An Interview with Mike Kendall

Mike Kendall, Partner, Goodwin Procter LLP, speaks with Growthink University's Dave Lavinsky

Dave Lavinsky: Hello everyone. Dave Lavinsky here from Growthink and today I'm really excited to be able to interview Mike Kendall. Mike is a partner at Goodwin and Procter which is a top tier law firm which has offices all over the United States and around the world. Mike represents leading private equity and venture capital firms in early and later stage investments. He also advises emerging growth companies who are seeking to raise capital.

Naturally based on his background I thought Mike would be a great person to speak with today about the legal aspects of raising capital. So I'm really excited. Mike thanks again for taking the time to speak with me today.

Mike Kendall: You bet, Dave. Happy to help.

Dave Lavinsky: Excellent. Let's start off by discussing some of the legal pitfalls of raising capital. What are some of the biggest mistakes you see entrepreneurs make from a legal perspective when raising capital?

Mike Kendall: Well unfortunately there are number of them. Let's start maybe with choice of entity. There are a plethora of entities out there that entrepreneurs can choose to form their businesses in – C corporations, S corporations, limited liability companies.

Investors have various views about which of those entities they prefer to invest in. There are a number of potentially thorny tax issues wrapped up in that choice. So spending some time with your lawyer making an intelligent choice about that early on is an important thing for an entrepreneur to do.

Dave Lavinsky: Okay.

Mike Kendall: I'd say another area of legal pitfall is around the security law aspects of raising capital. David as you know, the security laws view individuals and institutions and particularly in terms of their wealth and sophistication,

investing acumen, differently for purposes of security laws and whether or not a company might be liable to those people after selling them stock. Taking care around the security law aspects of raising money is also fraught with legal peril and very important to keep your eye on.

Dave Lavinsky: Got it. If we're talking specifically – you mentioned these two pitfalls. One is choice of entity and one is security laws. If we're looking specifically at venture capital, is there generally one choice of entity which trumps the others and are these same security laws applicable?

Mike Kendall: Yes. Starting with the choice of entity question, most venture capital firms just as an example won't want to invest directly in a limited liability company. More often than not they invest in C corporations.

Entrepreneurs should start their companies in subchapter S corporations, which have favorable tax attributes for entrepreneurs in the early days of a business before it has any institutional investment. Those things can be automatically converted into C Corporations very easily if you take institutional venture capital later.

But generally speaking the most efficient vehicle to be in to take in venture capital is either a C corporation or an S corporation that will become a C corporation at the time of investment.

In the context of the securities laws, if you raise capital solely from an institutional venture capital fund then you will have very few securities laws issues to worry about, mostly as a result of the fact that your investor, the venture capital fund is sophisticated and is treated as such for securities laws purposes.

You know Dave I did want to mention in the area of legal pitfalls, you asked specifically about capital raising. I would be remiss though without mentioning one other one in terms of founding a business, being an entrepreneur particularly

in the technology space. From the very first day of founding a business, again particularly in the technology space, an entrepreneur needs to be very aware, very focused on protecting the intellectual property of the business.

Dave Lavinsky: Right. Sure.

Mike Kendall: We've seen lots and lots of examples of entrepreneurs with great ideas who paid little to no attention to that idea and find out later that their idea is worth substantially less than they thought or even nothing later when it becomes a successful idea, somebody looks to invest in it and realizes that the idea isn't actually protected.

Dave Lavinsky: That it's not protected you're saying.

Mike Kendall: Right. That can be a major problem and pitfall if it's not focused on. If it turns out later you didn't file a patent or you didn't sign up – somebody who developed software for you to an assignment agreement, a non-disclosure agreement and so on.

The entrepreneur, the company may not even own the invention or software application or whatever was developed, almost inadvertently, which usually can be pretty easily avoided with a little bit of time and a relatively modest amount of legal expense.

Dave Lavinsky: Can you talk through that? We get that, we see that a lot in terms of entrepreneurs wanting to raise capital but at the same time wanting to protect their idea from being stolen or losing value.

Obviously when you're raising capital you're telling your idea to a lot of people. Particularly with venture capitalists they generally will not sign non-disclosures.

Can you talk a little bit about what the entrepreneur should do to protect their idea yet still raise venture capital?

