AN INTRODUCTION TO HIGH IMPACT ANGEL INVESTING OUTSIDE OF THE MAJOR VENTURE CAPITAL CENTERS

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MICHAEL BEST & FRIEDRICH LLP

An Introduction to High Impact Angel Investing Outside of the Major Venture Capital Centers

Introduction

This introduction to high impact angel investing is aimed at angels located outside of the major venture capital centers. Many factors – high tolerance for risk, more "open" innovation models, flatter management structures and accelerated development timelines – make this part of the business and investment world quite different from the more traditional worlds of big and small business. By "outside of the major venture capital centers" we mean outside of Silicon Valley, Boston and those few other locations where sizeable venture capital investment communities are well established. High impact angel investors in these venture-scarce markets face some challenges that their counterparts in venture-rich markets generally don't have to worry about as much.

This introduction is by no means a comprehensive guide to high impact angel investing. It is, offered as a general introduction – a 30,000 foot view, if you will. While the principles discussed in this brief introduction are widely applicable in the high impact angel investing space, this introduction is targeted most directly at what we will call "alpha" angels: angels that are making independent investment decisions (whether on behalf of themselves or on behalf of a group of angels) and actively engage with the entrepreneurs they are investing in for some time after the investment closes.

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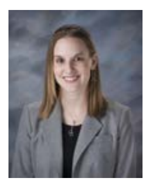

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Some Foundational Issues

Why Angel investing?

Before delving into the "how" of angel investing, it is worth spending a little time discussing the "why" of angel investing. Most successful angel investors define "success" on a broader basis than just risk adjusted returns. This is a good thing, because very few, mostly venture center "super angels," have the deal flow, networks, time and relevant experience to consistently generate investment returns comparable to seed/early stage venture capital investors. Very few angels, at least in the formal way that economists understand the word, are completely "rational" investors, focused exclusively on maximizing risk-adjusted returns.

If you are thinking about getting involved in high impact angel investing, you need to ask yourself, "why, beyond (hopefully) making some money, do I want to do this?" Based on our own experiences in and around the high impact investing and entrepreneurial worlds, here are the most common motivations, beyond financial rewards, that motivate angel investors.

1. An interest in mentoring the next generation of high impact entrepreneurs: by providing some of the assistance that they themselves would have found helpful in their own entrepreneurial/business careers.
2. An interest in "giving back" to the community generally, by helping new entrepreneurs create new wealth and economic opportunities for their communities.
3. An interest in "staying in the game" even if, for whatever reason, the high impact entrepreneurship role itself is no longer the place they want to live full time.

There are other "beyond the money" reasons that motivate some angel investors, but these are the big three that are most common. Hopefully, if you are considering getting into high impact angel investing, you see yourself in one or more of these categories.

Philanthropic objectives aside, though, a word to the wise: whatever your ancillary goals for your high impact angel investing, never lose sight of the business/investing fundamentals. Sacrificing a bit of return, and putting in a little extra elbow grease, is one thing. Throwing capital, time and energy at deals that just don't make sense is another.

Location, Location, Location

Angel investors outside of the major venture capital centers invest in a world that is different in some very important ways from the world their cohorts in the major venture capital centers inhabit. Those differences, in turn, can make the art of high impact angel investing even more challenging than it is in places like Silicon Valley. Important differences include:

1. Good angel investing "people" resources – experienced angels, venture investors, entrepreneurs and high impact investing and entrepreneurship service providers – are much scarcer. This makes it harder for the new angel to learn about and keep up with "best practices."

2. On the other hand, the supply of less sophisticated "wannabe" angel investors and advisers is relatively plentiful. These folks don't know a lot about the subject, but often think of themselves as experts, and create a lot of noise in the market.

