CHAPTER 1

The Players

While it might seem like there are only two players in the financing dance—the entrepreneur and the venture capitalist—there are often others, including angel investors, lawyers, and mentors. Any entrepreneur who has created a company that has gone through multiple financings knows that the number of people involved can quickly spiral out of control, especially if you aren't sure who actually is making the decisions at each step along the way.

The experience, motivation, and relative power of each participant in a financing can be complex, and the implications are often mysterious. Let's begin our journey to understanding venture capital financings by making sure we understand each player and the dynamics surrounding the participants.

The Entrepreneur

Not all investors realize it, but the entrepreneur is the center of the entrepreneurial universe. Without entrepreneurs there would be no term sheet and no start-up ecosystem.

Throughout this book we use the words *entrepreneur* and *founder* interchangeably. While some companies have only one founder, many have two, three, or even more. Sometimes these co-founders are equals; other times they aren't. Regardless of the number, they each have a key role in the formation of the company and any financing that occurs.

The founders can't and shouldn't outsource their involvement in a financing to their lawyers. There are many issues in a financing negotiation that only the entrepreneurs can resolve. Even if you hire a fantastic lawyer who knows everything, don't forget that if your lawyer and your future investors don't get along you will have larger issues to deal with. If you are the entrepreneur, make sure you direct and control the process.

The relationship between the founders at the beginning of the life of a company is almost always good. If it's not, the term sheet and corresponding financing are probably the least of the founders' worries. However, as time passes, the relationship between co-founders often frays. This could be due to many different factors: the stress of the business, competence, personality, or even changing life priorities like a new spouse or children.

When this happens, one or more founders will often leave the business—sometimes on good terms and sometimes on not such good terms. Some investors know that it's best to anticipate these kinds of issues up front and will try to structure terms that predefine how things will work in these situations. The investors are often trying to protect the founders from each other by making sure things can be cleanly resolved without disrupting the company more than the departure of a founder already does.

We cover this dynamic in terms like vesting, drag-along rights, and co-sale rights. When we do, we discuss both the investor perspective and the entrepreneur perspective. You'll see this through the book—we've walked in both the investor's and the entrepreneur's shoes, and we try hard to take a balanced approach to our commentary.

The Venture Capitalist

The *venture capitalist* (VC) is the next character in the term sheet play. VCs come in many shapes, sizes, and experience levels. While most (but not all) profess to be entrepreneur-friendly, many fall far short of their aspirations. The first signs of this often appear during the term sheet negotiation.

Venture capital firms have their own hierarchies that are important for an entrepreneur to understand. Later in the book we'll dive into all the deep, dark secrets about how VCs are motivated and paid, and what their incentives can be. For now, we'll consider VCs as humans and talk about the people.

The most senior person in the firm is usually called a *managing director* (MD) or a *general partner* (GP). In some cases, these titles have an additional prefix—such as *executive managing director* or *founding general partner*—to signify even more seniority over the other managing directors or general partners. These VCs make the final investment decisions and sit on the boards of directors of the companies they invest in.

Principals, or *directors*, are usually next in line. These are junior deal partners—they are working their way up the ladder to managing director. Principals usually have some deal responsibility, but they almost always require support from a managing director to move a deal through the VC firm. So, while the principal has some power, he probably can't make a final decision.

Associates are typically not deal partners. Instead, they work directly for one or more deal partners, usually a managing director. Associates do a wide variety of things, including scouting for new deals, helping with due diligence on existing deals, and writing up endless internal memos about prospective investments. They are also likely to be the person in the firm who spends the most time with the *capitalization table* (also known as a *cap table*), which is the spreadsheet that defines the economics of the deal. Many firms have an associate program, usually lasting two years, after which time the associate leaves the firm to go work for a portfolio company, to go to business school, or to start up a company. Occasionally the star associates go on to become principals.

Analysts are at the bottom of the ladder. These are very junior people, usually recently graduated from college, who sit in a room with no windows down the hall from everyone else, crunch numbers, and write memos. In some firms, analysts and associates play similar roles and have similar functions; in others, the associates are more deal-centric. Regardless, analysts are generally smart people who are usually very limited in power and responsibility.

Some firms, especially larger ones, have a variety of *venture partners* or *operating partners*. These are usually experienced entrepreneurs who have a part-time relationship with the VC firm. While they have the ability to sponsor a deal, they often need explicit support of one of the managing directors, just as a principal would, in order to get a deal done. In some firms, operating partners don't sponsor deals, but take an active role in managing the investment as a chairman or board member.

Entrepreneurs in residence (EIRs) are another type of part-time member of the VC firm. EIRs are experienced entrepreneurs who park themselves at a VC firm while they are working on figuring out their next company. They often help the VC with introductions, due diligence, and networking during the three- to 12-month period that they are an EIR. Some VCs pay their EIRs; others simply provide them with free office space and an implicit agreement to invest in their next company.

