2

The Entrepreneurial World

The Entrepreneurship Process in Stages: From Seed to Exit

What is entrepreneurship? Entrepreneurs work with others to transform ideas into new products or services for which there is a market. They try to convince others to share their vision, and, even in the face of skepticism, assemble supporters to move their ideas forward. Along the way, they interact with numerous potential partners, adjust their vision, and produce a business plan. They pitch their ideas, vision, and plan to potential investors and customers – sometimes offering shared control or ownership in exchange for the funding and support they need. With or without external funding, entrepreneurs must find a way to develop, engineer, build, and pursue their (changing) vision so that their founding team and a growing circle of stakeholders are satisfied. Entrepreneurship involves transforming a "seed" idea into an "early stage" start-up and, from there, into a "growth company" and ultimately – through additional "rounds" of funding – into a successful operating company, as depicted in Fig. 2.1 and Table 2.1.

Many variations exist because each venture evolves in a slightly different way. Nevertheless, certain defining characteristics are likely to be present at each stage.

The early stages of the entrepreneurship process pose unique challenges and opportunities. For example, when we try to determine which players are involved in early stage financing of a venture, we may find that the number of players, influencers, decision-makers, and stakeholders is evolving quite

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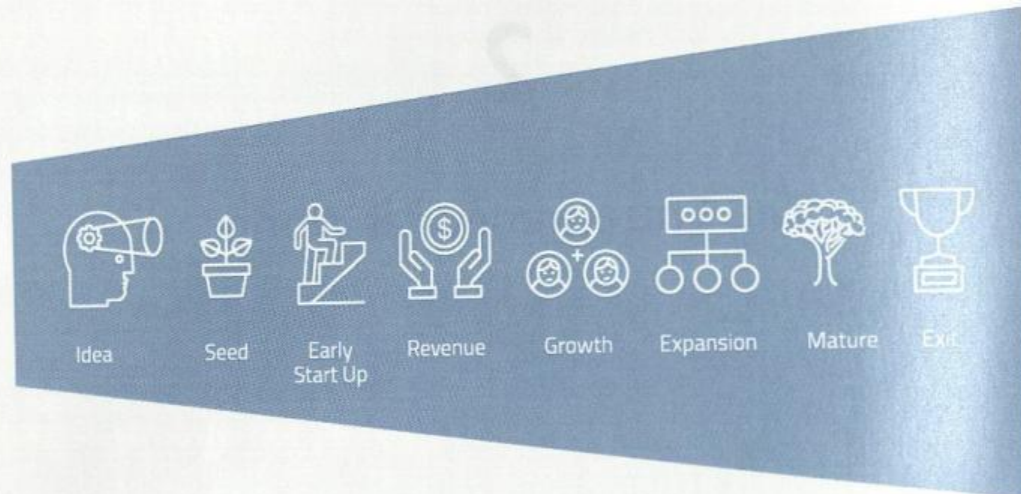

Fig. 2.1 Stages of entrepreneurship

rapidly. The financial world has adopted a system of flexible demarcation focused on various "rounds" of financing. As the example of Fig. 2.2 shows, the rounds may or may not correlate with the stages listed in Table 2.1, leading to progress and exit.

Entrepreneurs Who Can Negotiate Can Make Things Happen

An entrepreneur is a person who can initiate, organize, and manage an enterprise, such as a start-up business, often in the face of considerable pressure and uncertainty. Entrepreneur is a French word with English origins dating back to theater productions in pre-Shakespearean times. Theater projects required convincing many people to take a risk and support a production. Some were paid and others were promised a share of the upside if a venture was successful. In the nineteenth century, the meaning of the word expanded to cover general business initiatives. By the end of the twentieth century, it had come to mean a "start-up" business. Larger corporations and organizations eventually adopted the label to describe new initiatives within existing institutions. In the last decade or so, the term social entrepreneurship has emerged to describe initiatives aimed at achieving public good or social change, and where profit is not the primary objective. Entrepreneurs of all kinds use persuasion to recruit the resources they need to achieve their vision. As our Harvard colleague Howard Stevenson says, "Entrepreneurship is the pursuit of opportunity beyond resources currently controlled."

Table 2.1 Entrepreneurial stages and characteristics*

(Idea)
Team: Founder is exploring the idea part-time, in parallel to other work (or activity). May or may not have, or be seeking, another cofounder(s) to join
Investors: No investors
Product: No product. Just an idea, or a feasibility prototype may exist
Customers: No customers. A conceptual business model may or may not exist
Revenue: No revenue
Valuation: Does not exist

Seed
Team: Partially or fully committed founder(s) only
Investors: Funded by founder(s), their friends, or family. Commitments may take the form of a promise, and at some point be memorialized in a letter of intent (LOI), or a short agreement promising future equity stakes (%) or actual common shares
Product: The product does not yet exist. Some kind of feasibility prototype ("alpha") may exist. The team is defining the specifications of the future product
Customers: The company is exploring the market and developing estimates for pricing, calculating potential market share, and formulating a business model. (In some cases the price to consumer may be free, and revenue may come from other customers or advertising.)
Revenue: The company has no revenue
Valuation: Does not exist yet or involves arbitrary numbers set by founders. Available money is used to bridge initial costs until "real" fundraising can begin
Note (a) – *In recent years the term "seed stage" has been used by companies and investors to describe companies that have grown into later stages of development. This is typically done for investment marketing reasons and results in significant amounts invested by VCs or strategic investors claiming to invest in seed stages. See footnote*[a]

Early start-up
Team: Fully or partially committed founder(s). Initial employees are hired. Responsibilities are assigned and typically people wear "multiple hats." Investors may join the Board of Directors
Investors: Funded by founder(s), their friends, or family. Investment may come from an angel, a group of angels, or an initial professional investor (small fund, incubator, early stage VC). Distinction may be made between common shares and preferred shares. Sometimes a strategic investor (SI) may show an interest and negotiate the right to invest in the future
Product: Developing a minimally viable product or service (physical object or digital), or proving the technology is performing well with reduced scientific risk
Customers: Market has been validated. Potential customer and market feedback are used to influence the product definition and chart a future roadmap. There are potential customers ready to place tentative orders (oral, written, or LOIs) or using the product for validation (as a "beta")
Revenue: The company may be collecting some revenue, down payments, or partner research funding
Valuation: Set by the first professional investors (or angel), or may be left TBD with a committed discount on the next round of investment. Based on a negotiation with the investor referencing future potential value and other comparable venture deals (and strongly influenced by the opportunity and "hype" surrounding the start-up's domain)

(continued)

Table 2.1 (continued)

Revenue

Team: Fully or partially committed founder(s). Managers and employees have been hired. Other executives may be added. Organizational structure is established with clear roles and responsibilities

Investors: Professional investment documents are in place, with clear shareholders and investment documents (may have been done earlier). Different shareholder classes have been established. A combination of early investors (common) and later (preferred) professional investors such as VC and SI

Product: A minimally viable product has been launched, generating revenue. Customer and market feedback are used to plan improvements and build a roadmap. In some cases (such as drug development) the technology is not yet a product, but strategic partners are willing to pay significant sums to fund the development process as a service

Customers: There are early adopter customers, and additional sales efforts are ramping up

Revenue: Revenue is being generated

Valuation: Valuation is established based on expected future value according to business plan projections, under different scenarios. In early investments this may be calculated based on the trailing year or next year's income, for example what the multiple of topline revenues or bottom line (EBITDA) might be. In other cases, the valuation may also be based on future possible acquisition value of the start-up by strategic players. Strategic players may place a value on the technology, platform, or other asset that is far beyond what anyone else in the market may attribute due to the subjective advantages to having it "in house." From the investor's perspective, certain metrics are being used to analyze the valuation threshold for making an investment – such as expected financial return on investment (e.g., internal rate of return) or multiple of the amount that is invested (such as 10×)

Note (b) – We call this the revenue stage, although we know that for some companies revenue would not be the focus of this "later start-up" phase: The timing of revenue in a company's life is very dependent on the product, market, and business model. In many cases one will find revenues being generated at the earlier stages, and in other cases one may find a company well into growth mode that is still not generating revenue. For example, a start-up offering a software app that is offered to users for free, and is growing rapidly using funds from investors and a skyrocketing valuation – we would probably consider them as going from start-up phase to growth phase directly

Growth

Team: Fully or partially committed founder(s). Executives, managers, and employees have been hired. Organizational structure has been established and decision-making processes have been put in place

Investors: A combination of equity and debt financing has been arranged. There are documents describing various priorities, preferences, and terms. New investors may include larger VCs, larger SIs, venture debt, and purely financial (passive) professional investors. Money is used to grow the organization, accelerate product development, increase offerings, and professionalize operations

Product: The first product is being produced. A second product may be in the works or already have been added

Customers: The customer base is growing, and could be expanding to new high-growth potential markets

(continued)

Table 2.1 (continued)

Revenue: Revenue is growing
Valuation: Based on future business projections, analysts' opinions and future acquisition potential

Expansion

Team: Executives, managers, and employees are in place; more are added. The organizational structure and decision-making procedures are clearly defined. Founder(s) roles as employee may be redefined or eliminated
Investors: A combination of equity and debt financing, with documents describing various priorities, preferences, and terms. Investors may include more SIs, larger VCs, venture debt lenders, and purely financial (passive) investors. Money is used to expand operations
Product: Product traction is proven. Product offerings may be growing to include additional products or product lines
Customers: Customer base is growing. May be expanding to new high-growth potential markets
Revenue: Revenue is growing
Valuation: Based on future business projections, analysts' opinions, and future acquisition potential

Mature

Team: The team has been in place for some time. Organizational structure and processes have been in effect. Founder(s) roles as employee may or may not exist
Investors: May not require any additional outside cash for operations. Financing and/or dividends will depend on the size of the markets and the financial strategy selected. May include plans to use funds acquisition of other companies or technologies in order to enable growth, expansion, or the maintaining of markets
Product: Successful products are optimized for customer retention and margins (reduced production costs). Additional products and variants may be produced. Unsuccessful, nonprofitable, or low profit products are eliminated
Customers: The company has a large customer base. Focus may be on maintaining or growing the customer base or market share
Revenue: Revenue is stable, slightly growing, or slightly declining
Valuation: Based on future business projections, analysts' opinions, and future acquisition potential. These estimates are supported by detailed financial analyses including cost reduction bottom-line potential
Note (c) – Innovation through in-house initiatives or through acquisition will help drive a mature company "back" to an earlier stage of growth and expansion

Exit

Company has been sold, acquired, merged with another company, or become a public company. This could happen at any stage above. If not successful – the company may be closed (shut down), and whatever assets remain distributed to debt holders and shareholders. This is also a form of an "exit"
Note (d) – Exit negotiations may happen at any stage, and indeed in most cases exits happen at one of the earlier stages

*In the public-at-large, there is a tendency to use the terms "start-up" to refer to all the stages of an evolving company. We make a finer distinction and encourage you to do the same: Many founders and investors call companies "start-ups" well into their later stages. This is done either for simplicity (as in "we invest in start-ups from very early to $10M valuation") or for marketing purposes (as in "we are a seed-stage VC, and we like to invest early, but we prefer companies that are already producing a product or generating revenue")