Mike Kendall: Sure. I agree with you 100% that is a very common situation you run into. I'd look at it like this. The really critical issues I was talking about like accidentally ending up with somebody else owning your idea, that's much more the case in situations where they're either hiring employees or combining in a venture with an inventor who's already filed a patent in their own name, or you're hiring maybe a software engineer, a consultant to write code for you.

Activities around actually building the business and developing the idea, that's where some of these really critical losses of intellectual property can happen. When you're in capital raising mode and you're talking to people who aren't in the business of founding and running companies, who aren't likely themselves to actually take your idea. They're a venture capitalist and maybe the worst that happens is they tell somebody at a company they're already invested in that might be competitive with your business something about what you plan to do.

But you've otherwise protected your ownership rights and your intellectual property so that other company while they may know what you're up to at some level of detail, you're already protected. They can't literally go out and steal your idea. It's much less a concern in that context.

Having said that, what prudent entrepreneurs do is they stage the disclosure of the information to those people to make sure that the venture capitalist is seeming committed and actually interested in potentially investing in the business rather than just on a fishing expedition trying to learn about what you're doing in order to exploit it.

For example, as you well know because I know you've helped some of your clients do this. You might start out with what's sometimes referred to as a teaser or an executive summary where you have a very brief description of your business and

the idea and so on in the market, just for purposes of getting an initial meeting. And then you might have a slide presentation that adds some more detail about what it is exactly you're working on -- maybe it's a technology idea, more about the market you intend to address and why it is you think your product would be successful in that market, and then maybe something about your financial model. None of that is really that proprietary.

After that you can start to get some signals from venture capitals about whether they're really interested in going deeper. Then at some point in time it will be appropriate to start revealing some more of the secrets underlying your intellectual property.

At some stage it is possible later in the process to get venture capitalists to sign NDAs in some cases, particularly when there are patents involved. But again, taking that staged approach. Even if you never get an NDA signed, it helps weed out people who might otherwise just be looking for some free information.

Dave Lavinsky: Agreed. I think that's a great idea. Particularly with venture capitalists, their time is usually very, very limited and they're not going to do an expedition to find out more about your company if they're not interested in investing I don't think.

Mike Kendall: Exactly right.

Dave Lavinsky: Excellent. Can we go into that first issue you were mentioning about losing rights to your ideas through hiring employees, outside inventors or contractors? Are these typically things that you can avoid with the right contract in the place, the right agreement in place?

Mike Kendall: Yes. In almost every case that's really all you need.

Dave Lavinsky: Ok so to make sure, if you're hiring a contractor or employee or you're working with an outside inventor that you have something in place – either some sort of work for hire, obviously it may be more complicated than that, but some sort of agreement – that specifies that the intellectual property resides with the company.

Mike Kendall: That's exactly right. And it's important to have that up-front because sometimes it's difficult or impossible to actually get those rights even if you can get somebody to sign an agreement six or eight months later. Sometimes that's too late.

Dave Lavinsky: Got it. So you want to make sure you have those up front.

Mike Kendall: Correct.

Dave Lavinsky: Okay. Excellent. Very helpful. Thank you.

I'd like to switch gears a little bit and talk about venture capital negotiating issues. A venture capital firm is interested in a company. The next step obviously is for the VC to send a term sheet.

Let's say you're representing an entrepreneur and your client receives a term sheet from a venture capital firm. What are the first things that you're looking at?

Mike Kendall: The first things I typically focus on are the economics of the security that they want to buy. As a lawyer, we spend very little time advising clients on the general issue of valuation. It's frankly not something we're particularly expert in although there are some rules of thumb.

By and large the entrepreneurs have a better sense of what they think their business is worth and how it stacks up in terms of their track record of entrepreneurship and all the things that go into the softer side of valuation.

If you take valuation as a given, the next most important thing is what are the economic terms of the security. As you know, venture capitalists typically buy preferred stock which of course means that they get their money back before the entrepreneurs does which protects their downside. But there are various flavors of preferred stock that have different economic attributes, some of which are quite detrimental to entrepreneurs.

So for example if a venture capitalist was going to make a $5 million investment in a business and let's say $5 million bought them 33% of the company. A traditional, plain vanilla, straightforward preferred stock would say that if the company were ever sold or liquidated the venture capitalist would be entitled to either their $5 million or the first $5 million or 33% of the company's value.

