Venture Best

Entrepreneur's Introduction to Venture Capital Financings

Michael Best
Michael Best & Friedrich LLP

VentureBest

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Introduction - Venture Capital for the Uninitiated

This brief introduction to raising venture capital is aimed at early-stage entrepreneurs trying to figure out if venture capital is a good option for financing their businesses and, if so, what to expect during the process of identifying, selling, and closing the right venture capitalist and deal. Far from comprehensive, this guide provides a 30,000-foot view of the venture capital landscape. Needless to say, nothing in this guide should be construed as legal advice and you should contact one of our Venture Best professionals with specific questions regarding your situation.

Many entrepreneurs find the process of courting venture capital investors obscure; the venture capital decision making process opaque; and the process of negotiating and closing a venture capital investment tedious, confusing, and expensive. We hope this guide will help entrepreneurs develop a better understanding of the venture capital mating game. That should, in turn, make the selling proposition a bit more straightforward; the decision making process a little more transparent; and the negotiation and closing of a transaction a bit less tedious, perhaps less confusing, and maybe even a bit less expensive.

Section 1 - Finding, Approaching, and Courting Venture Capital Investors

Is Your Deal Right for Venture Capital?

If you're wondering whether venture capital is a good fit for you and your new business, you should focus on two critical questions. First, does your business model fit the venture capital investment model? Second, are you, as an entrepreneur, ready to bring in a stranger as a key partner in your business -- a stranger with interests that in crucial ways and at crucial times may not line up with yours?

Venture Capital Investment Model

The key to figuring out whether your deal is ripe for venture capital, and, if so, how to pitch it to potential venture investors ("VCs"), is understanding how venture capitalists think of investment returns. To get right to the point, while you think of your deal as *the* deal, a VC thinks of your deal as *a* deal. In practice, this means that while the entrepreneur thinks of return expectations in terms of their particular deal, prospective VCs evaluate each deal in terms of how it will impact their portfolio of deals.

The standalone vs. portfolio perspective on deal returns is critical because entrepreneurs often mistake a VC's portfolio return expectations (say a 40 percent IRR, a decent and common enough rough estimate) with the VC's much higher expectations for each of the several deals that make up her portfolio of investments. A venture capital portfolio of 10 deals, for example, will likely include one or two "home runs," generally 10 times or greater returns, measured on a cash invested/cash harvested basis (see sidebar on page three for a brief discussion of IRR vs. Cash-on-Cash measures of return), a couple of doubles and triples, a couple of singles, and a couple of strikeouts.

If you think about that for a minute, the implication is clear: a VC's success is driven almost entirely by how many home runs she hits. One home run might cover the fund's capital base, a second home run doubles that, and a couple of doubles and triples provide the frosting on the cake. It is almost impossible for a venture fund to succeed without at least one and often two home runs, and industry-leading performance is almost always built on more home runs, not more doubles and triples. As a result, VCs generally only invest in deals that have home run potential. So, the question of whether your deal suits the venture capital investment model really comes down to this: assuming your deal works, can the prospective early stage venture investor reasonably expect to get back at least $10 for each $1 invested?

Forget IRR, Cash is King

Most people think of investment gains in terms of rates of return on investment, the most common of which in the investment business is the internal rate of return or "IRR." And lots of VCs, their investors, and entrepreneurs spend a fair amount of energy calculating IRRs. When you are presenting your deal to a prospective venture capital investor, though, don't waste your time. What the venture investor wants to know is how much cash he can expect to get back, if the deal works, relative to how much he put in. Why? Mostly because given the way venture investors draw down capital from their investors (more or less as needed to make investments), the fact that the capital is not recycled for new investments (it's distributed to the fund's own investors), and the short life of the typical venture investment fund (10 years), a much simpler and easier way to look at returns – both on individual deals and on aggregate investment distributions to a venture fund's investors – is how much cash went in and how much came back. The cash-on-cash measure is easier to calculate, easier to understand, and much less susceptible to gaming. And 10 times or better is what early stage venture investors want to see.

Next question: Are you really, deep down, ready to let a third party in on your dream, a third party with real power, real interests that don't always mesh with yours, and, in most cases, an ego more or less as big as yours?

Venture capital investors have all kinds of personalities and styles (though, in our experience, there aren't many VCs out there short on self-confidence). Hopefully, you can find one with a style and personality that is compatible with your own. Even if you do, you still have to remember two things. First, it's the fund – usually made up two and sometimes a dozen or more professionals -- that makes the investment, not the particular VC that you work most closely with. And the thing is, funds and their internal teams evolve in composition and focus over time, and either event can complicate, and sour, your relationship with your venture fund investor. Second, your VC (and her fund) is a fiduciary charged with looking at your company solely in terms of maximizing the returns of her fund's own investors. The vast majority of VCs, even those considered the most "entrepreneur-friendly," put their obligations to their own investors ahead of the interests of the entrepreneurs they've invested in. Industry terms like "founder redeployment" may be funny, in a gallows humor sort of way, but they exist because, well, VCs send founders to the gallows more often than most of them would like to admit. One of the deans of the industry, Don Valentine, is widely cited for his statement, "I have never fired a CEO too soon."

Venture capitalists sometimes have a reputation as "vulture capitalists," whose primary purpose is to take advantage of entrepreneurs. We have worked with dozens of VCs over the years and that is (almost) never the case. Most VCs are, if not charming, at least bright, adventurous, interesting, and as benign as any other group of workaholics I can think of (including entrepreneurs). The "value added investor" pitch most VCs tout is more than a marketing slogan. Many VCs can and do make real contributions to the success of their portfolio companies beyond providing capital, and many of them genuinely care about the people and businesses they invest in. But never forget: when, for whatever reason, a VC needs to make a choice between supporting an entrepreneur or protecting the best interests of her investors, she will always make the choice that best serves her investors. And she should. That's her job.

The bottom line? Entrepreneurs with venture capital-worthy deals should seriously consider seeking venture capital investment. But they should do so with their eyes wide open to the realities of bringing another powerful and interested party into their business. It may, at the closing of the courtship, feel like a deal made in heaven. But it's often a Faustian bargain.

Targeting Venture Capitalists

Entrepreneurs who are not located in Silicon Valley or one of a handful of other venture capital hubs are often surprised at the breadth of the venture capital universe. "Serious" venture funds can range in size from a few million dollars to billions of dollars; there are funds that specialize in early-, mid-, and late-stage deals; funds that invest exclusively in narrow segments of specific industries; funds that invest only in certain places; and countless other fund variations and flavors. Further, every venture fund has a life cycle, roughly divided into four overlapping periods: raising capital, investing capital, managing investments, and harvesting (or "exiting") investments. Finally, while almost every venture investor says that he likes to lead deals, in fact most funds play "follow the leader" more often than they play "follow me."

