The Basics of Early Stage Legal Issues — A Guide for Entrepreneurs

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Table of Contents

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2007 Update to Guide to Starting a Corporation

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Guide to Starting a Corporation

Introduction

This guide describes certain basic considerations and costs involved in forming a Delaware or California corporation. Although Delaware and California law are emphasized, the legal concepts are much the same in other states. One important tip is that you should avoid making business decisions in a vacuum. Instead, consider how a decision may impact future alternatives. For example, an improperly priced sale of common stock to founders immediately followed by a sale of preferred stock may result in a significant tax liability to the founders. Another example is that converting a limited liability company into a corporation immediately before the business is acquired, rather than at an earlier time, may prevent the transaction from being tax-free.

This guide is only an overview, particularly as to tax issues and cannot substitute for a professional advisor's analysis and recommendations based on your individual fact situations when establishing your business.

A. Selecting the Form of Business Organization

No single factor is controlling in determining the form of business organization to select, but if the business is expected to expand rapidly, a corporation will usually be the best alternative because of the availability of employee incentive stock plans; ease of accommodating outside investment and greater long-term liquidity alternatives for shareholders. A corporation also minimizes potential personal liability if statutory formalities are followed. The characteristics of a corporation are described below, followed by an overview of other traditional forms of business organizations. Each of the following factors is described for comparison purposes: statutory formalities of creation, tax consequences, extent of personal liability of owners, ease of additional investment, liquidity, control and legal costs.

1. Corporation

A corporation is created by filing articles of incorporation with the Secretary of State in the state of incorporation. Corporate status is maintained by compliance with statutory formalities. A corporation is owned by its shareholders, governed by its Board of Directors who are elected by the shareholders and managed by its officers who are elected by the Board. A shareholder's involvement in managing a corporation is usually limited to voting on extraordinary matters. In both California and Delaware, a corporation may have only one shareholder and one director. A president/CEO, chief financial officer/treasurer and secretary are the officer positions generally filled in a startup and, in fact, are required under California law. All officer positions may be filled by one person.

The reasons for using a Delaware corporation at startup are the ease of filings with the Delaware Secretary of State in financings and other transactions, a slight prestige factor in being a Delaware corporation and avoiding substantial reincorporation expenses later,

since many corporations which go public reincorporate in Delaware at the time of the IPO. Delaware corporate law benefits are of the most value to public companies. However, if the corporation's primary operations and at least 50% of its shareholders are located in California, many provisions of California corporate law may be applicable to a private Delaware corporation and such a company would pay franchise taxes in both California and Delaware. These considerations may result in such a business choosing to incorporate in California instead of Delaware. Another reason for keeping it simple and using a California corporation is the current non-existent IPO market which makes an acquisition a more likely exit for a start-up.

There is more flexibility under Delaware law as to the required number of Board members. When a California corporation has two shareholders, there must be at least two Board members. When there are three or more shareholders, there must be at least three persons on the Board. Under Delaware law, there may be one director without regard for the number of stockholders. Most Boards stay lean and mean in number as long as possible to facilitate decision-making. Since the Board is the governing body of the corporation, when there are multiple board members, a party owning the majority of the shares can still be outvoted on the Board on important matters such as sales of additional stock and the election of officers. Removing a director involves certain risks even when a founder has the votes to do so. Thus, a founder's careful selection of an initial Board is essential. You want board members whose judgment you trust (even if they disagree with you) and who can provide you with input you won't get from the management team.

A corporation is a separate entity for tax purposes. Income taxed at the corporate level is taxed again at the shareholder level if any distribution is made in the form of a dividend. The S Corporation election described below limits taxation to the shareholder level but subjects all earnings to taxation whether or not distributed. The current maximum federal corporate tax rate is 35%. The California corporate income tax rate is 8.84% and the Delaware corporate income tax rate is 8.7% but Delaware income tax does not apply if no business is done in Delaware and only the statutory office is there. There is also a Delaware franchise tax on authorized capital which can be minimized at the outset but increases as the corporation has more assets.