In small firms, you might be dealing only with managing directors. For example, in our firm, Foundry Group, we have a total of four partners, all called managing directors, each of whom has the same responsibility, authority, and power. In large firms, you'll be dealing with a wide array of managing directors, principals, associates, analysts, venture partners, operating partners, EIRs, and other titles.

Entrepreneurs should do their research on the firms they are talking to in order to understand who they are talking to, what decision-making power that person has, and what process they have to go through to get an investment approved. The best source for this kind of information is other entrepreneurs who have worked with the VC firm in the past, although you'd also be surprised how much of this you can piece together just by looking at how the VC firm presents itself on its web site. If all else fails, you can always ask the VC how things work, although the further down the hierarchy of the firm, the less likely you'll get completely accurate information.

The Entrepreneur's Perspective

Managing directors or general partners have the mojo inside venture capital firms. If you have anyone else prospecting you or working on the deal with you (associate, senior associate, principal, venture partner, or EIR), treat him with an enormous amount of respect, but insist on developing a direct relationship with an MD or a GP as well. Anyone other than an MD or a GP is unlikely to be at the firm for the long haul. The MDs and GPs are the ones who matter and who will make decisions about your company.

The Angel Investor

In addition to VCs, your investor group may include individual investors, usually referred to *angel investors* (or *angel* for short). These angels are often a key source of early stage investment and are very active in the first round of investment, or the *seed stage*. Angels can be professional investors, successful entrepreneurs, friends, or family members.

Many VCs are very comfortable investing along with angels and often encourage their active involvement early in the life of a company. As a result, the angels are an important part of any financing dance. However, not all angels are created equal, nor do all VCs share the same view of angels.

While angels will invest at various points in time, they usually invest in the early rounds and often don't participate in future rounds. In cases where everything is going well, this is rarely an issue. However, if the company hits some speed bumps and has a difficult financing, the angels' participation in future rounds may come into question. Some of the terms we discuss in the book, such as *pay-to-play* and *drag-along rights*, are specifically designed to help the VCs force a certain type of behavior on the angels (and other VC investors) in these difficult financing rounds.

While angel investors are usually high-net-worth individuals, they aren't always. There are specific SEC rules around *accredited investors* and you should make sure that each of your angel investors qualifies as an accredited investor or has an appropriate exemption. The best way to ensure this is to ask your lawyer for help on the rules.

Some angel investors make a lot of small investments. Recently, these very active, or promiscuous, angels have started to be called *super angels*. These super angels are often experienced entrepreneurs who have had one or more exits and have decided to invest their own money in new start-ups. In most cases, super angels are well known in entrepreneurial circles and are often a huge help to early stage companies.

As super angels make more investments, they often decide to raise capital from their friends, other entrepreneurs, or institutions. At this point the super angel raises a fund similar to a *VC fund* and has actually become an institutionalized super angel, which is starting to be known as a *micro VC*. While these micro VCs often want to be thought of as angels instead of VCs, once they've raised money from other people they have the same fiduciary responsibility to their investors that a VC has, and as a result they are really just VCs.

It's important to remember that there isn't a generic angel investor type (nor is there a generic VC type). Lumping them together and referring to them as a single group can be dangerous. Never

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assume any of these people are like one another. They will all have their own incentives, pressures, experiences, and sophistication levels. Their individual characteristics will often define your working relationship with them well beyond any terms that you negotiate.

The Entrepreneur's Perspective

Don't put yourself in a position where you can be held hostage by angels. They are important, but they are rarely in a position to determine the company's direction. If your angel group is a small, diffuse list of friends and family, consider setting up a special-purpose limited partnership controlled by one of them as a vehicle for them to invest. Chasing down 75 signatures when you want to do a financing or sell the company is not fun.

Also, true friends and family need special care. Make sure they understand up front that (1) they should think of their investment as a lottery ticket, and (2) every time they see you at a holiday or birthday party is not an investor relations meeting.

The Syndicate

While some VCs invest alone, many invest with other VCs. A collection of investors is called a *syndicate*.

When VCs refer to the syndicate, they are often talking about the major participants in the financing round, which are usually but not always VCs. The syndicate includes any investor, whether a VC, angel, super angel, strategic investor, corporation, law firm, or anyone else that ends up purchasing equity in the financing.

Most syndicates have a *lead investor*. Usually, but not always, this is one of the VC investors. Two VCs will often co-lead a syndicate, and occasionally you'll see three co-leads.

While there is nothing magical about who the lead investor is, having one often makes it easier for the entrepreneurs to focus their energy around the negotiation. Rather than having one-off negotiations with each investor, the lead in the syndicate will often take the role of negotiating terms for the entire syndicate.

Regardless of the lead investor or the structure of the syndicate, it is the entrepreneurs' responsibility to make sure they are communicating with each of the investors in the syndicate. As the entrepreneur, even though the lead investor may help corral the other investors through the process, don't assume that you don't need to communicate with each of the investors—you do!