For entrepreneurs, the implication of venture fund diversity is homework and careful targeting. Shot gunning your deal to every venture investor you can find wastes time, energy, and money, and broadcasts your newbie status to the venture world. It's also a good way to get your deal from the "new inventory" rack to the "shopped deal" bin in very short order. So, before you think of contacting a venture capital investor about your deal, make sure the fund does your kind of deal (stage, industry, geography), that it is currently doing them (that it is in the investing stage of its own life cycle), and, ideally, that it is, or has good connections with, a credible lead investor. On this last point, it's ok to spend some time talking with well-regarded funds that might participate in your deal but are unlikely to lead it: they can be good referral sources to potential leads.

Venture Capital Investment Decisions

Entrepreneurs are often confused about how venture capital funds make investment decisions. While subject to a variety of twists, the key thing to understand is this: venture capital firms almost always vest investment decisions in a group of the firm's senior professionals. Investment decisions often must be unanimous, and most often be brought to the "investment committee" (a term of convenience here) by a member of the investment committee. Unless and until an entrepreneur has the support of a venture capitalist on the investment committee (sometimes referred to as someone with "deal authority") the entrepreneur should not consider themselves anything more than a deal that hasn't been turned down yet. In a larger firm, you may need to get a junior professional interested in your deal first, but doing that should not be confused with the firm being interested in your deal. On the other hand, once you get a venture professional with deal authority behind you, you are somewhere in the 50/50 range of getting the firm to at least offer a term sheet.

Venture Capital Courtship

Ok, you've identified your targets. What next?

First, avoid the temptation of immediate, direct contact. One of the better known realities of venture investing is that deals that "come in over the transom" almost never get funded. These are the unsolicited and unannounced business plan arrivals that, even if they amounted to less than half the numbers that the typical venture capitalist claims, would have a material impact on deforestation around the globe. "Over the transom" deals get little if any consideration and almost never get funded. For every 100 funded deals, maybe one arrived at the lead investor's shop via the transom. So, don't go there.

Instead, find a credible contact in your network who knows a fund you have targeted to introduce you. The best person? An entrepreneur who has made money for the particular venture fund before. But if that is the gold standard, there are plenty of acceptable silver and bronze referral sources out there. Lawyers, accountants, and other professionals who work with venture investors and venture-backed entrepreneurs typically have good direct and indirect contacts with venture capital investors and the broader venture network. They also likely want your business (and want to get credit for good deal flow from the venture investors in their network) and are almost always anxious to introduce promising entrepreneurs to qualified investors. Finding a good referral source for a particular venture fund may take some work, but in this hyper-connected age, any entrepreneur who can't dig one up for a particular investor is probably not the kind of entrepreneur who is likely to get funded.

Assuming you've been appropriately referred, or introduced to, a VC, your first meaningful objective is to get a face-to-face meeting with an investment professional at the fund, ideally a person with deal authority (i.e., a person who is a voting member of the firm's investment team. See text box "Venture Capital Investment Decisions"). Your Pitch Deck, Executive Summary, Business Plan, and preliminary contacts and meetings with lower level professionals are all tools to get you in front of a VC with deal authority. This is not to say the Pitch Deck, Executive Summary, Business Plan and junior level contacts are not important: to get you in the door, one or more of them will have to make the deal authority members of the investor team want to know more. But ultimately VCs invest in people, not business plans, and getting in front of (and impressing) the people who can “speak for the firm” on investment matters is the most critical step in the venture capital courtship process.

Broadly, there are three possible outcomes to your first meeting with a venture capital investor: “thanks but no thanks,” “interesting, keep us posted” perhaps accompanied by some suggestions or referrals, and “we want to know more, and then perhaps meet again.”

If you get the “thanks but no thanks” treatment send a nice “thank you for your time” note and ask for any advice, critiques, or networking referrals the investor might share with you. If there is an opening, ask if you can follow up with them later, when you accomplish something (finding a lead investor, getting a customer, etc.) that seemed important to them when you met. Beyond that, put them in the “turned us down for now” category and move on. And, don’t take too seriously any reason(s) they give you for not doing the deal: as often as not the readily offered reasons are pro forma at best, incomplete, and perhaps not even true.

If you get the “interesting, keep us posted” or similar non-committal but at least vaguely positive response, you should follow up along the same lines, but instead of the “turned down” file put the investor in the “some interest” file and periodically keep the contact live with updates on your status and to take their temperature. Try, over time, to make them feel like a part of your project and a valued counselor.

A warning about the “interested but won’t commit” investor: While you should generally keep these investors in the loop, do not assume they are seriously interested, do not share your troubles with them gratuitously, and do not suggest to others, particularly other potential investors, that they are seriously interested unless they give you permission to do so. One all-too-common investor turnoff is the entrepreneur who overstates the interest level of other investors. And one all-too-common investor trick is dragging entrepreneurs along so that they can later say they were always interested when a solid lead steps up to the plate.

If after the first meeting you’ve got a live one, the chase is on, and the next objective is a term sheet. The time from establishing serious interest to a term sheet can take anywhere from a few days to a year or more. We’ve been involved with several deals that took a couple of years to go from first meeting to a term sheet, and several deals that took as long as six months to go from a term sheet to a closing. That said, once you have a term sheet – and there is likely going to be some back and forth negotiating of the same – you should target 30-90 days for the closing, depending on complexity and surprises.

Venture Capital Syndication

One way to characterize venture capital financings is by the number of investors; more specifically, “Is there more than one?” If so, the investor group is typically called a “syndicate.” While working with a syndicate can pose challenges, in most cases the advantages of syndicating a deal exceed the disadvantages.

Let’s start with the disadvantages. The primary disadvantages of assembling and closing a syndicate are (i) the additional time and expense it takes to assemble the syndicate, get through due diligence, and close the investment and (ii) the complications that can arise if multiple members of the syndicate view themselves as empowered to negotiate on behalf of, or in addition to, the syndicate itself. The key to dealing with these challenges is to clearly identify, for all parties, a “lead” investor as the primary conduit for all communications between the syndicate and the company. Once the lead investor is identified, it is incumbent on the company and the lead investor to make sure that all substantive communications between the company and the syndicate members go through the lead investor, particularly all negotiations regarding the term sheet and the closing documents. Keeping all the members of the syndicate on the same page – deal wise and due diligence wise – is very important to a smooth closing process.

