Things like casinos and alcohol, I don’t believe those are now even thought of as vice. The proliferation of gambling has become so great that I don’t think casinos or online gaming like DraftKings or FanDuel are considered use of the word “vice,” as if it is something negative. Caesars, MGM, Churchill Downs, they tend to use the term “gambling” as little as they can and use

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of their business practices); *see also generally* Andrew K. Jennings, *Criminal Investors*, 93 GEO. WASH. L. REV. (forthcoming 2025) (manuscript at 32–33), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=5032267](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5032267) [perma.cc/7FY4-LWLL] (theorizing the criminal liability and incentives of those who knowingly invest in illicit enterprises that have some chance to become lawful in the future).

118. Vice founders make deliberate language choices in describing their businesses, which are frequently euphemistic. For example, gambling is typically referred to as “gaming” and the adult industry is sometimes referred to as “sexual wellness.” More, some descriptors, such as “addictive,” are avoided entirely. Interview TZY (discussing the intentional use of “gaming” rather than “gambling” and the non-use of “addictive”).

119. Interview FRO.

120. *Contra id.*

121. *Murphy v. NCAA*, 584 U.S. 453 (2018).

122. *See infra* pp. 30–31 and notes 182–185.

“entertainment.” Yes, there’s a blackjack table and gambling, but come out to the local casino and entertain yourself at the blackjack tables and stay overnight. And there’s still high profit margins from gaming, but really food, beverages, and entertainment, try to reel people in. Over the years that’s why it’s no longer viewed as vice.<sup>123</sup>

Vice restrictions are sometimes based on weak aversions (on the part of GPs, LPs, or both) and so are amenable to re-evaluation if market developments warrant. One alcohol entrepreneur, for example, described his industry as one that until recently had few exciting and innovative startups. There was thus no reason for VC investors to revisit alcohol exclusions in LPAs and side letters, given the lack of investment opportunities in that industry.<sup>124</sup> But, the entrepreneur reports, the \$38 billion valuation of Juul (a vaping company)<sup>125</sup> and billion-dollar acquisition of Drizly (an alcohol-delivery service)<sup>126</sup> prompted new interest by VC firms in alcohol-related businesses. In some cases, that new interest led them to push back against LPs’ restrictions.<sup>127</sup>

Although vice changes over time, vice exclusions also exhibit stickiness, consistent with the literature on contractual boilerplate.<sup>128</sup> Multiple respondents reported that once an exclusion makes its way into an LPA or side letter, it is unlikely to be removed when those documents are recycled in future fund formations. That is so even if the original reasons for the exclusion no longer hold.<sup>129</sup> As a result, vice clauses have become longer.<sup>130</sup> As one respondent explained:

Once an exclusion is added, it just isn’t taken off—ever. Which makes sense. If you’re Yale Foundation and have to go to the board and say, “We want to remove rubber bullets from the exclusion because it’s no longer an issue,” then they might say, “Why do you want to invest in rubber bullets? Why are rubber bullets good now?” It’s easier to just leave it alone.<sup>131</sup>

### *B. Vice is Subjective and Unlikely to Be Fully Captured in Formal Agreements*

The definition of vice is subjective and follows the normative preferences and reputational concerns of investors and their stakeholders (including LPs and LPs’

123. Interview MQS.

124. Interview WYK.

125. Angelica Peebles, *Tobacco Giant Altria Takes 35% Stake in Juul, Valuing E-Cigarette Company at \$38 Billion*, CNBC (Dec. 20, 2018, 4:43 PM), <https://www.cnbc.com/2018/12/20/altria-takes-stake-in-juul-a-pivotal-moment-for-the-e-cigarette-maker.html> [perma.cc/7FK3-ZXXH].

126. Kate Conger, *Uber Buys Drizly, an Alcohol Delivery Service, for \$1.1 Billion*, N.Y. TIMES (Feb. 2, 2021), <https://www.nytimes.com/2021/02/02/business/uber-buys-drizly.html> [perma.cc/79BM-F3U4].

127. Interview WYK.

128. See generally MITU GULATI & ROBERT E. SCOTT, THE THREE AND A HALF MINUTE TRANSACTION: BOILERPLATE AND THE LIMITS OF CONTRACT DESIGN (2012); Omri Ben-Shahar & John A.E. Pottow, *On the Stickiness of Default Rules*, 33 FLA. ST. U. L. REV. 651 (2006); Marcel Kahan & Michael Klausner, *Standardization and Innovation in Corporate Contracting (or “the Economics of Boilerplate”)*, 83 VA. L. REV. 713 (1997).

129. See *infra* note 131 and accompanying text.

130. Interview CPQ.

131. Interview HGY; *cf.* Interview CPQ (noting that exclusionary lists have grown much longer). See *supra* note 128 and accompanying text.

constituents). Although it is no surprise that vice is subjective, the full extent of the variation in our respondents' concerns and preferences *was* surprising. Importantly, multiple respondents emphasized that the true extent of vice aversion will not be fully captured in LPAs and side letters, as informal consultations over the moral acceptability of investments are common.<sup>132</sup>

Most investor interviewees expressed that there are normative limits to the investments they will make.<sup>133</sup> That is, despite the financial or business profile a startup might present, it would not receive capital if it fails a normative screen. A religious institution, for example, might not want its endowment invested in firearms manufacturers.<sup>134</sup> Residents of a state might not mind public funds being invested in firearms manufacturers, but they might draw the line at public dollars being invested in pornography.<sup>135</sup> A VC investor and its LPs might be willing to invest in alcohol but reject tobacco.<sup>136</sup> Another VC investor might add other industries—like fossil fuels—to its categorical do-not-invest list.<sup>137</sup>

One investor discussed his own varied approach to vice:

**Q:** If someone comes to you and says, “I want to work with a vice-industry company.” It could be tobacco, alcohol, cannabis, etc. What would be your reaction to that?

**A:** . . . I would be less likely to work on it. My own morality would be less interested. Certainly, when it comes to the gambling one. . . . I see positives in cannabis when dosed correctly and used for certain things. However, it could also be highly addictive. I would stay away from those things. . . .

**Q:** So you'd stay away because of personal qualms. Are there other reasons?

**A:** Yeah. First, from an investor standpoint, I don't think any of those industries is an abundant industry aside from cannabis. One of the biggest industries is oil. . . . It's a race to the bottom. Why would you invest in a company that invests in finite resources when you can invest in infinite ones. It's a race to the bottom. Whether or not you believe that guns should be a thing in the

132. See Interview OKG; Interview TAC; Interview RKZ (reporting informal consultation with a LP to ensure it would not be offended by a proposed investment).

133. One respondent associated with a governmental LP noted that even among investors that are singularly motivated by achieving the highest possible returns, there are normative limits. Interview OZF. Some investors, for example, will not invest in “anything remotely associated with guns . . . at any price because of competing regulatory and moral, etc., deliberations.” *Id.*

134. See, e.g., *Companies Subject to No-buy Portfolio Restrictions*, CORP. SOC. RESP. COMM. EPISCOPAL CHURCH EXEC. COUNCIL (June 2023), <https://www.episcopalchurch.org/wp-content/uploads/sites/2/2023/10/No-Buy-List-Of-Prohibited-Stocks.pdf> [perma.cc/3X89-YDYG] (prohibiting Episcopal Church funds from being invested in firms responsible for human-rights abuses, militarism, for-profit prisons, tobacco, or fossil fuels).

135. Compare FLA. STAT. § 656.0323(a)(5) (2023) (protecting firearms manufacturers, as part of a 2023 anti-ESG statute, from losing access to financial services, including credit), with Andrew Perez & David Sirota, *Jeb Bush Administration Invested Florida Pension Money In Porn Purveyor*, INT'L BUS. TIMES (May 6, 2015, 3:34 PM), <https://www.ibtimes.com/jeb-bush-administration-invested-florida-pension-money-porn-purveyor-1911298> [perma.cc/D947-V46K].

136. Cf., e.g., *infra* note 138 and accompanying text.

137. *Id.*

U.S., of all things you can invest in, even the economics, it just doesn't make sense. It might be a small win, but it is never a big win. This is where it gets squishy. It's not team human. I'm team human. I don't think we need guns.<sup>138</sup>

Our interview data point to a particularly strong tobacco aversion, including around vaping products.<sup>139</sup> This finding admittedly surprised us given that tobacco products are legal, are still relatively widely and openly used,<sup>140</sup> and have deep histories in commercial and capital markets.<sup>141</sup> But the stigma associated with tobacco is also borne out in investing activity by large tobacco incumbents, which have sought to diversify into the *less*-stigmatized cannabis industry.<sup>142</sup>

Outside traditional vice categories, businesses that tread on religious or moral sensibilities receive vice-like treatment.<sup>143</sup> One startup founder whose business model defies traditional vice labels but that could offend religious sentiments reported that “[t]here were probably actual belief systems that prohibited certain things, like there were definitely religious beliefs of some LPs that hindered us.”<sup>144</sup> Other normative objections to a business’s products or services that are facially non-vice help articulate the nature of moral, ethical, or aesthetic discomfort with certain kinds of investments. For example, one investor referred to anonymous chat applications Yik Yak and Secret.<sup>145</sup> Although such applications might appear to be normatively neutral, in practice they have contributed to adolescent bullying and suicide.<sup>146</sup> The investor reckoned with the morality of investing in such companies:

138. Interview JXQ.

139. See, e.g., Interview 13; Interview 14; Interview 16; Interview 24; and Interview 28.

140. See *Current Cigarette Smoking Among Adults in the United States*, CTRS. FOR DISEASE CONTROL & PREVENTION (Sept. 17, 2024), [https://www.cdc.gov/tobacco/php/data-statistics/adult-data-cigarettes/?CDC\\_AAref\\_Val=https://www.cdc.gov/tobacco/data\\_statistics/fact\\_sheets/adult\\_data/cig\\_smoking/index.htm](https://www.cdc.gov/tobacco/php/data-statistics/adult-data-cigarettes/?CDC_AAref_Val=https://www.cdc.gov/tobacco/data_statistics/fact_sheets/adult_data/cig_smoking/index.htm) [perma.cc/RV4R-6WL7] (reporting that nearly 15% of adults in the United States are smokers); MARIA A. VILLARROEL, AMY E. CHA & ANJEL VAHRATIAN, *ELECTRONIC CIGARETTE USE AMONG U.S. ADULTS, 2018* (2020) (reporting that 3.2% of U.S. adults were users of e-cigarettes in 2018).

141. American Tobacco Company, after all, was one of the original components of the Dow Jones Industrial Average. See Stuart A. Thompson & William Power, *The Ins and Outs of the Dow Jones Industrial Average*, WALL ST. J. (Jan. 25, 2017, 11:30 AM), <https://www.wsj.com/graphics/djia-components-history> [perma.cc/8E9N-9V77].

142. For example, British American Tobacco, one of the world’s oldest and leading tobacco manufacturers, purchased a 20% stake in a Canadian cannabis startup. One analyst observed that the investment made “strategic sense for big tobacco” given cannabis’s industrial similarity to tobacco and given that it poses “arguably less reputational risk” than tobacco investments would pose for a *tobacco company*. Patricia Nilsson, *British American Tobacco Takes Stake in Canadian Cannabis Producer*, FIN. TIMES (Mar. 11, 2021), <https://www.ft.com/content/4690ba7b-d8a8-4e0e-84f6-cf600f52fb6c> [perma.cc/5T9Z-2SEG].

143. Investment restrictions on pork provide another example. See Interview PHL; see also Email from VC Investor to Authors (Jan. 4, 2023) (on file with authors). See also IBRAHIM KHAN & MOHSIN PATEL, *HALAL INVESTING FOR BEGINNERS: HOW TO START, GROW AND SCALE YOUR HALAL INVESTMENT PORTFOLIO 113* (2003) (“[P]ork, night club activities, etc. These are things that we can unequivocally say are haram to invest in without the need for detailed analysis.”).

144. Interview ONY.

145. Interview DMS.

146. Alyson Shontell, *How 2 Georgia Fraternity Brothers Created Yik Yak, a Controversial App that Became a ~\$400 Million Business in 365 Days*, BUS. INSIDER (Mar. 12, 2015, 7:13 AM), <https://www.businessinsider.com/the-inside-story-of-yik-yak-2015-3> [perma.cc/49FT-QY2J].

“Too many times VCs write checks and turn a blind eye. At some point with capitalism, you have to say, ‘is that worth being the person who financed this?’”<sup>147</sup>

Even those who share core moral or ethical systems can differ in their vice perspectives. One respondent leads a VC firm with multiple Christian denominations as LPs. The respondent conducted an in-depth survey to identify his LPs’ moral and ethical views around certain industries and business models. He reported considerable variation in views, despite the LPs being both co-religionists and directly engaged in investing denominational assets.<sup>148</sup>

This Article focuses on vice startups in the United States, but we note that, as observed in the literature, vice definitions also vary across geographies.<sup>149</sup> For example, a respondent at a VC firm that has both U.S. and European funds opined that investments in gambling startups would be more acceptable to American LPs than European LPs.<sup>150</sup>

### *C. Vice Reflects and Predicts Investor and Reputational Concerns*

Apart from how “vice” is defined, how does vice aversion embed in the startup capital market? We identify four normatively rooted barriers to funding for vice startups: (1) contractual commitments and extracontractual considerations from VC investors to their LPs;<sup>151</sup> (2) VC investors’ personally held vice aversions;<sup>152</sup> (3) VC investors’ reputational considerations within their firms;<sup>153</sup> and (4) VC investors’ reputational considerations within the broader VC industry.<sup>154</sup> As a reference for our discussion of these barriers, the following diagram relates direct and indirect controls and influences on vice-startup investment channels. It illustrates that VCs and individuals/angels (including family offices) make direct investments (or don’t) in vice startups, whereas LPs may contractually or extracontractually control VC investors’ ability to make vice investments. They do not, however, make investment decisions themselves. When a vice startup goes public, the broader market decides whether or not to invest in it.<sup>155</sup> The diagram further identifies two powerful, indirect influences on investment decision-making: investors’ peers (investors at other firms) and LPs’ constituents (such as the universities, pension beneficiaries, religious bodies, or governments on whose behalf they allocate funds to external money managers, like VC firms).<sup>156</sup>

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147. Interview DMS.

148. Interview CSH.

149. *Cf.* Fabozzi, Ma & Oliphant, *supra* note 55 (conducting a sin-stock analysis across twenty-one countries).

150. Interview YMW.

151. *See infra* Section II.C.1.

152. *See infra* Section II.C.2.

153. *See infra* Section II.C.3.

154. *See infra* Section II.C.4.

155. *See generally supra* Section I.A (reviewing the literature on “sin stocks” in public capital markets).

156. *But see* Email from Coleman Stipanovich, Exec. Dir., Fla. State Bd. of Admin., to Arletta [omitted] (Oct. 15, 2005) (on file with authors) (explaining to a Florida resident outraged that the state pension board invested in a company that rented pornographic films that the board routinely rejects calls to divest from normatively objectionable investments).

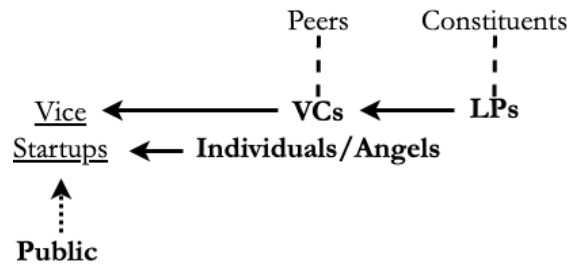


Fig. 3. Normative channels in vice investment.

### 1. Vice Aversion is Contractual and Extracontractual

Vice aversion in the startup capital market manifests through a number of mechanisms. Several are rooted in the relationships between GPs and LPs, including contractual restrictions in multi-lateral LPAs and bilateral side letters<sup>157</sup> and extracontractual GP responsiveness to LP sensitivities.<sup>158</sup> The contractual relationship of VC funds' GPs and LPs are first defined in LPAs that impose contractual limits on GPs' investment decisions.<sup>159</sup> Common terms include, for example, diversification-forcing provisions that limit the size of an investment in any given firm, prohibitions on public-securities investments or investments that violate applicable law, and permission to invest according to a GP's ESG policy.<sup>160</sup> LPAs might be the site of industry-specific restrictions, such as vice exclusions, as well.<sup>161</sup>

Beyond the multilateral LPA, which binds the GP and all LPs in a fund, investment restrictions are also commonly embodied in bilateral side letters between a GP and individual LPs.<sup>162</sup> Respondents report that LPAs and side letters frequently restrict funds from investing in traditional vices—adult, alcohol, tobacco, cannabis (or other illegal drugs), gambling, and weapons, in addition to other exclusions.<sup>163</sup> Thus, as a matter of contractual obligation, VC investors might be unable to invest in some startups due to restrictions imposed by LPAs.<sup>164</sup> Unlike

157. See generally Elisabeth de Fontenay & Yaron Nili, *Side Letter Governance*, 100 WASH. U. L. REV. 907 (2023).

158. See, e.g., *infra* note 170 and accompanying text.

159. See generally Kate Litvak, *Venture Capital Limited Partnership Agreements: Understanding Compensation Arrangements*, 76 U. CHI. L. REV. 161 (2009).

160. Cf. INSTITUTIONAL LIMITED PARTNERS ASSOCIATION, THE ILPA MODEL LIMITED PARTNERSHIP AGREEMENT (WHOLE-OF-FUND WATERFALL) § 7.1.5 (2020), <https://ilpa.org/model-lpa> [perma.cc/Z6S8-KSB9].