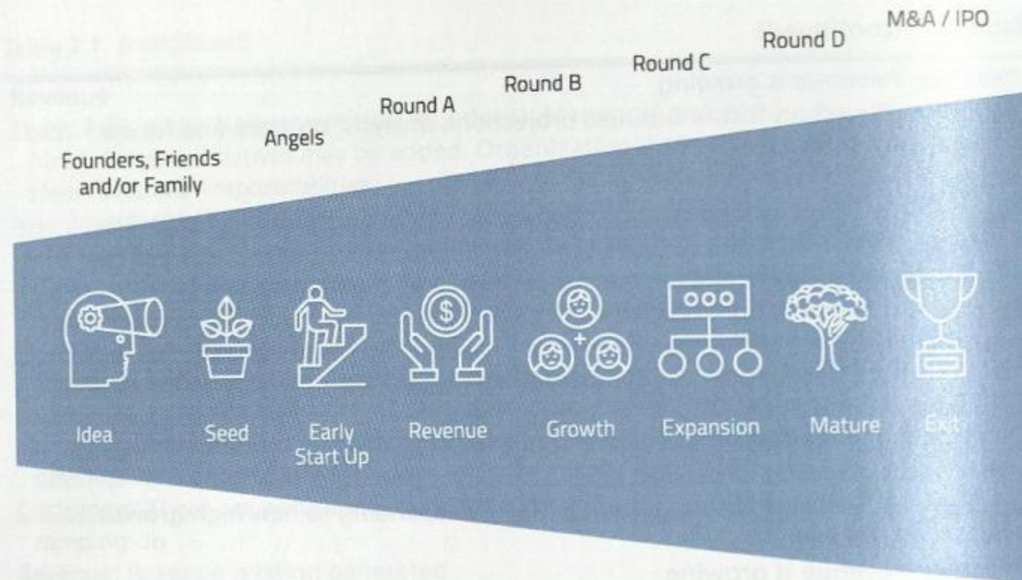

Fig. 2.2 Stages of start-up financing

We work as teachers, mentors, and entrepreneurs in the Greater Boston area. We also have experience teaching in other hotspots of prolific innovation in other parts of the world. Entrepreneurs can reshape an economy. An MIT report suggested that 30,000 companies had already been founded by MIT alumni, employing 4.6 million people and producing annual revenues of $1.9 trillion, equivalent to the 10th largest economy in the world (2015). MIT alumni form hundreds of new companies ever year. Almost a quarter of these are founded outside the United States. Of the MIT alumni who have started companies, 40% are serial entrepreneurs; that is, they have launched multiple enterprises.

To build a successful company, entrepreneurs must convince others that certain ideas have merit. To secure the capital they need, they must persuade external investors that their business plan will work. Similarly, talented engineers and product development specialists who join a venture need to agree on how they are going to proceed. Negotiation is key to almost every step an entrepreneur has to take. We define negotiation as "communicating with others to influence them to do what you want, when you want, the way you want."

A Map of the Entrepreneurial Galaxy

Throughout the stages of the entrepreneurship process, individual entrepreneurs are called upon to negotiate with a widening circle of players. The relationships involved fall into four categories, and move along two axes. The categories are

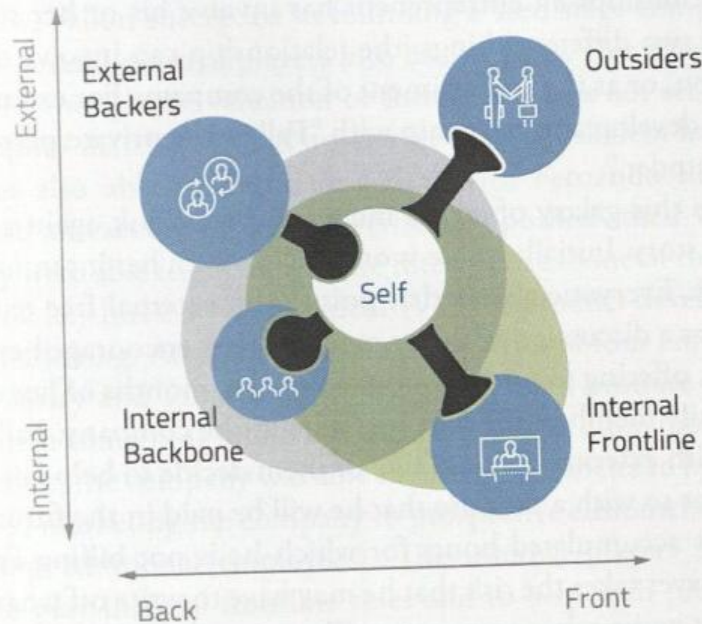

Fig. 2.3 Entrepreneurial negotiations – categories of players

the four types of players involved: external backers, internal backers, internal frontline, and external free entities (also called outsiders). Each is described in detail below, drawing on the interactions between Fallon and Fernando described in the Introduction. The two axes should be obvious. One moves from internal to external interactions. The other, from those who are backing a company (by investing money or working as an employee) and those who are out in front (representing the company or facing it). As shown in Fig. 2.3, in every instance, the entrepreneur is at the center of these negotiations.

Internal employees are backers of the vision the company was established to fulfill. We see them as the "internal backbone." As the company develops, these backbone members become the core of the company's organizational structure. This structure changes, of course, as people join, leave, or switch roles and titles. The "internal frontline" describes those who represent the company, whether employees or contractors, in interactions with external actors. When there is no company in place, the whole world is external to the enterprise. Since all external players have no relationship with the company, they are all considered "free" entities or "outsiders." When some come to the front, developing a relationship with the company's founder(s) and deciding to lend their support, we call them "external backers." They are external to the company, but take on a formal backer role, including a financial interest. Many of these backers are assigned specific rights and responsibilities that give them influence and some measure of control. Many can be long-term relationships.

All the relationships an entrepreneur has involve his or her self, although this can mean two different things: the relationship can involve the entrepreneur as a person, or as the embodiment of the company. For example, Fallon's mentor could develop a relationship with "Fallon the private person," or with "Fallon the founder."

To illustrate this galaxy of actors more fully, let's look again at the Fallon and Fernando story. Initially, there is only Fallon with her intention of founding a company. Everyone else at that point is an external free entity, or outsider. Fallon has a discussion with her parents. They encourage her to start her own company, offering to underwrite the first few months of her efforts. This makes her family members the first investors in the company. Fallon starts to test her idea with external entities. Two of them decide to help her get started. Her lawyer does so with a promise that he will be paid in the future at his full rate (for all his accumulated hours for which he is not billing Fallon at the outset). The lawyer takes the risk that he may have to write off what he is owed if the company never raises any money. The mentor works with Fallon as an informal advisor, with an understanding that there will be some equity awarded in the future for their efforts. In this way, both the lawyer and the mentor become backers. Fallon is at the center of her future venture, with a handful of external backers, and everyone else is an outsider, see Fig. 2.4. At this very early idea stage of the start-up, transitioning from idea to pre-seed, there are yet no internal players other than Fallon herself.

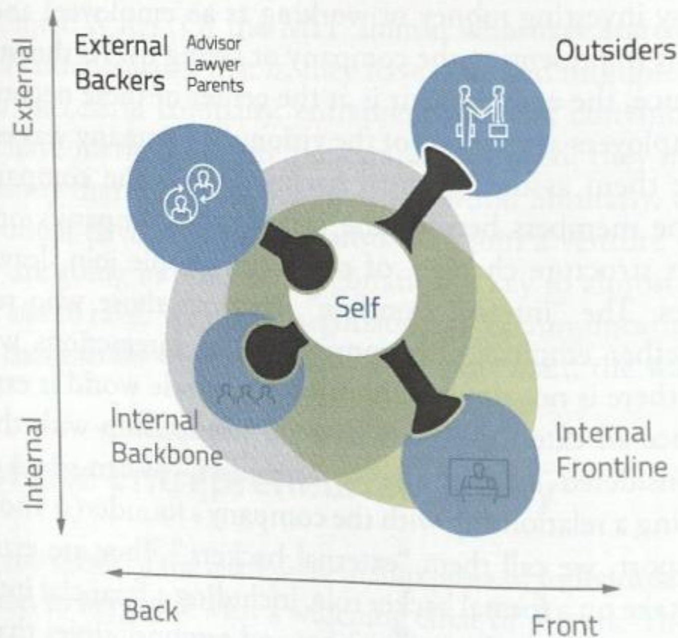

Fig. 2.4 Fallon's pre-seed idea stage

As we know, Fallon succeeded in founding a seed stage company. She was able to "pull" several external players into backer roles. Her parents were early investors (even though the valuation of their shares was not set). Her advisor became an equity shareholder and her lawyer is an at-risk debt holder. In addition, she was also able to negotiate a deal with Fernando that made him cofounder and an executive. She and Fernando "pushed" their vision into the market. They were able to strengthen the internal backbone of the company by making several key hires: a vice president (VP) for product development and a director of marketing. At that point, the company had four employees. Some were paid a salary and some were working only on a promise of equity that would be worth something when the company raised more money. With this initial backbone, the company was able to find two agencies to help with frontline tasks (i.e., marketing the company to prospective customers and investors, and recruiting additional employees). The internal players relied on paid employees to play internal frontline roles and to help with product development. The company was able to augment its organizational structure by hiring an assistant to manage the office along with three talented employees to accelerate the R&D required to create a minimally viable product. The internal team pushed and pulled free outsider players to explore possible markets and product ideas. This allowed them to learn more about the market and others who might be interested in the company and its future products (see Fig. 2.5).

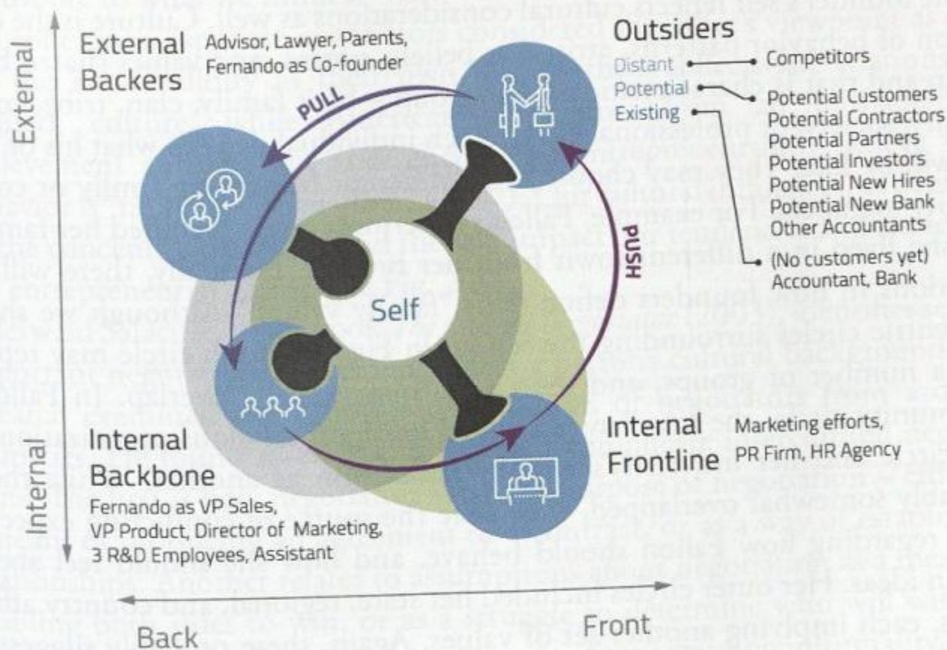

Fig. 2.5 Fallon's seed stage

When considering the founder's self, we have to take account of the various ways in which founders identify themselves: as family members, members of a circle of friends and acquaintances, and as members of the larger society. Each of these membership layers helps to explain why founders make the decisions they do. For example, Fallon asked herself whether she should buy a fancy company car or rent a more expensive office with a view of the river: "Am I deciding to do this in response to my personal preference, or because this is what I should do as the founder of the company?" This decision, and the many others she had to make, reflected her core values and beliefs (i.e., her founder's self). But, they also reflected the pressures she felt from her family, her professional community, and the larger society. We would argue that all decisions by a founder reflect the way that person responds to the pressures posed by each of the four circles that make up their entrepreneurial self. As the company grows in size, reach, and influence, these tensions become more intense. As more external non-stakeholders are affected by the decisions a founder makes, the pressures imposed by the outer circle increases. Other similar decisions include where the company's headquarters should be located, whether to allow workers to unionize, whether to do business in countries that violate child labor laws, and whether to create an offshore tax shelter. In making these "self-identity" choices, a founder needs to pay attention to the interests and perceptions of all the internal and external players in their galaxy. When people and entities deal with a founder, they must remember to take that founder's self-identity into account.

