Generate, Inc.

Partnering With a Strategic Investor

Concord, Massachusetts

On a cold winter day, Tom and Darr Aley, twin brothers in their mid-forties, were busy working in a spacious office above Tom's attached garage. Shafts of midday sunlight warmed the room. Tom's dog, Billje, slept in the corner.

Having successfully sold their company, Generate, Inc., Tom and Darr now had the financial wherewithal and the leisure to choose their next opportunity. As serial entrepreneurs, the brothers would not be idle for long. "We're both ADD types," they liked to joke. In fact, Darr was at that moment creating a Webpage for their newest opportunity, a social venture project that aims to help single mothers re-enter the workforce.

As Darr was working, Tom thought back to their experience in starting, developing, and eventually selling Generate, Inc. "What a journey that was." And their relationship with a strategic corporate investor had helped bring the journey to a happy conclusion.

Tom worked for his father for two years following college, then went on to work for several technology ventures, including a speech recognition software developer. He would add an MBA from Northeastern University's High Tech MBA program to his résumé. While in that program, Tom took a product management job with ZDNet, the Web arm of the Ziff Davis computer publications empire, where he rose to found and lead its e-commerce business, creating a number of new services, including one of the first successful PC e-tailing sites: "ComputerShopper.com"

Tom, however, had the entrepreneurial bug and left ZDNet to help found OneZero Media, which created a CBS-backed nationally broadcast TV show called "The Wild Wild Web." The show featured the lifestyles and sports of the young and wild, and drove viewers to a Website where they could purchase products featured on the show. It was one of the first true "convergence plays," attempting to marry traditional media with an e-commerce back-end. After several years of national syndication, the company was acquired for over $20 million by GT Interactive Software, game software company most well known at the time for "Doom." GT Interactive Software had gone public the prior year with one of the largest public offerings of the time.

Moving on, and working with Darr, he helped to create Net Value Holdings, a multi-city business incubator that went public during the halcyon days of the Web bubble.

> Using about $5 million of investor capital, we began funding promising companies in many cities around the country. Shortly after going public, our market value approached $50 million. Analysts were telling us that we were the next CMGI [at one time, a hugely successful publically traded venture investment company.] However, most of that value evaporated when the market bubble burst in 2000.

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Tom knew it was time to move on and to try his hand at another side of the venture finance business.

Between 2000 and late 2004, Tom worked in the corporate venture capital wing of Reed Elsevier, the $8 billion leading global publisher and information provider with prowess in legal (LexisNexis) science and technology domains. In that position, he worked with an interval venture capital team, sniffing out investment opportunities for Reed Elsevier. During this time, Reed Elsevier made a number of successful investments in software and information products companies that in one way or another leveraged its own formidable information assets.

This was good preparation for Tom's next venture, Generate. He had learned how to evaluate the merits of different opportunities and, equally important, to understand the mix of market opportunity and management talent that made venture capitalists sit up and take notice. He had also learned the ins and outs of the different types of venture financing: angel investing, "institutional" venture capital (typically, VC firms), and corporate or "strategic" investing.

While Tom was building his finance and deal-making skills, brother Darr was also working in several successful startups. One of these was Lycos, one of the top search engines of the 1990s. Subsequently he co-founded an "e-procurement" company that was acquired by Accenture, and was recruited from there to run Amazon's entry into the procurement market. He later helped run corporate development and strategy, helping Amazon identify and make several acquisitions.

Experience in marketing and finance for information intensive industries, and their combined networks of software and computer infrastructure development, prepared the twin brothers for a new, bolder venture.

The Seed of an Idea called Generate, Inc.

While at Reed Elsevier, Tom marveled at the success of one of that company's business units, a $2 billion legal data service called LexisNexis. Lexis offered subscribers searchable data bases from newspapers, periodicals, legal documents and other printed sources. This provided real value to users—the legal research community—allowing them to slice and dice a wealth of information with a few simple keystrokes. For Reed Elsevier, LexisNexis became a source of continually recurring revenues as subscribers came to rely on it in doing their work.