161. Interview 30.

162. See De Fontenay & Nili, *supra* note 157, at 916–17 (finding that side letters between private-equity sponsors and LPs predominantly related to LPs' regulatory or tax concerns).

163. See, e.g., Interview 8; Interview 10.

164. In theory, GPs can seek waivers from their limited-partner advisory committees (LPACs) from restrictions in LPAs. In practice, seeking such waivers is a sensitive matter and thus the possibility of waivers for vice investments may be illusory. Interview WNI (“If you really want something, you go speak to the [LPAC]. . . . [But h]ow often do you go to your board of advisors?”).

LPAs, side letters do not directly bind other fund LPs.<sup>165</sup> But to the extent that an LP's funds cannot be carved out of investments that violate its side-letter restrictions, one LP's restrictions effectively limit the use of other LPs' capital.<sup>166</sup> Even when carveouts are contractually permitted, this restrictive effect could persist given the high transaction costs of structuring a carveout around a single portfolio company.<sup>167</sup>

In addition to contractual restrictions, VC investors might also avoid investments that they anticipate their LPs would disapprove of or, if the investments generated negative publicity, could meet with the LPs' constituents' disapproval.<sup>168</sup> Although these considerations are not contractually mandated, they are nevertheless critical to the repeat-player relationship between VCs and their LPs. Successful GPs raise new funds every few years, and investors in existing or prior funds are a critical fundraising base for the future.<sup>169</sup> As a result of this repeat-player dynamic, normative LP-motivated restrictions tend to be broadest and most entrenched at more mature VCs. That is because those firms have assembled a valuable investor pool over several years and funds, and with that, their investors' normative investment restrictions. One VC investor captured both these points:

We have to be thinking about our LPs all the time. . . . We go out in the market to fundraise every three years, and it changes every three years. Every three years, there's a new flavor to worry about. LPs never want to be embarrassed. They have to answer to someone else. That being either a state legislature or committee that gets to sit there and say, "Do you realize you embarrassed us?"<sup>170</sup>

By contrast, new VC firms are less likely to have institutional investors: Their first few funds will be raised primarily from friends, family, colleagues, and wealthy individuals/family offices.<sup>171</sup> Only once they have established a track record will they raise larger sums from institutional LPs, like endowments, insurance companies, and pension funds.<sup>172</sup> Although it is possible that newer VCs anticipate future LPs' normative objections and preemptively conform to them—lest LPs with those objections decline to invest due to the inclusion of vice companies within the

165. Renee Fischer, *Regulatory Focus on Investor Side Letters*, CADWALADER (Feb. 3, 2023), <https://www.cadwalader.com/fund-finance-friday/index.php?nid=225&eid=1693> [perma.cc/4YYD-LMPM] ("Side letters are a common way of formalizing bilateral negotiated arrangements between a private fund and its investors, where investors seek to modify the rights and entitlements generally applicable to investors pursuant to the fund's constituent documents.")

166. *Cf.* Interview ZIS ("[W]e have seen LPs restrict certain investments you can make in medical treatments. It is usually a religious organization. They have carveouts that say if you choose to invest in these areas, we have the option to opt out. We don't prohibit it, but we don't want our money flowing into it."); *but see* Interview KRB ("Side letters limit any investment within that fund. There are no blue dollars and red dollars. There are just red dollars. You cannot separate it theoretically based on investor.")

167. *See supra* note 166.

168. *See infra* note 170 and accompanying text; *see also supra* note 135 (reporting citizen outrage that Florida public pension funds were invested in a company with a pornographic film rental business).

169. *See supra* notes 90–91 and accompanying text.

170. Interview JJW.

171. *The Best LPs for New VC Firms*, FOUNDER INST., INC., (Jan. 18, 2022), <https://fi.co/insight/the-best-lps-for-new-vc-firms> [perma.cc/ZS3U-2R3E].

172. *See, e.g.*, Interview BQP.

VC's current portfolio—no respondent reported such a consideration. One VC investor—the leader of a fairly young firm now on its third fund—insisted, rather, that restrictions sought by future institutional LPs would be resisted on a principle of maintaining his decisional authority.<sup>173</sup> He might nevertheless accept those restrictions, however, if necessary to obtain funding, particularly if the restrictions were consistent with the VC investor's own normative views.<sup>174</sup>

Although we use confidential interviews to outline the contractual and extracontractual aspects of the GP/LP relationship, we identify a public case to illustrate our points. In that case, the *Financial Times* reported that Cornell University's endowment participated in a \$362 million syndicated loan to Manwin (later renamed MindGeek), a leading online pornographer.<sup>175</sup> Although university endowments keep their investments confidential,<sup>176</sup> Cornell released an unusually transparent statement about its Manwin investment:

Our examination swiftly discovered that in 2016 [an external] fund manager, one of our approximately 350 fund accounts, had invested in what was described by the manager as 'online media distribution.' That investment, without our knowledge, related to a firm associated with exploitive online pornography.

Although that same review determined that this investment had been removed from our portfolio in May 2018, within days of learning of this past relationship and confirming this past unacceptable investment decision, Cornell immediately moved to sever its relationship with this manager and terminate this account.<sup>177</sup>

Cornell's statement raises several possibilities. The first is that Cornell objected to its endowment being used to fund pornography, especially after Manwin had been accused of hosting images of child exploitation and nonconsensual content.<sup>178</sup> The second is that Cornell likely would have objected to participating in the Manwin investment even if the company's websites hosted only images of consenting adults. After all, it stated that its outside investment manager had described the investment euphemistically as "online media distribution," implying

173. *Id.*

174. *Id.*

175. Arash Massoudi, Kaye Wiggins, Robert Smith, Javier Espinoza, James Fontanella-Khan, Ortenca Aliaj, Sujeet Indap, Eric Platt, Mark Vandeveld, Francesca Friday, Antoine Gara & Miles Kruppa, *Due Diligence: Under the Covers of an Industry No One Talks About*, FIN. TIMES (June 8, 2022), <https://www.ft.com/content/6d2d7fde-5625-4192-9921-3d1cf1c8c77e> [perma.cc/ZR2V-BRVV].

176. See, e.g., *Ethical Investment Policy*, YALE INVT. OFF., YALE UNIV., <https://investments.yale.edu/social-responsibility> [perma.cc/WL35-KFA6] (last visited Apr. 2, 2025) (explaining that the Yale University endowment keeps its investments and external manager relationships confidential, in part to comply with contractual obligations with those managers and, even when disclosure is contractually permitted, to maintain the Yale endowment's competitive advantage in selecting superior external managers).

177. John Carberry, *Statement on Financial Times Report*, CORNELL UNIV. (Dec. 18, 2020), <https://statements.cornell.edu/2020/20201218-financial-times.cfm> [perma.cc/U764-WVGT].

178. Nicholas Kristof, *The Children of Pornhub*, N.Y. TIMES (Dec. 4, 2020), <https://www.nytimes.com/2020/12/04/opinion/sunday/pornhub-rape-trafficking.html> [perma.cc/P84Q-BSCV]; see also Elise Nicole Blegen, *Sex, Drugs, and Rock & Roll: Effectively and Equitably Moderating Vice and Illegal Content Online*, 76 VAND. L. REV. 1265, 1269–72 (2023) (recounting the accusations against Manwin).

that the university's hackles would have been raised earlier had the description been something more specific, like "online *adult* media distribution."<sup>179</sup> The third is that apart from Cornell and a number of for-profit financial institutions, the *Financial Times* did not uncover other noteworthy LPs (like other universities, religious denominations, charities, or pension funds) that had participated in the Manwin syndicate, else that would have been reported, too.<sup>180</sup> And fourth, outside investment managers that value relationships with LPs are wise to avoid investments that could embarrass their LPs. Especially for LPs that engage multiple outside managers, the GP/LP relationship might be dearer to the GP than to the LP, making termination a predictable consequence for failing that wisdom.<sup>181</sup>

Cornell's aberrant appearance among the Manwin investors supports that it and LPs like it, whether for reputational or other reasons, are averse to vice investments. The Cornell case also points to the role of communication and euphemism in concealing, and perhaps reshaping perceptions around, vice. Our interview with one gambling entrepreneur further illustrates this role:

**Q:** You use "gaming" a lot on your website, as opposed to words explicitly related to gambling. What's the reasoning?

**A:** It's intentional. You follow the lead of industry colleagues in some ways. It's the naming the industry uses. Gaming has been an industry that has a stigma to it. Saying "gaming" probably doesn't change anything but for whatever purpose, the industry uses those words to soften adverse reactions to it. A more real distinction is you'll never hear someone in the gaming industry use the word "addictive." There are connotations to it. They'll use words like "engaging" instead. I'm not sure it matters, but I, and others, are so used to using such secondary language. . . .<sup>182</sup>

For investors, the prospective awkwardness of communicating to LPs about vice investments further weighs against making them. As a manager for a major university endowment said:

It is an area now where we think about, we've got a small exposure to, let's just say we, had a really small exposure to a company that does pornography. . . . Do we even want to have to show that on our transparency report? Even if that investment was generating good returns, it's just probably not worth it. So we probably would sell that off if we could, because it's just not worth bringing that up, having to show that up on our transparency report, because . . . you'll end up having to talk about that: "Well, that's only a \$10 million position of a [multibillion-dollar] fund."<sup>183</sup>

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179. *Cf. supra* note 177 and accompanying text.

180. *See supra* note 175 and accompanying text.

181. *See, e.g., supra* note 177 and accompanying text.

182. Interview IFS; *see also* Ralph Slovenko, *Euphemisms*, 33 J. PSYCHIATRY & L. 533, 537 (2005) ("Vices are sanitized by euphemisms. Topless bars and pornography shops provide 'adult entertainment.' . . . Gambling, also once illegal, is now called 'gaming,' and stocks in gambling casinos are listed on the New York Stock Exchange.").

183. Interview MWW.

To overcome that prospective awkwardness—or perhaps to provide an LP plausible deniability if questioned by its own constituents—investors might employ euphemism, as Cornell’s external manager did.<sup>184</sup> One VC respondent stated his thinking around communication, euphemism, and vice investment:

We saw a sex-toy company recently. We certainly considered it. We looked at it, treated it like any other business: unit economics, market potential. We passed early in our process. I wonder, had it met all our financial criteria, I think it would be fine. I often think about, what’s the paragraph in our quarterly email to investors. Probably euphemisms we’d use in the newsletter.<sup>185</sup>

Despite their critical role in the VC business model, however, LPs do not have unlimited market power to impose normative restrictions on their GPs. They might even lack market power to impose *any* restriction. New VC funds launched by firms with the best historical returns and the best access to deal flow will be oversubscribed.<sup>186</sup> LPs—especially those that are not anchor LPs<sup>187</sup>—might be forced to accept a GP’s terms if they wish to participate in a sought-after new fund. Even large LPs might be “price takers,” as an LP respondent explained:

[T]here are no real restrictions to be blunt. We’ll endeavor to do this or that, but we don’t handcuff our managers. The reason for that is because the [VC funds] that we all want to be in have so much demand that if we were to come in and say, “Hey, we need you to say you won’t invest in X, Y, and Z,” they’ll probably tell us “no.” And what that will mean is you just simply won’t be able to invest in the fund.<sup>188</sup>

And although VC firms are extracontractually responsive to LPs’ sensitivities, a particularly compelling investment can overwhelm potential LP objections. A respondent from a top VC firm discussed one technology that the firm invests in that could raise normative objections from some LPs or their constituents:

We invest in [a technology]. Nobody has ever stopped or said anything about that. We wouldn’t take somebody’s money if we were told to stop investing in it. . . . If an investor wanted to limit this investment, we would have to turn them away. It is too large of an opportunity . . .<sup>189</sup>

More, some VC firms are willing to eschew LP capital that will encroach *at all* on their decisional flexibility. For those firms, control is preferred over potentially higher returns from incremental, but normatively restrictive, capital. One successful-founder-turned-VC expressed that preference: “We have, I don’t know,

184. See Carberry, *supra* note 177 and accompanying text.

185. Interview IIG.

186. Pascal Gantenbein, Reto Forrer & Nils Herold, *Venture Capital, in* PORTFOLIO THEORY AND MANAGEMENT 666 (H. Kent Baker & Greg Filbeck, eds., 2013).

187. Interview PYH (reporting that some VC funds have “anchor LPs” which have a more direct hand in negotiating the LPA and that some LPs obtain most-favored-nation provisions in side letters, which entitle them to any concessions that other LPs negotiate in their own side letters).

188. Interview OLG.

189. Interview JTJ.

a hundred LPs. We don't have a single side letter. No constraints. No constraints. You believe in me, or if you don't, f— off. . . ."<sup>190</sup>

## 2. *Vice Aversion is Personal*

Beyond LP-imposed or -regarding vice restrictions, investors might also impose their own personal screens. One investor—who is also a successful serial founder—stated that he is happy to invest in normatively neutral businesses because they contribute to the broader economy, and that he is willing to invest in vice industries (like gambling and wine) under the right conditions, but that he draws a line at firearms:

We don't have a formal ESG or similar screen. I would say that my personal preference is, I would like our investing to have a positive effect on the world. . . . I look pretty broadly. If I'm backing a founder doing something neutral to the world, I can feel good about that: I'm having a positive effect on the ecosystem and market. I don't have interest personally in anything having to do with guns.<sup>191</sup>

The application of VC investors' normative screens also implies that they impose personal vice aversions on their firms and LPs. One founder, whose company went through a prestigious startup accelerator, reported experiencing both the contractually rooted vice aversion discussed in the prior subsection, as well as an investor's personal vice aversion:

**Q:** I want to talk about your funding opportunities, the investors who said no. How did the fundraising process work for you? Were there some who said they were interested then pulled? Why did they make these decisions?

**A:** Yeah, mainly not moral. There were three funds that were restricted by LP agreements and one that felt the GP was entirely uncomfortable due to their moral judgments, which is ridiculous. They have invested in a company that was killing people.<sup>192</sup>

Personal vice aversion can prompt moral and ethical dilemmas for investors in cases when investment in vice can be framed as less socially harmful than vice non-investment. One investor, for example, noted his personal objection to, and thus refusal to invest in, any tobacco- or smoking-related startup.<sup>193</sup> He worried, however, that his smoking aversion could be socially counterproductive if such a startup instead received funding from investors that were comparatively less inclined to monitor and discipline its negative externalities, such as sales to minors.<sup>194</sup> This concern tracks those that divestitures of “dirty assets” by responsible firms could lead to those assets being acquired by less responsible

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190. Interview VOW.

191. Interview XBJ.

192. Interview YXH.

193. Interview XPL.

194. *Id.*

operators that would increase negative externalities.<sup>195</sup> Imagine, for example, a public company under the ESG spotlight offloading its highest-polluting assets to private operators, who in turn would have little reputational motivation to mitigate their pollution.<sup>196</sup>

*Non-aversion* to vice is also personal. Just as a personal vice aversion might cause a VC investor to impose that view on his or her firm, a VC partner might use personal funds to circumvent the *firm's* aversion to a startup that the partner has conviction in. Several interviewees reported individual partners personally investing in vice startups that their firms rejected on that basis. One VC-firm leader, for instance, discussed an investment that was advocated by one of the firm's partners but was rejected on vice grounds: "That individual partner signed his own check and I think they'll do well."<sup>197</sup>

### 3. Vice Aversion is Collective

In all but the smallest VC firms, investment decision-making is a collective process driven by professionals with mixed levels of internal power and status.<sup>198</sup> Even absent LP-imposed or -regarding vice restrictions, or personal vice aversion, VC investors must consider whether advocating for, or even openly considering, vice investments might harm their internal reputations. One founder of a sexual-wellness company recalled a positive response from a VC investor who nevertheless had peer-regarding reputational concerns:

On the seventh slide [of the pitch deck] he said, "I absolutely love it. If I'm going in, how do I tell other people that I'm taking a meeting with this company? I would be worried about what people would think of me. So I need to create some paper trails with the founders, that we are a business-like interaction, that I'm not a kinky person. When I create this paper trail with the founders, then I'll be more comfortable. Gosh I really love this deck, such a great company."<sup>199</sup>

Preserving reputational capital is especially important because VC firms have internal investment processes with multiple veto points.<sup>200</sup> Those vetoes can occur on an informal or ad hoc basis, as one adult-content entrepreneur experienced:

It happens many times to people, not just [adult] images but also products. You have a call with one or two people, [who would say] we support you! And it goes up the chain to anonymous

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195. See, e.g., John Armour, Luca Enriques & Thom Wetzer, *Dark and Dirty Assets: Greening Climate-Driven Asset Partitioning*, OXFORD BUS. L. BLOG (June 14, 2022), <https://blogs.law.ox.ac.uk/business-law-blog/blog/2022/06/dark-and-dirty-assets-greening-climate-driven-asset-partitioning> [perma.cc/Z35T-L32Z].

196. *Id.*

197. Interview HQL.

198. Douglas Cumming, Grant Fleming & Armin Schwiendacher, *The Structure of Venture Capital Funds*, in HANDBOOK OF RESEARCH ON VENTURE CAPITAL 155 (Hans Landström ed., 2007); Yoram Landskroner & Jacob Paroush, *Venture Capital: Structure and Incentives*, 4 INT'L REV. OF ECON. & FIN. 317 (1995).