As for the advantages of syndication, the most obvious plus is in the case where your capital needs exceed the capacity of a single investor. This is most often the case in markets that are served mostly by Angels and smaller venture funds with limited capital. Still, even when your deal could be funded by a single investor, there are good reasons to consider a multi-investor syndicate instead. Two in particular stand out. First, a syndicate provides some insurance against any single investor souring on the deal, or undergoing some internal evolution or stress that limits its interest or ability to participate in subsequent financing rounds. For example, the partner responsible for your deal might leave the fund; the fund might shift its strategic focus away from your industry; the fund might find itself overcommitted to other investments, etc.

A second advantage of working with a syndicate is a reduction in financing risk. If for whatever reason, be it related to company performance or market conditions, you find yourself needing additional capital in an unfavorable financing environment, how much “dry powder” your current investors have on hand is a critical factor in your ability to navigate through the crisis. The more motivated investors you’ve got, the less likely you are to be left to fend for yourself in difficult negotiations with potential new investors.

A final, often overlooked, advantage of some syndicates is the potential for multiple “value adds” from different members of the syndicate. One of the reasons venture financing is so expensive, or at least one of the rationales, is that good VCs and their funds bring more to the table than money. As you work with your lead investor to assemble a syndicate, try to include investors that have complimentary value-add propositions. For example, if your lead is long on industry/technology operating experience, try to include an investor with broader and deeper networks with downstream investors in the syndicate. If your lead is a fund that will have limited dry powder for subsequent rounds, try to include among the followers in the syndicate an investment from an investor that typically does later, larger investment rounds.

For good or bad, venture financings often involve syndicates. While not without their distractions and potential for problems, in most cases the advantages of working with a syndicate comfortably outweigh the disadvantages.

A Note on Angels

So-called “Angel” investors often fill an important funding gap for very early stage entrepreneurs with limited initial capital needs (generally $1 million or less, occasionally $2 million or more). Angels run the gamut from clueless individuals who don’t really know what they are doing (dumb money) to groups of sophisticated investors who for all practical purposes operate as and provide the value-added capital that institutional venture capital funds provide. Given the low concentration of institutional venture capital resources “between the coasts,” entrepreneurs outside of the major venture hubs are fortunate that a number of variously sophisticated Angel groups are active in these regions.

Working with more sophisticated Angel groups is more or less like working with smaller venture capital funds. The primary difference will be in the decision making and due diligence processes (assuming the Angel is a group of individuals and not a “lone wolf”). In theory, Angel groups can and sometimes do offer quicker decisions and due diligence. In practice, they can also be slower than traditional venture investors because they tend to have more people with a voice in the investment decision, and in many cases allow individual members of the group to make personal side investments, which can complicate the process. Against these modest inefficiencies, most Angels are motivated, at least in part, by one or more entrepreneur-friendly concerns such as mentoring new entrepreneurs, giving back to the community and supporting regional economic development, in addition to maximizing investment returns. Their more public-spirited motives sometimes result in better deal terms for entrepreneurs, and reduced investor and entrepreneur stress.

In contrast to working with more sophisticated Angels, there are some special, not very intuitive, warnings and rules about working with “dumb money” Angels. First, and most counterintuitive of all, you have to be careful and not let them pay *too much* for your deal. Less sophisticated Angels are often willing to pay substantially higher prices than traditional venture investors and more sophisticated Angels. There is nothing wrong with taking advantage of that, to a degree. However, taking too high a valuation from a less sophisticated Angel can (and too often does) hamper later professional venture investment. More sophisticated later investors are often very reluctant to “cram down” or “washout” the earlier Angel investors by pricing the new deal at a fraction of the Angel round. Even if you can convince the Angel to cooperate (including, in effect, exempting the entrepreneurial team from much of the pain) the new investors will be reluctant to “invest in a potential lawsuit” from the washed-out Angels if the deal subsequently does emerge as a home run. Rule of thumb? Be wary of taking money from less sophisticated Angels at more than two times of the price you would likely get from a professional investor.

A few more warnings about working with less sophisticated Angels. By their very nature they are less likely to offer any value added beyond their capital. Worse, because of their lack of familiarity with the ups and downs of the high-risk world of venture capital-worthy startups, they can be particularly difficult to manage when things go wrong, as they often do, even in ultimately successful startups. The same naiveté that can make doing the deal easier can make managing the less-sophisticated investor more difficult down the road. Finally, less-sophisticated Angels will often seek terms that, even if seemingly reasonable, are not “market” or typical: terms that can make a follow on round with a sophisticated VC problematic and, now and again, even not doable.

In sum, entrepreneurs between the coasts are fortunate that there are Angel investors that can supplement and leverage the limited supply of institutional venture capital. Just make sure you understand just how sophisticated your potential Angel investor is, and deal with them appropriately.

Section 2 – The Term Sheet

Preliminary Thoughts

The purpose of a term sheet is clear enough: the parties should make sure they agree on the material terms of an investment before they start the expensive process of having their attorneys draw up the deal documentation and perform the related due diligence. What is less clear, for many entrepreneurs, is the significance and inter-relationship of the various pieces of the term sheet. Terms controlling key issues can be hidden in provisions that seem quite unrelated. For example, in most term sheets, if you want to know who gets what if the business is sold for a handsome profit, the place to look is the often contentious and heavily negotiated “Liquidation Preference” term. It pays for entrepreneurs to familiarize themselves with the structure and sometimes less-than-obvious inner-workings of term sheets before they try to negotiate one (remember the venture investors do this for a living).

Another preliminary thought on term sheets. At any given point in the business cycle, term sheets and term sheet negotiations will reflect important elements beyond the specifics of the particular deal being negotiated. Beyond the state of the business cycle, one such element is the accumulated experience of VCs over the last 60 years or so (approximately the lifetime of the venture capital industry as we know it today). While specific terms can and will vary from deal to deal and over the business cycle, as can the level of detail in the term sheet, the basic structure of venture capital term sheets, and even most of the key terms and their common variations, is largely a given in venture capital negotiations. Term sheet particulars evolve, but slowly, and while every deal is unique very few term sheets break significant new ground.