Lexis's combination of real value delivery and recurring subscription revenue got Tom to thinking about other information services for the corporate world. Several already existed in an industry estimated at $200 billion per year. These included Dun & Bradstreet, Bloomberg, ThompsonReuters, Hoovers, Experian, Equifax, MarketWatch and InfoUSA. Yahoo!Finance provided a wealth of free information, choosing to make its money off advertising. These information services provided mountains of financial, credit, and transactional data (e.g., on mergers and acquisitions), and also listed corporate executives.

Other ventures had tried to gather detailed information about public and private companies, such as product information and the names of executives in charge of different parts of a company. These included Individual, Inc. and Corptech, both started in the Boston area. While neither of the ventures was particularly successful, the idea of allowing individual users to set filters to screen real time events and announcements for specific companies was an important building block in Tom's thinking.

Something new entered the game in the early 2000s. By 2004, Web-based social networking had taken hold. Tom looked at LinkedIn and liked what he saw. That Website allowed users to develop personal networks of business contacts, and then, through the magic of database cross referencing, provided a modest ability to find out "who knew who," making it possible to bridge across personal networks.

By November 2004, Tom was eager to make a move. He had learned a great deal at Reed Elsevier but did not want a big company career. He wanted to do a startup instead—and with his brother. For his part, Darr had enjoyed great success as an Amazon executive, but he too wanted to get back into a startup. Together, they had enough money saved to provide seed funding for a new information products/services business. And the more they talked, the more they were convinced that combining social networking capabilities with the real-time news feeds and data aggregation represented solid opportunity. Their vision was to create an information service for the business-to-business space that would harness a world of information and put it at the finger tips of B2B sales people, wealth managers, investment bankers, and many others. "Our vision," said Darr, "was to provide people like us with all the *who, what, where* in real-time about executives and their companies, and then provide them with a path on how to reach an executive through a personal social network. There was nothing like it and people needed it." He continued:

> For example, if a computer systems salesperson were to open the *Wall Street Journal* and read that XYZ Inc. had just taken in $250 million through an IPO, he'd immediately think, 'XYZ is growing and probably needs to buy more computing power—and it has $250 million in the bank.' The sales person would now have a prospect company. The next step would then be to arrange a sales call. Everyone knows that cold calls are tough and will do whatever is possible to avoid making them. So, the salesperson would ask, who is the executive in charge of IT? Who do I know that might introduce me to that executive? When I get a chance to talk to that person, how can I break the ice and develop a relationship? What can I learn about the executive's background, his or her prior jobs, or whether he sits on company boards?

The Aley brothers played through this and a number of other use case scenarios—such as the sales triggers created from real estate transactions, new product announcements, and legal proceedings. And the more they did this the more they were convinced that such a service would deliver concrete value to corporate sales forces around the world.

A Company is Born

At the beginning of 2005 each of the brothers decided to put up $100,000 as seed capital for their new company, and would have to double this amount over the course of the year. "We were fortunate to be our own seed investors," said Tom, "because we didn't have to give up half our company just to get started." Having their own skin in the game would also mean a lot for the next round of investors.

The brothers left their respective corporate jobs "on good terms." And Darr, to the chagrin of his warm-weather loving wife, moved his family from the Seattle, Washington area to Concord, Massachusetts to work out of Tom's home office. Tom had just built a house near the banks of the Concord River, upstream from the Old North Bridge, scene of the celebrated battle that touched off the American Revolutionary War. After being there 4 years, however, Tom and his wife would sell that house and invest some of the capital in the new company. The family then moved into a smaller house on the other side of town. Tom had three young kids; Darr, two. Both families were putting a lot on the line to make this venture successful.

The number one job at this point was to capture company and executive information in real-time and make it accessible to the B2B sales community via a front-end portal on a subscription basis.

GENERATE'S BUSINESS MODEL

Most enterprise subscriptions to Generate's service were sold "per seat" (initially $3,000) with volume discounts. Generate also licensed it's content and functionality to News and information publishers (OEMs) who used it to provide more compelling services to their end-users, and in turn derived ad revenue and incremental subscription revenue.

