

**Early Stage Capital F03
15.391**

**MITunes, Inc.:
Fact Packet for Simulations**

Summary: You are a founder of a new college campus online-media delivery software and infrastructure provider. You have pitched, won over, and shaken hands with a venture capitalist on your first round of VC financing, and have received a draft term sheet from them outlining the basic investment deal. You will be 1) meeting with your lawyer to go over the term sheet and consider legal and negotiating strategy and then 2) negotiating with your VC over a few provisions you identify as crucial.

MITunes, Inc.: For purposes of this memo, the name of the startup is MITunes, Inc. (You will each choose your own team name.) MITunes is an online-media delivery software provider for college campuses. It has developed server software and a revolutionary user interface (UI) which, once installed, would create a lawful model for colleges to permit students to download and share audio and video files and video games on their networks. A short overview of this business model, in the form of an executive summary, is provided. (This information is provided as purely supplemental, background material for discussions with your lawyer and VC.) Remember, you've *already* sold the VC on your technology and service business model by this time; the question in this exercise is, "for what kind of preferred?"

Operating History: You and your co-founders worked together in various departments at Apple for a number of years and became friendly during and after work. Your engineer co-founder(s) had been early team members on Apple's iTunes Music Store project and immediately recognized that Apple would be too slow to offer iTunes on a Windows platform. It was obvious to you that Apple had effectively and permanently abandoned the educational market that had for many years been its most loyal customer base.

In light of the intensifying but conflicting legal efforts by the music industry against illegal file-swappers on college campuses, you and your co-founders began conceptualizing software solutions and approaches, on your own time, to help colleges not only limit their liability but develop new revenue streams as well. Each of you has had a desire, growing over time, to break out on your own. Sensing disaster—and seeing opportunity—in Apple's extended delay in introducing iTunes for the Windows platform, your team made the break in June 2002.

As your loose group began to seriously take form as a new start-up, you experienced an epiphany: the path to profitability should start from the East, not West, Coast. Each of you had ties, through family or your MIT days, with the Boston area. Given the high concentration of colleges and universities, of all shapes and sizes, and the strength of your own East Coast informal networks, you collectively decided that the way to really leverage your team's development lead-time and other competitive advantages would be to trade in the good weather and sky-high living costs of Santa Clara Valley for the bad

weather and sky-high living costs of Cambridge. You all moved back to the East Coast over the summer of 2002.

In some respects, doing a startup in the post-Bubble world has been easier than you expected: talent remains surprisingly abundant and commercial real estate is available just about everywhere. You moved into a dirt cheap sublease on Broadway in late July 2002, and were able to pick up furniture and computers for almost free from a recently closed-down optical networking firm. You began work in earnest on the business plan and software design and development in August. You were able to enjoy one of your first family Thanksgivings in years, seeing those various aunts and uncles in Dedham and Woburn and Quincy. You finished the first draft of the business plan in early December.

Over the past year, you have successfully negotiated licensing arrangements with a majority of the major music companies on innovative terms. You have developed a beta version of the product and implemented it at one major university and several smaller, local colleges. You have signed letters of intent with another 16 schools to implement by the beginning of the 2004 academic year. You have compellingly framed the financial advantages and opportunities for schools (and the bureaucracies that run them) to persuade them why they should join--and pay for--the MITunes model. You have hired an additional two business types to ramp up and support the marketing and licensing efforts.

Despite some onerous design problems, you have made significant technological progress, so much so that you brought on two more engineers early this summer. They are talented people, but relatively expensive (for your small budget). You have also been in conversations with some senior decision makers at Time Warner (former Apple co-workers from your early cube days who turned corporate) and have received a warm reception to the idea of partnering to sell the product alongside their AOL for Broadband offering. They are concerned, however, with your ability to support their user base, and stay ahead of the competition in subsequent product development and improvement.

You work really long hours, but are truly committed to your product and to MITunes. You believe in the value of your business model, and believe you are building something for the right reasons, and have the maturity and experience to see it through. Although you know you must grow quickly, you are not looking for a quick flip, and have avoided investors looking for one.

