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 (and bankers and lawyers, for that matter) realize it, but the entrepreneur is the center of the entrepreneurial universe. Without entrepreneurs there would be no term sheet and no startup 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 cofounders 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, as the way your lawyer represents himself will directly reflect on you. 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 cofounders 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 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 throughout 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 sign of this often appears 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.

Partners are usually not what their title says they are. Many VCs these days carry business cards with a "Partner" title but are not actually partners in the firm. Instead, they are often junior deal professionals (also referred to as *principals* or *directors*—see the next paragraph) or are involved in specific aspects of the investing process such as deal sourcing. In some firms, which are described as *full-stack VC firms,* these partners help companies across a variety of dimensions, including recruiting, operations, technology, sales, and marketing, but are not decision makers in the investment process.

Principals, or *directors,* are usually next in line. These are junior deal professionals 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 a 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, often lasting two years, after which time the associate leaves the firm to go work for a portfolio company, go to business school, or 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 experienced entrepreneurs who have a part-time relationship with the VC firms. While they have the ability to sponsor a deal, they often need explicit support of one of the MDs, 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 3- 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 MDs. For example, in our firm, Foundry Group, we have a total of five 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 MDs, principals, associates, analysts, venture partners, operating partners, EIRs, and other titles. Since we wrote the first edition of this book in 2011, there has been a huge amount of title inflation among VC firms as what was referred to as an associate in 2011 might now be referred to as a partner.

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 processes they have to go through to get an investment approved. The best sources for this kind of information are 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 a VC firm presents itself on its website. If all else fails, you can always ask the VC how things work, although the further down the hierarchy of the firm they are, 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 her 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.

Financing Round Nomenclature

Aside from the humans who work at a venture firm, there are also different types of venture firms. Understanding the different types of firms will help you target the right ones as you are raising a financing.

Most firms define themselves by the stage of financing they invest in. You've probably heard of different letters associated with financing rounds: Series A, Series B, Series B Prime, Series G, Series Seed, and even Series Pre-Seed. You'll hear about Series B-2 rounds and Series D-3 rounds. As funding cycles change, you'll hear about "The Series A Crunch" or "The Series B Crunch," or even the notion that "The Series A is the new Series B."

There is no magic or legal definition in naming rounds. We'd prefer to name them after different hiking trails in Boulder, but we'd confuse too many people, so we stick to letters. It used to be that the Series A round was the first financing, the Series B was the next round, and the Series C was the next round. After the Series C often came the Series D. You get the picture.

At some point, investors who were making very early-stage investments, also referred to as *seed rounds,* decided that there needed be a letter before "A" and started to call those deals *Series Seed.* While we have always felt it was perfectly reasonable to call these seed rounds a Series A, this emerged around the time that there was a new wave of VC firms making seed investments, while at the same time many of the firms who previously considered themselves early-stage investors were letting these new firms make the first investment. The other firms still liked to refer to themselves as early-stage investors, so the old Series A became the Series Seed and the old Series B started to be called Series A. Today, you'll occasionally hear of a *Pre-Seed Round,* which is simply an effort to label an earlier round that occurs before the seed round.

At the same time, companies didn't want to have letters that extended far into the alphabet. When you are doing your Series K round, the first thing a VC wonders is "what is wrong with you?" Since an increasing number of rounds were inheriting the same terms, either at the same or different price as the earlier round, one started getting numerical round extensions. When the same investors who invested $10 million in a Series B added on another $5 million to the company on the same terms, this became the Series B-1. If another $5 million was invested in the company at the same terms, this became the Series B-2. When a new investor led the next $22 million financing, this finally became the Series C, instead of the Series E, which is what it would have been if the B-1 were the C and the B-2 were the D.

While the labeling of rounds can be complicated, what is important is that there is a language to discuss how early or late stage a company is when determining what VC might be right for you. Generally, Pre-Seed, Seed, and Series A are early-stage companies, Series B and C are mid-stage companies, and Series D or later is a late-stage company.

Types of Venture Capital Firms

Now that we've got the nomenclature of rounds down, we can talk about which types of firms invest in which rounds.

A *micro VC fund* is a small venture firm that often has only one general partner. Many of these folks started out as *angel investors,* which we will talk about in the next section, and, after some success, created a fund to invest other people's money alongside their own. Sizes of these funds can vary, but are usually less than $15 million in total capital per fund. These firms almost exclusively invest at the seed and early stages, often alongside other micro VC firms, angel investors, and friend and family investors.

Seed-stage funds are generally bigger than micro VCs and can scale up to $150 million per fund. They focus on being the first institutional money into a company and rarely invest in later rounds past a Series A. Seed-stage funds often provide your first noncompany board member, so be thoughtful as this relationship goes well beyond just the investment.

Next up are the *early-stage funds*. These are the funds that are generally $100 million to $300 million in size and invest in seed stage and Series A companies but occasionally lead a Series B round. These firms also often continue to invest later in the life of a company, often taking their *pro rata* in subsequent rounds, which we'll explain later in this book.

Mid-stage funds are those that generally invest in Series B and later rounds. The funds are often called *growth investors,* as their first investment in a company is at a point where a company is clearly working, but now needs capital to accelerate, or continue, its growth. These funds usually range from $200 million to $1 billion in size.

Late-stage funds enter the picture when the company is now a successful stand-alone business, typically doing its last financing before a prospective initial public offering (IPO). These include specific late-stage VC funds, but also can be hedge funds, crossover investors that invest primarily in the public markets, funds associated with large banks, or sovereign wealth funds.

Like all things in the VC world, you can't categorize each firm tightly. Some firms with billion-dollar funds have early-stage programs that invest in young companies. Some firms have multiple funds that invest in different stages of a company, like we do at Foundry Group. We have early-stage funds that invest in the early stages (seed, A, and B) and later-stage funds (which we call Foundry Group Select and Foundry Group Next) that invest in growth rounds, similar to what a mid-stage firm would do. Some firms have dedicated programs or partners per stage and others invest along the company life cycle with no special delineations.

Ultimately, the key is to make sure that you are targeting the types of firms that invest in your stage of company. One of the most common mistakes entrepreneurs make is focusing on firms that are irrelevant for them at the stage they are at.

The Angel Investor

In addition to VCs, your investor group may include individual investors, usually referred to as *angel investors* (or *angels* 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 alongside 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 Securities and Exchange Commission (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. This has become more complicated with the passage of the JOBS Act in 2012, and we'll discuss this further in Chapter 9, "Crowdfunding." The best way to ensure you are following the rules correctly is to ask your lawyer for help.

Some angel investors make a lot of small investments. These very active, or promiscuous, angels are 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 startups. 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 becomes 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 archetype (nor is there a generic VC archetype). Lumping them together and referring to them as a single group can be dangerous. Never 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 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 a 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!

Be careful of too many cooks in the kitchen. In the past few years, the idea of a *party round,* where many investors make relatively small investments at the early stage, has become popular. It isn't unusual to see a $2 million seed round with 10 VCs and 20 angel investors in the round. While it might seem nice to have all these fancy names in a press release, the entrepreneurs get very little attention from any of the investors since their investments were all tiny relative to what the VCs normally invest. As companies raise their next round, they realize they have the worst of all possible worlds—lots of VCs who are investors, but none who are committed in a meaningful way.

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 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, annoying 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 an entrepreneur wants to use a 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 startup 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 2016, an early-stage financing can be done for between $5,000 and $20,000 and a typical mid- to late-stage financing can be completed for between $20,000 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 cap their fee at a modest number 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, primarily 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.

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.