Something else to keep in mind about term sheets. Putting one on the table is something VCs consider their prerogative, not yours. Entrepreneurs should be generally familiar with the “standard” term sheet format and range of terms, and communicating that familiarity is fine. Having a sense of the kind of deal you are looking for (tempered, of course, by a sense of reality) is a good idea as well. But don’t make the mistake – and it will be perceived as a mistake by the VC – of putting a term sheet in front of a VC. Unless you are specifically asked – which is very rare – let the VC put the term sheet ball in play.

A final preliminary thought on term sheets. Term sheets invariably reflect two primary variables: the specifics of the particular deal, and the state of the market when the term sheet is negotiated. An entrepreneur has some control over the particulars of the deal, but has no control over the state of the market. That said, in any market, the only way for an entrepreneur to get the upper hand in term sheet negotiations, to move the ball away from the “going rate” in the market and into the entrepreneur’s favor, is to have more than one potential *lead* investor on the hook. The single best way, some would argue the only good way, for an entrepreneur to change the rules of the game in any meaningful way during term sheet negotiations is to have, and keep, more than one lead investor competing for the deal.

Understanding Your Term Sheet

Term sheets for venture capital transactions are generally in the two-to-eight pages range, depending on the complexity of the transaction and the level of detail. Form, in this case length, should follow function, and the function, in the case of a term sheet, is to summarize the material terms of a proposed transaction in sufficient detail that closing documents can be prepared without the likelihood that either party will want to add or change material terms after the term sheet is finalized. Such changes at best add to the expense of closing, and at worst can derail the transaction. Absent new, unexpected information that materially impacts the value of the proposed investment, neither party should expect “another bite at the apple” once the term sheet is final.

The National Venture Capital Association (“NVCA”) has developed a model set of venture capital financing documents, including a term sheet, which can be found at www.nvca.org. The document is quite comprehensive, and includes a variety of common alternative approaches to specific terms. There is also extensive commentary on the pros and cons of the various alternative provisions. The following discussion focuses on a few of the most significant term sheet provisions.

Valuation

The first section of the term sheet, typically annotated “The Offering” or “The Transaction” or some similar term, is where the valuation agreed to by the parties is memorialized in several different ways (it’s a pretty fundamental point). These provisions will say what kind of security (usually convertible preferred stock), and how much, the various investors are purchasing in one or more closings. The valuation is based on how many “fully-diluted” shares the investors are buying and for what price per share, relative to the total outstanding fully-diluted shares which will be outstanding subsequent to the closing. “Fully-diluted” takes into account all the shares of common stock that would be outstanding (including any shares issuable upon conversion of any outstanding convertible securities and any shares issuable upon exercise of any outstanding options or warrants), plus an additional number of shares that the parties have agreed can be issued as equity incentives to employees (see “Employee Incentive Pool” on page 12). By way of a simple example, if an investor buys 40% of the fully-diluted post money equity for $1.0 million, the post money valuation is $1,000,000/0.4, or $2.5 million. The pre-money valuation would be $2.5 million minus $1.0 million, or $1.5 million (note: the valuation discussion is around the value of the company as a whole, not the valuation per share. Per-share pricing falls out from the valuation discussion, and is often adjusted (via dividing or combining the shares prior to the closing) to get a convenient figure – say $1.00 per share).

Dividends

Because early-stage venture-backed companies seldom pay any dividends, this section of the term sheet is easy to overlook, and that can be a big mistake. Beyond providing that dividends cannot be paid to other shareholders unless they are first paid to the investors who hold preferred stock (a reasonable result), the dividends section will establish whether dividends on the preferred stock accumulate. So-called cumulative dividends, that is, dividends that carry over from year-to-year if they are not declared and paid in any given year, can be a subtle but significant way to transfer value from founders and other common shareholders to investors. Suppose, for example, an investor purchases preferred stock and holds it for five years, during which no dividends are paid. The company is then sold for $1.40/share. If the dividend was non-cumulative, the investor would likely be entitled to $1.00/share on the sale, with the remaining $0.40/share divided, as per other provisions of the term sheet, among all of the shareholders. On the other hand, if the investor’s stock was entitled to cumulative dividends, the investors would be entitled to the entire $1.40/share proceeds of the exit transaction.

Cumulative dividends can be appropriate if, and when (e.g., dividends could start to accumulate only in some out year), a company can reasonably be expected to generate predictable earnings from which dividends could be paid. For the vast majority of early-stage, venture- backed companies, the “when” variable, at least, is so problematic as to make a cumulative dividend provision unreasonable, and thus unacceptable.

Liquidation Preference

The term “liquidation preference” seems to suggest that this provision is about what happens if the company fails and is liquidated. And it does. But it is much more important than that. This is because the provisions of the Liquidation Preference section are generally applicable not only to situations where the company has failed, but also to situations where the company is sold to or merged with another company. As the vast majority of successful “exit” or “liquidity” events involve sale or merger transactions (M&A Exits), entrepreneurs *must* understand the common alternative approaches to the construction of the Liquidation Preference section of the term sheet.

There are two basic approaches to the Liquidation Preference, with a broad middle ground available for compromise. On one end of the spectrum (widely thought of as the common sense approach by entrepreneurs) is “non-participating” preferred stock. In the event of an M&A Exit, a holder of non-participating preferred stock has a choice: (i) surrender its preferred stock in exchange for its basic liquidation preference (typically the amount paid for the stock plus any declared but unpaid or accumulated dividends); or (ii) convert its preferred stock into common stock and then share the proceeds of the M&A Exit pro rata with the other holders of common stock. On the other end of the spectrum is “participating” preferred stock. In the event of an M&A Exit a holder of participating preferred stock can choose either (i) to surrender its preferred stock in exchange for its basic liquidation preference *plus* the number of shares of common stock that it would have been entitled to had it converted, and “participate” pro rata with common shareholders in any remaining proceeds of the M&A Exit, or (ii) simply convert its preferred stock into common stock and then share the proceeds of the M&A Exit pro rata with the other holders of common stock. The difference between these two alternatives is of no importance if the M&A Exit transaction is for an amount less than or equal to the base liquidation preference of the preferred stock, and of limited practical importance if the M&A transaction generates a huge, say 10 times or more, sum relative to the base liquidation of the preferred stock. In between those extremes, the more so the smaller the M&A Exit proceeds, it can result in a substantial shift of the M&A Exit proceeds in favor of the investors.