If the business fails, the losses of the initial investment of up to $1 million in the aggregate (at purchase price value) of common and preferred stock (so-called "Section 1244 stock") may be used under certain circumstances by shareholders to offset a corresponding amount of ordinary income in their federal income tax returns. An individual may deduct, as an ordinary loss, a loss on Section 1244 stock of up to $50,000 in any one year ($100,000 on a joint return).

If statutory formalities are followed, individual shareholders have personal liability only to the extent of their investment, i.e., what they paid for their shares. If the corporation is not properly organized and maintained, a court may "pierce the corporate veil" and impose liability on the shareholders. Both California and Delaware law permit corporations to limit the liability of their directors to shareholders under certain circumstances. The company can

raise additional capital by the sale and issuance of more shares of stock, typically preferred stock when an angel or venture capitalist is investing. Though rare, the power of a court to look through the corporation for liability underscores the importance of following proper legal procedures in setting up and operating your business.

Filing fees, other costs and legal fees through the initial organizational stage usually total about $3,500 to $5,000, with a Delaware corporation being at the high end of the range.

2. Sole Proprietorship

The simplest form of business is the "sole proprietorship," when an individual operates a business on his own. The individual and the business are identical. No statutory filings are required if the sole proprietor uses his own name. If a different business name is used in California, a "fictitious business name" statement identifying the proprietor must be filed with the county clerk of the county where the principal place of business is located and published in the local legal newspaper. A sole proprietor has unlimited personal liability to creditors of his business and business income is taxed as his personal income. Because of the nature of this form of business, borrowing is the usual method of raising capital. The legal cost of forming a sole proprietorship is minimal.

3. General Partnership

When two or more individuals or entities operate a business together and share the profits, the enterprise is a "partnership." Partnerships are either general partnerships or limited partnerships (described below). Although partners should have written partnership agreements which define each party's rights and obligations, the law considers a venture of this type as a partnership whether or not there is a written agreement. No governmental filings are required for a general partnership. A partnership not documented by a written agreement is governed entirely by the versions of Uniform Partnership Act in effect in California and Delaware.

In the absence of an agreement to the contrary, each partner has an equal voting position in the management and control of the business. Each partner generally has unlimited liability for the debts of the partnership and is legally responsible for other partners' acts on behalf of the business, whether or not a partner knows about such acts.

The partnership is a conduit for tax purposes: profits (even if not distributed) and losses flow through to the partners as specified in the partnership agreement. There is no federal tax at the entity level. Some partnerships contemplate raising additional capital, but accommodating future investment is not as easy as in a corporation. The legal cost of establishing a partnership is minimal if no formal written agreement is prepared but not having a written agreement may cause disputes over the economic benefits, intellectual property and assets of the partnership. The cost of preparing such an agreement begins at about $2,000 and depends on the number of partners, sophistication of the deal and other factors.

4. Limited Partnership
This is a partnership consisting of one or more general partners and one or more limited partners which is established in accordance with the California and Delaware versions of the Uniform Limited Partnership Act. Like the corporation, this entity has no legal existence until such filing occurs. The limited partnership is useful when investors contribute money or property to the partnership but are not actively involved in its business. The parties who actively run the business are the "general partners," and the passive investors are the "limited partners." So long as the limited partnership is established and maintained according to statutory requirements, and a limited partner does not take part in the management of the business, a limited partner is liable only to the extent of his investment. Like a general partnership, however, the general partners are personally responsible for partnership obligations and for each other's acts on behalf of the partnership.

For tax purposes, both general partners and limited partners are generally treated alike. Income, gains and losses of the partnership "flow through" to them and affect their individual income taxes. A properly drafted limited partnership agreement apportions profits, losses and other tax benefits as the parties desire among the general partners and the limited partners, or even among various subclasses of partners subject to certain requirements imposed by U.S. tax law, i.e., the Internal Revenue Code (the "IRC").