The founder's self reflects cultural considerations as well. Culture is the collection of behavior patterns, attitudes, beliefs, norms, and values shared by a group and that is characteristic of that group – be it family, clan, tribe, community, society, or professional circle. Each individual decides what his or her self will be like. They may choose to be different from their family or community members. For example, Fallon's innermost circle included her family, but she lived in a different town from her brother. Naturally, there will be variations in how founders define their "family values." Although we show concentric circles surrounding the self, as in Fig. 2.6, each circle may represent a number of groups, and the circles may actually overlap. In Fallon's community circle, she may have included her local religious organization as one circle and her university's alumni association as another. While these probably somewhat overlapped, they were the source of conflicting expectations regarding how Fallon should behave, and how she should feel about certain ideas. Her outer circles included her state, regional, and country affiliations, each implying another set of values. Again, these probably suggested socially preferable behaviors. For example, while some national cultures give priority to individualism others emphasize communitarian values.

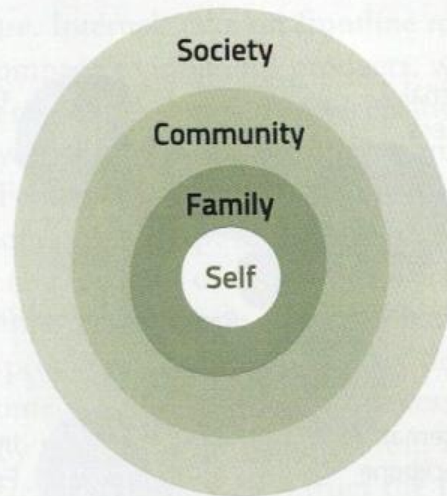

Fig. 2.6 Entrepreneurial self at the center of the galaxy

We carry biases that are both conscious and unconscious. Often, we are unable to distinguish between universal biases and those that are a product of each self's cultural setting. The latter are learned. The former are a by-product of the way our brains are wired. Each entrepreneurial negotiator must be aware of his or her learned biases as well as universal cognitive basis. According to our colleague Francesca Gino in her book *Sidetracked* (2013), simple, irrelevant factors can have profound consequences on your decisions and behavior. One area that we are particularly concerned about is egocentric biases that contribute to what we think is "fair." For example, in experiments by Gelfand and colleagues, Japanese negotiators considered the other's viewpoint as having the same validity as their own due to their collectivist, relationship-focused, culture, while American negotiators from an individualistic achievement culture (one that encourages entrepreneurship) believe their behavior is "more fair" than others (2002). Our cultural influences, as depicted by the concentric circles around the self, impact our tendencies and choices in the entrepreneurial galaxy (see Fig. 2.7).

Jeswald Salacuse, in his book *The Global Negotiator* (2003), identifies several important negotiating moves that reflect a person's cultural background. His research examined the behavior of hundreds of negotiators from a dozen countries. He found several behaviors that complicate intercultural negotiations. The first is how negotiators view the purpose of negotiation – either as a means of producing an agreement or a contract, or as a way of establishing relationships. Another relates to assumptions about negotiation as a means of enabling both sides to win, or as a struggle to determine who will win and who will lose. Other findings concern preferences regarding informality (such as using first names and talking about personal lives), directness, and attitudes toward risk-taking.

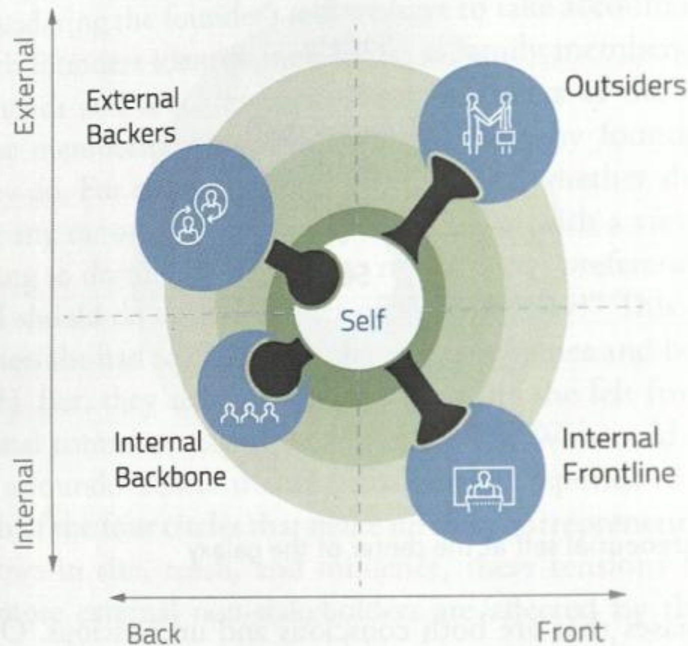

Fig. 2.7 Entrepreneurial self in negotiations

While remembering the cultural or societal forces that define the self, we also must remember that we share common or universal attributes with all men and women as a product of our shared evolutionary biology. We have basic bodily needs, and we all share social and behavioral traits that trigger emotional and social reactions. That is true regardless of our cultural backgrounds and the language we speak. We rely on verbal communication (choice of words, phrasing, tone of voice, rhythm of speech, and volume) and nonverbal communication (body language, gestures, facial expressions) to convey meaning and emotion. Psychologist Ekman identified seven universal expressions of emotion – surprise, joy, sadness, anger, fear, disgust, and contempt – that are mostly understandable, regardless of differences in cultural background (1984).

One of the main advantages of understanding the self as a set of concentric circles is that it explains why the behavior of founders changes as a company grows. Over the life of the company, the outer circles bring more pressure on the inner self.

The complete entrepreneurial "galaxy" can be seen centered around the entrepreneur's self. Initially, all the external players are free outsiders. As the company grows, some are brought in as backers. External backers are appointed directors, join the advisory board, and become shareholders and stakeholders. They help to shape overall strategy. External entities may actually control some company dynamics, while internal players form the

organizational structure. Internals take on frontline roles, including expanding or focusing the company's vision and products, while pulling customers and other outsiders in to join the company on its planned mission. It is worth noting that some players appear simultaneously in multiple locations in the galaxy. For example, Fernando transitioned from being an external player to serving in three locations on the map: (a) as cofounder with equity and membership on the board, and thus one of the external backers; (b) as an executive managing part of the internal backbone of the company; and (c) as a frontline actor responsible for probing the market to better define possible products, attract potential customers, and raise brand awareness (including identifying potential investors). By looking at the distance from the center, we can symbolize how close or far a certain player is from the founder, and how close their relationship is to others in the galaxy. For example, some outsiders have current existing relationships, others are being watched as candidates for a potential relationships, while many others are distant outsiders who will not have a relationship with the founder or company (at least not in the foreseeable future).

As you can see in Fig. 2.8, we include the following actors in the entrepreneurial galaxy:

- Self
- Family
- Friends
- Cofounders
- Advisors
- Employees
- Lawyers, accountants, and agents
- Customers
- Angel investors
- Consultants
- Board members
- Venture capitalists
- Business partners
- Executives
- Competitors
- Banks
- Industry associations
- Regulators
- Government agencies
- Shareholders

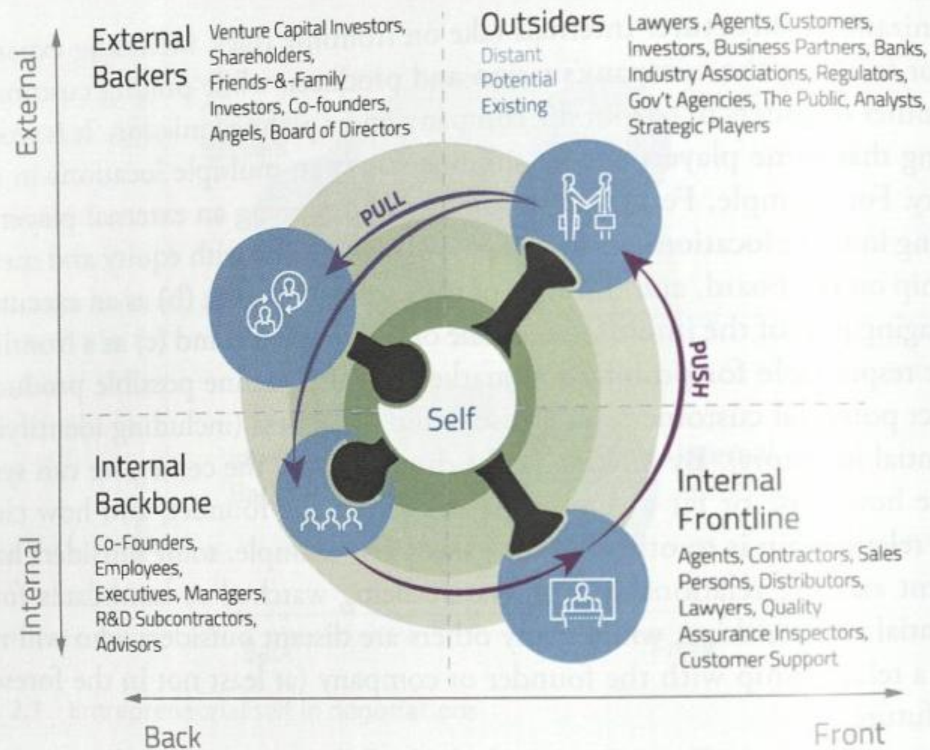

Fig. 2.8 The entrepreneurial galaxy

- The public
- Analysts
- Strategic players (investors/partners)

With this map of the founder's galaxy, we can identify and locate the mistakes that most entrepreneurs make at key points of interaction. It's this view of the galaxy that allows us to reimagine entrepreneurship through the lens of negotiation.

