BRAD FELD
JASON MENDELSON

venture deals

BE SMARTER THAN YOUR LAWYER AND VENTURE CAPITALIST

FOURTH EDITION

WILEY

Venture Deals

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AND VENTURE CAPITALIST

Fourth Edition

Brad Feld
Jason Mendelson

WILEY

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Foreword by Fred Wilson (3rd Edition)

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, poked his head into my office (yes, I had an office in Rockefeller Center at age 25) and said to me, "Can you model out a financing for XYZ Company at $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 and so that wasn't an option. So, after spending about 10 minutes getting up the courage, I walked back to that big office, poked 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 genesis 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 Union Square Ventures, 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 a friend and frequent co-investor, Brad Feld. 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 got 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 premoney 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, angel, and venture capital financings should do themselves a favor and read it.

Fred Wilson
USV Partner
July 2016

Foreword by James Park (3rd Edition)

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? 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 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. Honestly, 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 biggest-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 and 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 literally 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 the best you can with advice from some of the best VCs I know.

James Park
Fitbit Cofounder and CEO
July 2016

Foreword by Dick Costolo (1st and 2nd Editions)

I wish I'd had this book when I started my first company. At the time, I didn't know preferred stock from chicken stock and thought a right of first refusal was something that applied to the NFL waiver wire.

Today, as the CEO of Twitter and the founder of three previous companies, the latter two acquired by public companies and the first acquired by a private company, I've learned many of the concepts and lessons in this book the hard way. While I had some great investors and advisers along the way, I still had to figure out all the tricks, traps, and nuances on my own.

My partners and I in our first company, Burning Door Networked Media, were novices, so we made a lot of mistakes, but we managed to sell the company in 1996 for enough money to keep ourselves knee-deep in Starbucks tall coffees every morning for a year.

Several years later, my partners at Burning Door and I started a new company called Spyonit. This company did better and was sold to a public company called 724 Solutions in September 2000. Our stock was tied up for a year (we weren't that tuned in to registration rights at the time) and when we got our hands on the stock in mid-September 2001, the collapse of the Internet bubble and the financial aftermath of 9/11 had caused our stock to decline to the point that it was worth enough money to keep us knee-deep in tall skim lattes at Starbucks every morning for a year.

So, like all good entrepreneurs, we tried again. This time, armed with a lot more knowledge and humility, we started FeedBurner in 2004. We raised several rounds of venture capital, including a seed round from DFJ Portage, a Series A round from Mobius Venture Capital (the firm Brad Feld and Jason Mendelson were part of at the time) and Sutter Hill, and a Series B round from Union Square Ventures. FeedBurner grew quickly, and before we knew it we had attracted acquisition interest from several companies, including Google, which purchased us in 2007 and allowed me to stop using coffee-purchase analogies to quantify the payout.

After spending several years at Google, I was recruited to join Twitter, where I now am the CEO. During my tenure with the company, Twitter has grown dramatically, from 50 people to more than 430 people, and has completed two major rounds of financing, having raised over $250 million.

When I reflect back on what I now know about VC deals, acquisitions, how VCs work, and how to negotiate, it's very satisfying to see how far I've come from that day back in the early 1990s when I cofounded Burning Door Networked Media. When I read through this book, I kept thinking over and over, "Where were you when I started out?" as the knowledge contained between these covers would have saved me a remarkable amount of time and money on my journey.

Brad and Jason have written a book that is hugely important for any aspiring entrepreneurs, students, and first-time entrepreneurs. But it's not just limited to them—as I read through it I found new pearls of wisdom that even with all the experience I have today I can put to good use. And if you are a VC or aspire to be a VC, get in the front of the line to read this to make sure you are armed with a full range of understanding of the dynamics of your business. Finally, if you are a lawyer who does these deals for a living, do yourself a favor and read this also, if only to be armed with things to use to torture your adversaries.