Dave Lavinsky: Got it. For those listening, if the venture capitalist gave our firm $5 million and eventually the firm sold for $5 million the entrepreneur would get nothing. In the case where they say they get the first $5 million, the VC would get all of the $5 million or if they sold it for $6 million, the VC would get their $5 million and the $1 million or possibly only a percentage of that would go to the entrepreneur. Is that correct?

Mike Kendall: That's right. Yep. Because in the case of $6 million, a third of that is $2 million.

Dave Lavinsky: Right.

Mike Kendall: So if you were the venture capitalist you wouldn't choose to have a third of the $6 million. Instead you'd take your $5 million.

Dave Lavinsky: Correct.

Mike Kendall: You'd take your $5 million and the balance, the extra $1 million, would go to the entrepreneur.

Dave Lavinsky: Okay. Good.

Mike Kendall: But if you sold the business for $15 million then a third of that is more than $5 million right?

Dave Lavinsky: Right.

Mike Kendall: So in that case the venture capitalist would convert and they would simply be entitled to a third. The reason I said we focus first on the economic terms of that security is that there are other flavors of that.

One of those other flavors is something that some people refer to as *participating preferred stock* or more pejoratively as *double-dip preferred stock*. That kind of security would say the venture capitalist would get their $5 million back and 33% of what's left.

So in our $15 million example, they would get the first $15 million and then $3.3 million of the balance of $10 million for a total of $8.3 million. That's obviously economically much better for a venture capitalist and substantially worse for an entrepreneur.

There are lots of different flavors in between. Sometimes in a very risky situation a venture capitalists will say, "*Well I'll put in the $5 million and I won't ask you for the participation feature on the 33% but I want more than $5 million of protection.*" Maybe I want a two times or three times preference.

We call that initial investment – the $5 million – the *liquidation preference*. Maybe I want a $10 or $15 million downside liquidation preference and then on the upside I only get 33%. That's sort of another flavor of preferred stock. It accomplishes something different. Economically it's sort of somewhere in between the plain vanilla preferred and the participating preferred and you'll see lots of different aspects of it.

But the point is that modeling out, graphing out what those returns look like in terms of the preferred stock being requested by a venture capitalist is very important because it goes directly to what ultimately ends up in the pocket of the entrepreneur when the business is sold.

Dave Lavinsky: Got it. Can you go through that last example with some numbers just so people understand it better?

Mike Kendall: Sure. Let's say it was a 2x preferred stock on our $5 million investment. That would say that the venture capitalist is entitled to the first $10 million or 33% of the company. So they're protected. They get all of the first $10 million and they continue to get $10 million unless and until in this example the company is sold for more than $30 million.

Because if the company is sold for more than $30 million, then a third of it is worth more than $10 million. Again, it's not a participating preferred. They don't get $5 or $10 million and 33% percent. But they get more protection, $10 million in our example, than the amount of their investment which was only $5 million.

So they get substantially more downside protection than in the first example of the straight, plain vanilla convertible preferred.

Dave Lavinsky: Excellent. Thank you. How negotiable have you seen in your experience these economic terms to be regarding securities?

Mike Kendall: It depends on a number of things, the most important of which is how hot is the company and how many other VCs are swarming around it.

If you're struggling to get funded, you're a first time entrepreneur and you've only got one term sheet, it's almost not worth trying. I suppose you should try because you never get what you don't ask for, but you're not likely to get it.

If you're serial entrepreneur and you've already sold two companies for more than $200 million each, I guarantee you have more than one term sheet. You'll probably have four or five or more, several of which probably come from VCs who have funded you before and made a lot of money from you. That situation is highly negotiable.

Dave Lavinsky: Got it. Agreed. So what else on the term sheet besides the economic terms of the security are you looking at first or second?

Mike Kendall: Probably the next most important thing to focus on – there are some economics around the stock option pool. Traditionally in a venture-backed company where management is using stock options as an equity incentive there's a discussion around how big a stock option as a percentage of the company will be available as an equity incentive.

And an important corollary question is who suffers the dilution from the issuance of those stock options. Is it all the entrepreneurs, is it somehow shared between the entrepreneurs and the venture capitalists? That discussion goes similarly to the one about the economics of the security.