Create Disruption, Thrive on Change, and Adapt

Entrepreneurs pride themselves on creating disruption and driving change. They use innovative products, services, and business models to disrupt targeted markets. Most entrepreneurs thrive on disruption and change, hoping that they will be better at adjusting to new circumstances than their competitors. Small and nimble start-ups are often able to move faster than larger established players. This is why start-ups are attractive acquisition targets for larger corporations. By absorbing new companies they hope to infuse their

new features and capabilities into their existing organization. While some corporations try to promote "intrapreneurship," creating new units within the old company and urging them to operate in transformative ways, others purchase disruptive start-ups that are free of corporate drag and friction.

Thus, at each stage of entrepreneurship (or intrapreneurship), and sometimes even within a stage, things can change quickly (and unexpectedly). This can be the result of external forces, like shifts in the market, anticipation of new regulations, or the sudden emergence of competitors. Change can also come as a result of internal shifts caused by people coming or going, cash flow problems, or technological challenges. The entrepreneur's job is to adapt. In the Fernando and Fallon example we saw how they handled such a "pivotal" moment when they realized the product they were developing was not going to meet market expectations. They had to react, revise their plans, and notify potential customers there would be delays. They had to deal with vendor and customer frustration, regardless of the toll it took on the internal team, their board, investors, and advisors. Earlier than they initially imagined, the founders were forced to bring in more experienced management and seek funds on less than favorable terms.

Having a plan is critical to any entrepreneurial effort and to every negotiation. Yet, even the best plans cannot take account of all possible disruptions. While having a plan helps keep everything moving in the right direction, the real power of the plan derives from your ability to update it. As Winston Churchill said: "Plans are of little importance, but planning is essential," or in the American version: 'Plans are nothing; planning is everything"– Dwight D. Eisenhower.

Michael Wheeler in his book *The Art of Negotiation* (2013) has written about improvisation skills. These are the tools that planners use to deal with continuing uncertainty. Based on his look at improvisation in a variety of fields, Wheeler concludes that the successful negotiator needs to be, at the same time, both methodical and flexible, self-confident and humble, calm and alert, patient and provocative, as well as practical and creative. Since negotiation is a social activity that requires the ability to adapt quickly, it requires being present "in the moment," while at the same time relying on essential structure and sound training. In our experience, negotiators have to deal with unexpected situations that are full of drama and tension, and where the skills Wheeler identifies are crucial. In this book we try to provide the essential structure within which founders can improvise successfully.

Innovation Does Not Mean Reinventing Every Wheel

Whether disruption is the result of external forces (e.g., markets, regulation, competitors) or internal forces (e.g., people, financial pressures, development challenges) entrepreneurs must be able to adapt. While some observers of entrepreneurial dynamics assume that constant change and the pressure to adapt make planning unnecessary, we disagree strongly. The exact timetable for each company to move from stage to stage cannot be known, but it is possible to anticipate the way a start-up will evolve. It is also possible to anticipate interactions that will be required in each start-up's galaxy

Founders who pay close attention to what's happening around them while keeping a clear map or plan in their head will get the best results. Although each growth phase requires different skills and handling new interactions, it is possible for an entrepreneur who has never met a particular situation before to prepare effectively. They also need to reflect on what they can learn from others and continue to acquire new skills.

By using our map of the entrepreneurial galaxy, a founder can make his or her way, even in unchartered territory. For example, when Fallon's start-up reached the growth stage, she anticipated the following negotiations, shown in Fig. 2.9:

- After raising money from friends, family, angels, and venture capitalists, appointing a Board of Directors, and forging an agreement with a team of advisors, Fallon knew she would have to negotiate a potential investment by an SI as part of Round B.
- There were 5 management team members (Fallon, Fernando, the new COO, and two more VPs) managing 7 director-level staff, 22 manager-level leaders, and 53 individual-contributor employees. She knew that the management team would have to reach agreement on certain key points. They could not operate independently of one another.
- Some of the company's 87 employees were serving as the company's frontline. These included the VP of sales and marketing with his directors and sales managers. The frontline also included members who interface with external players on customer support, procurement, vendor quality assurance, finance, and other operations. Fallon knew that the efforts of the frontline had to be coordinated, even harmonized. When the HR firm was replaced by an internal HR director and an in-house recruiter, public relations was still being managed by the external PR agency that Fernando had hired earlier. This inside-outside split had to be reconciled.

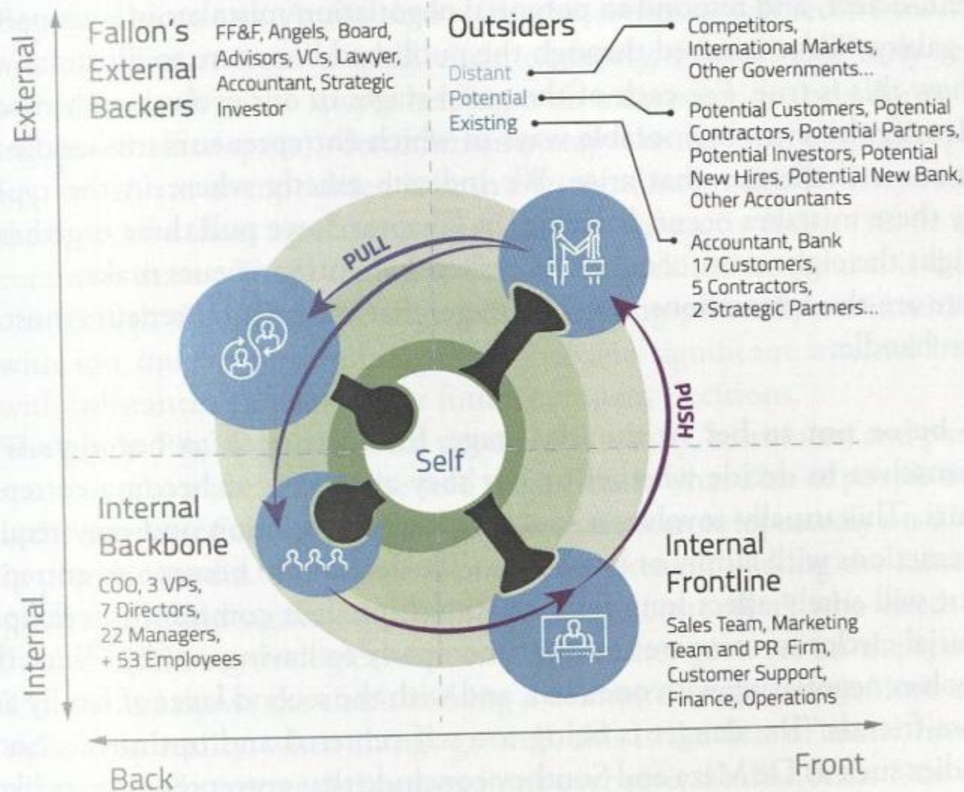

Fig. 2.9 Fallon's growth stage

- The external free entities were plentiful. However, Fallon's dashboard allowed her to track her outsider relationship status with seventeen customers, five contractors, two strategic partners, and many more potential customers, contractors, investors, new hires, banks, accountants, competitors, and even government regulators. She knew that every one of these interactions would probably require direct negotiations of some type. She also tracked some distant outsiders who might shape her galaxy and influence other key players.

Negotiating Is a Vitally Important Entrepreneurial Skill

Even with all the glamour and hype, becoming an entrepreneur can be hazardous. According to *Forbes, Bloomberg,* and *other news outlets,* as many as 80–90% of all start-ups fail. While there are many reasons for this, our research and experience suggest that the single biggest threat to entrepreneurial success is an inability to handle the negotiations that arise at key interactions in the evolution of a start-up. In our view, founders must be able to

prevent, detect, and respond to potential negotiation mistakes in each part of their galaxy. We've combed through the published literature to illustrate why and how this is true. For each of the seven stages in our evolutionary model, we identify the most memorable ways in which entrepreneurs mishandle the negotiation challenges that arise. We indicate exactly where in the typical galaxy these mistakes occur. Later on, in Chapter 3, we pull these together to highlight the eight most common mistakes that entrepreneurs make.

Here are the interactions, stage by stage, that most entrepreneurs must be able to handle:

- **To be or not to be?** At the idea stage, founders need to negotiate with themselves to decide whether or not they are going to become entrepreneurs. This usually involves a soul-searching negotiation and may require interactions with family or loved ones. The decision to become an entrepreneur will surely affect long-term relationships. It is common in entrepreneurial circles to compare starting a company to having a baby. Thus, this involves negotiating with one's self, and with the second layer of family and close friends. The danger is being too self-centered and optimistic. Some studies such as De Meza and Southey conclude that entrepreneurs are likely to be drawn disproportionately from the ranks of super optimists (1996). Other studies such as Arabsheibani, de Meza, Maloney, and Pearson claim that optimists minimize the downside of unpredictability, thus making entrepreneurship seem overly attractive (2000).
- **Licensing idea.** At the idea stage, many founders need to negotiate a license for the intellectual property (IP) they intend to use. For example, Fallon needed to negotiate with the university for permission to use the discovery she made while working at the university. In such situations, there is a danger of negotiating too aggressively about the royalties or equity the university will get. In actuality, this is a negotiation with an outsider who could become an external backer, and whose goodwill a founder may need to trade on in the future.
- **Cofounder agreement.** At the seed stage, a founder may need to choose a partner and work out a cofounder's agreement. For first-time entrepreneurs, this is a highly sensitive negotiation. Many people compare it to getting married. So, a founder's agreement could almost be seen as a prenuptial agreement. The danger (in both contexts!) is that it is easier to avoid talking about all the things that can happen. There is a tendency is such situations to compromise too quickly just to "get it over with," and get back to the fun part of starting a company. The cofounder will become a significant player on multiple fronts as an internal backer, external backer, and internal frontliner.

- **Equity allocations.** At the seed stage, the company will receive money or in-kind support from a small circle of family, friends, and early service providers (such as the lawyer helping with incorporation, or a donor hosting shared office space). Commitments may take the form of spoken promises, which are memorialized later in a letter of intent (LOI). They can take the form of a short agreement promising future equity stakes (%) or actual common shares. There are many unknowns at this point, and it is dangerous to rush through these negotiations, relying primarily on intuition or with too much optimism. Investors become significant internal backers with substantial influence over future company decisions.
- **The pitch.** Pitching to external potential investors, customers, and partners starts to take place during the seed stage. This is what a lot of people believe is the essence of entrepreneurship. They have seen it repeatedly on TV and in popular media. The image is of an entrepreneur making the same sales pitch again and again to "sharks" or "large customers" who need to be "wowed." The mythological outcome is that they get a yes on-the-spot (the TV version shows the shark making a commitment based on "love at first sight"). In reality, when things go well, this is the first of many meetings that will lead to extended negotiations over several milestones. Due to the repetitive nature of "the pitch," there is a danger that the founder becomes too self-centered. This can lead to overemotional reactions and bad negotiating mistakes.
- **Hiring early team members.** During the early start-up stage, it is often necessary to convince potential new hires to join even if there are inadequate financial resources in hand and the risk of failing is high. These negotiations tend to focus on roles, responsibilities, equity shares, salaries, incentive plans, titles and other items close to the core identity of the founder as well as each of the employees being hired. Once hired, employees become internal backers. Some will bring attractive frontline skills and experience, and assume a frontline role. The key danger in these negotiations is that the founder will be in such a rush to get started that longer-term considerations will be short-changed.
- **Angel investment.** Also during the start-up stage equity allocation negotiations with potential angel investors occur. These are shaped by the angel's experience and desired level of involvement. The angel could become an external backer, and have significant influence over future decisions. The danger here is that the founder will accede to the angel's demands because they don't see any other sources of funding. From a negotiation standpoint, this represents a failure to work harder to improve your BATNA.

