We're now going to spend some time talking about negotiations and how negotiations work. We're going to start off by talking about what really matters in negotiations.

Clint: When an entrepreneur enters a negotiation with a venture capitalist, what should their priorities be?

Brad: If you remember from the conversation at the beginning about the term sheet, there are two primary things that you're concerned about, economics and control. In the negotiation you should have a clear sense in your mind about what's important to you in those two contexts.

While there are lots of other terms in the term sheet, many of which we've talked about. A lot of them don't have anything to do with either economics or control. Within the context of either economics or control you have different priorities. In some cases you might want to really maximize your control and you're willing to give up some economics for that. In other cases you might be really obsessed about the economics and be willing to give up some control for that.

Understanding how you think about those things is important in the context of the negotiation, but it's even more important to recognize that those are the two things that should dominate your focus in the negotiation.

Clint: I've heard it said that you never make money on terms. What does that mean?

Brad: The phrase 'you never make money on terms' is a good venture capital cliché, which really speaks to the goal of what most VCs are after, especially at the early stages which is upside. They're not investing in the company to have a modest outcome. They're investing in the company to have a huge outcome.

Whenever a VC makes an investment, he or she believes that the company you're creating and that they're investing in can be hugely valuable. A VC wouldn't invest in a company that they didn't think had a huge potential upside.

In a lot of ways, focusing as an investor on the companies that have this huge potential upside is much more important than optimizing on the margin on terms. That said, a lot of VCs will then be focused on very specific things in the context of the terms; again, coming back to economics and control.

Economics because as an investor you want the lowest reasonable entry point that you can have so that in the success case you get the biggest outcome. From a control perspective, you want to be able to have the ability to protect against problems that happen when a company is not working. Most of those situations, in a positive control sense, are things that the investor would want to do to change things to potentially get to that big upside.

Clint: How should an entrepreneur prepare for a negotiation with a VC?

Brad: I think the most important thing is to understand who you're negotiating with. One of the mistakes that a lot of people make in negotiation is they don't do their research on the person that they're negotiating with. They don't know the style of the person. They don't know what's important to that person. They don't know much about the person's background. They don't have a sense as to how they've operated and comported themselves in previous negotiations.

In addition to understanding and having a clear sense of what's important to you, it's very important to understand what is important to the other person and what the frame of reference of that other person is.

Clint: Could you share with us a couple of examples of a negotiation that you've had with an entrepreneur that went really well and one that didn't go so well?

Brad: Sure. An example of one that went really well would be the example of BigDoor and how that first financing came about. Keith Smith is the entrepreneur and CEO of the company. Keith and I had gotten to know each other some through a mutual friend, a fellow named Andy Sack, who had been an investor in Keith's previous company as well as an investor in Keith's new company.

Keith's previous company had a stratospheric rise and fall. It had been very successful and then it fell apart after that. The dynamics between him and the investors were very tense because of mixed expectations and a variety of other stresses that happen when a business which is growing very quickly starts to fall apart.

In the case of BigDoor, Keith was very focused on a certain set of things from his frame of reference that he viewed as negative dynamics that came out of that first situation that he had with an investor. When he sat down to talk to me about the investment he was very clear about what mattered to him.

My offer to him from an investment perspective was very straight forward. It was literally an email with a half dozen bullet points that addressed all of the key issues that I thought mattered. Rather than going through an eight page term sheet and worrying about all of the little nuances, I tried to address head-on economics and control.

I tried to be very sensitive to the specific control dynamics that he was concerned about. We went back and forth one time. He responded with a counter, in terms of economics. The control dynamics he accepted because I focused on the control issues that were important to him. His request on economics, while I didn't meet it, was not unreasonable and we compromised very quickly on that.

The total negotiation probably took, elapsed time, maybe five minutes. It didn't even require a phone call because the two of us had prepared each other in advance. I knew what was important to him. He understood my frame of reference and knew what was important to me. We were both very focused on getting to a fair outcome.

Another example, this time a negative one, unlike the case that I just described with BigDoor. This was a negotiation for a financing that I was involved in that didn't end up resulting in a successful financing. The entrepreneur didn't really know what she wanted in the context of the financing and I didn't understand as I was negotiating for my side that the entrepreneur didn't really know what she wanted.

The way this played out was, I got to know the entrepreneur and her partners over a two or three month period. I was very excited about investing in a company that was a seed stage company. The entrepreneur and I spent time getting to know each other, but when I reflect on it, it was getting to know each other at a very surface level.

Whenever I probed on specific things that were important to the entrepreneur it was very opaque what came back to me. I thought I was very open to the entrepreneur about what was important to me. I have no way of judging that because I wasn't on the other side of it.

As we went through the negotiation I presented the entrepreneur with a term sheet. In this case, unlike the one with Keith, it was a fairly detailed term sheet because the entrepreneur had never done a venture backed deal before. She had a lawyer who was, I would say, mediocre at best and ended up going after a lot of terms that weren't that relevant and trying to do a lot of things that didn't really make that much sense and didn't have a rational basis behind it.

When I went to talk to the entrepreneur about it, she couldn't really make the argument about why something mattered to her or didn't matter to her that her lawyer was bringing up. The front end of the process, as we tried to negotiate the term sheet, was tedious. It took a long time. There was a lot of back and forth.

There was a lot of elapsed time, where we'd go back and forth on something and two or three days would pass while the entrepreneur thought about what to do and what the response would be. Eventually it felt like we were getting close to the end. By the way, my view was that we were making progress on the deal. Even though the term sheet was taking a fair amount of time to work through, we started the process of drafting the definitive agreements.

