

SILICON VALLEY BUSINESS JOURNAL

A startup lawyer's guide to things a founder should do before raising venture capital

JOHN RAFFERTY
Guest contributor

Once a startup matures to a stage where it needs significant funding of \$1 million or more, a founder typically looks to venture capital firms to provide equity financing to the company. We often see founders jump into the VC capital raising process without much advance preparation. However, spending some time getting the company's "ducks in a row" before launching a fundraising process can determine the ultimate success of the startup's fundraising efforts. We counsel hundreds of startups every year, and have compiled our list – from a startup lawyer's perspective – of the top six things a founder should do before raising venture capital financing.

Select the appropriate amount of equity financing

Before starting fundraising efforts, a founder should determine how much funding is needed for the company to reach its next inflection point – i.e., the point at which a key company milestone is expected to be met, and at which time the company's valuation is expected to significantly increase. At early stages of the company's business, valuations are generally much lower than they are later once the company has grown and met key company milestones. The lower the company's valuation, the more equity in the company the venture capital firm will receive for its investment.

Accordingly, in order to reduce the amount of dilution resulting to the founder from the investment, the founder typically will want the financing to be an amount that is at least equal to – but not significantly in excess of – the amount needed by the company to reach its key milestone. But this is a very delicate balancing exercise: obtaining an insufficient amount of funds to reach the targeted milestone could set the company up for an early failure. As a result, a founder will want to carefully assess the appropriate size of the financing before initiating fundraising efforts.

Prepare for due diligence from the VCs

A venture capital firm will undertake a due diligence review of the startup's business and financials before investing. A founder should take the time necessary to confirm that the company's financials, accounting records, employee records, customer contracts and capitalization table are all in order before initiating the fundraising process. In addition, perhaps the most important item is to ensure that the



SORBETTO/GETTY IMAGES

Before a startup founder sets off to raise money from venture capitalists, it's wise not to rush into the process without taking into consideration such aspects as building a team of advisers, lining up good legal help and more.

startup's intellectual property rights in company property are secure through strong intellectual property agreements with employees and consultants.

There are few things that can derail a potential investment more than a company not having adequate rights in intellectual property generated by employees or consultants. Some advance planning on this front can save a founder from potential lost investment opportunities from VCs that are concerned about the company's lack of recordkeeping or intellectual property rights.

Conduct your own due diligence of the VCs

Each venture capital firm focuses on specific businesses, sectors and financing sizes. In most cases, a startup's potential VC investors are a fairly limited set of firms that have a particular interest in businesses operating in the startup's field and a focus on financings of the size sought by the startup.

A founder should identify in advance the venture capital firms that are likely to be interested in (and be a good fit for) the startup, and the founder should then seek to identify contacts in his or her network that may be able to make an introduction to each such VC firm.

Familiarize yourself with VC term sheets, including liquidation preferences

A founder will be rewarded in the nego-

tiation process if he or she spends some time familiarizing him- or herself with the terms typically included in a VC term sheet for an equity financing. The term sheet will set forth the primary economic and corporate governance terms of the VC's equity investment in the startup (which typically takes the form of preferred stock). This document, once agreed upon, will be used by the parties to prepare definitive financing documents.

An important term for a founder to understand is how preferred stock and liquidation preferences can be structured. At the time of a subsequent sale of the startup, the preferred stock's liquidation preference structure may have a dramatic impact on the amount of sale proceeds distributed to all equity holders of the company.

Build a team of advisers

We have found that founders of startups are surprisingly successful in forming advisory boards consisting of well-known and industry leading experts. The advisor can provide valuable guidance to the startup as it scales up and grows but, perhaps more importantly, these advisers can become an invaluable source for future business leads for the startup, including with respect to potential venture capital financing sources.

Last but not least, get good legal advice early

There are many smart and experienced lawyers (some would say too many) focused on advising startups. Make sure you retain one of them before you start the process of raising capital. You will want a startup lawyer to advise you on how to prepare for the VC investment and how the various terms proposed by the VC firm may impact the company in the future.

Moreover, an experienced startup lawyer will be aware of the latest legal developments (e.g., the National Venture Capital Association recently provided long-awaited updates to its model financing legal documents) and the pros and cons of financing alternatives to a VC investment (e.g., initial coin offerings and cryptocurrencies). Good legal advice is vital to a successful startup financing.

John Rafferty is a partner with Morrison & Foerster, a leading global law firm. His practice includes public and private mergers, tender offers, going private transactions, and strategic and financial investments. You can reach him at jrafferty@mfo.com.