199. Interview OAE.

200. Interview DHF.

people, they say “what if.” I have multiple times said, “Put me on the phone with someone who’s shutting us down.”<sup>201</sup>

It can also occur as part of a formal, multi-step process, as one VC noted:

**Q:** How do you make decisions around industries you are interested in investing in?

**A:** Generally each of [our investment teams] is doing a deep dive on proposed potential investments. You do due diligence, put together investment memos. Companies will then come to present to the broader teams. The broader teams then vote whether to proceed or not. Then the GP will vote. Then the vote will be brought to the broader firm. Then to the whole [partner] group of ten [partners]. It’s a bottoms-up approach that has to pass each gate before investments are made.<sup>202</sup>

But regardless how firms reject vice investments, there is little incentive for individual investors to bear reputational costs advocating for vice startups that will fail internal screens. In that light, vice aversion is collective in part because it is also *personal*: A potential investment might be vetoed on normative grounds at multiple points.<sup>203</sup> As we discuss in Section III.C, this internal reputational concern is heightened for women and other minoritized VC partners.<sup>204</sup>

#### 4. *Vice Aversion is Industrial*

VC investors might also avoid vice startups due to reputational concerns within the broader VC industry. Because VC firms tend to publicly tout their portfolio companies, making their investments easily observable by peers,<sup>205</sup> this mechanism would suggest that VC investors avoid investing in vice startups that would cause professional loss of face.<sup>206</sup> This possibility is consistent with a VC firm that invested in the startup of a cannabis founder we interviewed. We observed from the firm’s website and profile on PitchBook that its investments are largely in non-vice companies, but it does have one investment in an entirely legal vice industry and another (the respondent’s company) in cannabis. Although the firm’s website includes a page featuring names and logos of its portfolio companies, it excludes the respondent’s cannabis company.<sup>207</sup> Consistent with this observation, one VC suggested that even a successful vice investment could be a source of embarrassment within the industry:

If you made [twenty times your investment] on a sex-toy business and you’re pretty excited about it, maybe you don’t talk about it, but you’re happy. If it blows up, that’s embarrassing. We invested

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201. Interview BGG.

202. Interview CIY.

203. *See supra* Section II.C.3.

204. *See infra* Section III.C.

205. *See* Interview 35.

206. *See infra* note 208 and accompanying text.

207. This observation relates to Interview MQU and was made by reviewing the respondent’s company’s PitchBook profile and visiting the websites and profiles of its investors. *See* Interview MQU.

in a company, the founder went to jail for fraud. That was embarrassing. I don't think it's any worse for vice.<sup>208</sup>

But another respondent reported that although real, such stigma within the industry is hypocritical:

I know lots of people in the tech world, and I know many VCs. What they are worried about is other GPs, and partners in the fund. Then they are worried about the LPs. Also, some funds have vice clauses. The clauses force them to commit to not investing in tobacco, guns, porn, and so on. Anything to do with sex falls in the vice-clause category. They also worry about what their peers will think. It is ironic, because the people I know and the circles I move in, all of those big VC investors who refuse to touch anything related to sex are the ones holding sex classes, and [being promiscuous] at Burning Man. They are the ones doing all those things, but fear of what others might think. . . . Those VC investors who claim they do not give a f— about anything give a lot of f—s about sex.<sup>209</sup>

#### *D. Vice Might Not See Itself as Vice*

Vice entrepreneurs described their businesses as socially responsible. And like many other entrepreneurs, they believe deeply in their corporate missions.<sup>210</sup> Perhaps unsurprisingly, then, founder respondents almost uniformly considered themselves to be engaged in socially responsible activity, while recognizing that the outside world characterizes their businesses as vice. Some—particularly female founders in the sexual-wellness space—expressed outrage that they should be grouped with weapons, tobacco, and other stigmatized industries.<sup>211</sup>

Even in categories that fit comfortably within the vice heartland, entrepreneurs sometimes distinguish themselves from “real” vice because their companies mitigate a given vice’s potential social harm. An earlier cited entrepreneur, who sees his company as harm-reducing, rejected normative reservations from VC investors and their LPs and noted that their portfolio included a company that was “killing people.”<sup>212</sup> Another, an alcohol founder, noted that his business model mitigates risks associated with underage drinking, which has been a boon to his company’s investment, commercial, and regulatory prospects.<sup>213</sup>

In Section III.C.2, we discuss the cost-of-capital implications of vice aversion.<sup>214</sup> Rejection of the “vice” label by entrepreneurs and investors can also implicate cost of capital. One cannabis founder, for example, reported choosing the lower valuation between two competing investment offers because the chosen

208. Interview HBI.

209. Interview WWX.

210. See Sophie Bacq, Madeline Toubiana, Ifeoma Ajunwa, Jarrod Ormiston & Trish Ruebottom, *Stigma Entrepreneurship: Exploring Stigma as a Source of Entrepreneurial Motivations*, FRONTIERS OF ENTREPRENEURSHIP RSCH. 139, 144 (2018).

211. E.g., Interview VUP.

212. Interview YXH, *supra* note 192.

213. Interview BPO.

214. See *infra* Section III.C.2.

investors saw the company as pro-social: “They did not see us as a quote-unquote vice, but rather as a socially responsible investment. Safer than alcohol . . . .”<sup>215</sup>

As we explained earlier, vice is subjective.<sup>216</sup> That point holds even among vice and vice-adjacent founders. Although they might reject the vice label for their companies, they are willing to stigmatize *other* industries just as the broader market stigmatizes their own. Indeed, one sexual-wellness founder’s rejection of a vice label suggests that there is no cross-vice solidarity among stigmatized entrepreneurs: “Our industry is lumped into the same categories as guns, alcohol, and psychedelics. It is ridiculous.”<sup>217</sup> We attribute such an attitude not as hypocrisy or even collective-action failure, but rather as evidence that the normative considerations that animate vice aversion are socially ubiquitous as well as personally subjective.<sup>218</sup>

#### *E. Not All Vices Are Equally Stigmatized*

Recall that “vice” industries traditionally include the adult, alcohol, tobacco, gambling, and weapons industries and that most empirical studies attempting to study the returns to “vice” define it as including some or all of these categories (and sometimes others).<sup>219</sup> These studies do not distinguish, however, among potential differences in stigma levels within a single vice category.<sup>220</sup> Our respondents, however, report nuances in stigma within a single vice industry. This differentiation is sometimes, but not always, related to regulatory hurdles or illegality.

For example, whether a cannabis business is plant-touching—that is, directly involved in the cultivation, distribution, or marketing of products—is a critical distinction within that industry.<sup>221</sup> According to our respondents, this distinction is solely a regulatory consideration, as cannabis remains illegal under federal law,<sup>222</sup> rather than a normative consideration. Non-touching businesses—for example, a software company or a fertilizer manufacturer that serves plant-touching companies—involves comparatively lower regulatory risk.<sup>223</sup> That is to say, an investor who is willing to invest in cannabis at all would not be expected to draw a subjective distinction between plant-touching and non-touching businesses, were it

215. Interview IRQ.

216. See *supra* Section II.A.

217. Interview QUL.

218. Cf. Maureen A. Craig & Jennifer A. Richeson, *Stigma-Based Solidarity: Understanding the Psychological Foundations of Conflict and Coalition Among Members of Different Stigmatized Groups*, 25 CURRENT DIRECTIONS IN PSYCH. SCI. 21, 25 (2016) (“[A]t times, stigmatized-group members may view other stigmatized groups simply as out-groups, [but] there is potential to perceive commonality due to shared societal stigmatization.”).

219. See *supra* notes 50–56 and accompanying text.

220. See *id.*

221. See Eric Sandy, *Less Than 25% of Plant-Touching Cannabis Businesses Are Profitable, According to New Report*, CANNABIS BUS. TIMES (June 28, 2023), <https://www.cannabisbusinesstimes.com/news/whitney-economics-report-business-conditions-market> [perma.cc/6CLE-LEFZ].

222. But see Joseph Biden, *Statement from President Biden on Marijuana Reform*, THE WHITE HOUSE (Oct. 6, 2022), <https://www.whitehouse.gov/briefing-room/statements-releases/2022/10/06/statement-from-president-biden-on-marijuana-reform> [perma.cc/4BD7-ZBVQ] (instructing federal agencies to consider reforms of federal cannabis prohibition, including ending cannabis’s status as a Schedule I drug).

223. See Section III.A.1 for a fuller discussion on regulatory uncertainty’s implications for investment in vice.

not for regulatory considerations. One cannabis entrepreneur described the distinction and its importance to investors:

The defining factor is, are you plant-touching or non-plant touching? There are tons of cannabis investment firms who only invest in cannabis but will not invest in any company that touches plants—meaning holding licenses to sell cannabis. You can be servicing as a [point-of-sale] system, marketing software, a packing company, or whatever recruiting/hiring platform, and none are “federally illegal.” But the second you touch plants or participate in the business, it is federally illegal and most funds cannot touch you.<sup>224</sup>

Said another:

[O]ur family-office investor made the first investment in us. They were comfortable with us as an ancillary company . . . but we could not take any interest in any plant-touching companies. That proved to be maybe not the best decision for us.<sup>225</sup>

Weapons also have a binary distinction. Respondents report that investors are averse to investments in firearms and ammunition for consumers, whereas weapons for military and police applications might be considered investable.<sup>226</sup> A similar distinction exists within the alcohol industry between beer, wine, and cider versus spirits. In contrast to cannabis, this distinction was only partly attributable to regulatory or legal differences, with a number of respondents suggesting that beer, wine, and cider were simply less taboo than spirits. As one spirits entrepreneur explained:

**A:** Certain funds that were interested wanted to do an investment, but their LPs would say they can’t touch it. There are a whole bunch who probably could but didn’t like that we were [dealing with] more than just wine. They would have invested in wine, but then spirits and liquor was like, “uh.”

**Q:** Do you think that is because of the nature of the industry or higher regulations on spirits?

**A:** There are definitely a ton of regulations but mostly they are state level. . . . If I went to get a loan to start a winery, I would get it tomorrow. If I wanted to open ten liquor stores, no way. Some rejections were because of stigma, some because of morality clauses and LP agreements with endowments and pension funds. . . . [M]ore investors invest in products—low-alcohol beverages or things like that. Very little goes towards spirits.<sup>227</sup>

224. Interview HDR.

225. Interview IRQ, *supra* note 215.

226. Interview AHF (discussing a fund’s decision to prohibit firearms investments, with a carveout for military applications); Interview YJA (speaking about a startup defense contractor that has not experienced meaningful vice aversion); *see also, e.g., CCIR Statement Regarding Investment in Assault Weapon Retailers*, YALE NEWS (last visited Apr. 15, 2025), [https://news.yale.edu/sites/default/files/CCIR%20Statement%20%20Assault%20Weapon%20Policy%20\(FINAL\)%5B1%5D.pdf](https://news.yale.edu/sites/default/files/CCIR%20Statement%20%20Assault%20Weapon%20Policy%20(FINAL)%5B1%5D.pdf) [perma.cc/U73Z-CUB3].

227. Interview GFS.

An investor respondent, while characterizing his approach to vice investments as “extremely conservative” due to his firm managing capital from public LPs that face political scrutiny, also said that his firm had invested in some alcohol companies, but only bars, restaurants, and beer/cider brewers, none of which felt controversial:

We’re really reticent [about vice] because of the publicity in the press. It’s just a huge concern . . . We just never want to be in the limelight for that kind of stuff. And we definitely want to stay away from it to the degree that we can. We have invested in bars and restaurants. We actually even have one alcohol provider in our portfolio. We are invested in a company [identifying information removed], which makes [an alcohol product] that is sold in bars and restaurants. But that to us felt pretty mainstream and didn’t feel like there was much contention around it.<sup>228</sup>

A recurring “hard case,” already mentioned above in connection with cannabis, relates to how to categorize ancillary services, such as software applications developed to serve vice industries.<sup>229</sup> Perhaps the most interesting hard cases related to dating applications. Although some applications focus on helping users find a potential partner, others exist in a gray area between prostitution (vice and also illegal)<sup>230</sup> and dating (not vice). Said one respondent:

A third area of vice is online-dating apps. First it was eHarmony, Match, all sites geared toward marriage. Then came hookup sites like Tinder and Grindr. Some venture funds are quite comfortable with that. I know others that stayed out. I am speaking broadly, but one thing going back to marriage sites. [One app] was basically online prostitution. I mean I worked with an investor who refused to invest in one of those rounds because they dug in and found it was not just a hookup site but rather it was prostitution.<sup>231</sup>

Another respondent recalled earlier conversations about potentially bringing Grindr, an LGBT-focused dating application, into the public market: “[T]here was a lot of dialog around whether a gay-dating site, ten years ago, ‘oh my gosh, [mutual-fund giant] Fidelity could never own that.’ And now it’s the only gay public asset.”<sup>232</sup>

It is possible that some vice differentiation among investors is financially motivated, rather than rooted in a consistent assessment of vices’ relative moral, ethical, or social-cost aspects. Consider this VC investor:

Every firm is different. I can only speak about our firm. We have a philosophy that life is too short to invest in things that are socially bad. If I think it can make money, but is a net bad on society, as defined by us, we cannot do it. We looked at a vaping

228. Interview ULS.

229. See *supra* notes 221–225.

230. See Interview YEO (noting that prostitution would be considered an impermissible vice by LPs); see also, e.g., Fabozzi, Ma & Oliphant, *supra* note 55, at 85 (treating “prostitution” as a vice, albeit an illegal one that as a result would not be included in a study on publicly traded sin stocks).

231. Interview HIF.

232. Interview SJX; see also Giulia Heyward, *Gay Dating App Grindr’s Stock Soars After Going Public*, NPR (Nov. 19, 2022, 6:01 AM), <https://www.npr.org/2022/11/19/1137792556/grindr-stock-ipo-lgbtq-dating> [perma.cc/EZV2-UWJP].

company once. The argument by the partner who brought it in said it's the most ethical because [it mitigates the risk of use by minors]. His argument was also that vaping is socially bad, and people are going to smoke. You're offering something that's better than traditional cigarettes. We don't want to promote cigarettes.<sup>233</sup>

But after rejecting the reasoning that there is an insatiable consumer demand for smoking and thus it is ethical to invest in a risk-mitigating vaping company, the respondent later offered a similar argument *in favor of* risk-mitigated gambling.<sup>234</sup> We later noted from the PitchBook profile of the respondent's VC firm that it had invested in at least one gambling company.

However, to the extent that seed and Series A funding reveals relative vice aversion among investors, the data in our 2014 to 2023 PitchBook sample suggest a slightly different hierarchy of which vice industries investors tend to avoid. Table 1 reflects a hierarchy in which seed funding occurs most frequently in adult business and least frequently for alcohol businesses, although we caution that these placements could be driven by selection effects (that is, there are only 20 adult businesses in the sample, whereas there are 4,229 alcohol businesses). The other four vice categories—cannabis, gambling, weapons, and tobacco—fall in an order that is more consistent with the vice hierarchy suggested by interview data. Table 2 presents a different hierarchy based on Series A funding success, although again we caution that selection effects for the adult and alcohol categories might influence their placements.

Industry	Count	Received Seed Funding
Adult	20	15%
Cannabis	2,151	13.7%
Gambling	402	10.0%
Weapons	879	9.3%
Tobacco (inc. vaping)	417	8.6%
Alcohol	4,229	7.7%

Table 1: Vice startup seed-funding success (most to least successful)<sup>235</sup>

Industry	Count	Received Series A Funding
Cannabis	2,151	7.6%
Tobacco (inc. vaping)	417	5.3%
Weapons	879	3.9%
Gambling	402	3.7%
Alcohol	4,229	2.6%
Adult	20	0%

Table 2: Vice startup Series A fund success (most to least successful)<sup>236</sup>

233. Interview EAD.

234. *Id.*

235. *See infra* Appendix, Table 2.

236. *Id.*

## III. PROBLEMS FOR AND DISTORTIONS IN VICE CAPITAL

In Part II, we frame how normativity causes aversion to vice investment. In this Part, we extend that perspective by showing that vice status affects capital formation even absent normative aversion on the part of investors, including by increasing regulatory uncertainty, erecting hurdles to accessing business infrastructure, and depriving investors of the ability to compare a vice startup to similar firms with successful exits. More, we show that vice status can distort a startup's corporate governance and cost of capital. We close this Part with a preliminary consideration of the intersection of vice capital and minoritized entrepreneurs, investors, and customers.

*A. Not All Vice Aversion is Normative*

In Part II, we framed vice aversion in normative terms: A startup is not funded because one or more participants in the investment process object to the morality, ethics, or aesthetics of its products or services.<sup>237</sup> In this section, we show that vice aversion is not always normative: It can also be driven by business considerations that constrain even VCs that are otherwise vice-indifferent or -preferring.

These business considerations include probabilistic screens that consider whether a startup, its personnel, business model, and products will advance the investor's portfolio strategy.<sup>238</sup> Because startups fail these screens for numerous reasons, it is no surprise that a VC fund's default decision for even non-vice capital seekers is "no."<sup>239</sup> We focus on three business considerations that influence vice non-investment: regulatory uncertainty, business-infrastructure hurdles, and lack of comparable funded and exited startups.

*1. Regulatory Uncertainty*

Uncertainty around the legality or future regulation of a business's products or services increases the risk of investing in it.<sup>240</sup> For businesses that are illegal—such as those in the still-federally-illegal cannabis industry—that risk includes an investment being entirely lost due to unpredictable government enforcement

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237. See generally *supra* Part II. Tasos Vossos, *Porn Is Worse Than Pollution in Ethical Investing Portfolios*, BLOOMBERG (June 12, 2019), <https://www.bloomberg.com/news/articles/2019-06-12/in-ethical-investments-porn-is-a-bigger-taboo-than-firearms> (reporting that, for example, "40% of global credit funds would exclude adult entertainment when using negative screening").