- **Vision and strategy.** Every company needs a clear vision and a business strategy. This is critical for start-ups since they are especially vulnerable to the tribulations of high uncertainty. It is one of the fundamental roles of the founder to provide and promote a vision that employees and external players can share. This can only work if the founder negotiates an agreement with backers and gets buy-in from the internal team. These interactions involve two separate negotiations. The key danger is that the founder will be so wedded to their own vision of the company they won't hear or accept what the others are asking.
- **First customers.** During the early start-up stage, frontline negotiations with first customers need to happen. After the initial "pitch" is successful, or following a long process of market research, negotiations focus on terms (price, delivery, quantity, etc.) and risks (schedule, quality, etc.). A typical danger for founders in these interactions is that they are overly optimistic about what they can produce by when or overconfident regarding technological problems that need to be overcome. Another typical mistake is believing that first sales are about business terms, and denying the emotional drivers that motivate customers to take a risk on a small start-up.
- **VC term sheets.** This is what many people view as the major barrier to success: negotiating investment terms with a VC firm. It often hinges on determining how the company will be valued. The investing VC wants a lower valuation so that their investment gives them a larger portion of the company. For a simple example, if a company is valued at $3M before the investment (called "pre-money") then the VC's investment of $1M will buy them a 25% equity stake in the company (company's "post-money" valuation is now the $3M "pre-money" plus the $1M "new-money" for a $4M "post-money" valuation, and the VC's $1M investment is converted to equity worth $1M/$4M of the post-money value). If shortly thereafter the company is sold for $20M in cash, they will receive 25% of that amount, or $5M for a "5x" (meaning investment amount times five) return. While the investing VC wants a lower valuation, the founders and angel investors want to maintain a larger equity portion of the company, and therefore would prefer a higher "pre-money" valuation. In addition to funding, VCs can bring other kinds of added value. As with the angel investor, these negotiations are about equity allocation and control. VCs typically involve professional firms who do this on a regular basis. After the investment, they become significant external backers, typically receiving board seats and preferred shareholder rights. Typical dangers for founders in these negotiations are having tunnel vision or getting stuck on

assumptions about valuation. This often translates into haggling that obscures other important value-creating opportunities.

- **Hiring executives.** This usually occurs during the revenue stage. It is similar to hiring early team members, with the added complexity that these are likely to be more experienced players. Since they sometimes have more experience than the initial entrepreneur, and since they are being brought on to be part of management, they will insist on having a measure of control and significant rewards for their efforts. They will become internal backers. The founder's risk in this interaction is that they will try to handle this negotiation on their own. Also, they may have to bridge the culture gap between big company thinking and a start-up mentality.
- **The pivot.** When external forces shift or the company needs to change direction, everyone involved has to make adjustments. Decisions about such pivots need to involve consultation with both internal and external players. The negotiations that result could lead to drastic measures like eliminating a basic product, modifying the basic structure of the organization at significant cost, and firing certain employees to make way for newly needed expertise. These interactions can become terribly emotional because they touch on issues of trust, loyalty, and fairness. Another version of this type of negotiation is when a company decides to "spin-off" a portion of itself in order to create a new separate entity that is the result of a series of negotiations regarding which people and assets end up on which side of the split.
- **Strategic Investor Relationship.** During the revenue stage, the involvement of SIs requires complex negotiations. SIs differ from regular financial investors (such as angels and VCs, with different levels of active involvement) who are primarily focused on financial returns and the success of the start-up. Strategic players are themselves active players in the market, and have some nonfinancial (hence strategic) reason to be involved with the company: they may be a potential customer, potential marketing partner, potential competitor, or even a potential acquirer who by investing gets a close look at what is going on with the company and maybe the inside track on making an offer. Therefore, SIs have potential conflicts of interest. Their primary loyalty is to their own corporation's success in the market. For example, potential conflicts may arise when relationships with one of the SI's competitors are up for discussion. The same could be true when regulatory matters are on the agenda. A strategic player that starts out as an outsider may be a future potential competitor to the start-up itself. On the other hand, partnering with the strategic player provides significant validation, branding, marketing, and learning opportunities to the founder's company that they would not be possible

alone as a small company – such as bringing a new drug to market. Questions about how much control and what information rights the SI should be given once the SI becomes an external backer tend to make these negotiations quite difficult. SIs argue that their involvement enhances the perceived value of the company. The dangers for founders in these negotiations is that they will compromise when they shouldn't, and defer to the SI's experience, even though their interests run in different directions.

- **Commissions.** The negotiation of incentive plans is a very typical frontline negotiation. It involves both employees who provide frontline functions (such as sales or business development), as well as contractors who are hired to represent the company (distributors, marketing agents, HR agencies, fundraising consultants, etc.). When negotiating these relationships the primary dangers for the founder are overoptimism, a willingness to share too much control, and failing to take a long-term perspective.
- **VC next round.** The life of a fast-growing, ambitious company typically moves from one financing round to the next. Ideally, the company value is growing faster than the additional money invested will dilute. Again, negotiating investment terms with a new VC hinges on determining valuation. In this next round, the VC that invested previously now finds itself on the other side of the fence when a new VC presents a term sheet. Together with the founders and the angles and current investors, they want a higher valuation, so that their equity share does not get too "diluted" or reduced to a smaller share of the company. To continue the prior (simple) example, if instead of being acquired, the company receives a new investment of $5M at a valuation of $20M pre-money, then the 25% equity stake is translated to a quarter of the pre-money portion, which is translated to a $5M value, which is now 20% of the company's post-money value ($5 out of $25M post-money valuation). It appears that the current investors and the founders are totally aligned, but this would be a mistake. It is important to identify the differing interests due to the fact that current investors also have the option of investing in the new round. This is a good thing for everyone since it indicates a strong belief in the future growth of the company. However, this puts the current investors in a different situation: wanting a low valuation as the new investor and wanting a high valuation as an existing investor. Typical dangers for founders in these negotiations are having tunnel vision or getting stuck on assumptions about valuation, and not dealing with the conflicting interests of existing investors.
- **VC down-round.** Many entrepreneurs consider negotiating a VC term sheet with a down-round valuation as their most traumatic experience. Accepting a low valuation in order to secure the next round of financing is

only the most visible aspect of this event. The consequences are much more significant and require simultaneous negotiations with current external backers and incoming ones. All existing shareholders and option holders (such as employees with ESOP options) will find that their equity shares are significantly "diluted" or reduced in value in a down-round valuation. To continue with our prior example, if after the $25M post-money valuation the company runs into growth and market challenges such that new investors are willing to invest another $2M only at a valuation of $10M, then an investor (or founder) who owned 20% of the company that was valued at $5M will now be valued at 20% of the $10 pre-money valuation, and therefore will be left after the down-round with a diluted equity stake of 16.7%, that now has a book value of $2M. The founder may feel this is even more unfair if some of the prior investors have "anti-dilution" provisions that minimize their dilution at the expense of the common shareholder founders. The dangers for a founder entering these negotiations are, once again, "tunnel vision" on valuation, and the full range of cognitive biases (like reactive devaluation) that get in the way when ego and emotion take over.

- **IP dispute.** Legal disputes with a competitor or an "IP troll" (a person who "extorts" or "bullies" others using legal claims on IP) often arise during the revenue stage. This is different from a typical commercial dispute with a customer. And, it is not like an employment dispute with an employee. In an IP dispute, the "relationship" begins abruptly with a lawsuit or demand letter (as opposed to a dispute that arises in the later stage of a rolling relationship). An external entity uses a lawyer as their frontline agent. The dangers for a founder in this kind of interaction are getting into a win-lose haggling mindset, letting emotions interfere with the prospects for resolution, and dealing with agency issues raised by having to deal with the lawyer rather than the principal they represent.
- **Hiring a CEO (or COO).** Sometimes an incoming CEO also invests in the company, but mostly they become both an internal backer (employee) and an external backer (board). The added complexities of executive hiring during the growth stage relate to questions about the reporting structure and relationship with the founder. The addition of a new executive can also change the board dynamics since coalitions are likely to emerge. For a founder, interactions with a new CEO or COO can challenge their fundamental view of themselves as the person in charge. The dangers in these negotiations relate to ego (threat to founder's role) and competition for control (need to win).

- **Venture debt.** Venture debt is a softer version of the VC investment situation. Venture debt holders primarily get paid back as lenders (secured by some assets). In addition to that they get some equity (or warrants that enable them to purchase equity at a later date with favorable terms), but much less equity than if they would have invested the money similar to a venture fund. They usually seek less active control and may prefer to remain "passive" backers. If things go bad, they can exercise their right to be more active, but primarily to protect their own interests. Dangers for founders engaging in these negotiations are overoptimism and a propensity to haggle.
- **Terminating an early team member.** During the growth stage, it is often necessary to terminate an early team member. This happens when relationships among internal backers change. For founders, the dangers in these negotiations are the risk of triggering a lawsuit, the likelihood that change is taken too personally, and challenges to the corporate culture that has emerged in the start-up.
- **Joint venture/new markets.** Given the desire to grow, an external player may propose becoming a partner. A new entity that is closely associated with the company may be set up in a market that is unfamiliar to the company, and it relies on the partner's experience and expertise. This can have ripple effects among all the internal backers and the frontline players. Depending on who the player is, a joint venture or a shift into new markets may also have significant effects on external backer relationships as well. Moving into new markets or joining forces with another company can threaten the corporate culture that has developed. For founders entering these negotiations there is a dangerous tendency to try to handle everything by themselves. This leads to self-centered miscalculations and wrong cultural assumptions.
- **Investment bankers.** The advantage (and necessity in many cases) of engaging professional agents during the expansion stage is that they have a very high level of expertise and a strong network that can help multiply access to financial investors and financial resources. The risk is in "handing over" the process of pitching and valuing the company to someone else. The dangers for founders in the middle of these negotiations are, again, related to ego, control, and a desire to work alone.
- **Labor unions.** When the company gets larger (and this may vary based on geography) the employees may want to unionize. Or, there may be other government rules that are triggered. Collective bargaining has a long history. Founders with no experience in this kind of negotiation need to get help. There are serious dangers associated with escalation that surrounds win-lose bargaining.