As a practical matter, “double dipping” preferred (as entrepreneurs sometimes call participating preferred) is a common feature of preferred stock in venture transactions, particularly in tight markets. Nevertheless, among the various provisions of the term sheet, it is one of the most heavily negotiated. That’s because there is a pretty broad set of “middle ground” solutions to the problem, where the entrepreneur and investor agree that the preferred can choose to participate to a maximum of X times the base liquidation preference, or in the alternative, convert to common and share all proceeds pro rata with other common shareholders.

Control Provisions

Many entrepreneurs who have not worked with venture capitalists before think of controlling the business in terms of who controls the majority of the stock of the company, and perhaps to who controls the Board of Directors. In reality, even venture investors with distinct minority share holdings and minority board positions will usually enjoy a substantial measure of control. Both the “Protective Provisions” and “Voting Rights” set forth in the term sheet and the applicable state’s corporations code typically give holders of a distinct class of stock, such as the preferred stock typically held by venture capital investors, a variety of rights to, in effect, veto various corporate actions, including, for example, issuing additional shares of stock in future financings, changing the corporation’s bylaws or charter documents in ways that impair the rights of the holders of the preferred stock, or selling the company. While many of these provisions are "standard" and only rarely subject to substantial modification, entrepreneurs should make sure they understand them, and go into the relationship with new investors with their eyes wide open.

With respect to the Board of Directors, venture investors, particularly when working with less experienced entrepreneurs, will often seek control of the Board of Directors. Entrepreneurs should push back hard here. Most investors will ultimately agree at least to an equal split on the Board between the investors and the common shareholders, with a tie-breaking director nominated by one group and reasonably acceptable to the other group. As to the size of the Board, five is usually a good working number at this stage, supplemented, perhaps, by one or more non-voting Board observers.

Founder Vesting

Entrepreneurs are often surprised when, as part of the negotiations with investors, they are asked to take some of the shares of stock they already own free and clear and subject them to "vesting" such that if, after the investment, they leave the company (voluntarily or otherwise) the company can repurchase (usually at the price paid when the shares were acquired – which is typically nominal) some of the founder's shares. Stated that directly, it does seem a rather odd request. Alas, for all but the most proven entrepreneurs (and often even for them), investors will insist on some level of vesting as a mechanism for discouraging founders from leaving the company prematurely. The vast majority of investors rate the people as the most important part of the deal, over and above the market and the technology, and thus they are understandably interested in tying founders to the company as tightly as possible. So-called "golden handcuffs" are a common way to do that.

How many founder shares are subject to vesting over what periods of time is heavily negotiated, and can vary quite a bit. That said, a more or less common founder vesting agreement would subject half of the founder's stock to monthly vesting over 24 months after the closing. So, for example, if the founder quit 12 months after the closing, the company could repurchase a quarter of the founder's shares. The key variables are usually how much time/effort/value has been contributed before the financing; how important the investor thinks the particular founder sticking around is; and how committed the investor thinks the founder is to sticking around.

The Employee Incentive Pool

Sometimes overlooked during the pre-term sheet valuation discussions, the impact of the number of shares the company and the investors agree should be set aside for future equity incentives for employees ("Incentive Pool") on valuation is something that entrepreneurs should understand *before* they enter into serious valuation discussions. The reason is simple: the investors expect that their valuation will be unaffected by the Incentive Pool; that all of the shares set aside for the Incentive Pool will, in effect, be absorbed by the founders in terms of their impact on valuation.

By way of example, suppose that you agree with your investors that the pre-money valuation of your company is $2 million, and that the investors will be investing $2 million for a 50% interest in the company. The post-money valuation is thus $4 million. Then, when the term sheet starts circulating, the founders see that there is now an Incentive Pool included in the capitalization, equal, say, to 20% of the post-money valuation. Now, you might think that the new 20% dilution would be shared by the founders and the investors; a logical, but incorrect assumption. Rather, the new post-money ownership structure will be 50% investors, 20% Incentive Pool and 30% founders.

If this strikes you as unfair, well, it is what it is. The investors will argue that when they agreed that the company was worth $2 million pre-money they meant that it was worth $2 million including a “customary” set aside for the Incentive Pool. Thus, the Incentive Pool dilutes the founders, not the investors. Entrepreneurs are wise to talk about the size of the Incentive Pool, and include it in their thinking, at the beginning of the valuation discussions, or risk a nasty surprise when they get the first draft of the term sheet.

Negotiating the size of the Incentive Pool is a tricky matter. It is not uncommon for startups to provide for an Incentive Pool of 20%, particularly when the company anticipates the need to recruit a CEO relatively soon after the financing. As the investors may note, the dilutive impact on the founders is only real if/when the equity in the Incentive Pool is actually distributed to employees and vested. On the other hand, entrepreneurs should generally favor a smaller Incentive Pool. The reasoning (from the entrepreneur perspective) is that if the Incentive Pool proves too small, the dilution associated with any future additions to it after the financing will be shared by all of the shareholders, including the investors in the earlier round, equally. While entrepreneurs are unlikely to convince investors that there should be no Incentive Pool, to the extent they can keep it smaller rather than larger they can set the stage for sharing at least a part of the Incentive Pool-related dilution with their investors down the road.

Anti-Dilution “Price” Protection

As is all too familiar to most investors, when you buy a publicly-traded share of stock for, say $10, and the price subsequently falls to, say, $5, the investor now holds stock worth $5. Venture capitalists are not most investors. When they buy a stock from a startup for $10, and subsequently additional shares (other than from the Incentive Pool) are sold for $5, the venture capitalist will in almost every case now hold shares valued at somewhere between $5 and $10 dollars, depending on the kind of anti-dilution price protection that is incorporated into the terms of the investor’s preferred stock.

This is not the place to argue the merits of price protection. Suffice it to say that as entrepreneurs we’ve always thought it unfair, and as venture capital investors, we’ve never done a deal without it. Rather, as an entrepreneur, your realistic objective is to minimize the damage by getting the best price protection terms you can get.

What, as an entrepreneur, you want to avoid is “ratchet” price protection, the most draconian kind of price protection. When an investor proposes ratchet price protection, it is suggesting either that the investor thinks you are too naïve to object or that your deal is seriously troubled. In either event, it is not a good sign. While the mechanics are a bit more complex than this, the impact of ratchet price protection is to reduce the effective price paid by the investor for its stock, $10 in the example, to the price paid by a subsequent investor, $5 in the example. Ouch.

If the simplicity of the ratchet form of price protection is attractive, its application is brutal. If the company sells so much as one additional share of stock to an investor at a price below the price of the previous, protected investors, the effective price paid by the protected investors is reduced to the most recent price.