238. Cf. Paul A. Gompers, Will Gornall, Steven N. Kaplan & Ilya A. Strebulaev, *How Do Venture Capitalists Make Decisions?*, 135 J. FIN. ECON. 135, 181 (2020) (describing survey results in which VC investors' most important considerations around startup valuations are "exit considerations" and "[c]omparable company valuations").

239. For example, in a 2014 interview at the Stanford Graduate School of Business, prominent venture capitalist Marc Andreessen reported that his firm invests in only 20 startups out of every 3,000 considered (with hundreds being seriously considered). Stanford Graduate School of Business, *Marc Andreessen on Big Breakthrough Ideas and Courageous Entrepreneurs*, YOUTUBE (Mar. 8, 2014), <https://www.youtube.com/watch?v=JYYsXzt1VDc> [perma.cc/6SME-TK63].

240. See Jiwon Lee, David Schoenherr & Jan Starmans, *The Economics of Legal Uncertainty* (Eur. Corp. Governance Inst., Law Working Paper No. 669, 2022), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4276837](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4276837) [perma.cc/QN4D-FV69].

decisions.<sup>241</sup> Even for currently lawful but disfavored businesses—like those in the adult industry—the potential for new anti-vice statutes or regulations, or enforcement, presents a similar risk.<sup>242</sup> Although VC funds’ investment strategies require accepting high levels of risk compared to investing in mature public markets,<sup>243</sup> our interviews suggest that regulatory uncertainty can still dissuade vice investment at the margin. As one cannabis founder shared:

**Q:** I was interested in two things you mentioned about early waves of financing. One is the period pre-2018. I wonder if you could talk a bit more about what motivated the fact that you weren’t able to get funding? Fear of the gray market, or something more?

**A:** [O]n the fund side of it, most tier 1 funds were wary for the same reason that family offices are wary. “We are hedge funds, we can’t do it.” VCs . . . are not going to do it. That’s not stopping us from having conversations with qualified funds. They are all maybe keeping an eye on the market: maybe [a federal statute permitting] banking [by cannabis businesses] will pass.<sup>244</sup> What is Trump going to do? That’s where a lot of traditional VC interest comes from. Everyone wants to know about it, but then, I don’t know of anyone else who has raised from a fund that is not a cannabis fund, and it is likely not a top-tier, mega-fund VC.<sup>245</sup>

Beyond the risk of losing their investments due to enforcement, investors might also fear becoming the subjects of enforcement themselves,<sup>246</sup> as another cannabis entrepreneur explained:

**Q:** Going back to the touching/not-touching divide, what explains the greater lack of investment in plant-touching? Why is there a divide? Is it legal or moral?

**A:** It’s 100% regulatory. Nothing to do with morals. The concern is breaking federal law, which it definitely is. Ancillary gets in a

241. See OFF. OF INV. EDU. & ADVOCACY, *Investor Alert: Marijuana-Related Investments*, SEC. & EXCH. COMM’N (May 16, 2014), <https://www.sec.gov/resources-investors/investor-alerts-bulletins/ia-marijuana> [perma.cc/8QFZ-J2AW] (“If you are considering investing in a company that is connected to the marijuana industry, be aware that marijuana-related companies may be at risk of federal, and perhaps state, criminal prosecution.”).

242. See *infra* p. 155 and accompanying note 371.

243. See Broughman & Wansley, *supra* note 64 and accompanying text.

244. Cf. Letter from Kirsten Sutton, Exec. VP, Cong. Rels. & Leg. Affairs, Am. Bankers Ass’n, to Congress (May 2, 2023), <https://www.aba.com/-/media/documents/letters-to-congress-and-regulators/aba-letter-in-support-of-safe-banking-act-2023.pdf> [perma.cc/2874-3ZBM] (calling on Congress and regulators, on behalf of the American Bankers Association, to permit banks to service state-legal cannabis businesses).

245. Interview PYF.

246. See Fox Rothschild, LLP, *Opinion on Legal Status of Cannabis Companies Held by the AdvisorsShares Pure Cannabis ETF 9* (2019), [https://www.sec.gov/Archives/edgar/data/1408970/000161577419005745/s117396\\_ex99-q2.htm](https://www.sec.gov/Archives/edgar/data/1408970/000161577419005745/s117396_ex99-q2.htm) [perma.cc/YT4S-872S] (acknowledging the risk that investors in plant-touching cannabis companies might aid and abet criminal violations of the Controlled Substances Act).

gray area. Is [a power company] aiding and abetting if they allow companies to pay power bills? Is Microsoft for selling software?<sup>247</sup>

## 2. *Business-Infrastructure Hurdles*

No business is self-reliant. Each requires a myriad of products and services supplied by other firms. We refer to these essential business-to-business services as “business infrastructure.”<sup>248</sup> The simple point that every business must acquire products and services from third parties is meaningful to our study in that vice aversion is distributed throughout the commercial ecosystem. That is, business-infrastructure providers often avoid dealing with vice customers, thus inhibiting those startups’ commercial potential and prejudicing their evaluation by otherwise vice-indifferent or -preferring investors. A founder of an adult-content company articulated these hurdles as being “an enormous battle every day”:

**Q:** I read your interview with [a tech publication]. You faced a number of challenges. Can you discuss those challenges?

**A:** I had no idea that when I embarked on my journey that my tiny team would fight an enormous battle every day. Every piece of business infrastructure that gets taken for granted, we have to deal with. Our biggest issue is being considered “adult content.” I couldn’t get funded. I couldn’t get banked. One of the biggest challenges had to do with payments. PayPal would not work with us, [another payment processor] would not work. We have to work with adult-friendly payment processors which charge huge rates. The mainstream is 3% or less for transactions. We’re over 10%. Every service provider had it in their terms that they cannot work with adult content. It was a struggle to find email partners. MailChimp would not work with us. Every area has been and continues to be a huge challenge.<sup>249</sup>

To illustrate this effect, we consider two business-infrastructure hurdles—access to financial and digital services—that recurred through our interviews, that are salient for vice startups and their prospective investors, and that implicate capital formation and cost of capital.

### *a. Financial Services*

Every business needs to send, receive, and transfer money. For contemporary startups, that need implies two essential services: banking and payment

247. Interview DWF; *see also infra* Section III.B (suggesting that those who do make VC investments in vice startups, especially illicit ones, might eschew exercising their formal governance rights in part to avoid personal liability, such as aiding-and-abetting liability).

248. James Ainsworth & Matthew Laming, *Business Infrastructure: Best Practices*, BDO AUSTRALIA (Oct. 11, 2022), <https://www.bdo.com.au/en-au/insights/business-services/business-infrastructure-best-practices> [perma.cc/TS6V-ZBH2] (“Business infrastructure traditionally refers to physical assets, such as equipment, computers and plant, but it also includes the technology stack employed to support essential business functions . . .”).

249. Interview NFJ.

processing.<sup>250</sup> Being excluded from either could cast a pall over a startup's commercial prospects. For example, the inability of cannabis businesses—which remain federally illegal, despite legalization in some states—to obtain deposit accounts inhibits the mainstreaming of the industry.<sup>251</sup> Banks, after all, are highly regulated and would be expected to avoid knowingly providing services to criminal enterprises.<sup>252</sup> But banks also avoid lawful vice businesses, which they are permitted to freely service, including those in the adult and licensed gambling industries. Indeed, banks even sometimes target individual workers—such as those engaged in lawful sex work or performances in adult venues or on adult websites—for service denial.<sup>253</sup> A gambling entrepreneur, who enjoys the advantages of elite investor and academic networks, described vice's effect on obtaining banking and other business-infrastructure services as undermining those advantages:

**Q:** You have success now. What challenges have you faced in starting [your company] and do you know if those challenges relate to betting and gambling in particular?

**A:** The challenges specific to the gaming space are probably what you're more interested in. The first is that it's difficult to work with certain vendors. The whole startup industry—we just finished [a prestigious startup accelerator] and we're engaged with other resources through the [prestigious university] network. We're tapped into the scene. There are resources for banking and others, and a lot of these people are restricted from working with gaming clients. It makes it difficult to open a bank account, and there are other solutions that we are restricted from using.<sup>254</sup>

Beyond barriers to obtaining banking services, whether a vice business can process payments is an existential question.<sup>255</sup> In an economy in which commerce increasingly occurs via credit or debit transactions,<sup>256</sup> accepting card payments is

250. Cf. Bobby Allyn, *Silicon Valley Bank Failure Could Wipe Out 'A Whole Generation of Startups'*, NPR (Mar. 11, 2023, 2:00 AM), <https://www.npr.org/2023/03/11/1162805718/silicon-valley-bank-failure-startups> [perma.cc/3XWW-99Q8].

251. See Sutton, *supra* note 244; see also Heather Morton, *Banking and Cannabis: Yearning to Be Buds?*, NAT'L CONF. OF STATE LEGS. (Mar. 7, 2022), <https://www.ncsl.org/state-legislatures-news/detailed/banking-and-cannabis-yearning-to-be-buds> [perma.cc/2EFH-BMQQ] (“The risks [of banking with federally illegal cannabis companies] extend to companies working with cannabis businesses, including law and accounting firms, landlords, vendors, suppliers and employees. That means cannabis businesses must operate in cash—and the cost can be high.”).

252. See Julie Andersen Hill, *Cannabis Banking: What Marijuana Can Learn from Hemp*, 101 BOSTON UNIV. L. REV. 1043, 1043 (2021).

253. Tara Siegel Bernard, *Sex Workers Have Been Shunned by Banks, Even When Their Work Is Legal*, N.Y. TIMES (July 3, 2024), <https://www.nytimes.com/2023/11/18/business/sex-workers-bank-accounts.html> [perma.cc/JFS5-G7FY].

254. Interview EOJ.

255. See Patricia Nilsson & Alex Barker, *Inside the Secret, Often Bizarre World that Decides What Porn You See*, FIN. TIMES (June 23, 2022), <https://www.ft.com/content/cff23e36-b507-4717-8830-8b06741c8fd5> [perma.cc/7EFU-3RGL] (“[Visa and Mastercard] cut Pornhub off. The effect on [its parent company] was debilitating. The company's cash flow dried up. It broke the conditions of its loans, prompting a notice of default from its lenders. And the pressure kept building, as Visa considered making its temporary suspension permanent.”).

256. See *The Federal Reserve Payments Study: 2022 Triennial Initial Data Release*, BD. OF GOVERNORS OF FED. RSRV. SYS. (Nov. 13, 2024), <https://www.federalreserve.gov/paymentsy>

necessary for vice startups that sell directly to consumers.<sup>257</sup> Visa and Mastercard, as the world's two largest payment networks, provide those essential payment rails.<sup>258</sup> Given their power to exclude disfavored merchants, products, and services from their rails, they can control vice business with equal or greater force than public governments.<sup>259</sup> They do so by enforcing rules for banks and payment processors that prevent some vice merchants from accepting card payments or by imposing heightened restrictions on those granted network access.<sup>260</sup>

Mastercard, for example, prohibits any transaction that is “illegal, or . . . damage[s] the goodwill of [Mastercard] or reflect[s] negatively on [it].”<sup>261</sup> Although this standard is open-ended, Mastercard specifies that it includes any “product or service, including an image, which is patently offensive and lacks serious artistic value (such as . . . images of nonconsensual sexual behavior, sexual exploitation of a minor, nonconsensual mutilation of a person or body part, and bestiality), or any other material that [Mastercard] deems unacceptable to sell in connection with [its brand].”<sup>262</sup> For its part, Visa broadly prohibits “[e]ntering illegal or brand-damaging [t]ransaction activity into the Visa payment system,”<sup>263</sup> and it further identifies cigar stores and stands, dating and escort services, and gambling services as “high-integrity risk merchants” subject to heightened restrictions.<sup>264</sup> The kinds of businesses serviced by payment processors specializing in high-risk merchants—including cannabis, drug-paraphernalia, online-dating, and adult merchants—give

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stems/2023-April-The-Federal-Reserve-Payments-Study.htm [perma.cc/2PLR-DCBB] (reporting that debit- and credit-card transaction values increased 10% per year from 2018 to 2021 and were \$9.43 trillion in 2021); *see also* EMILY CUBIDES & SHAUN O'BRIEN, 2023 FINDINGS FROM THE DIARY OF CONSUMER PAYMENT CHOICE (2023), <https://www.frbsf.org/cash/wp-content/uploads/sites/7/2023-Findings-from-the-Diary-of-Consumer-Payment-Choice.pdf> [perma.cc/9TBP-K5QD] (documenting increased consumer preference for card transactions).

257. That is, vice companies that sell products or services directly to consumers need access to the Visa and Mastercard payment networks. Those that sell via retailers or other intermediaries might not need to process cards even if they do need banking services to receive customer payments via checks or bank transfers.

258. *See* Nilsson & Barker, *supra* note 255.

259. *Cf. id.* (“The biggest and third-biggest financial companies in the world now exercise more control over the global porn business than any government.”).

260. *See* Carliss Chatman, *Corporate Human Trafficking*, 102 TEX. L. REV. 1263, 1267 (2024) (explaining that Mastercard and Visa policies and actions can force vice merchants to reform business practices). Payment processors in the Visa and Mastercard networks are also businesses, and if they are startups themselves, their vice aversion might also stem from *their* financing. In a personal conversation with co-author Jennings, one startup attorney shared, “I briefly thought of this in the context of a former client that did payment processing. They signed a side letter saying ‘no more than X of the payment processing business will be used for tobacco, pornography, and other sin industries.’” (Dec. 12, 2023).

261. *Mastercard Rules*, MASTERCARD § 5.12.7 (Jan. 9, 2025), <https://www.mastercard.us/content/dam/public/mastercardcom/na/global-site/documents/mastercard-rules.pdf> [perma.cc/MXK6-DF6K].

262. *Id.* Although the four specific examples identified in the Mastercard rule are illegal (and, indeed, criminal), the prohibition on transactions involving images that are “patently offensive and lack[] serious artistic value” could, depending on subjective standards of “patently offensive” and “serious artistic value,” capture lawful adult content.

263. *Visa Core Rules and Visa Product and Service Rules*, VISA § 1.9.1.3 (Oct. 19, 2024), <https://usa.visa.com/content/dam/VCOM/download/about-visa/visa-rules-public.pdf> [perma.cc/9455-L96H].

264. *Id.* at § 10.4.6.1.

further shape to what kinds of businesses face stigmatic barriers to payment acceptance.<sup>265</sup>

Although Mastercard and Visa anti-vice rules express normativity in the form of brand-reputation concerns, they also reflect concerns around commercial, regulatory, and litigation risk associated with vice merchants. Online adult-content businesses, for instance, have high rates of disputed and fraudulent charges<sup>266</sup> and could expose network participants to regulatory and civil liability, making them risky for Visa and Mastercard, banks, and payment processors.<sup>267</sup> This risk is partly accounted for via higher processing fees. Whereas payment processors favored by startups (such as Stripe and Square) charge 2.9% of each transaction they process,<sup>268</sup> services like theirs reject merchants in the adult, gambling, and tobacco industries.<sup>269</sup> Payment processors that do service those industries, on the other hand, charge significantly higher per-transaction fees, such as 10.8% to 14.5% for adult businesses.<sup>270</sup>

These categorizations would tend to treat all firms within a vice industry the same, even if some do not feature the commercial, regulatory, or liability risks posed by other vice merchants. Echoing the self-differentiation among vice entrepreneurs we observed in Section II.C, one adult entrepreneur expressed frustration about being treated as a high-risk business when the company has unique features that (in the entrepreneur's view) render it non-risky from those commercial, regulatory, and liability perspectives:

We are a no-risk venture in a high-risk category, but nobody wants to hear us out, because we are considered adult content . . . . We have virtually zero chargebacks. Nobody is hiding anything on credit cards. [That and another risk mitigation] more than qualify us for mainstream business accounts, but nobody wants to listen because the processor says “no adult content.”<sup>271</sup>

#### *b. Digital Services*

For vice startups, especially those based online, the services they require for marketing and distribution are apt to be digital.<sup>272</sup> But like Visa and Mastercard—and perhaps for similar reasons around commercial, regulatory, and liability risk—

265. See *High Risk Processing*, MOBIUSPAY, <https://mobiuspay.com/services/high-risk-merchant-account-options.page> [perma.cc/335R-S3MB] (last visited Nov. 26, 2024); *Industries*, CCBILL, <https://ccbill.com/industries> [perma.cc/PEB3-2MCM] (last visited Nov. 26, 2024).

266. See *Managing Risk in the Adult Content Sector*, ASS'N OF PAYMENT PROS. (Oct. 21, 2021), <https://www.paymentpros.org/news/managing-risk-in-the-adult-content-sector> [perma.cc/R922-C8UA].

267. *Id.*

268. *Pricing Built for Businesses of All Sizes*, STRIPE, <https://stripe.com/pricing> [perma.cc/QMF8-BLXB] (last visited Apr. 3, 2025); *Understanding Square Payments Fees*, SQUARE, <https://squareup.com/us/en/payments/our-fees> [perma.cc/HE98-546Y] (last visited Apr. 3, 2025).