3. Entrepreneurs outside of the major venture capital centers are generally much less experienced in terms of working with sophisticated angel and venture investors, and building startup high impact businesses. Worse still, they have often sought the advice of well-meaning folks in the community who may have a lot of knowledge about small and big business management and investing, but little or no knowledge of high impact entrepreneurship and investing (see point 2 above).

4. The relative lack of downstream investment options is a huge issue outside of the venture capital centers. Venture capital, the primary source for post-angel high impact investment capital, is highly concentrated on the coasts. This is true in terms of the number of investors and the total investable capital under management. And, unfortunately (if not altogether without justification) venture capital investors on the coasts are generally cautious to a fault about the notion of investing in post-seed but still early stage opportunities very far from their coastal homes. Thus, angels in these venture-scarce locations must generally include elevated financing risk as a critical part of their investment decision making and management.

We would be remiss if we did not point out one occasional aspect for angels investing outside of the major venture centers. That aspect, paradoxically, is the relative dearth of nearby angel and early stage venture capital investors. As a result, competition for deals is generally less intense, and valuations generally lower than for comparable deals in the venture capital centers (though well-intentioned, if less informed, angels now and again bid deals to truly ridiculous prices).

As the reader works through the rest of this material, it is very much worth keeping in mind these special aspects of high impact angel investing outside of the major venture capital centers. While many of the principals of good high impact angel investing are widely applicable, their application in a given instance is often influenced by the location of a specific investment opportunity.

Criticality of Portfolio Diversification

Investing generally is about building a winning portfolio. That is to say, whether you want to make money in antiques, the stock market or bonds, the secret to sustained success is diversifying your investments across individual assets *and time*. This is all the more true the higher the risk/reward profile your preferred investment vehicle is. There are not many investments, on the right side of the law, that have a higher risk/reward profile than pre-venture-capital, seed stage high impact investments.

*Number of Investments***.** Consider early stage venture capital investing – the stage just after (and thus in theory less risky than) angel investing. A typical early stage portfolio for a venture capital fund will likely consist of at least ten investments. Over 50 years of data suggests that of those ten investments, and normalizing for "vintage year" (see below) perhaps one or two will return ten times or more the venture capitalist's investment. These home runs will account for the majority of the fund's returns, and drive the fund's overall returns to its investors to something in the 2.5x to 4x range. Something like two to three deals will range across the 2x to10x range, and will provide the rest of the return on the portfolio; one to three deals will go sideways, and two to three deals will result in a complete loss of the investment. Quibble with the specifics, but these numbers give a more or less accurate picture of the world in which the early stage venture capital investor lives.

Conclusions for the angel investor? First, if you intend to make money because you are good at angel investing, and not just lucky, you better be prepared to invest in a portfolio of at least ten or so deals. Second, you had better make sure that every one of those deals has 10x "home run" potential.

Timing of Investments. Another important aspect of diversification is investment timing. When venture capitalists (or their limited partner investors) talk seriously about their own returns they almost always talk about how they did relative to their "vintage year." That is because returns in the private equity market, while harder to track, are more or less as dependent on the broader business cycle as their public market counterparts. For example, a fund that officially started investing in 1999 and barely broke even, might not look like a very good fund until you factor in that even the top quartile of "vintage 1999" funds (the ¼ of funds with the highest returns) lost money. Conclusion for the angel investor: portfolio diversification should include diversifying across at least one complete business cycle.

Focused Diversification: Know and Invest in Your Strengths. While the importance of diversifying risk

The Pack Approach to Diversification

Unless angel investing is something you do more or less full time, building a portfolio of investments with optimal diversification across both deals and time can be pretty hard to do. Pooling resources with other angels – operating as part of a pack, instead of as a lone wolf – is a good way for "now and again" angels to achieve a decent amount of diversification. Angel packs come in two basic flavors, and one common hybrid.