Dick Costolo
Twitter CEO
March 2011

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, raised venture capital early in their lives. Some of today's most significant entrepreneurial companies, such as Facebook, Twitter, Airbnb, LinkedIn, and Uber were also recipients of venture capital.

Over the past 25 years we've been involved in hundreds of venture capital financings. About 15 years ago, after a particularly challenging financing, we decided to write a series of blog posts to 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 were regularly reminded that there was no definitive guide to venture capital deals and decided to create one.

In addition to describing venture capital deals in depth, we have tried to create context around the players, the deal dynamics, and how venture capital funds work. We have tossed in a section on negotiation, if only to provide another viewpoint into how venture capitalists (at least the two of us) might think about negotiation.

We also took on the task of explaining the other term sheet that fortunate entrepreneurs will encounter—namely, the letter of intent to acquire your company.

With each subsequent edition of the book, we have added sections on alternative forms of financing, including convertible notes, crowdfunding, and initial coin offerings. Most recently, we've added sections on hiring a lawyer and an investment banker, as well as a detailed section on raising venture debt.

We have 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 also try 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 aim 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 have heard a wide range of questions about financings and venture capital from first-time entrepreneurs. We have 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 the 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 those 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!

Before one becomes a first-time entrepreneur, one is often an aspiring entrepreneur. This book is equally relevant for the aspiring entrepreneur of any age. If you are in school and interested in entrepreneurship—whether in business school, law school, an undergraduate program, high school, or an advanced degree program—you will benefit from this book. We have each taught many classes on various topics covered in this book and hope it becomes standard reading for any class on entrepreneurship.

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

While we have aimed this book at entrepreneurs and investors, we hope that even lawyers 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 so that we can all speak a similar language around venture deals.

Finally, unintended beneficiaries of this book are the significant others of investors, lawyers, and entrepreneurs, especially those entrepreneurs actively involved in a deal. While our wives are quick to say, "Everything I've learned about venture came from overhearing your phone calls," we hope your life partner can dip into this book every now and then. This can be especially useful when an entrepreneur needs some spousal empathy while complaining about how a venture capitalist is forcing a participating preferred upon them.

Overview of the Contents

We begin with a brief history of the venture capital term sheet and a discussion of the different parties who participate in venture capital transactions. Following this is a section on preparing for fundraising and choosing the right lawyer.

We then discuss how to raise money from a venture capitalist, including determining how much money an entrepreneur should raise. This includes a section on how to properly prepare your company for fundraising and discusses the materials you will need before hitting the fundraising trail. As part of this, we explore 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 have separated this topic 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 for 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 next cover several alternative forms of fundraising, including product, equity, and token crowdfunding and how they differ from traditional venture capital deals. This is followed by a detailed section on venture debt.

We then go into a frank discussion about how venture capital firms operate, including how venture capitalists are motivated and compensated. We discuss how these structural realities can impact a company's chance of getting funded or could impact 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 negotiating and how particular strategies may work better or worse in the venture capital world. We 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 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. We include a section on how and when to hire an investment banker to help you sell your company.

Finally, we end with a section on why term sheets even exist in the first place, along with tips concerning several common legal issues that many startups face. While it's 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.

Whenever we introduce a new term, we italicize it. There is a glossary in the back of the book with short definitions for each of these italicized terms. 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 have created some additional materials that you may want to review, including resources for use of this book in a classroom. These materials are all on the Venture Deals website at www.venturedeals.com (referred to in previous editions as the AsktheVC website at www.askthevc.com). And no, the venturedeals.com domain wasn't very expensive.

Venturedeals.com 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 provided the standard forms that we use at Foundry Group (yes, you can use these if we ever finance your company). We 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.

If you use our book in an online course or at a university, you will now find an extensive "Teaching" section on the website, along with several example syllabi.

As we complete the fourth edition of this book, we humbly appreciate all the support we have received and people we have met through our writing. Thank you all very much for allowing us to do what we do.

Jason Mendelson and Brad Feld
May 2019

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

Huge thanks go 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 Lindel Eakman, Seth Levine, Ryan McIntyre, and Chris Moody 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 Annie Heissenbuttel.