269. See, e.g., *Prohibited and Restricted Businesses*, STRIPE (Feb. 2025), <https://stripe.com/legal/restricted-businesses> [perma.cc/K9X9-Q8YS].

270. See, e.g., *Pricing*, CCBILL, <https://ccbill.com/pricing> [perma.cc/PC75-HBKG] (last visited Apr. 3, 2025).

271. Interview CGP.

272. See generally Samantha Sineni, *Growth Hacking: A Deep Look into Online Marketing for Startups* (Dec. 2014) (Master's thesis, University of Southern California) (on file with University of Southern California Digital Libraries).

digital services often refuse to deal with vice companies or otherwise impose heightened restrictions on them. Although the kinds of digital services that reject vice are legion, we focus on two—advertising and mobile-application distribution—for their salience to startup/VC interactions and their demonstration of how vice aversion shapes the real economy.<sup>273</sup>

Vice startups often sell directly to consumers.<sup>274</sup> That means that some of their ideal marketing channels include digital-advertising platforms, which allow for efficiently targeting those who match their desired customer profiles.<sup>275</sup> But such platforms tend to prohibit or impose significant restrictions on vice products and services. For example, Meta (the parent company of Facebook and Instagram) and Google together account for half of digital advertising in the United States.<sup>276</sup> Meta prohibits advertising for weapons or ammunition, tobacco or nicotine products, or adult products or content (including “nudity, depictions of people in explicit or suggestive positions, or activities that are overly suggestive or sexually provocative”).<sup>277</sup> Advertising for alcohol, gambling, and cryptocurrency are permitted, subject to strict rules.<sup>278</sup> Google imposes similar restrictions.<sup>279</sup> One sexual-wellness founder identified advertising bans as a non-normative business concern for prospective VC investors:

**Q:** Fundraising is a struggle for any startup, and you have extra barriers. Do you have a sense of where [your company] would be if those barriers didn’t exist?

**A:** The biggest barrier is the inability to advertise. You speak with VCs and they say, “How are you going to grow the business if you don’t have access to a majority of the advertisement platforms?”<sup>280</sup>

To be sure, some vice, or at least vice-adjacent, companies can obtain *some* digital-advertising services. Meta, for instance, permits advertisements for “sexual and reproductive health products or services, like contraception and family planning” as long as they are “targeted to people 18 years or older and [do] not focus on sexual pleasure.”<sup>281</sup> Whether a given product “focus[es] on sexual pleasure” is potentially debatable, and Meta has been criticized for uneven

273. *Cf. supra* Section II.E (explaining how vice aversions reinforce each other).

274. Some vice startups emerge to serve other vice businesses. However, recall the plant-touching/not-touching discussion in Section II.D.

275. Oran Yehiel, *How To Build A Robust Marketing Budget For A Startup Company*, STARTUP GEEK, <https://startupgeek.com/blog/marketing-budget> [perma.cc/7PBF-44KS] (last visited Apr. 16, 2024).

276. Sara Fischer, *Slow Fade for Google and Meta’s Ad Dominance*, AXIOS (Dec. 20, 2022), <https://www.axios.com/2022/12/20/google-meta-duopoly-online-advertising> [perma.cc/VHT9-8KYF].

277. *Introduction to the Advertising Standards*, META, <https://transparency.fb.com/policies/ad-standards> [perma.cc/5RAJ-5P23] (last visited Apr. 3, 2025).

278. *Id.*

279. *Cf. Google Ads Policies*, GOOGLE, <https://support.google.com/adspolicy/answer/6008942?sjid=3468596471409468377-NA> [perma.cc/4G2C-Z9LM] (last visited Apr. 3, 2025).

280. Interview CVW.

281. *Introduction to the Advertising Standards*, *supra* note 277.

application of this standard,<sup>282</sup> which tracks the experience of another sexual-wellness entrepreneur:

[W]e are unique in that we do have some ads that are banned and some places we're not allowed to advertise, but because we're not a pleasure product we are not banned everywhere. So we actually can advertise on Meta because we're not pleasure-based. But we do face ad reductions. We face just the inability to advertise on TikTok.<sup>283</sup>

For technology-centered startups, distribution often comes by offering mobile applications via proprietary “app stores,” such as the Apple App Store or Google Play Store.<sup>284</sup> Here, too, vice encounters barriers. The Apple App Store, which accounted for 62% of global mobile-application revenue in 2022,<sup>285</sup> rejects applications that feature sexual or pornographic material, that facilitate weapons or ammunition purchases, or that promote tobacco/vaping or excessive alcohol consumption.<sup>286</sup> It allows, however, applications that facilitate gambling and cannabis transactions, provided that they are licensed and geo-restricted to permitted locations.<sup>287</sup> Apple's leading competitor, the Google Play Store, accounted for the largest number of mobile-application downloads in 2022.<sup>288</sup> It prohibits applications that facilitate pornography or prostitution, cannabis (even if permitted locally), firearms and ammunition, tobacco (including e-cigarettes and vaping), or inappropriate alcohol use.<sup>289</sup> But it does allow gambling-related applications that meet government licensing requirements.<sup>290</sup>

A gambling founder who had the benefit of raising VC investment identified accessing app-store distribution or other business infrastructure as still being a meaningful hurdle:

It is difficult to get on the app store. We have good investors, and a legitimate company, but there were hurdles from payment processors, tech companies, and others. You need to navigate,

282. See Jackie Rotman, *Meta's Censorship of Health Ads for Women and People of Diverse Genders*, CTR. FOR INTIMACY JUST, <https://www.intimacyjustice.org/report> [perma.cc/LS5Y-LQPJ] (finding that Meta has allowed sexually suggestive men's health advertisements but that it frequently rejects women's sexual-health and -wellness products and services as “adult content”) (last visited Nov. 26, 2024).

283. Interview GNB.

284. See Sarah Perez, *App Economy Recovered in 2023, with \$171B in Consumer Spending, but Downloads Were Flat*, TECHCRUNCH (Jan. 10, 2024, 3:00 AM), <https://techcrunch.com/2024/01/10/app-economy-recovered-in-2023-with-171b-in-consumer-spending-but-downloads-were-flat> [perma.cc/7CWA-AVNT].

285. *Mobile Application Market Size, Share, & Trends Analysis Report By Store Type (Google Store, Apple Store, Others), By Application, By Region, And Segment Forecasts, 2023 - 2030*, GRAND VIEW RSCH., <https://www.grandviewresearch.com/industry-analysis/mobile-application-market> [perma.cc/EB8Y-H9JL] [hereinafter *Mobile Application Market Size*] (last visited Apr. 26, 2025).

286. *App Review Guidelines* §§ 1.1.3, 1.1.4, 1.4.3, 5.3.4, APPLE, <https://developer.apple.com/app-store/review/guidelines> [perma.cc/TXG2-22E7] (last visited Aug. 24, 2024).

287. *Id.* at §§ 1.4.3, 5.3.4.

288. See *Mobile Application Market Size*, *supra* note 285.

289. *Inappropriate Content*, GOOGLE, <https://support.google.com/googleplay/android-developer/answer/9878810> [perma.cc/3PNN-CPM6] (last visited Apr. 3, 2025).

290. *Real-Money Gambling, Games, and Contests*, GOOGLE, <https://support.google.com/googleplay/android-developer/answer/9877032> [perma.cc/H3NZ-CPFN] (last visited Apr. 3, 2025).

and you must do anything in your power to make hurdles more achievable.<sup>291</sup>

These points suggest a negative feedback loop between startups, investors, and the real economy. If a new brand cannot advertise through efficient channels, it is less likely to achieve business milestones that will attract the Series A capital that will allow it to scale. Even if it receives that funding, it would be unable to spend in vice-averse marketing channels, again hindering its ability to achieve scale.<sup>292</sup> Savvy prospective Series A investors will understand this point and thus will not invest, even if they and their LPs are vice-indifferent or -preferring. Just as prospective Series A investors might believe that lack of access to marketing channels will prevent the firm from scaling and thus decline to invest, savvy prospective seed investors understand that the same dynamic will prevent the firm from obtaining Series A funding. Absent the possibility of achieving future funding milestones, those seed investors will also decline to invest.<sup>293</sup> Said one respondent,

I've had a couple of investors pass, saying they're worried about vice clauses restricting our investment ability at the Series A stage. They don't want to invest to help our company grow exponentially, only to find out later that we're restricted from funding additional growth because only a few Series A firms are able to invest in us due to vice clauses.<sup>294</sup>

Similarly, if a business model requires a mobile application that will not be approved, then that business will not be started or will fail quickly.<sup>295</sup> That is, even if prospective investors are not vice averse themselves, vice aversion among business-infrastructure providers might render a business model infeasible and thus a startup non-investable.

Beyond de-motivating vice-indifferent or -preferring VCs, these hurdles could also directly implicate the cost of and returns on capital for vice businesses. For example, if payment processors available to vice businesses charge 10% per transaction, versus approximately 3% for non-vice businesses, the additional 7% would drag potential profit margins and thus total return for investors.<sup>296</sup> Savvy investors will understand this reality and require investment terms that compensate for reduced expected financial performance caused by the industry's higher transaction costs (compared to firms that do not bear those costs).<sup>297</sup>

### 3. Lack of Comparators

The venture-capital industry prides itself on contrariness and investing in teams that seek to build products that lack precedent but have the potential to spark

291. Interview BPB.

292. See Interview CVW, *supra* note 280 and accompanying text.

293. Cf. Email from Interview TXC to Authors (May 25, 2023, 2:33 PM) (on file with authors).

294. *Id.*

295. Cf. Scott Kapor, *On Startups, Platforms, and Innovation*, ANDREESSEN HOROWITZ (Mar. 11, 2019), <https://a16z.com/on-startups-platforms-and-innovation> [perma.cc/XC6Z-L975] (“[T]here are no doubt times where too much platform risk can create problems for companies; that is, where complete dependency on these third-party platforms can impact a business.”).

296. Interview BQR.

297. Gompers et al., *supra* note 238, at 190 (“Like the private equity investors, the VCs rely on multiples of invested capital and internal rates of return.”).

new industries and reshape economic and social life.<sup>298</sup> Despite that aspiration, many of the over four-thousand U.S.-based VC firms tend toward trends.<sup>299</sup> That is, VC investors tend to select startups that have direct comparators in terms of business model, product and services markets, funding, and exits via IPO or acquisition.<sup>300</sup> Doing so allows an investor to confirm that the startup's plans are feasible, that there is a market for its products or services and, ideally, that its offering will be superior to those of incumbents or it has some other competitive advantage.<sup>301</sup> More, the presence of comparators guides the setting of financial terms, such as at what pre- and post-money valuation an investment will be made.<sup>302</sup>

In the case of vice, this preference for comparators can erect a non-normative barrier to funding: If investors require comparators—either comparable funded startups or, even more importantly, successful exits of similar startups—then the dearth of such companies due to earlier non-funding reinforces itself.<sup>303</sup> As one adult-content entrepreneur explained:

**Q:** Can you talk about how you advance the business, and what were your initial plans and hurdles in the financing arena?

**A:** The issues we encountered were largely related to benchmarking; figuring out what success looks like in a business like ours is challenging. There aren't precursors to say what is good and who is doing well. What frequency are people engaging with our content? What's the retention rate?<sup>304</sup>

Another entrepreneur in the sexual-wellness space shared a similar experience:

**Q:** Could you talk about the fundraising process for [your company]?

**A:** When it comes to [my company], the biggest challenges are that . . . there's not a clear winner and success in VCs in sexual wellness. They don't know how to pattern that, or what would make a successful business. That's the biggest hurdle to getting investments.<sup>305</sup>

We note that the only founder interviewees who cited lack of comparators as a funding barrier were in the adult space, which is consistent with the fact that in the 2014 to 2023 PitchBook sample, all vice categories *other than* adult had both exits

298. Chelsea Vail, *Peter Thiel on Entrepreneurship: Three Contrarian Ideas for Going from 'Zero to One'*, CHI. BOOTH REV. (Oct. 15, 2014), <https://www.chicagobooth.edu/review/peter-thiel-on-entrepreneurship-three-contrarian-ideas-for-going-from-zero-to-one> [perma.cc/JCF9-LW65].

299. NAT'L VENTURE CAP. ASS'N, 2023 YEARBOOK 46 (2023), [https://nvca.org/wp-content/uploads/2023/03/NVCA-2023-Yearbook\\_FINALFINAL.pdf](https://nvca.org/wp-content/uploads/2023/03/NVCA-2023-Yearbook_FINALFINAL.pdf) [perma.cc/LN2D-VQ7K] (reporting 4,602 active VC firms in the United States, with a combined 11,133 funds, as of the end of 2022).

300. Cf. Scott Kupor, *When Is a "Mark" Not a Mark? When It's a Venture Capital Mark*, ANDREESSEN HOROWITZ (Sept. 1, 2016), <https://a16z.com/when-is-a-mark-not-a-mark-when-its-a-venture-capital-mark> [perma.cc/CFH7-W9F8].

301. Cf. *id.*

302. Cf. Gompers et al., *supra* note 238, at 181 (describing survey results in which VC investors' most important considerations around startup valuations are "exit considerations" and "[c]omparable company valuations").

303. *Id.*

304. Interview PFP.

305. Interview KLL.

by acquisition and IPO.<sup>306</sup> As we observe in Section III.C, some startups focused on women's health (FemTech)—including medical device manufacturers—face vice-like stigma despite their products being tangential to sexual pleasure.<sup>307</sup> These firms also experience lack of funding and exit opportunities due to missing comparators. It is possible, however, that barriers affecting non-pleasure FemTech startups might prove more permeable. That is because although they face stigma, it is not based on a moral or ethical objection to women's *health*. If so, FemTech might be expected to eventually overcome the self-reinforcing dynamic that missing comparators creates for vice capital. As one FemTech founder observed, optimistically:

**Q:** [A chicken-or-the-egg question about exit opportunities in women's health.]

**A:** It's hard to tell because there hasn't been a lot to happen. It's a weird situation because there's not that track record. I think it'll come. Then we'll start to come, and we'll start to see more growth. I think there's an equal conversation on the other side of the table. Who are the companies that are actually actively looking and seeking out women's health as a strategy?

#### *B. Vice Distorts Startup Governance and Finance*

We interviewed an investment banker who has built a specialty in advising vice and other stigmatized businesses on fundraising.<sup>308</sup> The banker advises clients that whatever cost of capital might be appropriate in light of their business fundamentals and macro market conditions, they should expect to pay an extra “1,000 basis points”—10%—per year for capital as compensation to investors for the reputational and related risks they accept when investing in vice.<sup>309</sup> With that heuristic 10% vice premium in the background, we consider in this section how vice distorts startup governance and finance.

Startup governance and capital structure intersect. Capital structure—who holds debt and equity interests, in what proportions, and with what preferences and rights—shapes a startup's governance.<sup>310</sup> In turn, governance shapes capital structure.<sup>311</sup> That is, investors will require positive and negative governance rights in return for their cash.<sup>312</sup> The rights they will seek, and will receive, will vary on a number of factors, including whether the market for startup capital is more

306. See *infra* Appendix, Table 4.

307. See *infra* Section III.C.

308. Interview GBX.

309. *Id.*

310. See Darian M. Ibrahim, *The (Not So) Puzzling Behavior of Angel Investors*, 61 VAND. L. REV. 1405, 1408 (2008) (theorizing that angel investors require only simple contracts to avoid conflicts with later VC investors).

311. See, e.g., *id.*; see also Pollman, *supra* note 58, at 170–76; Broughman & Wansley, *supra* note 64, at 1304.

312. See Gompers et al., *supra* note 238, at 183 (“The least negotiable provisions for VC firms in descending order are prorata [sic] rights, liquidation preference, anti-dilution protection, valuation, board control, and vesting. The provisions on which VCs are most flexible (again, in descending order, the first being most flexible) are dividends, redemption rights, option pool, investment amount, and participation.”).

competitive for startups seeking investment or investors seeking startups;<sup>313</sup> the relative size of the investment in comparison to the size and lifecycle stage of the startup;<sup>314</sup> and other factors, like the idiosyncratic preferences of investors or entrepreneurs. Governance arrangements from one round of investment will, in turn, influence the company's access to and decision-making around further investment rounds,<sup>315</sup> going public or staying private,<sup>316</sup> and sharing equity with employees.<sup>317</sup> Several problems tend to emerge from this intersection, including conflicts between investors and founders or investors and other investors;<sup>318</sup> opportunity costs imposed by the strings attached to investment;<sup>319</sup> and other implicit costs of capital.<sup>320</sup> Vice accentuates these effects. In this section, we use three founders as case studies for the vice effect in startup governance and finance. We close with a note on vice investors' time horizons.

### 1. Vice, Corporate Governance, and Agency Costs

In the first example, a cannabis entrepreneur was actually successful in securing tens of millions of dollars in venture capital.<sup>321</sup> Although the VC firms that invested those millions have contractual rights to designate directors to the company's board, they have chosen not to do so.<sup>322</sup> Designating directors, or at least board observers, has traditionally been a substantive governance right negotiated by VC funds to protect their interests, although this practice has waned in recent years.<sup>323</sup> In this case, the investors declined to exercise their designation rights out of regulatory concerns. Given that cannabis remains federally criminalized, they preferred to maintain distance from its activities and decision-making.<sup>324</sup> “We haven't had board meetings . . . due to cannabis being illegal. They put in \$[##]

313. Marina Temkin, *OpenAI Tumult, FTX Blowup Help Bring VC Governance Back in Vogue*, PITCHBOOK (Nov. 30, 2023), <https://pitchbook.com/news/articles/VC-investors-startup-board-seats-FTX-OpenAI-governance> [perma.cc/BXA7-NUVS] (“[In the late 2010s/early 2020s many investors, driven by fear of missing out during the last boom cycle, relaxed various aspects of investment criteria, from the thoroughness of their due diligence to governance, even relinquishing certain information rights, including access to detailed financials and business plans.”).