Committed capital angel packs are like venture funds in that their investors – individual angels – make a specific capital commitment to the pack which is typically "called" more or less as needed to fund investments. Investment decisions are typically made by a sub-group acting as an investment committee for the pack. Some funds rotate membership on the investment committee, and, particularly for smaller packs, some funds have an "investment committee of the whole" to make investment decisions. Committed capital angel packs are generally more attractive to entrepreneurs because they generally move faster and more decisively than their "pass the hat" counterparts.

Pass the hat angel packs are looser groups of angels that may look at deals together but make independent investment decisions. These funds have a sometimes deserved reputation, among entrepreneurs, and other angel and venture investors, for tardy and less definitive investment decisions.

Finally, hybrid angel packs combine the committed capital and pass the hat forms with a core committed capital pool of money and an umbrella pass the hat group that can make "side car" investments or even invest in passed over deals from the core committed capital fund.

across a number of investments over the course of the business cycle is considerable, so too, strangely enough, is the importance of investing mostly in business and technology themes that you know something about. Equally important is understanding and respecting, in terms of an angel's capabilities and expectations, differences in capital intensity and time to exit (and related strategies) and regulatory environments of different investment themes. Good angels build diverse portfolios around deals in industries and technologies that they understand, with capital and time to exit expectations, and regulatory pathways, that they understand and are consistent with their capabilities and investment objectives. It is important to see two axes here:

1. invest in things you know something about; and
2. invest in deals with financing and exit strategies consistent with your own capital and time horizons.

Building Quality Deal Flow: An Often Neglected Secret Weapon

Before turning to the nuts and bolts, there is one more thing that is a critical success factor that too few angels focus on: building quality deal flow. The logic is simple: the more of the best deals you see, the more you are likely to do good deals. And it is not just a function of numbers. It is as importantly a function of developing a better sense of what a good deal looks like. The more you are exposed to good deals, the more you will begin to appreciate the finer points that distinguish the better deal from the merely good deal. And, of course, the more likely you will invest in more of the best deals.

The obvious question, then, is how do you maximize the number of quality deals you see? There is an obvious, but often wrong, answer here, and fortunately, a less obvious but also actionable (over time, at least) right answer.

The obvious and less helpful approach is to invest time, energy and cash in PR and marketing. There is nothing wrong with a decent web site; some targeted advertising; and sponsoring, speaking at and attending appropriate high impact entrepreneurship (and investing) events. That said, while there is something to be said for mindshare marketing, building a quality brand is finally about execution – that is, consistently delivering on a value-added investment proposition.

Look at it this way. Good deal flow comes either direct from good entrepreneurs or via the people who work with or otherwise see the best entrepreneurs (for example established entrepreneurs, lawyers, other angels, and downstream investors). In each case, direct or indirect, what will most motivate folks to contact you with a good deal? Long term, let's be honest here, the answer is doing good deals; that is, doing deals that ultimately succeed, for investor and entrepreneur alike. But what about the short- to mid-term? What can you do, besides have a long and successful track record, to make sure you get more than your share of the best deals across your desk?

It's not rocket science. The fastest way to build a good angel brand is to treat entrepreneurs, other angels and venture capital investors, and even service providers, with respect. Come across as tough, (if you are not asking tough questions, before and after the investment, you are not likely to succeed in any event) but also fair and efficient. Be responsive to entrepreneurs by providing timely, honest feedback. Share deals (with permission) with other investors, not just when they might be co-investors but also in the likely case where a deal might not be an ideal fit for you but might be a perfect fit for them. Good angels are helpful to quality entrepreneurs even if what they are doing at the time is not something in which they are interested. They may be doing something different that is interesting down the road, and in the interim, if you impress them as entrepreneur friendly now they will probably share that with the next entrepreneur who may have something of interest for you. In short, good deal flow is all about what you learned on grade school playgrounds: play well with others, and you will likely have more opportunities to play.