In the case of the first time entrepreneur it's probably a smaller pool and all the dilution comes out of the entrepreneur. And in a hot company, it's probably a bigger pool and the venture capitalist probably shares some of the dilution.

Dave Lavinsky: Got it. Just so those listening understand, dilution begins if I the entrepreneur own half the company and the venture capitalist comes in and takes half the company, I only own 25%. Employees may not be diluted or they may be diluted based on this clause in the term sheet. Is that correct?

Mike Kendall: It's not so much dilution to the employees. When options are issued to the employees, say the option pool is 10% of the company then the question is whether that 10% comes from the ownership of the entrepreneur, or somehow is that 10% shared between the entrepreneur and the venture capitalist?

I will say in most cases, the owners of the company take the dilution from the creation of the stock option pool. But not always – in really hot companies that can be negotiated.

Dave Lavinsky: One more question on stock option pool. A lot of entrepreneurs, if they're very early in the start up process, and maybe they're talking to venture capitalists, they may not have a stock option pool set up officially. Is that something they need to have set up before they raise venture capital? Can they do that concurrently with it? How does that work?

Mike Kendall: The necessity for the creation of a stock option plan has in some ways nothing to do with venture capital. Those options go to employees typically in connection with their hiring, an incentive to come work in the business.

It's typically a compensation tool that lots of entrepreneurial companies need to have well before venture capitalists come in. Very frequently there is already an option plan with lots of stock options issued and outstanding by the time the first venture capitalist comes into the picture.

Dave Lavinsky: Agreed. I guess if there's the entrepreneurial team, maybe it's two founders at that point. If it's just the two individuals they may not have something formalized but they are going to hire very soon thereafter.

Mike Kendall: Yep. Your question and maybe there's a more specific one you wanted to ask but it actually reminds me to mention another potential legal pitfall.

Other than your intellectual property, the one other thing about a company that an entrepreneur has to be incredibly meticulous about documenting is anything related to the equity ownership of the business.

Lots of startup entrepreneurs don't have large legal budgets obviously. Many of them are loathe to spend the capital that they have available on anything other than directly growing the business. But I will tell you that we end up running into lots of companies that either didn't pay enough attention to protecting their intellectual property, and now the value of their businesses is substantially lower as a result, or their records around who actually owns the company are a complete disaster and no one can really answer that question.

A venture capitalist and their counsel coming in to do due diligence on the business say to themselves, "*Well we'd like to own a third of the business but when you issue us the six million shares that you tell us represent 33% of the company, we have no confidence that that's right because the records are a complete disaster*."

You've got a group of founders and there was a bunch of discussion over dinner about who would own how much. But then one of the guys decided to go back to school or back to his old job or something like that. Nobody is clear whether he actually owned his stock or not because nobody actually issued any stock certificates to anyone. And even if they did, maybe there was some implicit understanding that there should be some vesting on the stocks. Folks should

have to stay around a while before they get to keep it. But that was never written down anywhere.

It's hard to imagine you could enforce a claim that there was vesting in place and on and on and on. Offer letters that go out to employees that talk about stock option grants at a time when there isn't even a stock option plan. What do you do about that? And by the way that employee quit a year later so how much do they own and in what form?

Those situations are just a complete disaster, particularly when you're trying to attract third party capital or later on trying to sell the business. You want to sell the company to Microsoft and they say, "*Okay. We just want to know that when we buy this company for $100 million we actually own 100% of it. Get us the signature of everybody who owns the company.*" And you're left scratching your head because you're not quite sure who all those people are.

Dave Lavinsky: Got it. You've got to be really clear about the equity ownership, stock certificates, vesting and really keep very, very clean files.

Mike Kendall: Absolutely. Anything about the equity of the business ought to be kept in writing and signed by everybody and written very clearly so everybody knows exactly who owns what.

Dave Lavinsky: Excellent. That's a great point. I guess my follow-up question on the stock option pool was if we have two founders looking to raise venture capital. They know they're going to hire a lot of employees upon raising venture capital. They'll have more money to work with, yet they have not formed the stock option pool. Do they need to do it before they raise the venture capital or can they do it concurrently or after?

Mike Kendall: They can absolutely do it concurrently, and in fact what will happen is the venture capitalist will require the creation of the pool as part of

their investment. And of course in that vein they will be requiring the founders to suffer the dilution.