314. Michael Ewens & Nadya Malenko, *Board Dynamics Over the Startup Life Cycle* (Nat'l Bureau of Econ. Rsch., Working Paper No. 27769, 2024), [https://www.nber.org/system/files/working\\_papers/w27769/w27769.pdf](https://www.nber.org/system/files/working_papers/w27769/w27769.pdf) [perma.cc/59AK-B3]N].

315. See, e.g., Ibrahim, *supra* note 310, at 1430.

316. See generally Roberto Ragozzino & Dane P. Blevins, *Venture-Backed Firms: How Does Venture Capital Involvement Affect Their Likelihood of Going Public or Being Acquired?*, 40 ENTREPRENEURSHIP THEORY & PRAC. 991 (2016).

317. See Gompers et al., *supra* note 238, at 183.

318. See Pollman, *supra* note 58, at 179–96 (theorizing internal interest conflicts between startup participants).

319. See Guillaume Andrieu & Alexander Peter Groh, *Specialist Versus Generalist Investors: Trading Off Support Quality, Investment Horizon and Control Rights*, 101 EUR. ECON. REV. 459, 464 (2018).

320. See, e.g., *supra* Section II.A (discussing the potential cost-of-capital effects of higher payment-processing fees for vice businesses).

321. Interview MQU.

322. See *infra* note 325 and accompanying text.

323. See Temkin, *supra* note 313 (noting that by 2021, only about 50% of VC investors took board seats). Reasons for this decline include increased market power on the part of founders of highly sought-after companies and diseconomies of scale; that is, as VC funds invest in larger numbers of startups, their partners have less per-investment capacity to attend to corporate governance. *Id.*

324. Interview MQU.

million. You don't do that to not have a single vote, unless there's way more investment or someone else on the board."<sup>325</sup>

Although the company's investors do not exercise formal governance rights, they do engage through informal consultation with the founder.<sup>326</sup> This informal consultation, however, does not fully substitute for board-level governance.<sup>327</sup> The founder, for example, worries about the risk of his engaging in conflicted transactions or taking other actions without a board to monitor, approve, or cleanse those conflicts or actions.<sup>328</sup> His conscientiousness about, and fear of litigation stemming from, such potential agency costs suggests that he will avoid imposing them on investors. Perhaps the same cannot be said, however, for less conscientious founder-executives,<sup>329</sup> and so this anecdote points to potential risks of vice-indifferent or -preferring investors eschewing participation in governance. Indeed, given that such firms operate in environments of commercial hostility and regulatory uncertainty, formal engagement by professional investors might be especially valuable in mitigating risk and overcoming operational barriers.<sup>330</sup> In other words, vice-motivated governance avoidance by investors could contribute to comparatively poorer firm governance and thus comparatively less attractive markets for vice-startup capital.<sup>331</sup> If true, and all else being equal, those effects would suggest higher costs of capital for vice startups due to investors requiring terms that compensate for less favorable governance.<sup>332</sup>

## 2. *The Opportunity Costs of Vice Capital*

The second example is the founder of a company that produces products that some would consider edgy, others offensive. The founder reported losing term sheets for a substantial fundraising round after ill-timed public controversy involving the company's products.<sup>333</sup> After losing those potential investors, the founder sourced new investment via a family office that was unconcerned with, and

325. *Id.*

326. *Id.*; see also Jennifer S. Fan, *The Landscape of Startup Corporate Governance in the Founder-Friendly Era*, 18 N.Y.U. J.L. & BUS. 317 (2022) (presenting findings from an interview-based study that startup governance often occurs informally).

327. After all, the "business and affairs of every corporation . . . shall be managed by or under the direction of a board of directors." See DEL. CODE ANN. tit. 8, § 141(a) (2020); see also STEPHEN BAINBRIDGE, *THE NEW CORPORATE GOVERNANCE IN THEORY AND PRACTICE* 80 (2008) (making the case for director primacy in corporate governance).

328. See, e.g., Del. CODE ANN. tit. 8, § 122(17) (2024) (waivers of corporate opportunity); Kahn v. M&F Worldwide Corp., 88 A.3d 635 (Del. 2014) (controlling-shareholder conflicts in take-private mergers); United Food & Comm. Workers Union v. Zuckerberg, 262 A.3d 1034 (Del. 2021) (derivative-litigation demand futility).

329. See Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, 3 J. FIN. ECON. 305, 317 (1976).

330. See Morton Sorensen, *How Smart Is Smart Money? A Two-Sided Matching Model of Venture Capital*, 62 J. FIN. 2725, 2725 (2007) (finding that startups with "experienced investors are more likely to go public" due to those investors' superior pre-investment abilities to select high-quality startups and their post-investment contributions to those firms).

331. Cf. Thomas Hellmann & Maju Puri, *Venture Capital and the Professionalization of Start-Up Firms: Empirical Evidence*, 57 J. FIN. 169, 194 (2002) (finding that VC investors' participation in a startup's governance could be associated with improvements to governance).

332. See Fan, *supra* note 326, at 331.

333. Interview JDW.

even embraced, the controversy.<sup>334</sup> In hindsight, the founder expressed relief about losing the earlier potential investors because their reaction to public controversy showed that once they designated directors or obtained other governance rights, they would have constrained the company's business activities due to their own normative objections.<sup>335</sup>

**Q:** Those deals that came close, but ended due to concerns, if some of those were signed and investors were part of your life today what would have changed? What would [your company] look like today?

**A:** . . . There were scenarios where we could have taken money from investors and there would be tons of stuff we can and can't do. . . . Had we had religious investors, a good chunk of our current materials would be off the table. Essentially, our ability to create work would be throttled. All of our energy would be pushed to us being more commercial. It would kill our magic and go poorly for the business.<sup>336</sup>

Forward-going restrictions on business activity imposed by outside investors could serve to reduce agency costs by forcing startups to act in accord with investor expectations.<sup>337</sup> In practice, however, savvy investors understand that a startup might prudently pivot from one business to another.<sup>338</sup> To the extent that investors limit a startup's flexibility, their investment imposes opportunity cost: Accepting cash for current needs and goals means also accepting constraints on future business decisions.<sup>339</sup> Although a startup might have one business model when accepting an investment round, management might deem another model or an evolution in product and service offerings necessary to achieve key objectives, like higher revenues or profit margins.<sup>340</sup> This point is a general one, but in practice investor-

334. *Id.*

335. *Id.*

336. *Id.*

337. Paul A. Gompers, *Optimal Investment, Monitoring, and the Staging of Venture Capital*, 50 J. FIN. 1461, 1486 (1995) ("Venture capitalists monitor entrepreneurs with increasing frequency as expected agency costs rise."); see also Steven N. Kaplan & Per Strömberg, *Financial Contracting Theory Meets the Real World: An Empirical Analysis of Venture Capital Contracts*, 70 REV. ECON. STUD. 281, 282 (2003) (summarizing shifting control rights between startup investors and entrepreneurs).

338. *But see* Daniel McGinn, *Too Many Pivots, Too Little Passion*, HARV. BUS. REV. (Sept. 2012), <https://hbr.org/2012/09/too-many-pivots-too-little-passion> [perma.cc/F4ZJ-NHLU] ("For [startup founders who lack advantages in the VC world], finding the right balance between passion, patience, and a practical respect for market feedback is probably a more realistic formula for start-up success.").

339. One founder, for example, reported receiving investment terms that would prospectively prohibit the company from manufacturing "pornography, stem cells, or weapons of mass destruction." Interview XAX. Although the founder had no interest in manufacturing stem cells or weapons of mass destruction, he noted that the company might in the future make what could be considered pornography. Although this restriction was mentioned in the original interview, the fact that the respondent had an interest in engaging in one of the to-be-prohibited activities, pornography, was shared in a subsequent in-person conversation with co-author Jennings (July 18, 2023).

340. *Cf.* Steven N. Kaplan & Per Strömberg, *Contracts, and Actions: Evidence from Venture Capitalist Analyses*, 59 J. FIN. 2177, 2178 (2004) ("[T]here will be circumstances when the VC disagrees with the entrepreneur and the VC will want the right to make decisions. Control theories . . . show that a solution to this problem is to give control to the VC in some states and to the entrepreneur in others.").

imposed restrictions would be more likely to restrict pivots to vice activity than pivots to non-vice.<sup>341</sup>

Such a pivot could include shifting from a less objectionable vice model (such as providing ancillary services to the cannabis industry) to a more objectionable one (like moving directly into a plant-touching business).<sup>342</sup> It might also represent a radical and unplanned transition from non-vice to vice. A video-hosting company, for instance, might discover that it has a quickly growing adult-content customer base that is quite lucrative, whereas its non-adult customers contribute less to its revenue, growth, or profit margins.<sup>343</sup> It thus might seek to shift toward specializing in the more lucrative adult-content business. Without regard to normative considerations, that specialty would seem the better *business*. But existing VC investors—aware of the potential for a video-hosting company to be used for adult content—might have embedded restrictions against entering into the adult-content business in their agreements with the startup. Or they might later exercise a veto over such a decision, perhaps motivated by contractual or extracontractual obligations to their LPs.<sup>344</sup>

In any case, existing investors might have negative rights over those changes in business model or product or service offerings. If exercised, those rights could force the startup (and all its shareholders, including those that did not object to or supported the pivot) to accept smaller returns in the form of a non-vice business's lower revenues, slower growth rate, or slimmer margins.<sup>345</sup> This effect is distinct from, for instance, investors opposing a pivot as financially, operationally, or conceptually imprudent. Rather, because a vice-averse decision would not be grounded in purely *business* considerations, it would implicitly and retrospectively increase the company's cost of capital.<sup>346</sup> As a consequence, when a startup accepts normatively rigid capital, doing so could meet present needs but limit long-term potential.

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341. For an explanation why VC investors are more apt to reject pivots to vice than to non-vice, *see generally* Section II.

342. *Cf.* Interview IRQ, *supra* note 215 (“[O]ur family-office investor made the first investment in us. They were comfortable with us as an ancillary company . . . but we could not take any interest in any plant-touching companies. That proved to be maybe not the best decision for us.”).

343. Or, a startup payment processor restricted in the volume of payments it can process for adult-content merchants might find that that category is more lucrative than other merchants and wish to exceed its investors' volume restrictions. *See* Chatman, *supra* note 260, at 1267.

344. *See supra* Section II.B for a discussion of contractual and extracontractual investment restrictions in the GP/LP relationship.

345. *Cf.* Patricia Nilsson, *OnlyFans Reverses Contentious Porn Ban*, FIN. TIMES (Aug. 25, 2021), <https://www.ft.com/content/5468f11b-cb98-4f72-8fb2-63b9623b7b2b> [perma.cc/6ABF-Q6QE] (reporting that a company known for its adult content “has tried to attract more mainstream influencers and brands, but it has faced scepticism over whether it could pivot to non-porn creators while maintaining its growth rate”); Paige Leskin, *A Year After Tumblr's Porn Ban, Some Users Are Still Struggling to Rebuild Their Communities and Sense of Belonging*, BUS. INSIDER (Dec. 20, 2019), <https://www.businessinsider.com/tumblr-porn-ban-nsfw-flagged-reactions-fandom-art-erotica-communities-2019-8> [perma.cc/5NXT-BGB3] (reporting that after Tumblr—a blogging startup acquired by Yahoo! for \$1.1 billion—banned adult content, its traffic “dropped drastically” and it was later re-sold for only \$3 million).

346. *See* Interview BPO, *supra* note 213 (reporting on a non-touching cannabis startup that wished to move to a plant-touching model to achieve target profits margins, which required approval from VC funds and, in some cases, those funds' LPs).

### 3. The Search Costs of Vice Capital

The third example is the founder of an adult-content company. When asked about her fundraising, she reported obtaining several million dollars across multiple rounds from a single angel investor, but that she has been unable to find other investors over the years.<sup>347</sup> This lack of success comes, she says, despite VC-firm partners acknowledging to her that her business is an attractive opportunity that their partners and LPs would simply not accept.<sup>348</sup> Instead, she says, to obtain more capital to grow the business, she must cast a wide net to elicit inbound interest from investors who match her sex-positive outlook.<sup>349</sup>

**Q:** Could you talk to us a bit about your financing and expectations prior to embarking on this endeavor, and how the financing actually went?

**A:** I realized early that it was not a VC-friendly business. I haven't even tried to go that route.<sup>350</sup> I know my investors are out there. There are tons in every country, but they are impossible to find by conventional means. Your willingness to fund [an adult-content company] is part of your sexual journey. It is shaped by your own experiences, and I have no way to search and target for that, because sex is one area where you cannot tell what someone is thinking from the outside. My challenge has been to put what I am doing out there all the time. I promote it across [omitted publicity channels]. I have to rely on making those connections.<sup>351</sup>

This experience suggests that obtaining vice capital might entail comparatively higher search costs.<sup>352</sup> For a non-vice startup, it is well known, or at least knowable, which VC firms might be a match.<sup>353</sup> As a result, startups can target those firms and perhaps make several matches.<sup>354</sup> More, the matching process between startups

347. Interview XFF.

348. *Id.*

349. *Id.*

350. As we noted in the text accompanying note 349, this founder received feedback from VCs who expressed that their partners and LPs would not accept their investing in her business. The founder's background is consistent with her having these conversations with people in her social and professional circles, which would explain both her business being rejected by institutional VC investors and her early determination that her business is not VC-fundable and that she would thus not pursue that route.

351. *Id.*

352. See Sabrina T. Howell, *Reducing Information Frictions in Venture Capital: The Role of New Venture Competitions*, 136 J. FIN. ECON. 676, 694 (2020) ("In the presence of asymmetric information and search costs, it is difficult for VCs to identify the most promising early stage startups. As the barriers to entry have fallen, especially for Internet- and software-based ventures, new intermediaries are screening and offering support to very early stage startups.").

353. One vice respondent who previously had a startup in a non-vice industry noted "I did get a list of fifty [VCs that invest in my former industry] and can easily contact them." Interview CRQ.

354. Liran Belenzon, *How to Get Multiple Term Sheets for Your Next Funding Round in Three Weeks*, MEDIUM (Aug. 6, 2020), <https://liranbelenzon.medium.com/how-to-get-multiple-term-sheets-for-your-next-funding-round-in-three-weeks-fc399075b0e4> [perma.cc/XNM5-N8LZ] ("The first step . . . is to identify your targets. I learned that the ratio of meetings to term sheets is 10:1, according to companies in our investors' portfolios who raised their A round by following this process.").

and VCs can be done on a one-to-one basis that offers strategic concealment around the fact that the startup is fundraising.<sup>355</sup>

But for vice startups, identifying the investors who have the freedom and proclivity to match with them is more challenging. Although the adult-content entrepreneur expects to have no traction with traditional VCs, her publicity efforts serve to alert family offices and angel investors who are in normative alignment to proactively contact her.<sup>356</sup> That broadcast approach does not come without cost. A vice startup that must cast publicly for capital does so without the benefit of strategic concealment that other startups use to avoid revealing information to competitors or otherwise sending unwanted signals to the market.<sup>357</sup> If a vice startup lacks efficient and private channels to identify prospective investors, then any such stealth advantages are forgone.

This broadcast approach would also tend to lack the temporal alignment offered by the prototypical pilgrimage to Sand Hill Road, whereby founders visit multiple VC firms in seriatim.<sup>358</sup> Meeting with multiple VC firms in roughly the same time period could produce multiple investment offers, allowing the entrepreneur to negotiate or choose between competing offers' valuation and governance rights (which would directly bear on the cost of the capital raised)<sup>359</sup> or other considerations (like the non-financial benefits, such as industry expertise or

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355. Whether and when a startup is fundraising can, in context, serve as a positive or negative signal that its management would prefer to control. On a positive note, fundraising can signal that the company is reaching meaningful commercial milestones or has grand ambitions. On a negative note, it can signal that the company *needs* money, perhaps because it has failed to meet commercial milestones or has been spending imprudently. Even more negative, if it fails to fundraise, or fundraises on undesirable terms, that outcome would signal sophisticated investors' unfavorable views of the company or its prospects.

356. Interview XFF, *supra* note 347.

357. More, express public solicitation of investment has traditionally been taboo in startup financing given the former general-solicitation prohibition in Regulation D, a securities-law safe harbor relied on by startups to raise capital. Although amendments to Regulation D abolished that general-solicitation prohibition in some circumstances, public solicitation continues to be viewed as a negative signal of investment quality. *See* Eliminating the Prohibition Against General Solicitation and General Advertising in Rule 506 and Rule 144A Offerings, Sec. & Exch. Comm'n, 78 Fed. Reg. 44771 (July 24, 2013) (permitting general solicitation in some circumstances). That negative signal assumes that high-quality startups will have existing relationships with sophisticated investors, like institutional VC firms, or receive introductions to them through trusted intermediaries. *See* Anup Agrawal & Yuree Lim, Does General Solicitation Improve Access to Capital for Small Businesses? Evidence from the JOBS Act (Oct. 2021), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=3602183](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3602183) [perma.cc/CN8N-PCR3]. Given this market dynamic, and given that such institutional VC firms are likely to be vice-averse, the normative stigma borne by vice startups can further stigmatize (perhaps erroneously) their *business* quality.