Doing the Deal: From First Contact to Closing an Investment

One of the enduring iconic myths of Silicon Valley is the deal done over a first lunch, based on the proverbial "back of the envelope" doodling. And, to be honest, it is a myth with roots in reality. Some good (and some not so good) deals have been done that way, and will be done that way in the future. What the short-form myth usually leaves out, however, is that those deals usually involve successful repeat players on both sides of the table. That means, as a practical matter, that the usual due diligence process is not so much ignored as abbreviated.

The "deal over lunch" scenario is not something most angels outside of the venture capital centers see very often. But it does have something important to teach less experienced angels about the craft. And that is this: *angel investing favors people who can timely make and act on investment decisions based on limited information in the face of substantial uncertainty.* No amount of due diligence, in a high impact angel investment scenario, can give even the most conscientious investor anything like the relative certainty the same investor might demand in a more conventional investment. The angel who comes to the table looking for that kind of assurance will miss out on most of the best deals, and, over time, see even fewer of them.

Step One: Qualifying a Deal and the Blush Test

Deal qualification is about quickly (no more than say ten minutes) ruling out those deals – the majority that most good angels hear about – because: (i) the form of the presentation is so amateurish as to conclusively indicate that the entrepreneur is not credible; (ii) the substance of the proposal is so outlandish as to so indicate; or (iii) the stage, industry, amount of funding required or some other basic factor is clearly outside of the angel's sweet spot. In the first two cases, a timely "this is not an area we are interested in" is Standard Operating Procedure (SOP) for most angels, though some may chance a more informative turndown. In the third case, to the extent the pitch seems credible, a referral to a more appropriate potential investor can be a good, if modest, investment in angel brand building.

If the deal qualification scan produces favorable results, perhaps 30 minutes to two hours of quick research is in order. Perform a quick web search around the technology, market and entrepreneur to spot any obvious issues (particularly in terms of possible competition). This "blush test" should efficiently scare up any information that raises obvious big red flags (the entrepreneur has, say, a less than flattering record with state or federal securities regulators) and/or issues that need to be addressed at the outset with the entrepreneur (for example, a bunch of well-funded companies appear to have the entrepreneur's target market well covered).

Step Two: Meet and Greet

If a qualified deal survives the "blush test", the next step is usually a meeting with the entrepreneur. The idea here is to either get fired up about the entrepreneur and the deal –

you have to be excited about both – or not. Entrepreneurs worth getting excited about can come in a variety of packages. But there are some common denominators:

- Do they have the kind of dogged determination and devotion to the cause often thought of as “fire in the belly?”
- Are they defensive (a huge red flag)?
- Are they situationally aware (i.e. does she project a good awareness of the competitive landscape)? The all-too-common entrepreneur who insists there is no competition is almost never successful.
- Can they explain the deal, including the technology, no matter how esoteric, in a way that an intelligent layman can at least intuitively grasp?
- How do they deal with hard questions (which it is your job to ask)?

Look for entrepreneurs who either have solid answers or are willing to say “that’s a great question – let me get back to you.” Avoid entrepreneurs that try and shift the subject and answer questions that were not asked.

Look for entrepreneurs who want to ask you questions, and seem genuinely interested in what you have to say. Get a sense whether or not the entrepreneur understands the investor’s need for an exit, and is committed to providing one, even if that means (as it usually does) selling the business to a third party. Finally, while it is generally not appropriate to get the entrepreneur to commit to a price/valuation this early in the process, it is, particularly with less experienced entrepreneurs, a good idea to get a sense of whether the entrepreneur is at all aware of the market price for comparable deals, and willing to live within those parameters.

In a more general sense, remember that a good plan/pitch is not (or should not be) so much about how the business will be run, but rather how the investor will make money. While a good plan/pitch will include a compelling customer value proposition and business model it will not go very far beyond that in terms of the nuts and bolts of operating the business.