When they come in and say our $5 million, we want that to represent 33% of the company. Of course what they're saying is today they think it's worth $10 million. Because it's worth $10 million today they're going to give it $5 million so it will be worth $15 million. They own a third of it and they put in $5 million so that means it must be worth $10 million today.

What they're saying is the owners of the other two thirds of the business need to include not just a founder's but also provision for the option pool. So in my example, a business that's worth $15 million after the investment or in the venture capital parlance it's called the *post-money valuation*.

Let's say there were fifteen million shares representing the ownership of the business. Obviously the venture capitalist would own five million of those. If there was no option pool the founders would own the other ten million shares. So the founders would own two thirds and the venture capitalist one third.

Instead the venture capitalist will say we want you to create out of your shares a 10% option pool. So a million and a half shares of that fifteen million needs to be set aside to be issued as stock options. That's got to come out of the ten million the founders would ordinarily otherwise have owned. So the founders only end up with eight and a half million shares out of fifteen or about 56% instead of 66%. The entire 10% dilution in that example comes out of the founders

Dave Lavinsky: Understood. And the reason for those listening is the venture capitalist wants to see equity in the hands of the employees so they can hire the best employees and everyone on the team is highly motivated to make their equity worth something.

Mike Kendall: That's right.

Dave Lavinsky: Excellent. Are there any other things you absolutely do not want to see in a term sheet?

Mike Kendall: There are some esoteric things like there are various forms of what we call anti-dilution in favor of the investor. There are some toxic versions of that that we typically want to avoid if we can.

Remember now that the venture capitalist is going to write a check to the company. They will probably visit the company only maybe four or six times a year. They are a passive, remote investor. They typically want some comfort that the company won't be off willy nilly doing things other than spending the venture capitalist's money on what the VC thinks they're supposed to be and growing the business.

There generally is a long list of what we refer to as negative covenance or protective provisions, things the company agrees not to do without the venture capitalist's consent. Frequently the company will agree that really major stuff like maybe selling the company, that's something that you should ask your one third partner about before just going to do it. Sometimes not.

But granular things like getting a line of credit from a bank, we don't want to have to chase down a signature from our venture capitalist every time we want to do that. Maybe the venture capitalist says, "*Hey, look. That's generally fine but for a $15 million business, if you go and try to borrow $5 million we would want to have a discussion about that. How about we say you can borrow up to $2 million without asking us but more than that you need our consent.*"

You go through a whole series of these things, capital expenditures, maybe sales of additional stock and so on, and you sort of negotiate this list of things where you have to go back to the venture capitalist and get their consent before you can do them. That's frequently negotiated to a fairly high degree.

Dave Lavinsky: Okay. One example that we recently came across was the venture capitalist making the company ask their consent for employees with a salary over $150,000, they want to give it the okay.

Mike Kendall: Another fairly typical one.

Dave Lavinsky: Excellent. Okay. Good. Let's go back to the entrepreneur.

They've received the term sheet. Next steps – how long does the negotiation process work? How long does it take? What are the next steps after that moving towards getting the check?

Mike Kendall: After the term sheet, generally the very first thing that happens is the investor dives in relatively deeply into *due diligence*.

While we talked about being relatively meticulous in terms of record keeping around intellectual property and stock ownership, the better organized the company is, the better record keeper they are about their various contracts and so on, the smoother, quicker, more efficiently the due diligence process will go.

If a company can very quickly put together a CD for example, electronic copies of all its various records or organize a room where copies of everything are available for the venture capitalist and their lawyer to look at, the more easily the company can do that, the more efficient the due diligence process will be.

The venture capitalist will also be doing their own stuff in the background, checking the market, and testing the thesis of whether there is a big market here for this company's product. If it's a company that's got revenue, that actually has customers, there will be customer checking and customer calls and that sort of thing, background checking on the CEO and maybe other members of

management to make sure CFO hasn't been convicted of securities fraud or something like that. That's never a good thing.

All of that due diligence activity is going on. At the same time the venture capitalist's counsel, they're usually the initial drafters of the legal documents memorializing the investment. They'll put those together, and send them over to counsel for the company. There will be negotiation over those contracts.

You asked about timing. In the current environment, the timeframe is dramatically longer than it used to be. At the height of the bubble in 1999 we were closing deals in a few days to a week. That was not a normalized environment.

