BRAD FELD
JASON MENDELSON

venture deals

THIRD EDITION

BE SMARTER
Than Your LAWYER and
VENTURE CAPITALIST

WILEY

Venture Deals

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AND VENTURE CAPITALIST

Third Edition

Brad Feld
Jason Mendelson

WILEY

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To our wives, Amy
and Jennifer, and our partners,
Seth, Ryan, and Lindel.

Foreword

I remember the first week of my career as a VC. I was 25 years old, it was 1986, and I had just landed a summer job in a venture capital firm. I was working for three experienced venture capitalists in a small firm called Euclid Partners, where I ended up spending the first 10 years of my VC career. One of those three partners, Bliss McCrum, peeked his head into my office (I had an office in Rockefeller Center at age 25) and said to me, "Can you model out a financing for XYZ Company at a $9 million pre-money, raising $3 million, with an unissued option pool of 10%?" and then went back to the big office in the rear he shared with the other founding partner, Milton Pappas.

I sat at my desk and started thinking about the request. I understood the "raising $3 million" bit. I thought I could figure out the "unissued option pool of 10%" bit. But what the hell was "pre-money"? I had never heard that term. This was almost a decade before Netscape and Internet search so searching online for it wasn't an option. After spending ten minutes getting up the courage, I walked back to that big office, peeked my head in, and said to Bliss, "Can you explain pre-money to me?"

Thus began my 31-year education in venture capital that is still going on as I write this.

The venture capital business was a cottage industry back in 1985, with club deals and a language all of its own. A cynic would say it was designed this way to be opaque to everyone other than the VCs so that they would have all the leverage in negotiations with entrepreneurs. I don't entirely buy that narrative. I think the VC business grew up in a few small offices in Boston, New York, and San Francisco, and the dozens—maybe as many as a hundred—of main participants, along with their lawyers, came up with structures that made sense to them. They then developed a shorthand so that they could communicate among themselves.

But whatever the origin story was, the language of venture deals is foreign to many and remains opaque and confusing to this day. This works to the advantage of industry insiders and to the disadvantage of those who are new to startups and venture capital.

In the early 2000s, after I wound down my first venture capital firm, Flatiron Partners, and before we started USV, I started blogging. One of my goals with my AVC blog (at www.avc.com) was to bring transparency to this opaque world that I had been inhabiting for almost 20 years. I was joined in this blogging thing by Brad Feld, a friend and frequent coinvestor. Club investing has not gone away and that's a good thing. By reading AVC and Feld Thoughts regularly, an entrepreneur could get up to speed on startups and venture capital. Brad and I received a tremendous amount of positive feedback on our efforts to bring transparency to the venture capital business so we kept doing it, and now if you search for something like "participating preferred" you will find posts written by both me and Brad on that first search results page.

Brad and his partner Jason Mendelson (a recovering startup lawyer turned VC) took things a step further and wrote a book called *Venture Deals* back in 2011. It has turned into a classic and is now on its Third Edition. If *Venture Deals* had been around in 1985, I would not have had to admit to Bliss that I had no idea what pre-money meant.

If there is a guidebook to navigating the mysterious and confusing language of venture capital and venture capital financing structures, it is *Venture Deals*. Anyone interested in startups, entrepreneurship, and angel and venture capital financings should do themselves a favor and read it.

Fred Wilson
USV Partner
July 2016

Foreword

I remember the first time I saw the exit sign for Sand Hill Road off of Highway 280. It was 1999. I was 22 years old, had just dropped out of Harvard, and was the cofounder and CTO of a startup based in Boston. My cofounder and I decided to cast the net wide in our search for money and flew out to Silicon Valley to meet with VCs. As I saw the exit for Sand Hill Road, I started to feel incredibly nervous and unwell. I immediately noticed the telltale signs of a distinct lack of preparation and knowledge. I felt this way if I hadn't studied thoroughly for a test in school. In high school, right before a cross-country race, I felt this way if I hadn't put in enough miles of running in practice. By this time, hadn't I learned my lesson about preparation and its effect on my digestive system? Why did I show up to such important meetings so uninformed about the people and the industry from whom I was trying to raise money from? Well, in 1999, it wasn't so easy for a 22-year-old first-time entrepreneur to figure all of this out.