In terms of form, the entrepreneur should be able to pitch the deal in no more than 30 minutes, and preferably no more than 20 minutes – with no more than 20 slides. In most cases, these kinds of meetings, if the entrepreneur is good and the angel a decent fit for the deal, will end up taking an hour or more, and will involve a lot of back and forth discussion and Q&A.

At the end of the first meeting, ask yourself these two questions. First, would you enjoy working with this entrepreneur? Only if the answer to that question is “yes” ask yourself if the deal fits your investing parameters and generates excitement in your world. A couple of “yes” answers to these questions and you are ready to get serious about a possible investment.

Step Three: Serious Deal Due Diligence (Getting to Yes – or No)

If after the initial meeting an angel decides a deal is worth serious investigation, the heavy lifting starts. This is the stage where the question “if we can reach acceptable investment terms, is this a deal I would like to invest in” is answered.

Preliminary Thoughts: The Due Diligence Conundrum. Due diligence is particularly challenging in the early stage high impact world for a number of reasons. The two that most need keeping in mind are as follows:

1. The deals are full of risks. There are always myriad reasons to say no to a deal. Because there are so many more or less unavoidable risks (for example, better funded unforeseen competitors might be lurking in stealth mode) it is imperative not to take risks that can be avoided (for example, investing in a company that has not been careful about establishing clear title to its intellectual property).

2. The deals are typically moving targets. It is not just discrete events that come so fast and furious that are hard to anticipate and react to, but the organic evolution of the business from little more than a wing and a prayer (an idea and an entrepreneur) to a supersonic aircraft – or a smoking hole in the ground seemingly overnight.

Value Added Due Diligence

One thing that distinguishes really good (and financially successful) angel investors is their ability and willingness to bring value to the entrepreneur as part of the due diligence process. Indeed, angels who are not adept at helping entrepreneurs flesh out their business/investment opportunities will miss out on most of the best deals that are brought to them by less experienced entrepreneurs, deals that, as initially presented by the entrepreneur, are often chock full of fatal mistakes of commission and omission. Good "value added" angel investors can help entrepreneurs correct these mistakes in a process that usually tells its own tale in terms of the quality of the fit between the angel and the entrepreneur.

These two factors make high impact angel investing uniquely challenging. The investor must, on the one hand, develop a deep appreciation for the risks of the investment and the likely evolution of those risks. On the other hand, the investor must be willing and able to make timely decisions with limited information. The best angels understand that not every due diligence question, even every good question, can be answered, and that a willingness to intelligently "shoot from the hip" is an important investor attribute. Nothing is more frustrating and less productive, for angel and entrepreneur alike, than a drawn out due diligence process that in reality simply masks an angel investor's unwillingness to timely pull the trigger on a deal while there are still substantial unknowns in play.

The "Big Four" Risk Factors. Due diligence, in early stage high impact investing, typically resolves itself into four major categories of risk: Team, Market, Technology, and Financing. A detailed approach to addressing these factors is going to be both deal-specific and beyond the introductory scope of this guide. Herewith, though, a quick look at approaching each of the big four risk parameters.

Team Risk. Most professional venture capital investors think the team is the single most important aspect of any early stage investment. The angel investor should have developed a preliminary appreciation for the team duding Step Two's meet and greet session. At this stage, you want to further test that early conclusion. In addition, you want to develop a sense of whether the entrepreneur can hit a curve ball: that is, when, as almost always happens, the deal heads in a direction other than anticipated, is the entrepreneur the kind of leader that will "roll with the punches" and find a new direction, or the kind who will more likely behave as a deer caught in the headlights (or, perhaps worse yet, the cornered wounded animal). For me, the best team "go/no go" question is this: if this deal failed, is this the kind of entrepreneur I would probably want to invest in again? (Lots of good deals fail: most good entrepreneurs eventually succeed.)