5. Limited Liability Company
This form of business organization is available in Delaware and California as well as many other states. It is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions identified below. An LLC has fewer statutory formalities than a corporation and is often used for a several person consulting firm or other small business. An LLC does not provide the full range of exit strategies or liquidity options as does a corporation. It is not possible to grant stock option incentives to LLC employees in the same manner as a corporation. Further, an acquisition of an LLC generally may not be done on a tax-free basis and the expenses of formation are higher than for forming a corporation.

B. S Corporations

A corporation may be an "S corporation" and not subject to federal corporate tax if its shareholders unanimously elect S status for the corporation on a timely basis. "S corporation" is a tax law label; it is not a special type of corporation under state corporate law. Like a partnership, an S corporation is merely a conduit for profits and losses. Income is passed through to the shareholders and is generally taxed only once. Corporate level tax can apply in some circumstances to an S corporation that previously had been a "C" corporation for income tax purposes. Losses are also passed through to offset each shareholder's income to the extent of his basis in his stock and any loans by the shareholder to the S corporation. The undistributed earnings retained in the corporation as working capital are taxed to a shareholder.

A corporation must meet certain conditions in order to be an S corporation, including the following: (1) it must be a U.S. corporation, (2) it must have no more than 100 shareholders, (3) each shareholder must be an individual, certain trusts, certain charitable organizations, employee stock ownership plans or pension plans, (4) no shareholder may be a nonresident alien, and (5) it can have only one class of stock outstanding (as opposed to merely being authorized). As a result, S corporation status will be terminated when a corporation sells preferred stock or sells stock to a venture capital partnership, corporation or to an off-shore investor.

California and Delaware recognizes the S corporation for state tax purposes, which may result in additional tax savings. California, however, imposes a corporate level tax of 1.5% on the S corporation's income and nonresident shareholders must pay California tax on their share of the corporation's California income. In addition, only C corporations and noncorporate investors are eligible for the Qualified Small Business Corporation capital gains tax break. The benefit of this tax break is that if the stock is held for at least 5 years, 50% of any gain on the sale or exchange of stock may be excluded from gross income. This benefit may not be as important because of the reduction in the capital gains tax rate.

C. Choosing a Business Name

The name selected must not deceive or mislead the public or already be in use or reserved. "Inc.," "Corp." or "Corporation" need not be a part of the name in California but must be part of a Delaware corporate name. Name availability must be determined on a state-by-state basis through the Secretary of State. A corporate name isn't available for use in California merely because the business has been incorporated in Delaware. Several alternative names should be selected because so many businesses have already been formed. Corporate name reservation fees range from approximately $10-50 per state for a reservation period of 30-60 days. Exclusive state rights in a trade name can also be obtained indefinitely through the creation of a name-holding corporation, a corporation for which articles of incorporation are filed but no further organizational steps are taken.

D. Selecting the Location for the Business

This decision is driven by state tax considerations and operational need, for example, to be near customers or suppliers or in the center of a service territory. A privately-held corporation cannot avoid California taxes and may not be able to avoid the application of California corporate law if it is operating here and has most of its shareholders here. For example, Delaware law allows Board members to be elected for multiple year terms and on a staggered basis rather than on an annual basis. A privately held corporation, however, may be able to have the benefits of these Delaware laws or any other state's corporate law if it is actually operating in California and more than 50% of its shareholders are here.

E. Qualifying to do Business in Another State

A corporation may need to open a formal or informal office in another state at or near the time of founding. This requires a "mini" incorporation process in each such state. If a California business is incorporated in Delaware it must qualify to do business in California. The consequences of failing to do so range from fines to not being able to enforce contracts entered in that state. The cost of qualifying is approximately $1,000 per state. Some states, like Nevada, also charge a fee based on authorized stock, so the fee could be higher in such states.