We did succeed in raising money for that startup, but due to our own mistakes and the tough environment at the time, we ended up closing our doors a couple of years later. However, I made a couple of great friends, Eric and Gokhan, from that startup, and we picked ourselves up and immediately started another company called Windup Labs. After four years of incredibly hard work, we sold Windup to CNET Networks (now part of CBS Interactive) in 2005, and as part of the acquisition, we all moved to San Francisco.

In 2007, Eric and I left CNET to start Fitbit. Eric and I started off with fairly modest ambitions for the company, but as the years passed, our ambitions grew. From 2007 to today, the company grew to over 1,500 employees, and our most recent guidance to investors called for approximately $2.5 billion in revenue in 2016. We raised over $66 million in private capital from VCs, including Brad and Jason at Foundry Group. In 2015, Fitbit went public, raising over $800 million in the largest-ever consumer electronics initial public offering (IPO) in history. I've remained its CEO from founding to today.

As I read this book, I was amazed at how succinctly it captured the sum of my 16 years of experience raising money, dealing, and working with VCs and corporate lawyers. I wish I could travel back in time and hand this book off to my nervous and ill 22-year-old self (along with an iPhone and the idea for Facebook).

You, the reader, have gotten a huge bargain. After finishing this book, you will have skipped years of painful experience, trial and error, and learning on the clock from expensive lawyers. This is the business book equivalent of Neo jacking in and learning kung fu in an instant in *The Matrix*. As you find yourself driving down 280 (or, depending on how long this foreword lasts, being whisked in your autonomous electric car) and the sign for Sand Hill Road comes into view, feel confident that you've been prepared by some of the best VCs I know.

James Park
Fitbit Cofounder and CEO
July 2016

Preface

One of the ways to finance a company is to raise venture capital. While only a small percentage of companies raise venture capital, many of the great technology companies that have been created, including Google, Apple, Cisco Systems, Yahoo!, Netscape, Sun Microsystems, Compaq, Digital Equipment Corporation, and America Online (AOL) raised venture capital early in their lives. Some of today's fastest-growing entrepreneurial companies, such as Facebook, Twitter, Airbnb, LinkedIn, Fitbit, and Uber were also recipients of venture capital.

Over the past 20 years we've been involved in hundreds of venture capital financings. A decade ago, after a particularly challenging financing, we decided to write a series of blog posts that would demystify the venture capital financing process. The result was the Term Sheet Series on Brad's blog (www.feld.com/archives/category/term-sheet), which was the inspiration for this book.

As each new generation of entrepreneurs emerges, there is a renewed interest in how venture capital deals come together. We encounter many of these first-time entrepreneurs through our activities as venture capitalists at our firm Foundry Group (www.foundrygroup.com), as well as our involvement in Techstars (www.techstars.com). We have been regularly reminded that there is no definitive guide to venture capital deals and as a result set out to create one.

In addition to describing venture capital deals in depth, we've tried to create context around the players, the deal dynamics, and how venture capital funds work. We've tossed in a section on negotiation, if only to provide another viewpoint into the brains of how a venture capitalist (at least the two of us) might think about negotiation. We also took on explaining the other term sheet that fortunate entrepreneurs will encounter—namely, the letter of intent to acquire your company.

We've tried to take a balanced view between the entrepreneurs' perspective and the venture capitalists' perspective. As early-stage investors, we know we are biased toward an early-stage perspective, but we try to provide context that will apply to any financing stage. We've also tried to make fun of lawyers any chance we get.

We hope you find this book useful in your quest to create a great company.

Audience

When we first conceived this book, we planned to target it at first-time entrepreneurs. We both have a long history of funding and working with first-time entrepreneurs and often learn more from them than they learn from us. Through our involvement in Techstars, we've heard a wide range of questions about financings and venture capital from first-time entrepreneurs. We've tried to do a comprehensive job of addressing those questions in this book.

As we wrote the book, we realized it was also useful for experienced entrepreneurs. A number of the entrepreneurs who read early drafts or heard about what we were writing gave us feedback that they wished a book like this had existed when they were starting their first company. When we asked the question, "Would this be useful for you today?" many said, "Yes, absolutely." Several sections, including the ones on negotiation and how venture capital funds work, were inspired by long dinner conversations with experienced entrepreneurs who told us that we had to write this stuff down, either on our blog or in a book. Well—here it is!