OEM's such as Dow Jones and Dun & Bradstreet came onboard as customers in 2006, when the company was very needy of cash. Revenues in that year were $500,000, thanks largely to these information providers.

"Our plan was to license-in corporate data through one of the current services—data was a commodity" Tom recalls. "But that was only half of the puzzle. Information on executives was thin and there was nothing available to tie those people to the companies." Convergence had been an important element in Tom's career—be it at ZDNet, in the television show, or overseeing Reed Elsevier's venture investments. "We wanted to do a convergence play between information about executives and information about their companies, and then personalize it to the individual salesperson via our relationship mapping services." The brothers decided on a strategy of performing extensive Web searches on people's names and then building their own proprietary extraction and indexing scheme to not only link individual with corporate information, but do so within a social networking framework.

For the first piece of the puzzle—information supply, such as company news and events—Tom and Darr talked with a number of established information suppliers and, over the next six months, came to terms with several major players. One of these was Thomson Financial—which held a massive amount of financial data on companies around the world. (Thomson subsequently merged with Reuters to become an even larger, global powerhouse.) Another important information supplier was American City Business Journals (ACBJ)—publisher of 44 regional business journals across the United States. Within a year or so, Thomson was not only a supplier, but also a major OEM customer, private labeling Generate's service as part of its own offerings. ACBJ evolved from information supplier into a potential equity investor in the business.

For the second piece of the puzzle—gathering information about the lives and events surrounding business executives—Tom and Darr knew that they needed a specialized Web search crawler. From his Reed Elsevier days, Tom knew of a small private firm in Montreal called NetVention. NetVention had a Web-crawler that gathered and aggregated company information from designated Web pages; Tom and Darr, along with Howard Schneider, the CTO of Generate, felt the technology could be re-engineered to also crawl and extract data about individuals, a very compelling, non-commoditized market opportunity. Tom and Darr thought they could rent the same capability from companies like ZoomInfo, but figured that the cost would be prohibitive and that they would sacrifice control over a key part of their business. Acquiring NetVention's technology outright might be another possibility. Said Tom Aley:

> Our vision was to capture and aggregate company and executive data from the Web and then map the relationships between the people and the organizations we found. Using LinkedIn-like software, we aimed to reveal connections between those executives and our users, up to three degrees of separation. In effect, we'd have LinkedIn meets Hoover meets Dun & Bradstreet on steroids—with the ability to filter out information that individual subscriber didn't need. They would also have a key ability to show subscribers corporate hierarchy and governance—something LinkedIn was not chasing.

Thus, if a Generate subscriber needed information on Jeff Bezos, Darr's old boss at Amazon, he would get whatever biographical information existed on the Web, along with data and news stories about Bezos and his company. The service would also reveal how the subscriber was related to Bezos through other people (relationship mapping). For salespeople and others looking for clients, this capability would save huge amounts of time, create new selling opportunities, and provide personal information on prospective clients that the sales person could use to initiate an interesting, meaningful conversation. The Aley brothers saw this as the essence of relationship-based selling.

The third piece of the puzzle was how to tie everything together within a scalable computer system. That meant building databases, connecting people with companies, creating user-defined filtering mechanisms on the raw data, and a portal for users to access everything. Infrastructure! Tom and Darr knew that they couldn't outsource this part of the business—it was the core engine. A large part of their invested capital would be used to hire the people needed to build that engine. The first of these was Howard Schneider, whom Tom had known at ZDNet. The information repository that Howard had built at ZDNet could slice and dice the information from thousands of articles across Ziff's various computer publications and make it available for individual search. The brothers made Howard an offer to join the company with a salary plus some stock, and he accepted in February 2005.

Going for the Money—The First Try

While Howard was designing an "alpha" version of the system, Tom and Darr further developed their concept, better defined the target market, and created what they believed to be a powerful business plan and presentation. Being a VC himself, Tom knew what VC investors were looking for. "I thought that getting funding would be a fairly easy. I knew these companies and their partners knew me." The plan was to show them a business plan and an alpha version of the software in three months, raise between $1 and $2 million in a Series A financing, and release a beta version four months later. They planned on having paying customers within 12 months.