- **Founder departure.** One of the deepest scars many former founders carry was caused by the Board/Shareholders/CEO demand that the founder depart the company. This typically gets put off for a long time, but it is almost inevitable when a company expands beyond a certain point. Almost every negotiating problem we have listed so far can come into play in these interactions: egocentrism, emotional overreaction, haggling, and overoptimism about one's own ability and the likelihood that things will work out a certain way.
- **M&A.** In parallel (or after) pursuing organic growth and expansion, a company may look to acquire another company (start-up) or to merge with still another. This is where individual interests and the best interests of the company may diverge. For example, there will only be room for one CEO once the merger is over, and many issues of control and culture will have to be worked out. Founders entering these negotiations should probably take a team of advisors with them to save them from the long list of negotiating mistakes they are likely to make.
- **EXIT – Acquisition by SI.** At any stage of its life, strategic players may offer to buy a start-up, at a certain valuation, typically by purchasing all the shares of the company. This is, of course, a great compliment to the founder's vision. And, it may represent a huge financial win as well. On the other hand, this brings to a close the entrepreneurial venture as the founder envisioned it. The final decision may be up to the founder (in the early stages) or require consensus or majority of external backers. Negotiations about the founder's exit are fraught with difficulty. Typical mistakes relate to egocentrism, emotional overreaction, a tendency to see things in win-lose terms (haggling), overoptimism about the prospects of risk avoidance, and a desire to make important decisions on one's own.
- **EXIT – Asset Sale.** At any stage, an SI may offer to buy some of the assets of the company, such as a certain product, technology, or group. This means that the venture will continue to operate after undergoing some changes. It may have to split some of its proceeds with shareholders (including the founder). The dangers associated with this type of negotiation and the third and fourth type of exit negotiations that follow are the same as those we have already enumerated.
- **EXIT – PE buyout or IPO.** A Private Equity (PE) company may offer to buy the company, or bankers may offer to take the company public through an initial public offering (IPO, such as on the NASDAQ stock exchange). PE firms bring their own vision to the table, and seek to gain control. An IPO means becoming fully exposed to the public, and triggers a new level of regulation and red tape. A PE buyout or an IPO is typically accomplished

through the sale of shares. There are usually restrictions on how much and when existing shareholders, including founders, can take their equity in "liquid" form (i.e., as convertible to cash).

- **EXIT – Shut Down.** Shut down could happen at any stage. A company could shut down because of a lack of money, or following a decision that it is better to liquidate and distribute all remaining assets among the shareholders. In the lifecycle of a "newborn" company, shut down is "death." Like death, it is a very difficult topic to negotiate. Founders are very likely to make mistakes if they attempt to handle these negotiations on their own.

Naturally, an entrepreneur is not expected to have the skills to handle all these negotiations at the moment of founding a company. This is naturally true with a first-time entrepreneur, and it is also true of a repeat entrepreneur. Even a founder who does go on to grow his company as the CEO through to an exit will not be required to negotiate all these different types of negotiations during their tenure. Some of these negotiations are extremely uncomfortable. We hope you are one of the lucky ones who won't need to actually go through with them. However, hope is not a strategy, and we believe that all entrepreneurs should be prepared to negotiate these situations if they arise. By that we mean that they should be able to recognize the situation and get the help they need to prevent, detect, and respond appropriately.

Negotiation Includes Agreements and Milestones

Many entrepreneurial relationships last for a long time and involve many agreements and contracts. Such long-term relationships involve many negotiations. Each of these negotiations, such as those described in the previous section, involves at least one major agreement, and sometime several. Throughout the relationship, there will be many milestones, and many of these milestones will carry specific contractual significance. But every negotiation process also has milestones that are internal to the negotiation process. We will describe some of these typical entrepreneurial negotiation milestones. In any negotiation, the parties typically agree on one main agenda item, or a list of agenda items, to discuss. After discussing the agenda, the parties will have a short list of main terms that they agree on. This signifies their intent to reach an

agreement, and is typically an intent that is non-committal, which may carry a name such as "Informal Letter of Intent" or LOI. The next milestone would be when the parties have negotiated the main terms into a draft "Term Sheet" or a draft "Memorandum of Understanding," which will typically include a clause on what level of commitment (to reaching a full agreement) the parties have taken on. After this draft is turned into a detailed term sheet (or MOU), it is typically signed, and serves as the subsequent basis for the more detailed negotiation of the full agreement. That agreement may require the involvement of many more players (and many more lawyers) and some complicated processes (such as large financial transfers, regulatory approvals, and collection of signed exhibits). Typically such a detailed agreement will include the milestones of reaching an agreed-upon draft agreement, the signing of a formal agreement, and the "closing," which will happen at signing or at some other date after signing to allow for the completion of all the supporting processes before the agreement formally becomes effective. Most agreements also include in them several post-closing contingency milestones that are part of fulfilling the agreement, or that would trigger some clauses in the agreement. In Table 2.2 we show the milestones in a typical entrepreneurial negotiation process.

Negotiations take up a significant portion of most entrepreneurs' time. They continue through all the long-term relationships that entrepreneurs are part of. They can also spring up quickly and unexpectedly; sometimes as a result of an abrupt external force, or neglected "pressure-cooked" internal dynamics. We believe that failed negotiations are at the root of most entrepreneurial failures. Knowing how to prevent a failed negotiation as well as how to recover after one occurs is essential. Having surveyed many entrepreneurs, we know that almost every interaction entrepreneurs face will test their negotiation skills. Those who succeed will prepare properly and keep trying to improve their understanding and skills.

Table 2.2 Milestones in a typical entrepreneurial negotiation

Milestones in a typical negotiation process
Agenda
Main terms (intent)
Draft term sheet
Formal term sheet
Draft agreement
Formal agreement
Closing
Post-closing contingency milestones

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5

The Entrepreneurial Galaxy Reimagined: Prevent, Detect, and Respond to Your Mistakes

Entrepreneurship as a Series of Negotiations

Every successful entrepreneur needs to be able to handle negotiations in a way that reflects his or her values, priorities, and preferences. This includes a careful approach to preparing for negotiations before they begin, a way of dealing with face-to-face interactions at the table (including both creating and distributing value) and managing "away from the table" pressures (including back table mandates on both sides). They also need to be disciplined about following through appropriately after each negotiation (e.g., completing action items, tending to relationships, and reflecting on what they learned). If they do these things properly, they can *prevent* mistakes, *detect* them as they are about to happen, and *respond* appropriately if they do occur. These actions are symbolized by the first three icons in Fig. 5.1, which are augmented by the *reflect* icon, which is represented by the "Janus"-like image that is simultaneously facing the past and the future.

As depicted in Fig. 5.2, after each negotiation, it is important to *reflect* on the lessons that should be learned (LL). This includes being honest about what worked well (WW) and what didn't, and thinking hard about what should be done differently in the future (DD). Reflecting on mistakes should lead to insights that are allocated to the LL category.

Over time, entrepreneurs need to get better at recognizing their mistakes, so they can catch themselves when they are about to make them again. Moving

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Fig. 5.1 Prevent, detect, respond, reflect

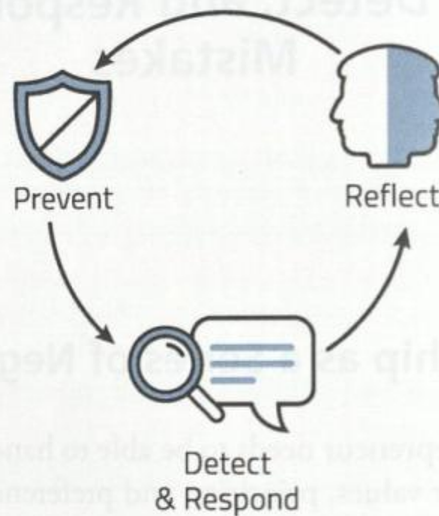

Fig. 5.2 The entrepreneurial negotiation loop

from prevention of errors, to detection of them when they occur, and, finally, to reflection on lessons learned constitute what we call the entrepreneurial negotiation loop.

Table 5.1 presents the simple steps that make it possible to integrate the key elements of the mutual gains problem-solving approach to negotiation with prevention measures, detection triggers, at-the-table responses, and post-session reflection.

Negotiating with Different Categories of Players

At each stage of the entrepreneurship process, as we noted in Chapter 3, individual entrepreneurs will probably be called upon to negotiate with multiple categories of players including external backers, internal backers, frontliners, and outsiders. Different negotiation mistakes are likely to arise when engaging each of these categories of players.

Outsiders Players in this category are the people to whom an entrepreneur must make a pitch to get them to buy a product, reduce their price, deliver

Table 5.1 Using the entrepreneurial negotiation loop

PREVENT
Clarify your own interests and the interests of others
Assess opportunities and risks
Anticipate likely mistakes
Seek additional information
Consider setup moves
Eliminate obstacles
Decide on the best means to create value
Practice scenarios
DETECT AND RESPOND
Embrace the unexpected
Avoid overly defensive reactions
Consider alternate explanations
Test perceptions with others
Display maximum flexibility
Make adjustments
De-escalate tensions
Consider apologizing
REFLECT
Debrief impacts
Note mistakes and gaps
Consider re-engagement
Clarify lessons learned
Revise your personal theory of practice
Think of changes in organizational incentives and controls
Commit to greater value creation
Talk through what you have learned

earlier, reduce the scope, join the development team as an employee, collaborate as a partner, or invest in a venture. These often involve new relationships, although they can build on previous interactions. In each case, there are likely to be information asymmetries, in one or both directions. If your goal is to get the "other side" to change their mind, then the only thing involved is persuasion. It is more likely, though, that both sides will need to make various adjustments to reach agreement. This requires negotiation, not persuasion. A potential customer may know very little about your product's specifications or prevailing price; at the same time, you probably know very little about their needs and financial constraints. As a result, your focus should be on bi-directional information gathering and relationship building.

Mistakes often occur when entrepreneurs dealing with outsiders shortchange their exploration of the other side's interests or rush to close too quickly. Also, mistakes result when negotiators rely too heavily on intuition rather than careful analysis. We saw such mistakes in the stories of how Illai, Ailis, Ben, and Stephen dealt with outsiders.

External Backers This is the only group that has formal authority over an entrepreneur. Board members can fire the founder and change compensation levels for every executive. Board approval is typically required for the annual budget as well as extraordinary expenses. Certain decisions, such as accepting additional financing, require the signatures of all shareholders. Some investors and board members may have significant experience, while others may have much less knowledge about the business domain than the founder or the top executives. External backers don't always have time to master the fine details (since some board members are likely to have full-time jobs, or sit on several boards). The role and power dynamics of engaging with external backers tends to evolve during the life of a company: When a company is still at the idea stage, there are no external backers. The founder controls 100% of the votes on the board and 100% of the shares. Then, in exchange for funding from investors, founders give up full control of voting shares and/or board seats. For example, an early family-friend investor may get a 30% share allocation and a board seat in exchange for their financial support, while an angel investor providing a later round of funding (of the same amount) might only receive 10% of the shares and no board seat.

Two cofounders might appoint themselves to the board along with a trusted advisor as a third board member. All angels who make subsequent investments may receive only shares and no board vote. As a company grows, usually after receiving additional funding, the founder may retain majority control, since the board may include cofounders or angel investors loyal to the founder. Eventually, usually after additional funding rounds, the board majority is likely to be made up of professional investors and industry experts whose loyalty and duty are to the company's financial well-being, not the founder. Such shifting patterns of control are often a source of tension. We saw this in both the Fallon-Fernando story and in the real-life Petra and Peter story. Petra and Peter were fired when they were in a founder-minority situation. They had a much better experience in a more balanced founder-majority situation in their later companies.