Of course, before one becomes a first-time entrepreneur, one is often an aspiring entrepreneur. This book is equally relevant for the aspiring entrepreneur of whatever age. In addition, anyone in school who is interested in entrepreneurship—whether in business school, law school, an undergraduate program, or an advanced degree program—should benefit from this book. We've both taught many classes on various topics covered in this book and hope this becomes standard reading for any class on entrepreneurship.

We were once inexperienced venture capitalists. We learned mostly by paying attention to more experienced venture capitalists, as well as actively engaging in deals. We hope this book becomes another tool in the tool chest for any young or aspiring venture capitalist.

While we've aimed the book at entrepreneurs, we hope that even lawyers (especially those who don't have much experience doing venture capital deals) and experienced venture capitalists will benefit from us putting these thoughts down in one place. At the minimum, we hope they recommend the book to their less experienced colleagues.

Finally, unintended beneficiaries of this book are the spouses of venture capitalists, lawyers, and entrepreneurs, especially those entrepreneurs actively involved in a deal. While Brad's wife, Amy, is quick to say, "Everything I've learned about venture came from overhearing your phone calls," we hope other spouses can dip into this book every now and then. This can be especially useful when your entrepreneurial life partner some empathy while complaining about how a venture capitalist is trying to sneak a participating preferred into a round.

Overview of the Contents

We start off with a brief history of the venture capital term sheet and a discussion of the different parties who participate in venture capital transactions.

We then discuss how to raise money from a venture capitalist, including determining how much money an entrepreneur should raise and what types of materials one will need before hitting the fundraising trail. Included in this section is a discussion about the process that many venture capitalists follow to decide which companies to fund.

We then dive deeply into the particular terms that are included in venture capital term sheets. We've separated this into three chapters—terms related to economics, terms related to control, and all of the other terms. We strive to give a balanced view of the particular terms along with strategies to getting to a fair deal.

Following the chapters on terms, we discuss how convertible debt works and the pros and cons versus raising equity.

We've introduced a new section in this edition about crowdfunding, how it differs from traditional venture capital deals, and how we think the crowdfunding ecosystem will affect venture capital.

We then go into a frank discussion about how venture capital firms operate, including how venture capitalists are motivated and compensated. We then discuss how these structural realities can impact a company's chance of getting funded or the relationship between the venture capitalist, her firm, and the entrepreneur after the investment is made.

Since the process of funding involves a lot of negotiation, the book contains a primer on negotiations and how particular strategies may work better or worse in the venture capital world. We also attempt to help the entrepreneur learn ways to consummate a transaction in a venture capital financing while avoiding common mistakes and pitfalls.

Since there is no such thing as a standard venture capital financing, we cover different issues to consider that depend on the stage of financing a company is raising. We also discuss some of the theories behind why any of these documents even exist so that you can understand the hidden incentives in the process.

As a bonus, we've tossed in a chapter about the other important term sheet that entrepreneurs need to know about: the letter of intent to acquire your company.

Finally, we end with why term sheets even exist in the first place along with tips concerning several common legal issues that most startups face. While not a dissertation on everything an entrepreneur needs to know, we've tried to include a few important things that we think entrepreneurs should pay attention to.

Throughout the book we've enlisted a close friend and longtime entrepreneur, Matt Blumberg, the CEO of Return Path, to add his perspective. Whenever you see a sidebar titled "The Entrepreneur's Perspective," these are comments from Matt on the previous section.

Additional Materials

Along with this book, we've created some additional materials that you may want to review. They are all on the *Venture Deals* website at www.venturedeals.com, which was referred to in previous editions as the AsktheVC website at www.askthevc.com. And no, the price of the Venture Deals domain wasn't very high.

Venture Deals (previously AsktheVC) started out several years ago as a question-and-answer site that we managed. We've recently added a new section called "Resources," where the reader can find many standard forms of documents that are used in venture financings. They include the term sheet as well as all of the documents that are generated from the term sheet as part of a venture financing.

We have included the standard forms that we use at Foundry Group (you can use these if we ever finance your company). We've also included links for the most popular standard documents that are used in the industry today, along with commentary about some of the advantages and disadvantages of using them.