Market Risk. Surprisingly, at least for many entrepreneurs, next up on the venture capital risk parade is usually market risk. Beyond questions about market size (bigger is better) and dynamics (smaller growing markets can be more attractive than larger static markets) market risk stands more subtly at the intersection between two questions. First, is there a compelling value proposition? Second, is there a plausible business model? Lurking in and around these two basic questions is the competitive landscape; not only how crowded it is or is likely to become, but how clear the competitive picture is (or, perhaps more realistically, how cloudy)? Beyond these basics, a lot of high impact startup value propositions are built around the notion – an assumption that deserves scrutiny – that the target customers will change their extant approach to a problem in order to choose the new solution offered by the startup. Plans based on changing consumer behavior can be particularly difficult to evaluate.

Technology Risk. Now we get to the factor that too many entrepreneurs like to put maximum focus on (and thus spend too much time/energy selling). A good first cut is whether the technology risk is in the nature of research (higher) or development (lower) and whether the team's technology assets correlate with that technology (academics generally have a better feel for research than development, which can be deadly). A couple of other technology risk basics are as follows:

> First, investors tend to overvalue patents, and even more so patent applications. Patents can be critical, but more often they are a variously important part of the technology value proposition, and not the be all/end all of the technology evaluation. In some fields, notably software and so-called business methods, they are most often problematic and overvalued by less sophisticated investors. In fact, when software and business methods represent the heart of the technology, the most penetrating question is usually "how far are we ahead of someone who knew what we were doing and wanted to copy it, and can we push that margin out?"
>
> Second, it is worth making sure that whatever intellectual property the business is based on is actually owned by the business. Too many entrepreneurs relay on common (but wrong) sense and/or oral understandings about technology ownership. Software or other copyrightable material can be particularly problematic in that many entrepreneurs don't realize that unless a development agreement specifically provides that the party paying for the development is the sole owner thereof, the developer will retain an interest in the work product that is the subject of the agreement.

Financing Risk. Financing risk is the risk that the business will ultimately fail not on the team/market/technology merits but rather because it could not at some future point be financed, or could not be financed at some point on terms favorable to preexisting investors. Always important, it is particularly important outside of the major venture capital centers, where venture capital is scarce, particularly for post-seed but still early stage deals.

Financing Risk: General Considerations. Financing due diligence is about making sure that the amount of capital raised at a given point in time, and the terms of that raise, are consistent with funding the business to the accomplishment of some meaningful milestone that will substantially reduce the risk of the deal and thus set the stage for timely subsequent financing at a substantially better price. A financing should be a bridge to a better place, not a pier to the middle of a lake. That better place is either an exit or (more likely in an angel scenario) another financing at a higher price. From the due diligence perspective, than, the angel must be convinced that (i) enough capital is being raised; (ii) at an appropriate price; to (iii) accomplish an appropriately significant milestone.

In terms of rules of thumb, when you think you know the right amount of capital needed, add 50% to it. And, don't forget to include sufficient capital to cover the burn rate between accomplishing the milestone and closing the next round. Finally, remember the wise counsel of one of Silicon Valley's iconic investors, Eugene Kleiner: "The time to eat the tarts is when they are being passed around."

The times they are a' changing

While the Midwest remains a long way behind the coasts, and even places like Austin, in terms of venture capital resources, the last several years have seen a modest uptick in terms of venture center funds investing in the region. In late 2012, one of the largest, oldest and highly regarded mega-funds, NEA, even announced it was opening a Chicago office. For folks who want to see high impact entrepreneurship flourish in the Midwest this is great news. That said, the process will not be without challenges for the region's angel investors. One "good problem to have" will be managing changing entrepreneurial/angel financing and exit plans if/when a deal attracts the interest of one or more larger, venture center funds. The interest of these bigger players will likely include investing bigger chunks of capital to build towards larger and likely farther out exit scenarios. If only to avoid being blindsided by evolving financing/exit plans, angels should make sure their dialogue with portfolio entrepreneurs includes regular review of the financing/exit expectations.