Tom's first stop was Union Square Ventures, where he knew one of the partners. That acquaintance, Fred, seemed receptive. He liked the concept and had confidence in Tom and Darr because of their successful startup experience. Fred made a soft verbal offer of $3 million on a pre-money valuation of $4 million. That would leave Tom, Darr, and Howard with about 57% of the company. In the next round of financing, a Series B presumably to build a sales force, Tom knew that the outside investors would have majority control.

Fred wasn't the only interested party. "By the end of Q1 2005," says Tom, "I thought that I had three big New England VCs who were very interested." The brothers twice left meetings with one of these financiers thinking that the deal was a *fait accompli*.

But funding would not be completed that easily. "We love the team," said one VC, "but it's a little early." Others had questions about the market: Was it large enough to support a knock out venture? "How can you prove demand?" said another. Tom thought these questions were ironic since Generate would provide a first of its kind service, and VCs were supposed to relish first of its kind technologies.

There were also concerns about the product itself: "You're adding too many bells and whistles and I'm getting distracted," said another VC. Tom's plan to acquire two or three small tech companies (including NetVention) to power Howard's system architecture also raised a red flag for some VCs: agreement on the valuation of these companies was not obtainable. Nor did most funding prospects fully understand the technology: "It feels like you're doing too much sausage-making," one complained.

By this time, Howard had identified four programmers he wanted to hire immediately to begin building out the system. Tom and Darr gave the okay, and before long Howard and his crew were busily working in Howard's basement. Tom and Darr now had to buy some computers and begin paying five monthly salaries. Their initial $200,000 contribution was now gradually moving from their personal bank accounts into those of the new employees.

"We had a two-stage plan at this point," recalls Tom.

> Stage 1 was to build an alpha version of the front end of the product, which we hoped to wrap up in three to four months. A beta version would occupy stage 2, with an end date of November 2005. In completing these, we'd have something to show potential customers and gain their commitment.

Tom and Darr were unconcerned about potential rivals stealing the march on them. In their view, the big B2B information providers (Dow Jones, Dun & Bradstreet, etc.) needed what Generate was building, but were not sufficiently tech-savvy or entrepreneurial to build it themselves.

Even as he kept up communication with interested VCs, Tom continued to make contact with other potential investors. "You have to turn over every rock. Placing all your bets on one VC is like putting a gun to your head. You have to talk to as many as possible while giving the impression that they are the only one you're courting."

Beyond Institutional VCs

The VCs approached by the brothers Aley were in the business of taking money from large institutions, such as pension funds, and investing it through limited partnerships in technology-focused companies. Most, however, had been badly burned during the crash of 2000–2001 and were gun-shy of new startups. At this point in time, their preference was for second or third stage equity investments. For these, "venture capital" and "venture startup" had become oxymoronic.

Frustrated by their reticence, Tom began turning over rocks elsewhere. During July and August of 2005, he began talking to "mega-angels," investors capable of putting a million dollars or more into a venture. Unfortunately, while Tom valued the operating experience of these private investors, and recognized how much they could help him grow the business, $1 million was simply insufficient. Consequently, he began courting potential strategic investors: large corporations that might wish to invest in a startup that would add to their own product or service portfolio. A corporate strategic investor might also increase the value of its equity holdings in the venture by being a sales channel for the start-up's product or service. A corporate investor might also want to acquire Generate outright at some point further down the road.

Knowing in his bones that Generate's product would have real value for any purveyor of business-related information, he cold-called American City Business Journals (ACBJ) the largest U.S. publisher of metropolitan business news weeklies, with 44 business journals across the country. ACBJ was owned by the $8 billion Advance Publications Inc., which also operated Conde Nast Magazines, Parade magazine, the Golf Digest companies, Newhouse Newspapers, and cable television interests.

Though its parent company focused on consumer products, Tom knew that ACBJ understood the market for B2B information and seemed a logical beneficiary of Generate's innovation—as either an outright owner or investor. Moreover, Generate would benefit greatly from access to the publisher's deep information sources. Perhaps a deal could be arranged.