Typical mistakes while dealing with external backers are often the product of the founder's self-centric view as well as disagreements over the allocation of authority and autonomy. Strong emotions also tend to arise in these situations, often as a by-product of concerns about status and appreciation.

We saw how critical backer relationships are, and how costly mistakes in dealing with external backers can be. Vinayak missed out on the added value that a strong backer might have offered. Dip and Ben lost valuable time and resources trying to accommodate their backer's directives without a sufficient

commitment to dialogue. Worst of all, Petra and Peter's strained relationship led to a terrible legal conflict. Errors like these can even lead to the closure of a company.

Internal Backers Insiders are unique in that they all report to the founder/ CEO and are dependent on the founder for their jobs, salaries, bonuses, and performance reviews. At the outset, a founder needs to recruit and manage every employee; often, without being able to guarantee certainty or rewards. Some early recruits end up wearing additional hats in their relationship to the founder's galaxy (such as sitting on the board or owning special cofounder shares). Power imbalances inherent to boss-employee relationships can confuse individuals who must work closely with a founder (indeed, many founders refer to their employees as "family" and develop close friendships). One significant source of tension in these situations is a lack of clarity regarding roles and responsibilities. This can lead to misaligned assumptions about who is actually a cofounder (in role, title, and/or in equity ownership) as exemplified in the famous lawsuits between Mark Zuckerberg and the Winklevoss twins regarding the ownership of Facebook. The same is true in a more recent lawsuit of a similar nature that pitted the founders of Snapchat against each other.

In the initial stages of an entrepreneurial effort, the founder CEO is usually the sole decision maker, and is therefore looked to as both visionary and authority figure. Later in the life of a company, as a venture grows, employees continue to "look up" to the founder/CEO. Some early team members (who were used to working intimately with the founder) may find themselves several layers away in the organizational structure, subject to new corporate rules and policies. CEOs need to continuously "sell" their company's vision and strategy to everyone with whom they interact. They need to maintain the trust of those who work for them.

Especially in the urgency-rich environment of a start-up, many employees tend to suppress their emotions ("during this critical time as a team, it is not appropriate to raise personal issues ..."), hold back from providing honest feedback to the founder (due to the perceived risk associated with speaking up), or allow tensions to escalate past a point of no-return ("Why are you resigning? You should have talked to me sooner..."). To ensure that the right communications take place, a CEO should insist on periodic feedback sessions (typically quarterly or annual reviews, scheduled with the aid of Human Resources (HR) to set milestones and give and get honest feedback. At these sessions, appreciation should be part of the agenda. These are important opportunities to revisit the changing interests of internal backers.

Workplace relationships often fall victim to classic negotiation mistakes including haggling (going back and forth on a number such as salary and neglecting other important factors), taking a self-centered view (one that disregards the interests of others), misusing power (in a way that triggers hostile emotional reactions), disregarding the importance of emotions, and avoiding difficult conversations needed to achieve clarity (due to the discomfort they can create).

We saw the fictional Fallon and Fernando face such challenges. In Chapter 4 we saw Barbara offend her employees when she avoided talking with them about hiring issues that were difficult for her.

Frontliners This group includes individuals who represent the company to the outside world. Many frontliners are involved in either selling or buying on behalf of the company. This includes the sales force or procurement representatives who negotiate price and delivery, the customer support representatives, or the quality assurance inspectors whose performance metrics are based on customer satisfaction surveys or yield metrics. Usually, in the case of sales and business development, an employee serves as an agent, and is compensated based on his or her performance. Some frontliners are not employees, but ad hoc business partners or contractors who will walk away if their relationship to the founder no longer serves their interests. Often, though, frontliners are also employees (internal backers). There is an obvious tension between treating these individuals as noncommissioned employees (and driving away the most talented sales people who want to be rewarded for exceptional achievements) and treating them entirely as cash-incentive-motivated employees (alienating those who do not want to feel as if they are "coin operated"). We will discuss the use of agents in more depth later in this chapter. Especially with frontliners who are also employees, this tension is something that needs to be balanced in a way that creates more value for everyone while simultaneously taking account of people's feelings about being treated fairly.

Typical mistakes while dealing with internal frontliners relate to overlooking the difference between the frontliners' role as an employee and their role as a representative (i.e., an agent with their own interests). Founders dealing with these tensions can make things worse by being overly self-centered and ignoring the emotions associated with how credit and blame are attributed.

Every venture is likely to be structured differently, with widely differing numbers of players fitting into the categories of backers, insiders, frontliners, and outsiders. In Chapter 4 we saw real-life instances of entrepreneurs making

predictable negotiation mistakes in dealing with each of these kinds of players in the entrepreneurship galaxy. In this chapter, we will offer advice on how to prevent, detect, and respond to these difficulties.

Prevent Mistakes Before They Occur

Preparation is one of the keys to successful negotiation. If we prepare well, we are actually engaged in "mistake prevention." As described in Table 5.2, preparation means focusing on interests, opportunities, risks, obstacles, and potential moves, including those "away from the table," with the other side or with other parties. Prevention also requires rehearsal, to transition both physically and mentally from theory into practice.

Analyze from Different Points of View

The first step in preparation is to clarify the interests of everyone involved. This includes mapping wants and needs that serve as the basis for trades, followed by creating value across the table, with back tables and with other parties. As

Table 5.2 Prevent entrepreneurial negotiation mistakes

Prevent	
Clarify own interests and the interests of others	• Consider substance, relationships, and environment (back table and other parties) • Dig under narratives, positions, needs, fears
Assess opportunities and risks	• Assess options, metrics, standards, no deal alternatives • Identify distributive issues, potential trades, and potential packages • Assess short-term and long-term; substance and relationships
Anticipate likely mistakes	• Include a historical review to identify likely mistakes for each player • List potential dangers of core identity, taboos, and sacred values
Seek additional information	• Consider open sources, other parties, and requesting material
Consider setup moves	• Consider changing alternatives, environment, coalitions, back table, public perceptions
Eliminate obstacles	• Eliminate counterproductive alternatives, constraints, and limitations
Decide on best means to create value	• Decide on favorable setting, participants, process, agenda, schedule, authority, ... • Prepare likely arguments, counterarguments, and victory speeches
Practice scenarios	• Experiment with communications and reactions. Select optimal choices

Vinayak's case taught us – it is important to consider both objective tangible interests as well intangibles, or subjective value. Sometimes interests are found hiding beneath stated demands and may require some "in-their-shoes" digging to differentiate between positions and interests. As Fisher, Ury, and Patton prescribe in their previously mentioned book *Getting to Yes* (2011), getting at the interest may be achieved by trying to answer "Why is this important to this person?" Underlying motivations can be intuited by reviewing prior proposals, communications, and open sources, as well as by considering the five emotional core concerns (appreciation, autonomy, affiliation, status, and role) enumerated in Chapter 4. Enumerating everyone's interests, in rank order, can prevent making the mistake of being too self-centered. A good proposed solution would satisfy each party's primary interests, at least reasonably well. Making options acceptable requires preparing justifications for various offers and referencing independent standards (e.g., of fairness).

Next, turn to what happens if no deal is reached and all parties are stuck with their "walkaway" alternatives, or their BATNAs. Once you have done your best to estimate the other party's walkaway, you should be able to determine whether there is likely to be a trading zone, or a ZOPA, within which both sides can meet their most important interests.

Think About the Opportunities to Create Value

A list of proposed agenda items is not the same as a map of the interests of all the parties. Each agenda item might be related to several interests, and there might be interests that are not associated with any agenda item. Consider all items and formulate trades that will create value for both sides. Avoid being self-centered around the agenda the way Illai was, or getting locked into a haggling mindset like Dip was. When trades lead to a conversation about multiple items, consider packaging a number of things at once. For example, when Fallon was called to meet her customer whose stated agenda was "price reduction for next year's product orders," she might have prepared several packages that included items whose value were perceived differently by the two sides. A larger quantity of orders would probably have represented a low-risk commitment for the buyer while guaranteeing significant value to Fallon. The buyer might have placed a higher value on the recurring procurement price for each unit and less value on the amount of parallel nonrecurring engineering (NRE) that is required to develop new features. This would have been of very high value to Fallon. Or, the buyer might have placed significant value on operational considerations and been willing to include bonuses for early delivery or meeting quality metrics. Fallon could have prepared multiple packages varying

in price, payment terms, order quantity, agreement terms, product features, joint development NRE funds, performance bonuses, or comarketing benefits. By preparing multiple packages even before negotiations begin, you are sure to be more open, flexible, creative, and more likely to prevent getting locked into a narrow focus.

Anticipate Likely Mistakes and Missing Information

Good preparation should make it easy to identify possible mistakes. Vinayak was very aware of his competitive tendencies, and Ailis was aware of her aversion to positional bargaining. Peter and Petra were aware of their strategic investor's need for control and his lack of domain knowledge. They all should have paid special attention to the mistakes these tendencies were likely to cause. Another type of mistake to avoid is making wrong assumptions about the other side. Being disciplined in listening to disconfirming evidence is important. Anticipating danger areas by assuming sensitivities that are related to the other side's core identity and sacred values (that may trigger a strong reaction or impasse) should be complemented by using caution before acting on assumptions that have not been verified. Open sources can help you find more information, as can talking to others who have experience negotiating with the people you are about to negotiate with.

Consider Your Process Design Components and Moves

The next phases of preparation and prevention have to do with choices or moves you must make away from the table before starting actual negotiations. Successful negotiators understand that there are set-up moves that can create value, eliminate obstacles, and prevent many typical mistakes. For example, smart negotiators try to improve their walkaway alternative before negotiations start, as Barbara did – by creating a better back table process for herself and by lining up several candidates in parallel before starting the face-to-face interviews. If Dip had been able to set up the situation better by breaking the link between his next financing round and the contract manufacturer's debt renegotiation, he could have been able to be more creative and escaped his haggling mindset. Moves away from the table can involve your own back table, the other side's influencers (such as their back table or coalition partners), and the external environment as well (such as public perceptions, government support, or the role that potentially impacted parties decide to play).

After completing a pre-negotiation analysis and sorting through possible set-up moves, it is time to decide on the best way of creating value and claiming

value. We recommend planning clearly labeled process design components, each with a clear purpose, and sequencing them in a manner that will increase the likelihood of collaborative problem-solving negotiations and decrease the likelihood of making the anticipated mistakes. For example, to avoid being self-centered, prepare a process design component of "listening" where your main purpose is to increase your understanding of the other side, using active listening to be open and curious about their interests, perspectives, constraints, and priorities. As another example, to avoid falling into the haggling mindset trap, create a positive environment and dynamics by talking first about value creation (which is joint problem-solving) instead of alternatives (which may be perceived as threats). Create a process designed with segments of cooperative value creation (using the mutual gains approach for brainstorming opportunities) before resorting to competitive value distribution moves (transactional closing). As was demonstrated by Ailis, prepare for a negotiation about how to negotiate, and what ground rules you will be using. As in any negotiation, you will need buy-in from the other side, so be prepared to explain your purpose for each process design component and the benefits to both sides by following this process.