Financing Risk Outside of the Major Venture Capital Centers. For angels outside of the major venture capital centers, the analysis of financing risk is particularly challenging. Post-seed venture capital funds are few and far between, and most of them are much smaller than their venture center counterparts. And, as previously noted, funds in the major venture centers are not very active outside of those centers, particularly in post-seed but still early stage deals. Put these factors together and the picture can be pretty bleak for angel investors who don't focus on and work with entrepreneurs that are willing and able to build businesses that are particularly capital and time efficient. While there have been and will be some high profile exceptions, sophisticated angels outside of the major venture capital centers should, until someone comes along and shows them the money, at least, focus on deals that can credibly forecast exit scenarios in three to five years with total risk capital needs to exit of less than $5 million, as well as entrepreneurs willing to get behind that model.

Step Four: Closing the Deal

Most startups successfully launched with angel capital will want to tap deeper pools of capital later on, often from traditional venture capital investors. That being the case, entrepreneurs and their angel investors should make sure that the structure and terms of angel investments are compatible with the likely needs of downstream institutional investors. Herewith, some of the issues entrepreneurs and angels should keep in mind when they sit down and negotiate that first round of seed investment.

1. Don't get hung up on valuation. Seed stage opportunities are difficult to put a value on, particularly where the entrepreneur and/or the investor have limited experience. Seriously mispricing a deal, whether too high or too low, can strain future entrepreneur/investor relationships and even jeopardize downstream funding. If you and your seed investor are having trouble settling in on the "right" price for your deal, consider structuring the seed round as convertible debt (or convertible equity), with a modest (10%-30%) equity kicker. Convertible debt generally works where the seed round is less than one-half the size of the subsequent "A" round and the A round is likely to occur within 12 months of the seed round based on the accomplishment of some well-defined milestone.

2. Don't look for a custom fit in an off-the-shelf world. In the high impact startup world, probably 95% of seed deals take the form either of convertible debt (or it's more recent twin convertible equity) or "Series Seed/Series AA" convertible preferred stock (a much simplified version of the classic Series A convertible preferred stock venture capital financing). Unless you can easily explain why your deal is so out of the ordinary (and why it is worth paying significantly more in transaction costs) that the conventional wisdom shouldn't apply, pick one of the two common structures and live with the fact that a faster, cheaper, "good enough" financing is usually also the best financing at the seed stage.

3. On the other hand, keeping it simple should not be confused with dumbing it down. If the deal is not memorialized in a mutually executed writing containing all the material elements of the deal, it is not a "good enough" financing. The best intentioned, highest integrity entrepreneurs and seed investors will more often than not recall key elements of their deal differently when it comes time to paper their deal – which it will at the A round, if not before. And the better the deal, the bigger those differences will likely be at that stage.

4. Get good legal advice. By "good" we mean "experienced in high impact startup financing." Outside Silicon Valley and Boston, the vast majority of reputable business lawyers have little or no experience representing high impact entrepreneurs and their investors in financing transactions. When these "good but out of their element" lawyers get involved in a high impact startup financing the best outcome is a deal that takes twice as long, and costs twice as much, to close. More likely outcomes include unconventional deals that complicate or even torpedo downstream financing. This suggestion is even more important if your deal is perchance one of those few that for some reason does need some custom fitting.

5. Finally, a pet peeve, if you think your startup's future includes investments by well-regarded institutional venture capital funds, skip the LLC tax complexity and just

incorporate your company as a “C” corporation (likely in Delaware). If you want to know why, ask one of those “experienced high impact startup lawyers” mentioned in the fourth point on the previous page.

The Angel's Role after the Investment Closes

Other than deciding when to sell, the typical investor in public company equity is generally a passive observer of the company's post-investment activities. In contrast active angel investors typically stay in variously close touch with their portfolio entrepreneurs and, hopefully, add some real value to the enterprise. Usually, at least one angel serves on the board of directors, and it is not uncommon for other angels to closely monitor, and occasionally get actively involved with, the management of the startup. Whether, in any given deal, an angel is going to be active or not, here are some tips about how to approach the angel/entrepreneur relationship post-closing.