Tom connected to an executive with ACBJ, Tim Bradbury, senior vice president of ACBJ's Interactive business. More than his colleagues on the print side of the business, Tim understood

information technology and its value to the enterprise. Though his company didn't normally invest in new ventures, Tim was intrigued by Tom's idea and offered to visit him when the alpha version was available. In the meantime, curious as to how Generate might handle ACBJ's data, Bradberry offered Tom a free data "feed."

In the meantime, Tom kept knocking on the doors of VCs, all of whom remained non-committal:

> "That's interesting. Come back and see us when you have customers."
>
> Or, "Let's talk again when you have a CEO—preferably a guy who has delivered for us before. You lack operating experience."
>
> Even the initial group of interested financiers, people who knew Tom well, were reluctant to move forward—at least on their own. Most proposed syndicating the deal as a way of hedging their bets.
>
> "Where's the 'venture' in venture capital," Tom asked himself. His frustrations continued until September 2005, when Howard and his tech team unveiled the alpha version of the product. By that time, the venture was scraping the bottom of the cash barrel, forcing each brother to put another $100,000 of his own savings into the enterprise. This was the point at which Tom and his wife sold their big house and moved to more modest quarters across town.

Three Potential Series A Deals

In September 2005, Howard unveiled his alpha version of the system's front end. Tom and Darr had their business plan worked out. (See financial projections in Exhibit 1.)

True to his word, Tim Bradbury traveled to Boston to see the system in action, using his company's data feed as one key input. Tim was impressed. He invited the brothers to visit ACBJ's Charlotte, NC headquarters in the next month and meet with the CEO Ray Shaw, a former Dow Jones executive, was an old school newspaper man who, Bradbury warned, would be more interested in Generate's people and concept than in the details of its technology.

Meanwhile, two of the VCs Tom had been courting came through with term sheets. VC #1 (called Great Capital for this case), and VC#2 (Ocean Capital) both had their fears allayed when Howard finished the alpha version and felt comfortable that beta was only three to four months off with proper funding. Great Capital put a pre-money valuation on the deal of $4 million. Ocean Capital's pre-money valuation was a little bit better at $4.5 million. The term sheets from both VCs were remarkably similar—and equally painful for Tom and Darr. Tom remarked:

> You have to be very careful about terms. A VC offer to buy 40% of the company typically leaves you with majority ownership but don't confuse ownership with control. There are always "protective provisions" in the term sheet—usually five to fifteen—that many uninitiated entrepreneurs fail to consider. Typically, these say that even though you own majority ownership, you can't sell the company, can't raise more capital, can't spend more than X dollars, and can't add a board member without their approval. Effectively, they can block any big decision the company faces. Additionally, the money that *you* put in vests over a number of years. So much for control. And if they don't like you, out you go!

He then shared another frustration: "participating preferred" shares. This was one of the provisions in the term sheets received from both Great Capital and Ocean Capital. Tom and Darr were aware that this type of structure was typical, especially in New England and in Series A-C term sheets.

> Here's how those work. If the VC puts in $3 million for a 30% ownership stake, and the company eventually sells for $30 million, the VC will take back its $3 million, before anyone else gets a dime, and then have a right to 30% of the remaining $27 million. In the industry it's called 'double-dipping.' The VC is first in line for a payout and then enjoys its pro-rata ownership of what's leftover. This can be very painful the more money a company raises. The only place this is legal is in the world of venture capital!

Tom Aley's reflections on those term sheets continued:

> They insisted that we create an incentive pool for future employees, which we wanted to do anyway. One firm proposed setting aside 10% of all equity, and the other, 20%. Fair enough. We want to incentivize our employees. But the problem was that the 10% or 20% option pool had to be taken out our own founders shares first, *before the VCs put in their money*. They want the entrepreneurs to take all the dilution. Again, Tom and Darr weren't strangers to these types of terms—they're the very ones that Tom had negotiated with entrepreneurs during his 6 years of being a VC himself. "That didn't mean it tasted good."