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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, T.A. 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 detailed 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 colleagues, 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, a board member 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 inflict himself on both law and business students while teaching many of the subjects contained in this book. Special thanks to Supreme

Beings of Leisure for providing the background music while Jason worked on this book.

A number of friends and colleagues found errors in previous editions, which we have corrected in this edition. 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 various errors. Thanks to Ian Herrick for all of his grammatical and spelling help with the fourth edition.

We thank all of the entrepreneurs we have ever had the chance to work with. Without you, we would 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.

Introduction: The Art of the Term Sheet

One of the first famous venture capital investments was Digital Equipment Corporation (DEC). In 1957 American Research and Development Corporation (AR&D), one of the first venture capital firms, invested $70,000 in DEC. When DEC went public in 1968, this investment was worth over $355 million, or a return of over 5,000 times the invested capital. AR&D's investment in DEC was one of the original venture capital home runs.

In 1957 the venture capital industry was just being created. At the time, the investor community in the United States was uninterested in investing in computer companies, as the last wave of computer-related startups had performed poorly and even large companies were having difficulty making money in the computer business. We can envision the frustration of DEC's cofounders, Ken Olson and Harlan Anderson, as the investors they talked to rejected them and their fledgling idea for a business. We can also imagine their joy when Georges Doriot, the founder of American Research and Development Corporation, offered to fund them. After a number of conversations and meetings, Doriot sent Olson and Anderson a letter expressing his interest in investing, along with his proposed terms. Today, this document is called the *term sheet.*

Now, imagine what that term sheet looked like. There are three different possibilities. The first is that it was a typed one-page letter that said, "We would like to invest $70,000 in your company and buy 78 percent of it." The next is that it was two pages of legal terms that basically said, "We would like to invest $70,000 in your company and buy 78 percent of it." Or it could have been an eight-page typed document that had all kinds of protective provisions, vesting arrangements, drag-along rights, and Securities and Exchange Commission (SEC) registration rights.

Our guess is that it was not the third option. Over the past 50 years, the art of the term sheet has evolved and expanded, reaching its current eight (or so) page literary masterpiece. These eight pages contain a lot more than "We'd like to invest $X in your company and get Y% of it," but, as you'll learn, there really are only two key things that matter in the actual term sheet negotiation—economics and control.

In DEC's case, by owning 78% of the company, AR&D effectively had control of the company. And the price was clearly defined—$70,000 bought 78% of the company, resulting in a $90,000 post-money valuation.

Today's venture capital investments have many more nuances. Individual venture capitalists (VCs) usually end up owning less than 50% of the company, so they don't have effective voting control but often negotiate provisions that give them control over major decisions by the company. Many companies end up with multiple VCs who invest in the company at different points in time, resulting in different ownership percentages, varying rights, and diverging motivations. Founders don't always stay with the company through the exit and, in some cases, they end up leaving relatively early in the life of a company for a variety of reasons. Companies fail, and venture capitalists have gotten much more focused on protecting themselves for the downside as well as participating in the upside. Governance issues are always complex, especially when you have a lot of people sitting around the negotiation table.

While it would be desirable to do venture capital deals with a simple agreement on price, a handshake, and a short legal agreement, this rarely happens. And while there have been plenty of attempts to standardize the term sheet over the years, the proliferation of lawyers, venture capitalists, and entrepreneurs, along with a steadily increasing number of investments, has prevented this from happening. Ironically, the actual definitive documents have become more standard over time. Whether it is the Internet age that has spread information across the ecosystem or clients growing tired of paying legal bills, there are more similarities in the documents today than ever before. As a result, we can lend you our experience in how venture financings are usually done. The good news is once you've negotiated the term sheet, you are done with the hard part. As a result, that's where we are going to focus our energy in this book.

Throughout this book we will cover not only the what and how of venture capital financings, but also why things work as they do. Let's begin our exploration by discussing the various players involved.