Additional resources for classroom use are available to professors. Please visit www.wiley.com/WileyCDA/WileyTitle/productCd-119259754 .html for more information.

Jason Mendelson and Brad Feld
July 2016

Acknowledgments

We wouldn't have been able to write this book without the able assistance of many people.

A huge thanks goes to Matt Blumberg, CEO of Return Path, for all of his insightful and entrepreneur-focused comments. Matt provided all of the sidebars for "The Entrepreneur's Perspective" throughout the book, and his comments helped focus us (and hopefully you) on the key issues from an entrepreneur's perspective.

Our Foundry Group partners, Seth Levine, Ryan McIntyre, and Lindel Eakman, put up with us whenever Brad said, "I'm working on Jason's book again," and whenever Jason said, "I'm working on Brad's book again." We couldn't do any of this without our amazing colleagues at Foundry Group, including our assistants, Jill Spruiell and Mary Weingartner.

A number of friends, colleagues, and mentors reviewed early drafts of the book and gave us extensive feedback. Thanks to the following for taking the time to meaningfully improve this book: Amy Batchelor, Raj Bhargava, Jeff Clavier, Greg Gottesman, Brian Grayson, Douglas Horch, David Jilk, TA McCann, George Mulhern, Wiley Nelson, Heidi Roizen, Ken Tucker, and Jud Valeski.

Jack Tankersley, one of the fathers of the Colorado venture capital industry, provided a number of his early deal books from his time at Centennial Funds. In addition to being fascinating history on some legendary early venture capital deals, they confirmed that the term sheet hasn't evolved much over the past 30 years. We'd also like to thank Jack for the extensive comments he made on an early draft of the book.

Thanks to Bill Aulet and Patricia Fuligni of the MIT Entrepreneurship Center for helping track down the original Digital Equipment Corporation correspondence between Ken Olson and Georges Doriot.

Our VC brethren, whether they realize it or not, have had a huge impact on this book. The ones we've learned from—both good and bad—are too numerous to list. But we want to thank them all for participating with us on our journey to help create amazing companies.

We can't think of anything we'd rather be doing professionally, and we learn something new from you every day.

We've worked with many lawyers over the years, some of whom have taken us to school on various topics in this book. We thank you for all of your help, advice, education, and entertainment. We'd especially like to thank our friends Eric Jensen and Mike Platt at Cooley LLP, who have consistently helped us during the fog of a negotiation. Eric was Jason's mentor, boss, and friend while at Cooley and originally taught Jason how all of this worked.

We'd like to thank one of Brad's original mentors, Len Fassler, for creating the spark that initiated this book. Len's introduction to Matthew Kissner, the chairman at John Wiley & Sons, resulted in a two-book contract with Wiley, which included *Do More Faster: TechStars Lessons to Accelerate Your Startup* by Brad and David Cohen. Although *Do More Faster* was published first, the idea for this book was the one that originally captured the attention of several people at Wiley.

Brad would like to thank Pink Floyd for *The Dark Side of the Moon* and *Wish You Were Here*, two albums that kept him going throughout the seemingly endless "read through and edit this just one more time" cycle. He'd also like to thank the great staff at Canyon Ranch in Tucson for giving him a quiet place to work for the last week before the "final final draft of the first edition" was due.

Jason would like to thank the University of Colorado Law School and especially Brad Bernthal and Phil Weiser for letting him subject himself to both law and business students while teaching many of the subjects contained in this book. Special thanks to Herbie Hancock for providing the background music while Jason worked on this book.

A number of friends and colleagues found errors in the first and second editions, which we dutifully listed at www.askthevc.com/wp/errata. Special thanks go to David Cohen, Anurag Mehta, Tom Godin, Philip Lee, Tal Adler, Jason Seats, and Jeff Thomas who were the first to identify each error.

We thank all of the entrepreneurs we have ever had the chance to work with. Without you, we have nothing to do. Hopefully we have made you proud in our attempt to amalgamate in this book all of the collective wisdom we gained from working with you.

Finally, we thank our wives, Amy Batchelor and Jennifer Mendelson, for putting up with us and making our lives so much more fulfilling.

Venture Deals

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