The alternative form of price protection is called “weighted average” or “formula” protection, which considers not only the price of a subsequent sale of stock below the earlier protected price but also the relative size of the subsequent sale as compared to the total capitalization of the company. In the extreme, a very large subsequent transaction, the net result can begin to approximate the result that would be applicable with a ratchet price protection scheme. In the other extreme, a very small subsequent sale of stock at even a very low price will have very little “repricing” impact on the protected shares.

Formula price protection comes in two flavors: narrow and broad. Entrepreneurs prefer broad based formula protection because it assumes that the pre-transaction capitalization included in the formula takes into account not only the shares actually outstanding but also shares that could be acquired if all then-outstanding convertible securities were converted, including all shares in the Incentive Pool, whether issued or still in the Pool. A narrow formula would not include shares that could be acquired by the conversion of shares (or exercise of options) that are in the Incentive Pool but have not been allocated to specific employees.

Stock Transfer Provisions

Entrepreneurs sometimes forget that investors are investing in the people as much or more than in the business. In most cases, few things would discourage an investor from making an investment more than concluding that the key people might leave the company prematurely. Beyond that, investors are also wary of co-investors opting out of the deal prematurely as well, at least in transactions that they themselves are not able to participate in. These concerns typically lead to a variety of restrictions on stock transfers by founders and investors, over and above those required by state and federal securities laws. Most of these provisions, with names like “drag along rights” and “first refusal rights,” are aimed at discouraging premature “exits” by founders and investors and making sure that any such exit opportunities are shared with the other investors and in some cases founders. While these provisions are, in many cases, less controversial than other important provisions of the term sheet, they are very important to understand. They not only have substantial impacts on premature exits when they happen, but their very existence can make negotiating such transactions much more difficult, which, for investors, is arguably the real significance of these provisions.

No Shops

Finally, many term sheets will include a “No Shop” provision that bars the entrepreneur from negotiating with other investors after the term sheet is signed. Entrepreneurs often can and do resist these provisions, but they are nevertheless quite common. The critical issue with a no shop is to limit its term. During the no shop period, the investor effectively has an option to invest or not: the company cannot negotiate with other investors. While it is not unreasonable for an investor to want some assurance that the company will not be looking for a better deal while the investor is actively engaged in due diligence and related activities and expenses to close the transaction, entrepreneurs should be careful to make sure that the term of the no shop is short enough to incent the investor to move with “all deliberate speed” towards closing.

Section 3 – Getting the Capital

Closing the Deal: More than a Formality

Ok, you've got a signed term sheet. What next?

The good news is that the large majority of signed venture capital term sheets with reputable VCs ultimately result in an investment, though you should never count your money until the checks clear. The bad news is that the time, complexity, and expense of going from term sheet to the done deal is almost always greater than the entrepreneur expects. The primary reason for this is the breadth and depth of the two-part due diligence process. A secondary factor is the number, length, and complexity of the transaction documents.

Due Diligence I: "Deal" Diligence

The due diligence on the business: you have to do more than just tell them the story, now you have to show them the family jewels (and the appraisals…)

Deal due diligence is easy to understand, if at times the process can be intrusive and, from the entrepreneur's perspective, a distracting waste of valuable time and energy documenting what the entrepreneur already knows about her business and technology. Indeed, deal due diligence is largely about confirming the truth of what the venture investor understood about the business from its pre-term sheet due diligence. The entrepreneur already knows it is all true, although in a fair number of deals, the deal due diligence in fact does generate valuable new insights for entrepreneurs and investors alike. The investors, however, have not been living and breathing the deal for nearly as long as the entrepreneur has. Further, as fiduciaries they have a responsibility to their own investors to thoroughly investigate every deal before it closes. If they don't, or even if they do, and something goes wrong that they should have discovered before making the investment, they can suffer enormous damage to their credibility, which is to say to their careers as VCs, not to mention possible legal action by their investors.

A True Tale of Deal Due Diligence Gone Bad

(The names and technologies involved have been disguised, to protect confidential information). Two well-known venture capital investment funds put several million dollars into an Ivy-League chemist's new technology that promised to lower the cost of producing designer peptides by two orders of magnitude. Less than 90 days after the investment closed, it was discovered that the technology, the prototype, in fact, was a complete fraud. Oops.

Due Diligence II: "Legal" Diligence

As a character in Shakespeare's Henry VI memorably said, "the first thing we do, let's kill all the lawyers." Well, someone has to do the legal due diligence and the best people to do it are the lawyers (and, of course, the paralegal professionals that work with them).

If entrepreneurs generally understand the "what" and "why" of deal due diligence, they often do not understand the content and purpose of legal due diligence. If the deal due diligence question is, essentially, "can these people do what they say they can do?," the legal due diligence question ultimately boils down to "if they can do what they say the can do, is the company we are investing in going to enjoy all of the financial benefits of their doing it?" This investment-critical question has two parts, both of which take real time and energy to answer, and both of which are more complicated than many entrepreneur's think.

The first legal due diligence question involves what lawyers often refer to as "corporate cleanup." Corporate cleanup involves identifying and tying up all of the legal loose ends that the typically administration-light entrepreneurial team has created while focusing on bigger picture tasks. Things like making sure that everyone who has had any access to the company's proprietary information has signed an effective confidentiality agreement; that all rights to the technology actually belong to the company; that the company's capitalization is fully-disclosed and that everyone understands and agrees to the specifics; that the company is in compliance with all of its material agreements as well as applicable regulatory, corporate governance, and tax provisions; etc. Now, experience tells venture capital investors that entrepreneurs, particularly less experienced entrepreneurs with limited funds and without outside investors, are seldom very good at dealing with all of these issues. There is, alas, often a lot to cleanup. In those rare instances where there isn't, there will still be a lot of paperwork to review.

The second aspect of legal due diligence is making sure that the investment transaction itself is legally enforceable and reflects the investor's expectations. Is there anything about the deal itself that is contrary to any other obligation of the company? Is the deal properly approved by all of the requisite parties (shareholders, board, in many cases key employees, or other third-parties)? Is the deal effectively filed and recorded with the applicable public authorities? Is the transaction executed in compliance with all applicable state and federal securities laws?