Darr reflected further on these VC deals:

> Here's the worst of the provisions. One of the VCs, Great Capital as I recall, wanted us to reconstitute all of our founders' shares as options that would vest over three years. This is called reverse vesting—and it is a lousy deal, but it's pretty standard with VCs. This doesn't sit real well—I mean we invested the same hard cash as the VCs and they want us to vest into *our* shares?! We bought those shares just like the VCs are buying theirs. We're not asking *them* to vest into their ownership!

This meant that if the company needed another round of capital in 12 months—a certainty if the enterprise were to grow—the founders would face an impossible dilemma. First stage investors are expected to participate in later rounds. If they don't, that sends a bad message to other potential investors. Thus, a VC sitting on a startup board who doesn't think the entrepreneur is the right person for the job might then say, "Listen, you've done a pretty good job so far, but we don't think you are the right person to run the business moving forward. You need to go start another company and let us build this one. For all your work, you can keep the first year's vested stock, but you need to forgo the rest. We are going to need it to bring on a professional management team. If you don't agree, your company will probably be dead and all of your stock won't be worth a dime."

Tom and Darr had seen a number of VC deals from both sides of the table. Tom had a special caution for the legal profession:

> You need a good lawyer to wade through all these provisions. And the rub of it is that your own lawyer—the person who you trust to represent you and tough it out in final negotiations—may not be entirely on your side. He wants the deal to get done so that he can get paid—usually $20,000 to $30,000, which comes out of the proceeds. The attorney has an incentive to urge you to sign. He'll say, 'These are standard terms,' which is true enough, but they're all in the VC's favor.

Also during October, Tom and Darr flew down to Charlotte to meet Ray Shaw. The meeting went well. Tom, who later described Shaw as one of the smartest, warmest, most genuine business people he'd ever met, was full of confidence.

With Tim Bradbury's endorsement, the CEO asked them, "What's the deal?" Generate had just signed three paying customers for its forthcoming beta version—one of them being ACBJ![1] Tom told him that he needed to raise $3 million. Shaw was agreeable and deferred to the Aley's request to eliminate most of the protective terms that Tom and Darr found so painful to swallow in the VC deals. Further, the investment would be structured without participating preferred shares. An incentive pool was set up, but with all owners contributing to it on a pro-rata basis.

As important as anything else was the valuation of Generate. Tom proposed a $9 million pre-money valuation on Generate, which for $3 million would leave the founders with 75% of the equity. Ray did not immediately say no, but as an experienced executive running a cash generating business, he said:

> "Tom, I like your team a lot. Tim says your system is going work just fine. But please explain to me now, why is a company with no revenue worth $12 million?"

Discussion Questions

1. What are the pros and cons of each deal? Which deal should Tom and Darr take?
2. How can the brothers justify their valuation to Ray?

Appendix A: Generate Proforma Financials

	Beta—2005	2006	2007	2008
New customers	2	30	49	147
Recurring customers		2	34	83
Total customers	2	32	83	230
Average revenue per customer	17,000	50,000	50,000	50,000
Recurring Bookings		28,900	1,066,831	3,020,568
New Bookings	34,000	1,571,000	3,034,043	8,458,897
Total Bookings	34,000	1,599,900	4,100,874	11,479,465
Revenue	4,250	1,001,844	3,401,870	10,102,559
COS	59,250	978,417	1,185,000	4,649,710
GM	(55,000)	23,427	2,216,870	5,452,849
%	–1294%	2%	65%	54%
OpEx	613,093	1,552,233	3,100,438	4,903,550
Op Inc +/–	(668,093)	(1,528,806)	(883,568)	549,299
Adjustments for Working Capital		(30,055)	(102,056)	(303,077)
Ending Cash	3,774,144	2,215,283	1,229,659	1,475,881
Headcount	11	33	73	91
FTE	5	27	55	81

[1] ACBJ signed a three-year subscriber agreement at $60,000 per year paid up front. The other two were T-Mobile, which has a large enterprise sales force, and Deloitte & Touche.

Appendix B: Explaining the Term Sheet Provisions

The offers that Tom and Darr Aley received from VCs were loaded with restrictive covenants. We will take one of these offers and examine the key terms and provisions.