We ended up eventually agreeing on the term sheet. We continued drafting the definitive agreements. As we got near the end of the definitive agreement the entrepreneur started coming back and tried to renegotiate things we had already agreed to in the term sheet.

In a couple of very specific cases she made major requests for changes around control provisions that were important to me, especially since it was a seed deal. At some point I said, "Look this is not something I'm going to accept. If you don't want to do this, we can walk away. We don't have to do this. You don't have to take the money. It's totally fine."

Ultimately we decided not to do the investment. The entrepreneur was, I think, perplexed and didn't really understand how we got to the place where something didn't happen.

I was disappointed because I really wanted to invest. During this period of time we went through this negotiation, it was clear to me that this entrepreneur wasn't aligned with her partners and that the team didn't have a sense of what they were trying to do in terms of building a business going forward.

In some cases it was likely good that we didn't end up closing the investment. The result of this at the end was I voluntarily paid their legal fees for all that we had gone through up to this point because I felt like we probably should have started the process of negotiating definitive agreement. It was clear that there wasn't a good understanding from the entrepreneur's perspective of what they really wanted to do.

While it was an unsuccessful negotiation, more preparation on the part of the entrepreneur could have easily turned it into a successful outcome from the funding perspective.

Clint: Questions.

Student: Jason had talked about, specifically in Foundry, how you want ever meeting to be better than the last. You kind of want to have this feeling of getting to know the entrepreneur better and getting more excited about the deal. If at any point that stops you're out. I assume at that point he was talking pre-term sheet.

My question is, once you give someone a term sheet, do the same rules apply? Do you ever say, "Hey, we met a few times and talked. This shouldn't be an issue." It's almost like the fact that you have to go back and forth many times should be a deal breaker on its own, or is that just a natural piece of how you negotiate?

Brad: For us there are very few cases where we got to agreement on a term sheet and then didn't close the financing. In fact, the one that I described to you is the only one that I can think of in recent memory.

Once we've agreed to terms, even in the case for example of BigDoor where there was no term sheet there was literally just an email exchange in agreement of terms, our view is that the rest of it is mechanics. By that point we want to make the investment.

If there's something really dramatic that comes up in the formal due diligence process, I can imagine a situation where we might decide not to do something. The sentiment for us of whether we're more excited about doing the deal or not, we're at that point when we agree to the term sheet. We've made the decision that we're in.

In the example that I gave you, the dynamic of the entrepreneur, in my mind and hindsight, once they realized that deal was going to happen and that they were going to really be committed long-term to this relationship with an investor, my sense is that they really didn't want to do the investment. I don't want to say that they backed out or chickened out, but it wasn't what they wanted to do.

In fact, they didn't go close of financing with another firm right after. They essentially restructured and reconfigured the team and two of the people left. The entrepreneur is subsequently working on trying to commercialize what she's done and has raised money to this point, probably two years later.

My view, and our view at Foundry, is if we agree to something we're going to get it done. We're assuming that the entrepreneur feels the same way. It's certainly okay, if the entrepreneur doesn't, to then say, "Look, this isn't going to happen."

A negotiation isn't over until it's done. I think that's an important part of understanding the people that you're dealing with when you're doing an investment. There are plenty of VCs who say, "It's not done until the term sheet is signed."

We've been on the side, and we talked about this earlier, where as investors we had a new investor coming into a financing, signed a term sheet and then somewhere before close backed out. We've had that happen multiple times. It's certainly not the norm that you're done.

That's part of the preparation for the negotiation, getting to know the investors, knowing where those investors close on the terms that they said they did, knowing whether, if you just have an email exchange on terms, whether or not you can trust that you're going to get to a fair outcome and definitive agreement, or if you need to have every single thing spelled out in detail beforehand.

Student: The market, or anyone here that reads your book, has a pretty decent understanding of what the terms are that you likely offer. Do you still negotiate on the side of control or are most of your negotiations now, given that everyone has a great expectation about what your term sheet will have in it, is it mostly on price and valuation?

Brad: At Foundry Group I would say we're open to negotiating on any aspect because we don't view it as a template deal where, "This is standard and you must take this deal." I would say our approach is generally we try to make it very middle of the road, very fair to both sides.

We’re focused on an outcome that we’re both happy with. Because we’re investing early, like the cliché that was mentioned earlier, we don’t make money on terms. We know that the terms themselves really don’t matter that much, except in the downside cases.

In the success case, which is of course the reason we’re investing, we’re hopeful that many of the terms that we agree to don’t matter at all. What’s important to us is mostly to have a clear understanding of what the expectations are going in. That’s why we focus on the terms.

Our negotiating style also tend to be one that is pretty narrow. In other words, we figure out what we’re comfortable with and what we think is fair. We’re willing to negotiate a little bit, but we’re not playing a high-low game, which we’ll talk about in a bit, where our strategy is, “Let’s start with a really low number and then expect the entrepreneur to come back with a really high number.”

That’s another part of making sure that you understand the person that negotiating with. Some people negotiate high-low. Other people negotiate in a fairly narrow range. Some people negotiate very directly, “Here are the terms.” Other people definitely have a bait and switch. Once they get you into the negotiation dynamic and pretty committed, all of a sudden some new things start happening.

Understanding that is an important part. What the person on the other side of the negotiation is going to do is an important part of preparing for the negotiation.