Your jobs: You are all co-founders of MITunes, but your job titles are *not* pre-assigned. You should assume a title* that matches or is close to your actual skill set. In other words, what job would a start-up hire you to do? It doesn't matter if your team has 4 engineers; that mirrors many real-life start-ups.

As a practical matter, you should name someone from your team the CEO*; the lawyers and VCs will look for the decision maker. (The CEO's assumed background, however,

* Items marked with an asterisk are to be assigned to team members, as discussed in the "Firm Profile" section of the "Lawyer Simulation Round" document.

should still be his or her actual background.) It is helpful to have a technical person or engineer (CTO or otherwise) as well. Assign other executive titles as your team sees fit.

Your financial and legal positions:

- You are each members of the board of directors*, and together, you constitute the whole board.
- Your “salary” is just about half the minimum wage, calculated on an hourly basis.
- You have operated up until now on pooled savings, family gifts and loans and credit cards. Everybody acknowledges a few big contributions, as set out below:
- Notably: after the stock tripled in value, one* of you sold your long-term holdings in HealthSouth in April 2002 right before leaving Apple and loaned the company around \$250,000. You haven’t executed a formal promissory note, but everyone understands that the money was intended to be a loan and that you expect to be repaid when VC money comes in.
- Another* of you has skipped paychecks altogether since the 4th of July as a way of contributing to the financial survival of MITunes. You all agree in principle that this foregone salary should be paid back when funding comes in.
- The CEO* owns 300,000 shares of MITunes common stock; the other founders each own 150,000 shares.
- No one has actually paid any money for their stock.
- No one else has been issued any stock, although you owe your 2 new engineers 25,000 shares each and your 2 new business people 15,000 shares each of common stock (part of their compensation deal). No disagreement over it; you just have not had time to get it issued.
- Everyone’s stock was issued without any vesting or other restrictions.
- You haven’t gotten around to granting any options or establishing an option pool. It’s a good idea, and you want to learn more about them; it just hasn’t been a priority.
- Similarly, you haven’t executed any legal documents about assignment of inventions or confidentiality or non-competition. Given your small founding team size and how well you all know each other, it seems too early for all that.

Quest for Cash: Having founded MITunes after the Bubble was long gone, you agreed and resolved to bootstrap as long as reasonably possible. As you all happen to be MIT alumni, you attended the 2002 MIT Sloan Venture Capital Conference last December, and were taken aback at just how bad things were. So, you kept your head down, living on the friends-and-family money, and pushing ahead on the technical side.

A few months later, however, in March 2003, you calculated your burn rates and realized you had to look in earnest for outside money. You also realized that your idea was in a space that investors were very interested in. None of you had any experience raising money and, candidly, you were pretty awful in your early pitches. Plugging back into the MIT alumni network, you got some excellent free advice and help to sharpen and better define your business model, your market and your sustainable competitive advantage.

In September of this year, with a revised, well thought-out business plan, you went back to a VC you had met at the MIT Conference. A well-regarded senior associate at a leading Boston firm, she was impressed by the progress you had made in the last several months, recognized the immediate potential of your approach, and the critical importance of hitting the market window fast. You may assume that the VC has sold the concept to the firm's partners, and that they have completed their technical and market due diligence to their satisfaction. They believe the technology works, that some IP protection is possible for the underlying design, and that MITunes has a one-year lead in development over other approaches to the same issue. They believe your team can execute to plan.

To be successful, you must ramp up your company quickly. You must prove to colleges, Time Warner, and other future customers and potential partners that your product can scale to support thousands of concurrent users. Furthermore, you realize that as soon as your product gains media attention, you will face a fierce competitive battle from the likes of Apple, MusicMatch, and Napster, as they struggle to catch up.