A True Tale of Legal Due Diligence Gone Bad

(Names, dates, and other particulars aside, as before). A company that had completed a successful initial public offering (IPO) of its share subsequently changed its law firm. About 18 months after the IPO, the company decided to do a secondary public offering. Everything was going well until, a couple of days before the closing, the company's law firm, in the course of its legal due diligence, discovered that the shares that had been sold in the IPO didn't exist. The applicable filing of the existence and terms of the shares with the Delaware Secretary of State's office never happened. If you think that legal due diligence is expensive, I can only say that in 20 years in and around venture capital transactions, I've never seen a legal due diligence bill that was within an order of magnitude of just the financial expenses associated with cleaning this particular mess up, much less the costs in terms of management time and focus.

The (Extensive) Paperwork

While all of the due diligence is going on, the lawyers are also preparing and negotiating deal documents. The bad news here is that even a simple, plain vanilla transaction can easily produce two inches worth of documentation, and larger, more complex but still not uncommon deals can easily get to the six-to-eight inch range. The good news is that 90% of the paperwork is standard language (or should be if the parties are at all serious about the expense and time-to-close of the transaction), perhaps 90% of the remaining language is "semi-custom" but still pulled from prior deals and forms, leaving only the remaining 1% for original drafting. The NVCA has produced annotated models of the important common venture capital transaction documents, which can be found at www.nvca.org.

Controlling Expenses (and they are all yours)

The reason most entrepreneurs think venture capital closing expenses are high is pretty simple: they are. Part of that is the inherent nature of the beast. Dividing up ownership and control of a rapidly evolving, high-risk, high-reward new business is complex. All kinds of good, bad, and indifferent scenarios have to be provided for, the only given being that the scenario spelled out in the business plan is almost certainly not, in at least some important ways, what is going to happen. The last thing you want, at some future crisis point, is to have the various parties uncertain about their rights and responsibilities, or the consequences on the same of alternative courses of action.

While the inherent complexity of most venture capital investments is an important, and to some extent, unavoidable cost-driver, there are several common cost-drivers that entrepreneurs can, to some extent, control. These drivers can and often do double or even triple the already hefty costs of closing a venture capital investment.

Overly Complex Terms

Cash-strapped entrepreneurs often quite sensibly look at spending decisions on a “how can I get 90% of the benefit for 10% of the time and expenses” basis. When it comes to who gets to share in the ownership and management of their business, however, they understandably can get pretty obsessed with even small details and fanciful contingencies. Venture capitalists, obsessed with their own fiduciary obligations to their investors, sometimes find themselves in the same situation, and since the company will be paying their legal fees as well as its own, they can be even less sensitive to costs. Put these two players in the same room, and you can end up with an expensive deal, indeed.

It is hard to generalize about what is “complex enough” and what is “too complex” because every deal is unique. That said, here are two ways of thinking about the problem. First, if you are working with good lawyers, tell them that you want a “West Coast” deal, not an “East Coast” deal. The allusion is to the historic (and to a lesser but real extent modern) tendency of venture deals on the East Coast being substantially more complex then comparable deals on the West Coast. If your lawyers don’t know this, they are probably not right for your deal (see below). Second, a clean, plain vanilla venture capital A round can usually be done in a stack of papers not taller than two inches.

Use Venture-Experienced Counsel

You would not ask the world's best heart surgeon, much less a general practitioner, to do a liver transplant. Neither should you ask a lawyer that doesn't regularly represent entrepreneurs and venture investors to handle your venture capital transaction. Lawyers who make venture capital transactions a regular part of their business are familiar with the current "state-of-the-art" documents on hand, and are aware of current market conditions. You can safely assume that a good corporate lawyer who has never handled a venture capital transaction before will, at least, double the expense of the transaction, and in the process, will probably not do as good a job as a more experienced professional.

Take the Paperwork and Process Seriously

There is a fine line between letting the lawyers do their job and making them do yours. If you don't think your lawyers should be spending a dozen hours reconstructing your corporate records, deliver them in a complete and indexed package. If you don't think your lawyers should be billing you for the multiple layers of costs that can be associated with late-in-the-day disclosures and document edits, focus on the document and disclosure issues early in the process. If you don't understand a part of an agreement, ask about it before it is sent to the other side. The bottom line is this: the amount and expense of corporate cleanup is largely a function of how seriously the entrepreneur takes the tedious but necessary job of administration and the amount and expense of document revisions is usually at least partly a function of how timely and carefully the entrepreneur reads and asks questions about the documents.

Section 4 - Care and Feeding of VC Investors

Venture capitalists have a wide variety of personalities and styles, making it difficult to generalize about the post-closing management of the venture capitalist/entrepreneur relationship. Still, there are a few commonalities in the care and feeding of most venture capitalists.

Surprises

VCs don't like them, particularly when they are unpleasant or problematic surprises, which, alas, they often are. While you shouldn't share everything with your venture investors, you should keep them timely informed of material events in your business. When you have a serious problem, share it. Your venture investors not only might have some good ideas for dealing with it, but nothing loses the trust and confidence of your investors faster than giving them cause to think you are not being up-front with them. Many a "redeployed" founder can trace her demise to a time when the venture investors lost faith in her commitment to timely and accurate communications about the business.

Managing a Syndicate

If you have two or more venture capitalists in your deal, try to identify one as your primary point of contact with the syndicate; usually the lead in the investment round. This does not mean that you should exclude others from what is going on, but rather that you try to inculcate a culture among the syndicate that company/investor matters are, at least as a matter of first impression, dealt with by the CEO for the company and the lead investor for the investors, much as the relationship was handled during the completion of the investment transaction. As appropriate, other investors can be brought into the discussion, but you don't want every investor to think of you every time they have a question or concern. Just as you are (or at least you should be) the focal point of communicating matters about the company to the investors, so you should try to identify a lead investor to fill that roll for the investor syndicate. Warning: complete success here is rare, but worth pursuing.

The Investor/Micromanager

Some investors are just micromanagers by nature, or become so over the life of your deal. In the latter case, when an otherwise reasonably engaged investor becomes a micromanager, the transition probably reflects a loss of confidence in management. There is no tried-and-true method for dealing with micromanaging investors. One approach that usually helps is being proactive about communications. For example, make your pre-meeting board packages thick and get them out early. We've seen many a problematic investor/director quieted down with the phrase "as you may recall, that information is at Tab F in the board package you received last week."

The Next Round, Part I

If, like most venture-backed entrepreneurs, you will need additional rounds of venture capital funding, you should start planning for that raise the day after the first round closing party. No matter how close you are to your current investors, and how reassuring they are about being able to put together the second round for you, do not rely on that. Even if they have the best of intentions, and even if they can deliver the goods, the best way to make sure the pricing and terms of the next round are as favorable as they can and should be is to have more interested players at the negotiating table than there are seats at the closing table. In no way should you turn away the assistance of your current investors. You should, however, cast your net farther afield.