Three years ago I would have said is sort of a normalized environment. Typical deal from term sheet to closing may be three to six to eight weeks on average.

In this environment I'd say you're talking twelve weeks and beyond typically, and mostly that's because there is extra due diligence going on, checking and double checking by the venture capitalist, just general hesitation in terms of pulling the trigger on an investment until they're really sure they've validated their thesis for investing in this business and in this industry.

Dave Lavinsky: Now how does an entrepreneur protect against a VC giving them a term sheet and stringing it out and then twelve weeks later or worse yet, fifteen weeks later or so the VC saying, "*I don't really want to do it anymore*." Aren't there provisions like no-shop agreements? Can you talk about that a little bit and what an entrepreneur should do to make sure they have a back-up?

Mike Kendall: Sure. I'll tell you that in the venture capitalist business in this environment there isn't a ton that an entrepreneur can do except make some modifications and let's jump in to what this so-called *no-shop agreement* is.

Generally the deal with a venture capitalist, when there's a term sheet and they start working on an investment, as I mentioned they're going to have engaged legal counsel to start running up a legal bill, preparing to do this investment, drafting up the documents and so on.

They're going to be spending a substantial amount of their own time on due diligence. They may be hiring some consultants, industry experts or folks to do technology reviews and so on. Typically the company is not bound to pay for any of those expenses if the deal doesn't happen. The venture capitalist is going to run up what can be a fairly substantial amount of expenses on their side of the ledger in the expectation the deal will close. In exchange for that …

Dave Lavinsky: Note there – the entrepreneur will end up paying the VC's legal bill. Correct?

Mike Kendall: If the deal closes, then typically *yes*. Typically the company ends up paying those expenses. Although the other way to look at it is generally they just net it out of the investment.

If they were going to invest $5 million and they incurred $50,000 or $80,000 of expenses, you'd get $5 million less $80,000. But the point is that before the venture capitalist is willing to go on the hook for those expenses and put the time in and so on, they'll generally ask the company for what we refer to as a no-shop provision.

A no-shop provision means that the company is prohibited from talking to other venture capitalists, seeking other financing sources for some finite period of time in order to give the venture capitalist comfort that they're not going to be wasting time and money only to be trumped by somebody's higher bid.

Dave Lavinsky: Got it.

Mike Kendall: The typical duration for a provision like that is 60 to 90 days. In this environment it can be longer, 120 to 180 days.

Sometimes a VC tries to write it so that it's effectively evergreen and says that the no-shop goes on forever so long as the VC continues to be negotiating the deal in good faith. That's something to watch out for if you're an entrepreneur because it's hard to ever get comfort that you can pull out of the deal until the venture capitalist is ready to.

It's much better to have a sixty to ninety day no-shop period and then if the due diligence is dragging on and on and on and so on, the company has an opportunity to say, "*Hey wait a minute. It's becoming obvious to us that the investor isn't as interested as they initially appeared. We'd rather go back into the market and see if we can find somebody else.*"

To your point, there are other things you can do negotiate a no-shop in a case where you are concerned about it. I'll say you typically only get things like this in the more competitive situations.

But sometimes the term sheet has a relatively detailed timeline for things like completion of legal and business due diligence and so on. The distribution or draft of the definitive investment contract and so on, and the term sheet would provide that if the investor doesn't meet any one of those timelines, then the no-shop terminates and the company is free to go out into the market.

But you typically have to have quite a bit of leverages as a company to get those kinds of things.

Dave Lavinsky: Excellent. At what point in the capital raising process should an entrepreneur consider getting legal counsel?

Mike Kendall: Immediately. Honestly because of all the pitfalls that we were talking about it's very difficult to successfully navigate the founding of a business without advice of counsel particularly if it's more than one person.

Dave Lavinsky: More than one person in the company you're saying.

Mike Kendall: Right. If you're a sole founder and you're working on some technology idea as an example, other than things like filing patents and so on, if you're not telling anybody else about your idea, it's very difficult to screw yourself up.

Number one, because you're the only one there's no risk of your idea leaking out and number two, there isn't anybody else in the capital structure of the business. Even if you never document it, you're the only possible person who could be an owner of the business so a lot of the issues I mentioned before aren't relevant.