358. *See* John B. Thompson, *The Pilgrimage to Sand Hill Road: Venture Capital Investment in Publishing-Related Tech Start-ups*, 9 MEDIA INDUS. 75, 79 (2022) (“[A]ll of the entrepreneurs . . . knew that, at one stage or another, they would have to make the trek to Menlo Park and pitch their ideas to one or more of the VC firms on Sand Hill Road.”).

359. David H. Hsu, *What Do Entrepreneurs Pay for Venture Capital Affiliation?*, 59 J. FIN. 1805, 1807 (2004) (finding that high-reputation VC firms that provide “extra-financial” benefits acquire startup equity at a 10-14% discount); *see also* Interview LPV (observing that high-quality founders will have their choice of VC firms and for him, it is important to match with funders who will not inhibit his business decisions, especially in light of their potential normative objectionability); Interview KTF (reporting that a cannabis company had investment offers from multiple VC firms and chose an offer that carried a lower valuation but that included preferable governance terms and promised a better interpersonal relationship with the VC firm's personnel).

relationships with prospective customers, a given VC firm might provide).<sup>360</sup> By implication, capital sourced from family offices and other non-VC investors via a broadcast approach might be costlier given that, as a matter of temporal misalignment, competing offers are less likely in those scenarios.<sup>361</sup>

These problems could be mitigated by the presence of vice-specializing VC firms. That is, if there were an alternative market for vice capital that was meaningfully equivalent to the non-vice VC market (including being able to provide adequate capital in line with consumer demand for vice products and services), then vice startups would be on even footing with their non-vice comparators. For example, a gambling-related startup could seek investment from a list of VC firms that are normatively aligned with investing in that industry; or a spirits entrepreneur could pitch to beverages-focused VC firms. In those cases, the vice startup's search costs would be reduced by targeting vice specialists, versus broadcasting or seeking investment from generalist VC firms in hope that one will overcome the industry's vice aversion.<sup>362</sup> This possibility is not borne out, however. Although such vice-specializing VC firms exist, they typically do not compare to generalist VC firms in terms of their fund sizes<sup>363</sup> or investment horizons.<sup>364</sup> Given that vice specialists likely do not provide an equivalent alternative market for vice capital, this problem for vice startups persists.

#### 4. *The Investment Horizon of Vice Capital*

A vice startup's potential returns might also be diminished if it is limited to raising money from investors with short-term horizons. A prestigious, but vice-averse, VC firm would seek to invest in companies that it expects could grow until they achieve exits that are materially accretive to its fund.<sup>365</sup> This model assumes that many investments will fail—that is, they will ultimately return less capital to investors than they invested—but that a few will achieve very substantial returns.<sup>366</sup> In that sense, it is inefficient and inconsistent with a standard VC investment strategy for funds to select for startups that they hope to be moderate successes in the short to mid-terms. Instead, they offer relatively patient capital—and in recent years, increasingly so<sup>367</sup>—in hope of an exit that delivers outsized long-term returns.<sup>368</sup>

360. See Hsu, *supra* note 359, at 1809.

361. This point follows the same demand-and-supply mechanism that could partly explain the “vice premium” for publicly traded sin stocks. See *supra* Section I.A.

362. One partner in a cannabis-focused VC firm suggested that specializing reduces the *fund's* fundraising search costs because its specialization attracts inbound interest from vice-preferring LPs. Interview NSR. Although institutional investors largely eschew his fund due to cannabis aversion, as with direct investments in vice startups, high-net-worth individuals and family offices might not share those aversions. *Id.* At the same time, he conceded, specialization in vice does limit the firm's investment strategy and growth potential. *Id.*

363. See *supra* note 29 and accompanying text.

364. See *supra* Section III.B.4.

365. See Pollman, *supra* note 71 and accompanying text.

366. See Dixon, *supra* note 72 and accompanying text.

367. See George S. Georgiev, *The Breakdown of the Public–Private Divide in Securities Law: Causes, Consequences, and Reforms*, 18 N.Y.U. J.L. & BUS. 221, 291 (2021).

368. Robyn Klingler-Vidra, *When Venture Capital is Patient Capital: Seed Funding as a Source of Patient Capital for High-Growth Companies*, 14 SOCIO-ECON. REV. 691, 704 (2016) (identifying “VC

In contrast, one respondent noted that the vice-specializing VC funds that invest in his industry “emphasize short-term returns,”<sup>369</sup> whereas “the Silicon Valley-type VCs were willing to wait longer.”<sup>370</sup> Such short-term investor horizons could force a startup to focus early on profitability. It would, in turn, need to forgo risky or costly efforts at scaling its business that, if successful, would have a large payoff.<sup>371</sup> That is, short-term-motivated capital can be costly because it limits a startup’s potential growth and thus its potential returns. For example, an adult-content platform that invests early in measures to prevent nonconsensual, child-exploitative, or otherwise illegal content would expect better long-term returns by avoiding litigation and regulatory risk. Not making those investments, however, would save money *today* and thus boost short-term profits.<sup>372</sup>

To the extent that the economic structure of a vice market ensures that only competitors that reach scale will survive, short-term horizons could be fatal.<sup>373</sup> Our 2014 to 2023 PitchBook sample supports the notion that vice investors have comparatively shorter investment horizons, which reduces the chances for vice startups to mature and increases their competitive need to be acquired. In the sample, only 0.72% of vice startups achieved an IPO and 9.3% were acquired.<sup>374</sup> For all startups, 0.96% achieved an IPO and only 5.2% were acquired.<sup>375</sup> Given that the timeframes for both samples were the same, the acquisition percentages in particular (higher for vice startups, lower for all startups) would be consistent with the all-startup cohort being allowed a longer horizon to mature before exit. Alternatively, the comparative acquisition rates would be consistent with vice startups needing to be acquired to survive.

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seed capital as having a long intended investment horizon and venture capitalists as engaged for the purpose of driving long-term value creation rather than short-term profits”).

369. Interview POB. This possibility is distinct from the functionally similar problem of vice startups that secure early-stage capital but for whom the larger, later-stage financing rounds relied upon by “unicorns” to scale and mature are not available. See Anat Alon-Beck, *Alternative Venture Capital: The New Unicorn Investors*, 88 TENN. L. REV. 983, 1003 (2020); see also Interview HSK (explaining that for the cannabis industry, although seed and Series A capital are available, there is a gap around later-stage funding that undermines the ability of cannabis startups to mature).

370. Interview HSK, *supra* note 369.

371. Cf. SAMUEL M. HARTZMARK & KELLY SHUE, COUNTERPRODUCTIVE SUSTAINABLE INVESTING: THE IMPACT ELASTICITY OF BROWN AND GREEN FIRMS 4–5 (2023), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=4359282](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=4359282) [perma.cc/T74P-NAEU] (“Financial distress or an increase in the cost of capital will make short-term cash flows more attractive relative to long-run cash flows. Intuitively, an increase in the cost of capital is equivalent to a higher discount rate for the future.”).

372. See Press Release, U.S. Attorney’s Office, Eastern District of New York, Pornhub Parent Company Admits to Receiving Proceeds of Sex Trafficking and Agrees to Three-Year Monitor (Dec. 21, 2023), <https://www.justice.gov/usao-edny/pr/pornhub-parent-company-admits-receiving-proceeds-sex-trafficking-and-agrees-three-year> [perma.cc/845L-WHXW] (announcing a \$1.84 billion settlement and the filing of criminal charges against “the parent company of Pornhub.com . . . for its role in hosting videos and accepting payments from criminal actors who coerced young women into engaging in sexual acts on videos that were posted without their consent”).

373. Cf. Lina. M. Khan, *Amazon’s Antitrust Paradox*, 126 YALE L.J. 710, 785 (2017) (“[O]ne of the most relevant factors of online platform markets is that they are winner-take-all. This is due largely to network effects and control over data, both of which mean that early advantages become self-reinforcing.”).

374. See *infra* Appendix, Table 3.

375. *Id.*

### C. *Vice Aversion Differs for Minoritized Founders, Investors, and Customers*

The VC industry has been subject to criticism in recent years over the underrepresentation of women, people of color, and other minoritized<sup>376</sup> people among founders of funded U.S. startups.<sup>377</sup> This underrepresentation has been much discussed in the popular press<sup>378</sup> and academic literature.<sup>379</sup> Although it was not the initial focus of our study, minoritized status recurred throughout our interviews, and we offer a preliminary analysis regarding distinctions in vice aversion in the context of minoritized founders, investors, and consumers.

Gender was our study's most deeply explored identity, but a number of interviews also featured discussions of race, sexual orientation, and socioeconomic and cultural privilege. We note, however, that although some respondents identified as people of color, all those respondents were women. As a result, we cannot qualitatively disentangle gender from racial or other identities. To these points, the Appendix's Table 5 reflects there being a very small world of vice founders of color.<sup>380</sup> In addition, to our knowledge, none of the investors we spoke to identify as people of color. Instead, experiences of minoritized investors came to us second-hand through other interviews.

#### 1. *Minoritized Entrepreneurs and Vice Capital*

Just under 30% of our respondents were women, which invited consideration whether the experience of funded female vice founders is different, either compared to male vice founders or to funded female founders in non-vice industries. Our respondents suggest that the answer is “yes.” Both male and female respondents reported—either from personal experience, second-hand experience, or observation of the startup ecosystem—that women, as well as people of color, who found vice firms face greater skepticism in obtaining investment. In other words, women and founders of color in vice industries face two potential barriers. First, VCs generally invest in non-vice businesses. Second, they generally invest in male

376. Erik Wingrove-Haugland & Jillian McLeod, *Not “Minority” but “Minoritized”*, 21 TEACHING ETHICS 1, 2 (2021) (framing “minoritized” persons as those “disadvantaged relative to the dominant social group by being systematically denied socioeconomic equity”).

377. See DIVERSITY VC, THE EQUITY RECORD (2022), <https://diversity.vc/wp-content/uploads/2022/11/The-Equity-Record-2022.pdf> [perma.cc/JJB6-EQMY].

378. See, e.g., Lyneir Richardson, *It's Critical to Protect Equity Investments in Minority Businesses from Activist Organizations*, TECHCRUNCH (Jan. 19, 2024, 9:35 AM), <https://techcrunch.com/2024/01/19/its-critical-to-protect-equity-investments-in-minority-businesses-from-activist-organizations> [perma.cc/3G6P-DWJF]; Herbert L. Drayton III, *Venture Capital Starves Resources from BIPOC and Women Founders*, BLACK WALL ST. TIMES (June 14, 2023), <https://theblackwallsttimes.com/2023/06/14/venture-capital-starves-resources-from-bipoc-and-women-founders> [perma.cc/8TXK-7XAV]; Jane Lee, *Four U.S. Venture Capital Funds Founded by Minority Women Band Together for Change*, REUTERS (Oct. 18, 2021, 3:13 PM), <https://www.reuters.com/business/finance/four-us-venture-capital-funds-founded-by-minority-women-band-together-change-2021-10-18> [perma.cc/N5VR-8R43].

379. See, e.g., Sabrina T. Howell & Ramana Nanda, *Networking Frictions in Venture Capital, and the Gender Gap in Entrepreneurship*, 59 J. FIN. & QUANT. ANALYSIS 2733 (2024); Robert Fairlie, Alicia Robb & David T. Robinson, *Black and White: Access to Capital Among Minority-Owned Start-ups*, 68 MGMT. SCI. 2377 (2022); Justine E. Tinkler, Kjersten Bunker Whittington, Manwai C. Ku & Andrea Rees Davies, *Gender and Venture Capital Decision-Making: The Effects of Technical Background and Social Capital on Entrepreneurial Evaluations*, 51 SOC. SCI. RSCH. 1 (2015); Jens Frankenreiter, Talia Gillis & Eric L. Talley, *Sex & Startups*, 42 YALE J. ON REGUL. (forthcoming 2025).

380. See *infra* Appendix, Table 5.

and White founders, particularly those with elite academic credentials and professional backgrounds.<sup>381</sup> Co-ethnicity between a VC investor and a founder—perhaps due to homophily—increases the likelihood of the founder obtaining funding from that investor.<sup>382</sup> In light of this existing literature and our interview data, we raise, and see some evidence for, two competing possibilities.

The first possibility is that pattern breaking could have a seesaw effect: As VC investors are willing to break one pattern (non-investment in vice), they might reinforce others (investment in founders who are male, White, or from elite backgrounds). The second possibility is that VC investors who are open-minded so as to break one pattern might be predisposed to breaking others. Under this possibility, a VC who invests in minoritized entrepreneurs might be more likely to invest in vice, or vice versa. Consistent with the first possibility, we heard from female founders of women’s sexual-health startups who saw male-led competitors secure larger amounts of venture capital despite the respondents’ companies having greater commercial and regulatory traction and having defensible intellectual property (which male-founded competitors might have infringed).<sup>383</sup>

At the same time, the influences of gender (or other minoritized statuses), vice aversions, and other factors (like founder social and educational backgrounds and network access) are difficult to disentangle, as one female founder conceded:

[The respondent introduced an instance in which a male-founded firm that went through a prestigious startup accelerator program raised several million dollars (contrasted to a much smaller amount the respondent had managed to raise) for a product that infringed the respondent’s patent.]<sup>384</sup>

**Q:** What do you think accounted for his success? . . . Was it in part his sex being male? Was he better connected? Did he have the type of background that they’re looking for? . . . What sort of factors would you point to that might explain the disparity here? . . .

**A:** [Y]ou cannot just say, “Oh, the only difference was he was a man,” right? I think there are differences there. I think privilege and access is a part of it as well. From what I can gather yes, more connections. He went through [a prestigious startup accelerator]. Anyone that goes through [that accelerator] gets money thrown

381. *The Funding Divide 2022*, DROPBOX DOCSEND, <https://docsend.com/view/ytshcechjuufnp27/d/gbh34gv8v8reep5m> [perma.cc/HZM3-HNH6].

382. See generally Ola Bengtsson & David H. Hsu, *Ethnic Matching in the U.S. Venture Capital Markets*, 30 J. BUS. VENTURING 338 (2015). But see Will Gornall & Ilya A. Strebulaev, *Gender, Race, and Entrepreneurship: A Randomized Field Experiment on Venture Capitalists and Angels*, MGMT. SCI. (forthcoming 2025) (finding in a correspondence study that angel and VC investors responded to emails purporting to be from female or Asian entrepreneurs at statistically significant higher rates than emails purporting to be from male or White entrepreneurs).

383. See, e.g., Interview GBF (referring to this competitive dichotomy between similar female- and male-founded startups).

384. *Id.* To preserve the respondent’s anonymity, we do not cite the patent here. But we confirmed that a patent for the startup’s product was granted by the U.S. Patent and Trademark Office soon after a male-led startup released its competing product. The male-led startup later submitted a patent application for a different product design, although as of the initial draft of this Article, that application had neither been granted nor denied.

at them. And they're, that's just part of it. There were two guys raising versus me and my [fellow executive].<sup>385</sup>

A 2013–2022 sample of Crunchbase U.S.-based startup data is more consistent, however, with the second possibility we raised. In the sample, 8.2% of vice startups with women founders received at least a Series A round (although only 1.2% of those with founders of color have achieved that milestone).<sup>386</sup> By contrast, 7.69% of all vice startups in the sample received at least a Series A investment.<sup>387</sup> The relatively higher share of women-founded vice startups receiving Series A investment is inconsistent with the idea that female vice founders are less successful than their male counterparts. Notably, however, these data are based on Crunchbase's Diversity Spotlight feature, which is self-reported and does not require that a startup be founded entirely by, or even controlled by, women.<sup>388</sup> Thus, we cannot rule out that some "Woman Founded" vice startups also benefit from homophily between male VC investors and a male co-founder; more, we cannot rule out that self-reporting biases the "Woman Founded" data in favor of those who have had fundraising success.

## 2. Minoritized Investors and Vice Capital

As we discussed in Section II.B, intrafirm reputational considerations might prevent VCs from investing in vice startups.<sup>389</sup> Gender, race, or other minoritized statuses can accentuate this effect. For example, respondents in the woman-focused adult and sexual-wellness spaces reported women partners at VC firms noting their precarity within male-dominated partnerships as a reason not to move potential investments forward.<sup>390</sup> Women VC investors feared being seen as practicing homophily themselves—by advocating that their firms invest in startups founded by other women—and were particularly sensitive to being seen as unserious by supporting vice or vice-adjacent startups.<sup>391</sup> This effect might also be driven in part by generational differences. One sexual-wellness founder, for example, reported having a generational heuristic for VC receptiveness:

**Q:** Have there been any demographic divides by folks who are funders? Are there any divides based on gender or race? Are they more open to investing due to their demographic?

**A:** Yes. I would go to any pitch competition and the most-friendly judges were the younger millennial and Generation X female-run VCs. Any marginalized identity was the second most friendly. Essentially anyone who wasn't a cis White male. However, nobody is harder to pitch than a female VC over the age of 45. They were repulsed and wouldn't take meetings with me. There's

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385. Interview VIK.

386. *See infra* Appendix, Table 5.

387. *See infra* Appendix, Table 5.

388. *What is Diversity Spotlight?*, CRUNCHBASE, <https://support.crunchbase.com/hc/en-us/articles/360049855154-What-is-Diversity-Spotlight> [perma.cc/RUG5-GEUD] (last visited Apr. 16, 2025).

389. *See supra* Section II.B.