The Next Round, Part II

As you will have learned in the process of reviewing the closing documents for your first round venture investment, your existing investors have a lot of control over the parameters of your next round of financing. In most cases, they have what is, in effect, a veto-like universe of ways to block, and thus to influence, the terms of subsequent investment rounds. However, while your current investors are most certainly a third-party to your negotiations with subsequent investors, in most cases their position is not as strong as it is on paper. First, like you, not being able to attract needed additional financing is a game breaker for them almost as much as it is for you. Second, they usually have so much power on paper that they dare not risk exercising it in a way that the legal system might find is abusive of their responsibilities to the company itself and other shareholders. There should be no mistake, your existing investors have a seat at the negotiating table with new investors in future rounds, and must be handled carefully. At the same time, the specific provisions of prior investment agreements are not as controlling as the real-time dynamics of the next round negotiations.

Venture Best

For more information, please contact any one of our Venture Best team members.

Shawn T. Stigler
Managing Partner, Broomfield & Boulder
Co-Chair, Venture Best®
ststigler@michaelbest.com
T. 303.800.1569 (Broomfield)
T. 303.800.1580 (Boulder)

Melissa M. Turczyn
Partner
Co-Chair, Venture Best®
mmturczyn@michaelbest.com
T. 608.257.7484

Patrick J. Bernal
Partner
pjbernal@michaelbest.com
T. 303.223.1707

Anthony J. Biller
Managing Partner, Raleigh
ajbiller@michaelbest.com
T. 984.220.8744

Adrienne S. Ehrhardt, CIPP/US, CIPM
Partner
Practice Group Chair,
Privacy & Cybersecurity
asehrhardt@michaelbest.com
T. 608.283.0131

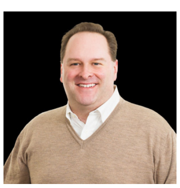
Brad R. Jacobsen
Partner
Co-Leader, Transactions
brjacobsen@michaelbest.com
T. 801.833.0503

Gregory J. Lynch
Co-Founder, Venture Best®
Partner
gjlynch@michaelbest.com
T. 608.283.2240

Omar Hakim
VP of Client Strategy
ohakim@michaelbest.com
T. 512.640.3177

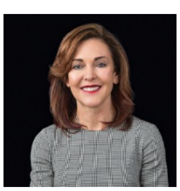
James R. Lawrence, III
Partner
jrlawrence@michaelbest.com
T. 984.220.8746

Aaron K. Nodolf
Partner
aknodolf@michaelbest.com
T. 262.956.6536

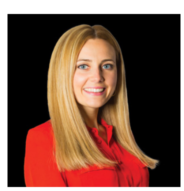


Jeffrey D. Peterson
Partner
jdpeterson@michaelbest.com
T. 608.283.0129

Lyndon L. Ricks
Partner
llricks@michaelbest.com
T. 801.924.4103



Elizabeth A. Rogers, CIPP/US
Partner
earogers@michaelbest.com
T. 512.640.3164



Betsy T. Voter
Partner
btvoter@michaelbest.com
T. 801.924.4105

Venture Best

Paul A. Jones
Of Counsel
pajones@michaelbest.com
T. 608.283.0125

Jolly L. Northrop
Senior Counsel
jlnorthrop@michaelbest.com
T. 303.536.1187

Drew S. Whiting
Senior Counsel
dswhiting@michaelbest.com
T. 312.515.9838

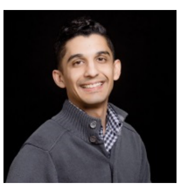
David M. Chambers
Attorney
dmchambers@michaelbest.com
T. 984.220.8733

David E. Cline
Associate
decline@michaelbest.com
T. 303.500.1441

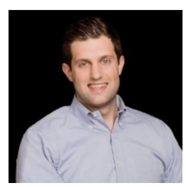
David M. DiGiacomo
Associate
dmdigiacomo@michaelbest.com
T. 303.536.1178

Daniel J. Gawronski
Associate
djgawronski@michaelbest.com
T. 608.283.0124

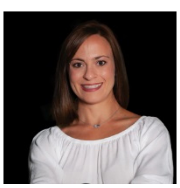
Nicholas J. Herdrich
Associate
njherdrich@michaelbest.com
T. 608.257.7473



Syed T. Madani
Associate
stmadani@michaelbest.com
T. 414.270.2736

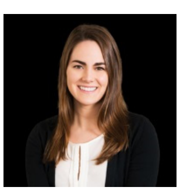


Vincent M. Morrone
Associate
vmmorrone@michaelbest.com
T. 414.277.3477

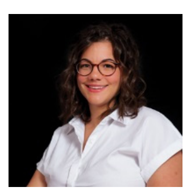


Elizabeth A. Prendergast
Associate
eaprendergast@michaelbest.com
T. 303.536.1737

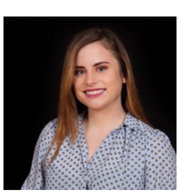
Elmon B. Tanielian
Associate
ebtanielian@michaelbest.com
T. 385.695.6455



Erika M. Tribuzi
Associate
emtribuzi@michaelbest.com
T. 608.416.1696



Kaitlyn E. Trizna
Associate
ketrizna@michaelbest.com
T. 303.309.6001



Rebecca Stifter
Transactional Law Clerk
rstifter@michaelbest.com
T. 720.398.0069

About Michael Best

Michael Best is a leading law firm, providing a full range of legal services to clients on a global, regional, and local basis. The firm has more than 340 legal professionals, including more than 250 attorneys, serving clients in 13 offices across the U.S. in Colorado; Illinois; North Carolina; Texas; Utah; Washington, D.C.; and Wisconsin.

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About Venture Best

Our Venture Best® group works closely with entrepreneurs, and with their venture capital and angel investors, to help new, high-growth companies find financial backing and grow their businesses.

We help companies and investors make connections, structure and close transactions, and maximize returns. We also counsel early-stage businesses on their financial, organizational, and regulatory needs as they grow.

We represent start-ups and emerging technology companies in many different industries, including biotechnology, information technology and software, clean tech, pharmaceuticals, medical devices, electronics, and other high-technology sectors. Members of our Venture Best ®team have themselves been venture-backed entrepreneurs, as well as angel and venture capital investors, giving us great depth of insight on both the legal and business sides of the start-up environment.