The minute you have more than one founder and/or you bring in other people into the company to work on building intellectual property, it's virtually impossible to do it correctly without a lawyer involved. It's just too complicated.

And then certainly once you're talking about selling stock for cash, raising capital, that's just a whole order magnitude more complicated when you bring in the federal and state securities laws issues and so on.

Dave Lavinsky: I hear a lot about legal counsel being able to refer their clients to venture capital firms. How does that work? Maybe you can talk a little bit about that.

Mike Kendall: Sure. We spend a tremendous amount of time doing that very thing. In fact we have a very robust internal referrals database. We are a firm – just to give ourselves a two second commercial here – we actually do one of the largest volumes of venture capital financing transactions in the whole country.

The good news of that is we have a very robust database of contacts both on the company side and on the investor side. We very frequently have companies asking us for help finding financing. As you probably know, one of the keys to being a credible referral source for venture capitalists is not wasting their time with potential investments that are just clearly outside their investment scope.

We have all of our venture capitalist contacts organized by size of investment, industry focus, geographic focus, all that sort of thing. If you happen to be a Washington, DC based technology startup looking for about $2 million in capital, we could line up a bunch of firms interested in that kind of investment as compared to somebody in Silicon Valley looking to raise $30 million on the next really cool social media application or whatever. Because those would be very different groups of firms interested in those investments.

Dave Lavinsky: Sure. Excellent. You guys can help in terms of looking at your database to see which VC firms are the right fit.

Mike Kendall: Absolutely. And then frankly, the real value add is they take a look at what we send them whereas they don't take a look necessarily at stuff that just gets e-mailed in or cold calls into the firm because they just don't have the time.

Dave Lavinsky: Agreed and understood. The question I have is what are some of, maybe some of the top ones because I'm sure you can go on for days on this one, what are some of the pitfalls of using the self service legal companies like LegalZoom for some of the initial documentation, incorporation.

Mike Kendall: To be honest I haven't studied LegalZoom much but I'll tell you that companies that come to us and hire us to do so not because they need access to a form because there are lots of places to get forms. Instead they want the counsel.

They want the advice based on experience for how to fill out that form. You look at that form and it gives you for any particular provision three choices. Very frequently our job is talking clients through those three choices and helping them figure out which is the optimal one for them.

For example, in setting up stockholder agreements amongst founders and trying to figure out what should everybody's rights be to their stock as among the founder group. If things don't work out for example, one of them decides to leave or whatever, what are the various options for restricting people's stock? What's typical? What do people typically agree to?

In the particular case, I've never seen any two companies that are identical literally and feel the same way about how some of these issues should come out. Lots of those forms I'm sure are fine forms and actually as a legal matter, the words probably work just fine. But when it comes to a question of which of these words should we choose? It's very hard to do it on your own unless you've been through it a bunch of times and have the experience.

Dave Lavinsky: Excellent. That's very helpful. Mike, I just have one last question for you. Is there anything else that thee entrepreneurs listening to this call should know about the legal aspects of raising capital that I may not have asked you?

Mike Kendall: I'm going to say "no" to keep it brief because the real answer is there are about a thousand things and we don't have time to talk about them all. But I will say that we've hit a lot of the highlights.

Just to sort of recap, be very careful and paranoid about your intellectual property and the stock ownership of your company. That's critical. Hire a lawyer to help you with some of this stuff as soon as you can reasonably afford it. Try not to go too far down the road of creating value in your business before you do that.

When you're choosing somebody to help you navigate a significant capital raising, like a venture capital financing, find somebody who's experienced on both sides of that transaction, who's both represented lots of companies taking venture capital and also represented a lot of venture capitalists, because they will be able to point out for you the pitfalls, the things to watch out for, the stuff that you can ask for that you're likely to get even though it wasn't initially offered to you, and make that whole thing a lot more efficient because you won't waste a lot of time arguing about things that frankly just don't matter.

Dave Lavinsky: Got it. Got it. Great point. Mike thanks again. I think this was just great. We hit on so many key points that entrepreneurs just need to know in order to successfully navigate the waters of raising capital. Once again, Mike Kendall from Goodwin Procter, really appreciate your time and thanks again for your time and wisdom today.

Mike Kendall: You bet, Dave. Pleasure to be here.