F. Initial Capital Structure

1. Structure

The capital structure should be kept as simple as possible and be within a range of "normalcy" to a potential outside investor for credibility purposes. A common initial structure is to authorize 10 million shares of common stock and 4 million shares of preferred stock. Not all authorized shares of common stock are sold at the founding stage. After initial sales to founders, there are usually only about 3-5 million shares issued and outstanding and about 1-2 million shares reserved in the equity incentive plan. This is referred to as the "1X model" below.

While at the outset there may not seem to be any difference between owning 100 shares or 1 million shares, a founder should purchase all of the units of stock he desires at the time of founding. Thereafter, a founder will generally lose control over further issuances and stock splits, particularly once a venture capital financing occurs. In addition, the purchase price will usually increase.

The number of shares issued and reserved in the initial capital structure are driven by a desire to avoid a later reverse stock split at the time of an IPO because of excess dilution. The number of shares outstanding at the time of an IPO is driven by company valuation at IPO, the amount to be raised in the IPO and IPO price per share range (usually $10 to $15). The "pattern" for the business value at the time of the IPO can be reached by forward or reverse stock splits. For example, if a corporation has a market valuation at IPO time of $200 million, it would not be feasible for 40 million shares to be outstanding. A reverse stock split is needed. Reverse stock splits reduce the number of shares held. On the other hand, forward stock splits add shares to holdings. Neither changes the percentage ownership, but seeing the number of shares held decrease because of a reverse split is still hard on employee morale.

Because of the great demand for engineers during the Internet bubble, many corporations used a multiple of this 1X model in order to have more equity units available for employees. The immediate need for employees to increase the possibility of business success outweighed the potential consequence of a later reverse stock split. Currently, most startups use a 1X or 2X model to avoid excessive dilution.

2. Minimum Capital
Neither Delaware nor California law require a minimum amount of money to be invested in a corporation at the time of founding. The initial amount of capital, however, must be adequate to accomplish the purpose of the startup business in order for shareholders not to have personal liability. For example, a corporation which will serve only as a sales representative for products or a consulting operation requires less capital than a distributor or dealer who will stock an inventory of products. A dealership or distributorship will require less capital than a manufacturing operation.

3. Legal Consideration
A corporation must sell its shares for legal consideration, i.e., cash, property, past services or promissory notes under some circumstances. A founder who transfers technology or other property (but not services) to a corporation in exchange for stock does not recognize income at the time of the transfer (as a sale of such property) under IRC Section 351 if the parties acquiring shares at the same time for property (as opposed to services) own at least 80% of the shares of the corporation after the transfer. Because of this limitation, Section 351 is generally available at the time of founding but not later. Since a party who exchanges past or future services for stock must recognize income in the amount of the value of the stock in the tax year in which the stock is received, it is the prefered practice to issue the shares at a low valuation for cash or property.

4. Valuation
The per share value at the time of founding is determined by the cash purchases of stock and the number of shares issued. For example, if one founder buys stock in exchange for technology and the other founder buys a 50% interest for cash, the value of the technology and the fair market value per share is dictated by the cash purchase since its monetary value is certain. Sales of the same class of stock made at or about the same time must be at the same price or the party purchasing at the lower price may have to recognize income on the difference.

Thereafter, value is determined by sales between a willing seller and buyer or by the Board of Directors based on events and financial condition. Value must be established by the Board at the time of each sale of stock or grant of a stock option. Successful events cause value to increase. Such determinations are subjective and there is no single methodology for determining current fair market value. There are pitfalls of hedging on the timing of forming corporation to save on expenses. The longer the delay in incorporating, the more difficult it is to keep the founders price at a nominal level if a financing or other value event is imminent.

A general objective is to keep the value of common stock as low as possible as long as possible to provide greater stock incentives to attract and keep key employees. Tax and state corporate laws generally require option grants to be made at current fair market value. IRC Section 409A has increased the diligence needed in determining pricing for stock option grants.