Pre-money valuation: $5 million. This is the valuation set by one of the VCs on Generate before investment. The VC offered to invest $3 million at this valuation. The post-money valuation would therefore be $8 million, and the VC would therefore receive 37.5% of the company stock in this Series A financing.

Participating Preferred Stock

Tom, Darr, and Howard all owned common shares, which represented ownership in the venture and carried full voting rights. These were founder's shares. The VC didn't want common stock. It demanded preferred stock. This type of security has numerous protections that a VC can use to limit its loss in the event of company failure or poor performance. The preferred stock had full voting rights in its pro-rata participation in all equity issued by the company (e.g. 37.5%). It also comes with liquidation preferences that are described next. It was also structured as "participating preferred stock," which means that upon any liquidation event, the preferred stock would convert immediately to common stock to participate pro-rata in the distribution of the company assets.

Liquidation Preferences

The participating preferred stock came with liquidation preferences. VCs usually have a broad definition of "liquidation," which includes an acquisition, bankruptcy, and the sale of company's assets. The purpose is that the VC wants to get its money *ahead* of the founders. This is usually structured as a 1X liquidation preference with terms attached. In the Generate case, Great Capital put a 1.5 times liquidation preference into the term sheet. Consider the following two scenarios:

1. If Generate was liquidated (acquired or went into bankruptcy) for only $4.5 million dollars, then even though Great Capital owned only 37.5% of the stock, it would still get all of its original $3 million dollars back plus another $1.5 million before the founders.
2. If Generate was acquired for $30 million, Great Capital would still get its $4.5 million right off the top before the common shareholders, and then 37.5% of the remaining $25.5 million, or $9.5 million, making for a total of $14 million or close to 5X its original investment.

Dividends

Great Capital also insisted on dividends on its preferred stock in the amount of 5% or $150,000 on its $3 million investment. If the company wasn't cash flow positive, then that amount would be paid in additional preferred shares.

Reverse Vesting. Great Capital insisted that Tom, Darr, and Howard put all their shares into the employee option pool, and then have their pro-rata amounts vest over a period of three years, losing effective control of the company even though the Series A investors owned only 37.5% of the venture! Even if Tom and Darr could negotiate the first third to vest immediately, that would still leave the founders with only 20% voting rights. In other words, Great Capital

could decide as a Board Member to replace the founders and get a new management team at any time, in which case 40% of the founding stock would go back into the kitty for whatever purposes the VCs thought best.

Reserved Stock

Great Capital requested that an employee stock option pool of 10% of all outstanding shares be set aside pre-money. For Tom, Darr, and Howard, that meant that they would have to give up 10% of their collective stock—e.g. dilute themselves by 10%—before Great Capital put in its money. That meant that Great Capital would still own 37.5% of participating preferred stock with a 1.5 X liquidation preference, and that Tom, Darr, and Howard's collective 62.5% ownership would drop to 52.5% ownership.

Great Capital's term sheet contained other significant clauses. These included:

- A "take me along" clause. If the founders wished to sell some of their stock to another party, they had to also sell the same percentage of the VC's at the same time unless the VC approved otherwise. This would prevent Tom, Darr, and Howard from using their stock to bring in another investor to effectively run the company.
- Preemptive rights. Great Capital also put clauses into the term sheet stating a right of first refusal to preserve any portion of its 37.5% equity stake in subsequent rounds of financing.
- A rachet clause. If the price of the stock dropped below the Series A price per share in any subsequent round of financing, Great Capital would first be issued additional participatory preferred shares in the amount that would preserve its 37.5% ownership. This was effectively an anti-dilution clause. For example, if the Series A price was $10 a share, and the next round was only $5 a share, Great Capital would be issued the same amount of shares that it already held to preserve its ownership stake. New investors coming in at the lower $5 per share price would effectively be diluting the common shareholders, e.g. the founders.
- Regardless of Board Membership, Great Capital inserted approval rights on any expenditure of cash over $100,000.

Taken together, these provisions meant that even though Great Capital would be a minority shareholder after its Series A investment, it would still effectively control the company.