The Tough Questions You Must Discuss Before You Take the Money

Xconomy.com, November 29, 2016 –

If all goes well, the day will come when just one small thing will stand between you and funding for your startup: your signature on a term sheet.

Most founders quickly sign on the line and get back to the business of growing their business. Smart ones set aside the paperwork, grab their business partners, and sit down together to talk.

What comes next isn't easy, but it's essential. It's a heart-to-heart, slightly uncomfortable let's-bare-all conversation, the kind couples should have before they get engaged. Because signing a term sheet demands a similar commitment (though without the reception and bridesmaids).

Before taking money, entrepreneurs need to be forthright about where they stand on the key issues that can derail a promising venture and devastate a partnership. Work through these questions with your co-founders, and you'll not only understand one another better, but you'll also be more likely to succeed together.

When do we sell?

Founders rightly focus on developing their enterprise, not preparing to let it go, so they often don't discuss when they'd be willing to sell. Put it out there. Level with your partners: Are we willing to sell at $50 million? How about $100 million? Ever? It's never too late to ask these questions, and you should revisit it every time you think about raising capital and at least every 18 months or so, as your business evolves.

Two entrepreneurs I advised were confronted with this question less than two years after launching their tech startup. Their product was so stellar that a big-brand company offered them eight figures. The founders did the math. They'd pocket enough money to buy houses, pay for their kids' college educations, replenish their bank accounts and still have plenty left to start another venture. They wanted to sell.

Their investors didn't. Being VCs, they wanted an even larger cash-on-cash return. For them, this was merely a business decision, while the founders analyzed the potential sale as a life-changing event. The entrepreneurs were ultimately able to sway the VCs, and the deal was done, but not without a lot of angst.

Does anyone want out now?

If you suspect that a co-founder's interest has waned or vanished over the past few months, talk it through. A round of funding can catapult your business to the next level—but it usually adds years to the probable exit horizon, which can make an already discontented partner feel trapped and even unhappier. Don't assume that everyone's ambitions and dreams are unchanging.

Are we willing to give up some control?

When you launch a business, it's all yours. When you take investors' dollars, you're giving them a measure of control of your operations and strategy.

Unfortunately, founders often don't have much leverage in negotiating those terms because those with the gold usually make the rules. That's a bitter pill for some entrepreneurs to swallow, especially when they've toiled so long on a venture. Creating competition is the best means to reduce onerous terms. You should also consider refusing an investment that comes with too many strings attached. Remember that future rounds rarely become less onerous. Your lawyer will advocate for provisions that safeguard your interests, but these often result in balancing ownership and control.

Are we getting the best partner for our needs?

A round of investment typically fuels a wave of growth. Perhaps you and your co-founders would benefit from some outside help as you scale the business during this cycle of rapid expansion. Admitting your weaknesses reflects deep self-knowledge, not poor leadership, but it might take some tough self-examination and discussion to reach that conclusion.

If you think you'll need support—and most of us do—make sure your investor is willing and capable of providing it. At a minimum, your investors should recommend people with expertise to help the company grow. Before they invest, though, vet them. Check references and scour the investors' websites for companies they've funded. Find out if those founders are satisfied with the quality of mentoring and guidance they've received.

You're usually not looking for someone to take control of your business. Instead, you're looking for tugboat pilots, the wise river masters who can help you steer your ship away from shoals and sandbars. Once you feel confident that you're getting knowledgeable, supportive partners along with your cash infusion, go ahead and ink that term sheet.

Dave Gammell, a former nuclear engineer, has nearly 20 years of experience representing companies in complex transactions throughout their lifecycle. As co-chair of WilmerHale's Emerging Company Practice, he partners with entrepreneurs, investors and startups to help clients navigate the legal issues, team dynamics and business challenges that the companies may encounter as they grow. Contact him at david.gammell@wilmerhale.com.