The Entrepreneur's Perspective

While you should communicate with all investors, you should insist that investors agree (at least verbally) that the lead investor can speak for the whole syndicate when it comes to investment terms. You should not let yourself be in a position where you have to negotiate the same deal multiple times. If there is dissension in the ranks, ask the lead investor for help.

The Lawyer

Ah, the lawyers—I bet you thought we'd never get to them. In deals, a great lawyer can be a huge help and a bad lawyer can be a disaster.

For the entrepreneur, an experienced lawyer who understands VC financings is invaluable. VCs make investments all the time. Entrepreneurs raise money occasionally. Even a very experienced entrepreneur runs the risk of getting hung up on a nuance that a VC has thought through many times.

In addition to helping negotiate, a great lawyer can help focus the entrepreneur on what really matters. While this book will cover all the terms that typically come up in a VC financing, we'll continue to repeat a simple mantra that the real terms that matter are economics and control. Yes, VCs will inevitably spend time negotiating for an additional S-3 registration right (an unimportant term that we'll discuss later) even though the chance it ever comes into play is very slight. This is just life in a negotiation—there are always endless tussles over unimportant points, sometimes due to silly reasons, but they are often used as a negotiating strategy to distract you from the main show. VCs are experts at this; a great lawyer can keep you from falling into these traps.

However, a bad lawyer, or one inexperienced in VC financings, can do you a world of harm. In addition to getting outnegotiated, the inexperienced lawyer will focus on the wrong issues, fight hard on things that don't matter, and run up the bill on both sides. We've encountered this numerous times. Whenever entrepreneurs want to use their cousin who is a divorce lawyer, we take an aggressive position before we start negotiating that the entrepreneur needs a lawyer who has a clue.

Never forget that your lawyer is a reflection on you. Your reputation in the start-up ecosystem is important, and a bad or inexperienced lawyer will tarnish it. Furthermore, once the deal is done, you'll be partners with your investors; so you don't want a bad or inexperienced lawyer creating unnecessary tension in the financing negotiation that will carry over once you are partners with your investors.

The Entrepreneur's Perspective

At the same time that you don't want an inexperienced lawyer creating unnecessary tension in the negotiation, don't let a VC talk you out of using your lawyer of choice just because that lawyer isn't from a nationally known firm or the lawyer rubs the VC the wrong way. This is *your* lawyer, not your VC's lawyer. That said, to do this well, you need to be close enough to the communication to make sure your lawyer is being reasonable and communicating clearly and in a friendly manner.

While lawyers usually bill by the hour, many lawyers experienced with VC investments will cap their fees in advance of the deal. As of this writing in 2011, a very early stage financing can be done for between $5,000 and $15,000 and a typical financing can be completed for between $25,000 and $40,000. Lawyers in large cities tend to charge more, and if your company has any items to clean up from your past, your costs will increase.

If your lawyers and the VC lawyers don't get along, your bill can skyrocket if you don't stay involved in the process. If the lawyers are unwilling to agree to a modest fee cap, you should question whether they know what they are doing.

In case you are curious, these numbers are virtually unchanged from a decade ago while billable rates have more than doubled in the same time. What this means is that document standardization is a reality, but it also means that the average lawyer spends less time per deal than in ancient times (the 1990s). Once again, the entrepreneur must take responsibility for the final results.

The Entrepreneur's Perspective

Don't be shy about insisting that your lawyer take a lower cap or even that the lawyer will only get paid out of the proceeds of a deal. There's no reason, if you are a solid entrepreneur with a good business, that even a top-tier law firm won't take your unpaid deal to its executive committee as a flier to be paid on closing.

The Mentor

Every entrepreneur should have a stable of experienced *mentors*. These mentors can be hugely useful in any financing, especially if they know the VCs involved.

We like to refer to these folks as mentors instead of advisers since the word *adviser* often implies that there is some sort of fee agreement with the company. It's unusual for a company, especially an early stage one, to have a fee arrangement with an adviser around a financing. Nonetheless, there are advisers who prey on entrepreneurs by showing up, offering to help raise money, and then asking for compensation by taking a cut of the deal. There are even some bold advisers who ask for a retainer relationship to help out. We encourage early stage entrepreneurs to stay away from these advisers.

In contrast, mentors help the entrepreneurs, especially early stage ones, because someone once helped them. Many mentors end up being early angel investors in companies or get a small equity grant for serving on the board of directors or board of advisers, but they rarely ask for anything up front.

While having mentors is never required, we strongly encourage entrepreneurs to find them, work with them, and build long-term relationships with them. The benefits are enormous and often surprising. Most great mentors we know do it because they enjoy it. When this is the motivation, you often see some great relationships develop.

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The Entrepreneur's Perspective

Mentors are great. There's no reason not to give someone a small success fee if they truly help you raise money (random email introductions to a VC they met once at a cocktail party don't count). Sometimes it will make sense to compensate mentors with options as long as you have some control over the vesting of the options based on your satisfaction with the mentor's performance as an ongoing adviser.