Before moving on, allow us to demonstrate how process design is a prevention mechanism for anticipated mistakes. Let's look again at Barbara's hiring negotiations, and her desire to prevent compromising too early. She may decide to prepare the following process design components for her negotiation: building rapport (small-talk); selling the company's vision (two-minute company pitch); listening to candidate's pitch; probing candidate's qualification; negotiating a process to explore good-fit; exploring candidate's interests; negotiating tentative employment terms; and discussing the next steps in the process. By having a clear purpose for each process design component, and planning for a purposeful transition from one to the other (in the given time-constrained allocation), Barbara can ensure finding out information she needs while preventing the mistakes she is aware she tends to make. While some of them may appear straightforward, let's detail a couple of these design components:

- Barbara will consider her *negotiating the process to explore a good-fit* as her *back table* process design component, which is the process segment where she considers her own back table pressures and input. She prepares to discuss with the candidate the joint interest of having a positive teamwork among the management team, and what process they can use to verify that as part of the negotiation. She also considers a first draft of the *victory speech* that she will use to justify to herself, her management team, and her board that the deal she reached is good (or great) for the organization.
- Barbara will have prepared various possible packages and arguments that support any proposals (or ideas) she may make on their merits – always with

a justification. In preparing for the *claiming value* process design portion of the employment terms negotiation with the candidate (around salary, title, equity), Barbara will be ready with her reservation values, targets, various possible anchors, and various norms and standards that she may use. This way she will not be shy about setting reasonably aggressive targets.

- Note that Barbara has a process sequence choice in negotiating tentative employment terms. She may plan to leave the actual decision as to the correct sequence until she learns more information during the preceding components. Then, based on the level of confidence she has regarding both BATNAs (hers and the candidate's) and the norms (industry norms, company comparable compensation levels and titles), and considering how informed she thinks the candidate is, Barbara will evaluate whether it would serve her better to make the first offer (when she is better informed), or wait to let them go first so she can learn more about their thinking.

In her preparations, Barbara thinks about the things that would create a better negotiating environment for her. She considers the setting, the process design components, the participants, the proposed agenda, schedule, and objectives for the first (and subsequent) meeting. Some of these may be under her control (more likely in a hiring situation), while others may be more under someone else's control (as in her trying to negotiate a business development deal with one of the big pharmaceutical players).

As depicted in Table 5.3, an effective negotiation process will begin with the parties understanding each other and aligning expectations, before proceeding to joint problem-solving attempts and coordinating their next steps in the process.

Table 5.3 Entrepreneurial negotiation process design components

Process design components of entrepreneurial negotiation	
ALIGN by establishing a collaborative setting	**Bonding** with other side by connecting, listening, understanding, and brainstorming **Generating options** with creativity **Setting norms** and expectations regarding behavior, metrics, and fairness
SOLVE the problem by committing jointly	**Trading** across differences in values and priorities **Resolving** distributives issues or process disputes **Assembling packages**, reasoning, and offers **Exploring contingencies** by imagining and committing to **"IF ... THEN"** clauses
REALIGN and coordinate	**Coordinating next** steps regarding communication and milestones

By preparing your process choices and thinking through each process segment's purpose and consequences, you should be able to foresee possible hazards and prevent most of them from turning into actual mistakes.

Practice Scenarios

Once all the analysis has been completed and a course of action has been selected, it is time for a practice simulation, or a rehearsal. This will permit you to visualize what is likely to happen when you present your ideas and arguments. Ideally, this should be done with several colleagues willing to play assigned roles. In a role-play, you can hear yourself speak specific words and feel your body's reactions to messages from your (simulated) counterparts. Returning to our Barbara example, Barbara could have tried several versions of what she had to say. She could have noted statements that caused increasing tension in herself or her listener, especially the kind of response that often led to her making the same mistake. Especially powerful would have been for Barbara to assume the simulated role of the other party so she could increase her understanding of their point of view. After practicing a few times, Barbara should have been able to decide what not to say.

Detect Mistakes as You Make Them

Detecting and responding is all about being mindful so that you can make mid-course corrections. A single mistake probably won't cause you to lose everything. Whatever damage occurs, if the mistake is detected early enough and followed by the proper response, the damage can be contained.

As we know, our minds can play tricks on us. Daniel Kahneman, in his book *Thinking, Fast and Slow* (2011), recounts a number of important experiments that provide insight into relevant human behavior. Kahneman and his colleague Amos Tversky, building on earlier work by psychologists Stanovish and West, describe two distinct parts of our self. The "Thinking Fast" part, called System 1, is the part that operates quickly, automatically, and effortlessly. When we use System 1, we do not feel like we are working very hard. The System 2 part of our self is used when we want to "Think Slow." The activation of System 2 requires substantial concentration and often involves a great deal of effort and complex computation. In order to conserve energy (N.B. our brain consumes about 20% of our body's energy),

our brain tends to revert to System 1 thinking unless we make an effort to move to System 2.

Most entrepreneurs adopt a general approach or a rule-of-thumb (called a heuristic) as a way to make difficult judgments. Using this method repeatedly, and counting on its effectiveness, can lead to a systematic error (called a predictable bias) in similar situations.

It is true that heuristics can enhance our intuition. Expert engineers rely on practically unconscious heuristics to compare two designs and "feel" which one is better before running any calculations. Expert intuition helps marketing executives confronted with three prototypes "sense" which is most likely to succeed before reviewing the results of surveys or focus groups. Unfortunately, many such intuitions are not the product of expertise. Sometimes intuitions turn out to be justified; other times an objective observer will see clearly the mistake the entrepreneur is making. If an entrepreneur operates without the help of an observer who has not internalized the same unconscious biases, they will need to rely on other "detectors" to help overcome the mistakes they are very likely to make.

"Slow" thinking allows us to see the bigger picture and avoid relying on the wrong heuristics. Entrepreneurial negotiations involve a difficult mix of emotion, uncertainty, complexity, and relationships. To prevent mistakes we have to be willing to go slowly, and allow System 2 to unfold. Sometime slowing down slightly can provide important added perspective.

Let's review the three most common categories of error detection moves. The first is *self-awareness* detectors. These involve anticipating our own triggers and maintaining perspective when something surprising happens, or when strong emotions surge. As the sign at the temple of the oracle of Delphi indicated – it is important to "Know Thyself." Learn what the physical actions and verbal statements are that upset you, and cause you physical and emotional discomfort. Daniel Goleman describes self-awareness as knowing our own internal states, preferences, resources, and intuition in his book *Working with Emotional Intelligence* (1998). His studies have shown that honestly assessing one's self improves self-confidence and workplace performance. Likewise, entrepreneurs who can spot their own instinctive responses and biases will be in a better position to override them with more productive responses.

The second set of detectors has to do with *situational awareness*. These allow us to pick up on signals from parties across the table. They involve being able to read body language and gestures, as well as careful listening. It is, of course, difficult to focus simultaneously on ourselves and on others. If your purpose is to listen, then don't' forget that your focus should be on the other person

(and not yourself). Active listening involves repeating back some of other side's own words and expressions (called mirroring), or better yet – paraphrasing them in your own words. A second basic component is verbally identifying with some of the emotions the other side is displaying (labeling their emotions in a way that reflects your understanding and compassion). Gary Friedman with Jack Himmelstein calls this "looping" in their book *Challenging Conflict* (2008). The real power of looping is that both parties are collaborating in generating the listener's understanding of the speaker's perspective. By deepening our understanding of what others are saying and thinking, we are better able to detect the impact our mistakes have on them, or better yet – prevent an imminent mistake before it happens.

The third category of detectors involves *interpersonal dynamics*. We use these to make sure we are tracking evolving patterns. In the real-life cases in Chapter 4 we saw Illai's reaction to being criticized and Barbara's negotiation-against-self in response to silence. These were communication patterns. There are typical patterns that any negotiation dyad may fall into regarding their relationship dynamics. In some situations individuals take on reactive negotiation styles, or roles. They might be more competitive, avoiding, compromising, or appeasing than they usually are. When taking on a competitive posture, whether triggered by the other side's behavior or for strategic reasons – negotiators are more assertive about their needs and requirements. This can include making threats. More conflict-avoiding styles are quite different – they avoid provocative moves, hoping that problems will work themselves out before there is a need to risk hurting anyone's feelings. When choosing to act in a more compromising fashion, negotiators look to find a middle ground that gives them some relief from the tensions of negotiating and allows them to go deeper emotionally and explore more options ("let's just get this over with in a way that makes us equally unhappy"). When assuming an appeaser's role, negotiators are so concerned about maintaining relationships and keeping negotiations on track that they hesitate to press their own interests for fear of offending the other side or ending the negotiation. Dyadic dynamics vary quite a bit, even during the same negotiation. Two cofounders who know each other might start out avoiding conflict or caring primarily about the relationship, but end up in an extremely confrontational or competitive posture. By learning how to recognize these different roles, and their precursor circumstances and triggers, we can avoid the pitfalls of negotiations getting out of control.

There are various ways of labeling the counterproductive behaviors that lead to negative feedback loops and cause a downward spiral. Coan and Gottman have used a coding system to distinguish criticism behaviors,

contempt behaviors, and defensive behaviors (2007). Criticism behaviors involve attacking another person instead of attacking their ideas or actions (examples include "It's all your fault," "You always …," "You traitor, I trusted you to …," "That's just part of your manipulation ..."). Contempt reflects an intention to hurt, combined with anger or disgust, and includes insults, hostile humor, and mocking (through words, imitation, facial expressions, or body language). Defensive behaviors usually occur in response to criticism and contempt behaviors. They include rejecting blame, denying responsibility, making excuses, and disagreeing with someone else's assertions about bad intentions.

By training yourself to recognize the initial triggers of such counterproductive (verbal and nonverbal) patterns, you will be better able to sidestep "invitations" to join downward spirals that undermine trust. Remember how Illai learned to identify his defensive detector (saying "But …")? Later, Illai uses that detector to pause and initiate a more thoughtful response: shifting to a more curious stance, and avoiding the criticism-defensiveness downward spiral.

Now that we have covered the types of detectors that can be used to identify impending mistakes, Table 5.4 shows how to respond when we detect such errors.

Table 5.4 Detect and respond to entrepreneurial negotiation mistakes

Detect and respond	
Embrace the unexpected	• Be ready and curious • Observe with awareness: yourself, your peers, and the situational dynamics • Listen to communications and patterns: verbal, nonverbal, and silences
Avoid overly defensive reactions	• Maintain perspective, purpose, composure, integrity, trust • Pause and break as necessary to stay centered, with level 2 thinking
Consider alternate explanations	• Suspend judgment and criticism • Study intent, impact, pressures
Test perceptions with others	• Check with team, back table, experts, neutrals, and joint-fact-finding teams
Display maximum flexibility	• Brainstorm contingencies and packages • Improvise using "Yes, and ..."
Make adjustments	• Adapt setting, participants, process, agenda, schedule, authority, analysis • Consult (with back table/stakeholders) before deciding
De-escalate tensions	• Demonstrate respect for personal status & autonomy • Explain reasoning and intent • Allow time-outs and frequent summaries
Consider apologies	• Present with sincerity and patience; and wait for audience to absorb • Proceed to do-over with permission