390. *See supra* note 382 and accompanying text; *see also, e.g.*, Interview PLI; Interview APV.

391. *See generally* the sources cited *supra*, note 390 and accompanying text.

just a major generation divide. They didn't want to be associated with it or risk their reputations.<sup>392</sup>

The effects of risk aversion by minoritized VC investors could be exacerbated if women founders and founders of color are channeled to minoritized partners within VC firms.<sup>393</sup> For example, if women vice entrepreneurs are channeled to pitch women VC partners—who might be especially vice averse due to a need to protect their internal reputational capital—then the interaction of gender and vice could exacerbate each other's funding/non-funding effects. Further, attention in recent years to inequities in VC funding have prompted some VC firms to do targeted investing in startups with minoritized founders.<sup>394</sup> Although White, male entrepreneurs receive disproportionate shares of VC capital,<sup>395</sup> even these modest initiatives have been attacked by conservative activists as discriminating against White and male founders.<sup>396</sup> But it is also possible that such initiatives could in aggregate amount to overly modest cosmetic attempts at mollifying criticisms of the VC industry.<sup>397</sup> If such diversity washing were to occur, then facially pro-diversity initiatives could have the pernicious effect of treating non-White, non-male entrepreneurs as a niche group. As one VC investor explained:

If there's an asset manager that has, let's say billions of dollars to allocate, but they have set up a diversity fund, which is a small portion of their total assets under management, they funnel all women and people of color managers to that diversity fund so that there's less available allocation there.<sup>398</sup>

And given the marginality of vice receiving investment at all, when allocations for minoritized entrepreneurs are already scarce, vice is further off the table. Such could also be the case for VC funds that are led by women, people of color, or other minoritized investors or that target startups founded by or serving minoritized persons. After all, those funds must still account to their LPs and their LPs' normative aversions. One female sexual-wellness founder, for example, shared that “a lot of woman-led health-focused funds told me that they don't invest in products that produce sexual pleasure. They can't be convinced otherwise. I have been told that by seven to ten funds.”<sup>399</sup>

392. Interview ZGA.

393. See Interview RPX (expressing one founder's view that this channeling occurs).

394. See, e.g., Marlize van Romburgh & Gené Teare, *Funding to Black Startup Founders Quadrupled in Past Year, but Remains Elusive*, CRUNCHBASE NEWS (July 13, 2021), <https://news.crunchbase.com/venture/something-ventured-funding-to-black-startup-founders-quadrupled-in-past-year-but-remains-elusive> [perma.cc/D5ZX-BH52].

395. See DIVERSITY VC, *supra* note 377 and accompanying text.

396. Taylor Telford, *They Invest in Black Women. A Lawsuit Claims It's Discrimination*, WASH. POST (Aug. 26, 2023), <https://www.washingtonpost.com/business/2023/08/26/dei-lawsuit-black-businesses-fearless-fund-edward-blum> [perma.cc/QP4L-8R3F].

397. Cf. ADA VENTURES, WOMEN IN UK VENTURE CAPITAL (2023), [https://www.adacon.online/\\_files/ugd/635e41\\_05cd581b999d48a1b71b4b1a2ff3cc87.pdf](https://www.adacon.online/_files/ugd/635e41_05cd581b999d48a1b71b4b1a2ff3cc87.pdf) [perma.cc/EHS6-W3AB] (presenting evidence that British VC firms engage in “diversity washing” around promoting and empowering women within their firms).

398. Interview OHQ.

399. Interview QML.

### 3. Minoritized Customers and Vice Capital

Stigma around the customers a startup serves might also generate vice-like stigma for the company. Across several interviews, we observed this effect in the context of longstanding social taboos, ignorance of, and discomfort around women's health, especially women's sexual health, function, and pleasure.<sup>400</sup> The founder of a women's sexual-wellness company gives an example of this commercial stigma:

**Q:** [Question regarding barriers faced by a sexual-wellness company.]

**A:** We face shadow banning. I mean we just launched in [a retail store] and we heard that our product was hidden in the back of the store because someone had a problem with the words on the box. Mind you, the box was in the aisle next to the condoms and butt plugs and Rhino pills. I don't know what it is about when you're trying to service the needs of women as opposed to men, people have a problem with it.<sup>401</sup>

Another founder of a sexual-wellness company offered a comparative assessment of the stigma between startups serving men's sexual-health needs versus women's:

**Q:** Is there a difference in receptiveness to sexual products for men and for women? Equal discomfort?

**A:** It's definitely different. You can see from the funding amounts. I don't think that being a company that makes products for men's pleasure during sex is a golden ticket. I am thinking of the rise of Hims & Hers, etc.<sup>402</sup> I don't know why it's comparatively easier for them. I have seen male-focused companies struggle. I think that it might be that you have a combination of being a White man making a product for men's pleasure, and you also have an amazing background, and you are handsome and charismatic, then you can get over the hump that it's a sexual-wellness product. If you have a perfect background, you can be a successful sexual-wellness company focused on men. I've definitely seen male-founded sexual-wellness companies also struggle.<sup>403</sup>

400. See Mirjam D. Werner, Maria Carmen Punzi & A.J.K. Turkenburg, *Period Power: Organizational Stigma, Multimodality, and Social Entrepreneurship in the Menstrual Products Industry*, 61 J. MGMT. STUDS. 2137, 2137 (2024) (investigating social stigma around menstrual products as motivating social entrepreneurship in that space).

401. Interview ZUW.

402. Hims & Hers is public company that initially launched as a telehealth provider and online pharmacy focused on treating male erectile dysfunction and hair loss. See Oaktree Acquisition Corp., Current Report (Form 8-K) (Sept. 30, 2020), <https://www.sec.gov/Archives/edgar/data/1773751/000119312520260569/d74354d8k.htm> [perma.cc/VUA9-YRVS]. Before going public via a SPAC transaction, it raised \$297 in VC funding. Kate Clark, *Wellness Startup Hims Enters the Unicorn Club with \$100M Investment*, TECHCRUNCH (Jan. 28, 2019, 8:40 PM), <https://techcrunch.com/2019/01/28/wellness-startup-hims-enters-the-unicorn-club-with-100m-investment> [perma.cc/9GMC-8DCJ].

403. Interview ZLE.

It is also possible that discriminatory, albeit non-invidious and non-normative, considerations around minoritized customers negatively weigh on minoritized entrepreneurs' fundraising. For example, a cannabis founder agreed that women in the industry do struggle to raise compared to male founders.<sup>404</sup> He also attributed his own funding success in part to gender and racial homophily he enjoyed as a White man, particularly when the industry was still quasi-prohibited in his state.<sup>405</sup> Although he did not dispute that invidious gender discrimination affects women cannabis entrepreneurs, he also noted that in his experience women-founded cannabis startups tend to focus on female cannabis users.<sup>406</sup> That target customer base, he argued, is less attractive to VC investors than a generalist or male-focused cannabis startup, given that men, particularly young men, are on average the heaviest consumers.<sup>407</sup> To the extent that this argument has explanatory power, it offers another example of the non-normative aversion we outline in Section III.A.<sup>408</sup>

Other customers' identities—such as being members of the lesbian, gay, bisexual, and transgender (LGBT) community—can generate similar stigma. This point comes as no surprise given that LGBT lives, particularly LGBT sex lives, have deep, longstanding, and even criminalized associations with vice.<sup>409</sup> In one example, while it was still a startup, Grindr, a “hookup” application for men who have sex with men, was considered too stigmatized to go public.<sup>410</sup> In another example, one founder of an LGBT-friendly sexual-health company reported similar vice aversion in the startup capital market, even from investors who were members or allies of the LGBT community and were motivated to expand opportunities for LGBT entrepreneurs.<sup>411</sup> In light of stereotypes of the LGBT community being hypersexualized,<sup>412</sup> those investors felt they could not be seen as supporting the founder's sexual-health product, although one of those skittish investors did invest personally.<sup>413</sup>

#### CONCLUSION

This Article is the first study of how vice aversion shapes the startup-capital market and its mechanisms for doing so. More broadly, we believe that our setting—entrepreneurs, venture-capital and angel investors, and limited partners—is an apt one for understanding vice aversion and its mechanisms in capital markets. That belief follows because the actors involved are identifiable, deal with each other face-to-face, and their decision-making can be directly understood through

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404. Interview LMN.

405. *Id.*

406. *Id.*

407. *Id.*; see also Lorraine Greaves & Natalie Hemsing, *Sex and Gender Interactions on the Use and Impact of Recreational Cannabis*, INT'L J. ENV'T RSCH. PUB. HEALTH, 2020, at 1, 4 (“[M]en are more likely to report greater frequency of use and are twice as likely as women to report daily or almost daily use (8% of men vs. 4% of women).”).

408. See *supra* Section III.A.

409. See generally ANNA LVOVSKY, VICE PATROL: COPS, COURTS, AND THE STRUGGLE OVER URBAN GAY LIFE BEFORE STONEWALL (2021).

410. See generally the sources cited *supra*, note 232 and accompanying text.

411. Interview PZP.

412. Meredith G. F. Worthen, *Queer Identities in the 21st Century: Reclamation and Stigma*, CURRENT OP. PSYCH., Feb. 2023, at 1, 2.

413. Interview PZP, *supra* note 411.

interview methods. In contrast, the same direct observation is not feasible in anonymous public markets. If we are right about the broad applicability of our study, it is because the basic human motivations we observe—normative aversion to stigmatized industries, concern for maintaining good investor and constituent relations, and desire to preserve one’s reputation within a firm or industry—apply in other investment decision-making settings. In that case, this study has direct applications to other parts of the private capital markets, as well as to the public capital markets.

For public markets, our study complicates existing literatures on the “vice premium” and ESG. We show, for example, that even within vice industries there is considerable normative nuance between sub-industries. Just how a business profits from ethanol or THC molecules matters to whether investors wish to finance it. This point suggests that “vice” is far harder to define and control for in empirical studies than has been understood. More, the study informs on mechanisms for vice aversion (and, potentially, for virtue preference, as in ESG investing). A theory of differential pricing for vice equity must account for unique search and opportunity costs that heighten hurdles to the capital formation and growth of vice firms, as well as premia that willing investors will extract to compensate for their own reputational risks from, or even their own normative discomfort with, their investments.

Beyond these capital-markets learnings, we have considered a specific stage in a business’s lifecycle—when it is first raising money from sophisticated equity investors—and show that normative judgments embed early in the capital markets. The literature has considered the role of ESG in VC investing. To the extent ESG investing, broadly considered, reflects normative considerations, we show that firms’ express ESG policies and practices are not the full story. Normativity in investment decision-making is also partly driven by contractual and business relationships and implicit expectations, values, and motivations. This point further suggests that normative judgments shape both the products and services available in the real economy, meaning that the questions we raise around vice capital apply to more than just investors, entrepreneurs, and other participants in the private capital markets. Instead, they matter to anyone who uses the internet, visits a pharmacy or grocery store, or journeys to any other commercial corner where stigmatized goods and services might be sold.

## APPENDIX

<b>Year Founded</b>	<b>Count</b>	<b>Seed</b>	<b>Series A</b>
<b>2023</b>	3,357	613	45
<b>2022</b>	13,960	1,792	210
<b>2021</b>	19,933	3,087	651
<b>2020</b>	24,465	3,467	1,046
<b>2019</b>	24,509	3,299	1,283
<b>2018</b>	24,389	3,255	1,584
<b>2017</b>	26,627	3,188	1,784
<b>2016</b>	27,099	2,937	1,718
<b>2015</b>	30,420	3,198	1,965
<b>2014</b>	33,155	3,203	1,953
<b>TOTAL</b>	227,914	28,039	12,239

Table 1: Funding success of all startups (PitchBook)<sup>414</sup>


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414. As of January 12, 2024. Column 1 indicates the total number of companies in the PitchBook database founded in a given year. Column 2 indicates the number of startups in Column 1 that have received a Seed funding round. Column 3 indicates the number of startups in Column 1 that received a Series A funding round.

Year Founded	Adult			Alcohol			Cannabis		
2023	1	1	0	18	2	0	8	0	0
2022	3	0	0	263	8	2	49	4	0
2021	3	2	0	364	18	0	104	13	1
2020	1	0	0	454	43	13	154	23	6
2019	3	0	0	417	39	14	274	42	11
2018	0	0	0	480	45	17	329	44	27
2017	0	0	0	500	42	17	322	44	24
2016	2	0	0	520	36	9	271	39	24
2015	2	0	0	636	50	23	328	46	37
2014	5	0	0	647	48	16	312	40	34
<b>TOTAL</b>	<b>20</b>	<b>3</b>	<b>0</b>	<b>4,299</b>	<b>331</b>	<b>111</b>	<b>2,151</b>	<b>295</b>	<b>164</b>

Year Founded	Tobacco			Gambling			Weapons		
2023	3	0	0	3	2	0	14	3	0
2022	9	0	0	33	4	0	59	6	2
2021	9	1	0	42	3	1	61	6	0
2020	28	2	1	52	4	1	85	8	0
2019	44	2	1	60	7	1	113	11	4
2018	49	6	2	54	2	2	102	7	6
2017	54	6	3	46	4	2	105	12	5
2016	43	5	4	31	2	2	102	11	10
2015	67	6	7	35	4	2	114	4	5
2014	111	8	4	46	8	4	124	14	2
<b>TOTAL</b>	<b>417</b>	<b>36</b>	<b>22</b>	<b>402</b>	<b>40</b>	<b>15</b>	<b>879</b>	<b>82</b>	<b>34</b>

Table 2: Vice startups and funding success by category (count/Seed/Series A) (PitchBook)<sup>415</sup>

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### Vice Startups

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### All Startups

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415. The explanation in note 415 applies to Table 2 (but restricted to those companies tagged as being in the alcohol, beer, wine, spirits, sex tech, pornography, adult content, cannabis, tobacco, vaping, firearms, ammunition, casino, or gambling industries).

Year Founded	Count	IPO	Acquired	Count	IPO	Acquired
2023	47	0	15	3,357	25	26
2022	416	1	7	13,960	45	116
2021	583	5	0	19,933	563	525
2020	774	2	36	24,465	540	935
2019	911	7	56	24,509	132	967
2018	1014	7	91	24,389	155	1,251
2017	1027	9	112	26,627	167	1,540
2016	969	4	112	27,099	141	1,826
2015	1182	7	151	30,420	189	2,200
2014	1245	16	176	33,155	231	2,575
<b>TOTAL</b>	8,168	59	756	227,914	2,188	11,961

Table 3: Vice and all-startup exits (PitchBook)<sup>416</sup>

Year Founded	Adult			Alcohol			Cannabis		
2023	1	0	0	18	0	0	8	0	8
2022	3	0	0	263	0	2	49	1	5
2021	3	0	0	364	1	3	104	3	5
2020	1	0	0	454	0	6	154	2	26
2019	3	0	0	417	1	15	274	5	40
2018	0	0	0	480	2	19	329	4	67
2017	0	0	0	500	0	21	322	7	79
2016	2	0	0	520	0	28	271	2	79
2015	2	0	0	636	1	38	328	5	104
2014	5	0	0	647	1	36	312	11	118
<b>TOTAL</b>	20	0	0	4,299	6	168	2,151	40	518

Year Founded	Tobacco			Gambling			Weapons		
2023	3	1	0	3	0	0	14	0	1
2022	9	1	0	33	0	0	59	0	0
2021	9	1	0	42	0	4	61	1	1

416. As of January 12, 2024. Companies were coded as “IPO” based on an IPO filter in the PitchBook database, and “Acquired” based on strategic, private-equity, and venture-capital backed M&A filters.

2020	28	1	3	52	0	4	85	0	3
2019	44	1	5	60	0	4	113	0	2
2018	49	0	14	54	0	2	102	3	1
2017	54	0	15	46	2	7	105	0	6
2016	43	0	11	31	2	4	102	0	4
2015	67	0	14	35	1	7	114	2	7
2014	111	1	20	46	1	8	124	2	11
<b>TOTAL</b>	<b>417</b>	<b>6</b>	<b>82</b>	<b>402</b>	<b>6</b>	<b>40</b>	<b>879</b>	<b>8</b>	<b>36</b>

Table 4: Vice exits by category (count/IPO/acquired) (PitchBook)<sup>417</sup>

Founding Year	Vice Startups		Non-Vice Startups	
	Woman Founder	Founder of Color	Woman Founder	Founder of Color
2022	0	2	55	101
2021	2	2	271	219
2020	9	5	654	389
2019	24	10	1,045	429
2018	30	6	1,329	420
2017	35	5	1,535	376
2016	21	3	1,666	308
2015	35	1	1,768	298
2014	29	1	1,789	247
2013	19	1	1,696	198
<b>TOTAL</b>	<b>204</b>	<b>36</b>	<b>11,808</b>	<b>2,985</b>
<b>ALL VICE/NON-VICE STARTUPS</b>	<b>3,441</b>		<b>210,603</b>	

Table 5: Women founders and founders of color (Crunchbase)<sup>418</sup>


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417. The explanation in note 414 applies to Table 4.

418. Companies with the following “Diversity Spotlight” indicators in the Crunchbase database, as of February 18, 2023, are deemed to have women founders or founders of color: “South Asian Founded,” “Middle Eastern/North African Founded,” “American Indian/Alaska Native Founded,” “Hispanic/Latine Founded,” “Native Hawaiian/Pacific Islander Founded,” “Southeast Asian Founded,” “Black/African American Founded,” “Women Founded,” and “East Asian Founded.”