Foremost among post-closing advice for angel investors is this: never forget that as an angel investor you are a coach, not an athlete. Many angel investors have been successful entrepreneurs themselves, and one of the "value adds" that these angels can bring to a startup is the benefit of their own entrepreneurial and management experience. But good angels understand that their role is to give counsel, not orders. Few things make for a more unhappy and usually dysfunctional angel/entrepreneur relationship than an angel who thinks he is, or should be, making decisions rather than offering advice and counsel.

Next on the list for the active angel is establishing regular communications between the investor(s) and the entrepreneur, including regular board meeting. While opinions vary, our view is that seed stage deals move so fast that monthly board meetings are in order, particularly where an entrepreneurial team lacks experience in one or more critical areas. Board meetings should generally not take more than a couple of hours, and should include extensive opportunities for questioning and testing plans and assumptions. Minutes should be concise – a sentence or two for each topic covered, plus formal resolutions where required and brief statements of any action plans agreed on that do not require formal board resolutions.

Good angels also remember that the business plan they invested in will likely change quite a bit, and often within months, or even weeks, of the closing date. "Pivoting" is the nature of the high impact startup beast. If you are skittish about major changes in direction based on less than complete information, high impact angel investing is probably not for you. Once in a deal, your thoughts and perspectives on pivots should be shared with the entrepreneur, but always with the caveat that that the entrepreneur should make the final call.

Expanding on the pivoting theme, angels investors in early stage high impact startups should remember that mistakes will be made, most likely quite a number of them, as a startup matures. In more traditional businesses, the first thing that happens when a mistake is discovered is usually a search for someone to blame. Later on, after the appropriate parties are duly punished and steps taken to reduce the risk of future mistakes, the focus shifts to correcting the mistake.

At high impact startups, mistakes are thought of more as learning opportunities than career killers. Entrepreneurs that don't make mistakes are likely not sufficiently pushing the envelope, and entrepreneurs who don't promptly learn from mistakes and move on seldom find much success. The angel investor's role in all of this is to hold entrepreneurs accountable for mistakes, that is, for timely recognizing and learning/recovering from those mistakes. Angels who take the more traditional approach of assessing blame and punishing the malfeasors simply waste resources, undermine entrepreneurial confidence, and discourage prompt recognition of mistakes going forward.

Taking a “let’s learn from this and move on” approach to entrepreneurial mistakes is important, but so too, paradoxically, is establishing a culture of accountability. Being supportive, even entrepreneur-friendly, does not imply passivity. Particularly for angels who are on the Board of Directors, being pro-active about regularly asking the hard questions about the business is a critical part of the job. Think of it like this: as an active angel investor, it is your job to make sure that when the entrepreneur starts pitching new investors for the A round, they don’t get any questions you have not already asked. If they do, they should hold you accountable.

Finally, good angels understand that as the company grows, their role will decline, in most cases precipitously. Typically, the arrival of a solid lead investor for the A round marks the beginning of the end for the angel as a key member of the entrepreneur’s cabinet. Angels that want to stay as close to an entrepreneur as possible are wise to recognize this rather than fight it. Even angels that still have a lot to contribute are best served by moving off center stage, if only because that is ground the downstream investors understandably consider their own.

Concluding Thoughts

Angel investing can be very rewarding – even when the financial rewards are not as robust as hoped for. But the rewards go disproportionately to those angels who (i) understand how very different angel investing is from more conventional investing in more established businesses; (ii) are looking for something beyond pure financial rewards from their angel investing work; and (iii) are comfortable working with high impact entrepreneurs in high stress, volatile business environments that reward quick, accurate thinking more than deliberate, precise thinking. If that sounds like you – welcome!

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