In this section we're going to talk about some of the things that happen in different stages in the financing process.

Clint: To what extent do the terms and investors at the seed round influence or constrain what happens in later rounds?

Brad: Your seed-stage investors matter a lot and can have a lot of impact on what happens later on in later-stage financings. The most important thing to focus on is the notion of precedence. The terms that you get in your company at the seed-stage often will flow through to later rounds.

If you get very lightweight terms in the seed-stage, it makes the next rounds easier to negotiate because you're starting from a position where you don't have a lot of weird funky things that you're trying to deal with.

If your investors over negotiate your early rounds, or your terms are very complicated, that tends to carry thorough to the later rounds. Getting a clean financing done is very important.

The other thing that can happen is your early-stage investors can help you a lot with later rounds, or not. They can help you through introductions. They can help you through the reputation effect of having them involved, or if they're investors who, even though their early-stage investors, have very inappropriate perspective on what should be happening.

They're not angel investors but they're devil investors. They're not focused on trying to help and support you; instead they want to control you. They can hinder those later-stage financings when they come up.

Clint: Could you share an example or two of where either poor choices of investors or terms up front created problems downstream?

Brad: Sure. We run into companies all the time that have raised seed rounds from a lot of different venture capital firms. The entrepreneur had, instead of one or two or three investors who were really committed at the seed level, they ended up with seven or eight investors committed at the seed level for very small amounts of money.

Those are commonly called 'party rounds' where a bunch of VCs are essentially all tossing a little bit of money in hoping something good happens. Then if something good happens there's a feeding frenzy for the next round.

Often times there's someone who wasn't an investor in those party rounds when all of a sudden I see an entrepreneur who is looking for their next round of investment but has all of these VCs as seed investors. The first question is, "Well, why isn't one or more of them just driving the process?" There's never a particularly good answer around that.

We've made a few investments in companies that had raised party rounds where the entrepreneurs themselves had made progress, but actively didn't want any of the VC investors in their next round. As a result of that they had a tougher negotiation because those investors, in some cases, wanted to participate because the company was making progress.

That configuration at the beginning matters.

Another type of example around that that we run into all the time is where there is one very large angel in a seed financing. That angel has some expectation about what's going to happen from an evaluation or terms perspective in the venture round, where that angel's expectations are wildly out of context with what a typical venture financing is.

That angel investor then is in a position where they can really hinder the financing process because of the size of their investment stake in the round.

Clint: Let's go to the other side. What is the kind of structure for a seed deal, where you're thinking, "Wow, that's great. That says great things about the entrepreneur and makes my life easy."?

Brad: There are two types of rounds at the seed level that work that way. One is a convertible debt round, where literally, the terms are lightweight, it's convertible debt with discount into the venture round. It is without fancy features around pro rata rights and stuff like that.

The other example is the seed round with something we call 'light preferred'. It's a preferred financing, series seed or series A. It has very light preferences. It has a simple liquidation preference, no participation, little to no protective provisions, no complicated board structures or blocking rights, things like that.

It's very lightweight, where the primary thing that the seed investors are getting is in the downside case they're getting their money back. They have some protection that their capital structure can't be changed.

Either of those two things in the seed round makes the next round financing straight forward and relatively non-contentious. The second you start layering more features and terms into the seed round, you often have a multi-way negotiation, which you can include with your earlier investors.

Clint: That's on the terms side. How about on the people side? The party rounds, it doesn't sound like you like those. What would be kind of a configuration of investors you think would be successful at the seed-stage?

Brad: I'm not sure it's that I don't like the party round so much, by the way, I just think they're pretty ineffective. We've seen them play out in one of three ways. There's the success case, where the company does extremely well and everyone really badly wants to invest in the next round.

There's the middle case, which is probably the typical case where the company makes progress, but not as much progress as it might otherwise think. Some of those existing investors want to support it, others don't. In which case there is often this dynamic about who supports it and who doesn't.

Then there's the downside case, where the company hasn't made as much progress and they're trying to find a new investor to come in because none of the existing investors have any interest. There's a fourth situation, where the entrepreneurs aren't happy with what they got out of the VCs who all tossed a little bit of money in the company with lots of promise about how much they were going to help, but didn't do much.

In my experience, the best configuration for a seed round is, again, one of two things. It's a bunch of angel investors, several of whom are leads and the rest whom are follows. The leads have an active engagement with the company, not necessarily a board seat, but an engagement that's really helping the entrepreneurs at that early stage.

The other is a situation in the seed investment where there's one or two VC investors and those VC investors are actively engaged with the company at a seed level.

Those are the two cases that we've seen to be most successful and from our frame of reference are the ones that are the most powerful for the entrepreneur.