To successfully capitalize on your one-year lead time in development, you must hire additional developers and a comprehensive QA team. Furthermore, you must hire experienced sales and business development and legal staff to build relationships, license media content, close deals with partners and sell to the decisionmakers within the bureaucracies of America's colleges and universities, your target customer.

In conversations with your VC, you have valued MITunes at \$7 million. You calculate you need \$5 million in this round to capitalize on your current competitive advantage and execute to plan.

The VC firm has made an offer and has presented a term sheet offering \$5 million on a \$5 million pre-money valuation.

You have looked it over, but think it is worthwhile to meet with your lawyer to understand it better. You make an appointment with your lawyer, an experienced Boston-based practitioner in the high-tech space. While you haven't thought much about legal advice since you were incorporated, you may assume that you have established a comfortable client relationship with your lawyer. You consider your deal points with your team, and then go to discuss the term sheet at your lawyer's office.

As discussed in the "Lawyer Simulation Round" document, you work with your lawyer to understand legal jargon, market practice and typical negotiating ploys and strategies in term sheet negotiations.

Armed with the keen and trenchant insight from your lawyer, you now meet with your VC at their offices. (You meet the VC without your lawyer.) Assume for this exercise that you are working with one VC. This will be the second meeting on the term sheet. You believe you have established a positive, non-adversarial working relationship and a good rapport. While the VC values your first-mover advantage and the growth potential of the market, they (and you) do stay awake at night worrying about the competition. Your team, while very committed and experienced, is unseasoned in a startup context. You are not a slam-dunk. The VC firm is a respected, experienced group, although not particularly active in this sector.

As detailed in the “VC Simulation Round” document, you are comfortable that the valuation negotiations are on track, and so have tabled discussions of pure valuation at this meeting and will take up only (so-called) non-financial provisions in the term sheet.

The tone of the meeting is not initially tense or confrontational; you shouldn’t enter with a sense that you are negotiating “deal-breaker” provisions. Rather, these are priority provisions that your team has agreed are important to MITunes and to your vision of what you want the firm to become.

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**MITunes, Inc.
Executive Summary**

MITunes, Inc. is focused on solving a key problem for the nation's colleges and universities. By sub-licensing pre-negotiated media content from the top five record companies and other media providers and through its tailored server software and revolutionary user interface, MITunes' customers can offer students subscription-based services that allow them to legally download and share media content. MITunes customers can avoid millions of dollars in costs from potential lawsuits while at the same time introduce revenue-generating services for their students.

The company was founded in June 2002 by an experienced team of software and media professionals. The technology has been developed and proven with an initial set of beta customers, and the company is well positioned to take advantage of a market window created by the inaction of major record labels and the incumbent market leaders in online-music delivery (Apple and Real Networks).

Media piracy is a troubling commercial and creative problem that deepens with every technological advance. Hackers overcome and compromise anti-piracy technologies for compact disks and DVDs as soon as they are introduced by vendors. The fledgling digital rights management software industry failed to move towards standardization and interoperability. As such, none of the hundreds of players in this space have been able to achieve growth let alone market traction.

The MITunes concept takes advantage of the strong interest among media companies to capture as much possible revenue from online media delivery services, especially to the most influential long-term buyers – college students. MITunes acts as an intermediary between colleges and the owners of media content, using its already-negotiated and exclusive college-use licenses to sub-license media to college campuses. This protects colleges from the spectre of anti-file-sharing lawsuits (as seen in recent press). Further, the MITunes server software allows colleges to provision, deliver streaming media, and bill student customers for downloading and sharing media. Finally, the MITunes UI simplifies and energizes the student experience of downloading and sharing media, while delivering laser-focused advertising campaigns.

In addition to completing the development and quality assurance associated with making MITunes ready for the college/university market, MITunes is seeking \$5 million to ramp up product development, undertake a large sales and marketing effort to effectively launch the product, and to develop an executive management team with the right background to undertake strategic partnering discussions with firms like Time Warner and Microsoft. MITunes is also developing a Professional Services team to assist customers with installation and provide high-quality customer and end-user service.