5. Use of Debt

Loans may also be used to fund a corporation. For example, if a consulting business is initially capitalized with $20,000, half of it could be a loan and the remaining $10,000 used to purchase common stock. Using debt enables the corporation to deduct the interest payments on the debt, makes the repayment of the investment tax free and gives creditor status to the holder of the debt. If a corporation is too heavily capitalized with shareholder's loans, as opposed to equity (usually up to a 3-1 debt/equity ratio is acceptable), however, these loans may be treated as additional equity for tax and other purposes. Debts owed to shareholders may be treated as contributions to capital or a second class of shares and subordinated to debts of other creditors. Eligibility for S corporation status is lost if a loan is characterized as a second class of shares.

6. Vesting and Rights of First Refusal

Shares sold to founders are usually subject to vesting and rights of first refusal in order to keep founders on the corporate team and to maintain control over ownership of the corporation. Grants of options under an equity incentive plan also have such "stickiness" restrictions. Such safeguards are essential to securing a venture capital investment. By designing and implementing a reasonable vesting scheme themselves, founders may forestall an investor from doing so on the investor's terms. Vesting also assures investors that the founders and others are committed to the corporation and not just looking for a quick pay day. The corporation typically retains the option to repurchase unvested shares at the initial purchase price at the time of termination of a shareholder's employment. Vesting usually occurs over 4 years, i.e., if the employee remains employed by the corporation for the entire period, all shares become "vested" and the repurchase option ends. A common pattern is for 25% of the shares to vest after 12 months and the remainder to vest monthly over the next 36 months. Vesting is implemented by stock purchase agreements. An IRC Section 83(b) election must be filed with the Internal Revenue Service by a party buying unvested shares within 30 days of the date of purchase in order to prevent taxable income at the times such shares vest.

A right of first refusal is the corporation's option to repurchase shares when a third party makes an offer to purchase shares. This type of restriction can be used by itself or as a backup to the repurchase option to maintain control over stock ownership once vesting occurs. The corporation may repurchase the shares on the same terms as the offer by the third party. Rights of first refusal are implemented by stock purchase agreements, including under stock option plans, or in the corporation's bylaws. Rights of first refusal (but not rights of repurchase on termination of employment) terminate upon an IPO or acquisition.

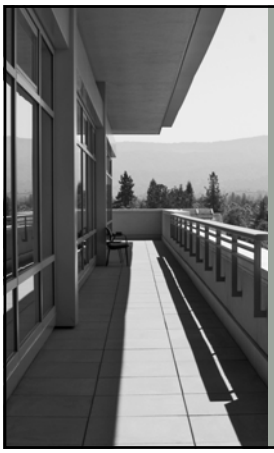
G. Sales of Securities

Offers and sales of stock in a corporation, certain promissory notes and loans, certain partnership interests and other securities are subject to the requirements of the Securities Act of 1933, a federal law, and of state securities laws, so-called "Blue Sky" laws. While some state laws are preempted by federal securities laws in some cases, an offer or sale

of securities in multiple states generally requires compliance with each state's law. The general rule under these laws is that full disclosure must be made to a prospective investor and that registration or qualification of the transaction with appropriate governmental authorities must occur prior to an offer or sale. An investor can demand its money back if securities laws are not followed. There are also severe civil and criminal penalties for material false statements and omissions made by a business or its promoters in offering or selling securities. Legal opinions regarding exemptions are not possible if securities are sold without regard for such laws. An opinion may be required in venture capital investments or an acquisition.

Exemptions from the registration and qualification requirements are usually available for offers and sales to founders, venture capitalists and foreign parties but offers and sales to other potential investors, even employees, are not legally possible without time consuming and expensive compliance with such laws. State laws have relatively simple exemptions for option grants and stock issuances under a formal equity incentive plan, which is why a plan should be the source of equity for employees and consultants.

The stock purchased in a sale exempt from federal registration and state qualification requirements will not be freely transferable. In addition to contractual restrictions, resales must satisfy federal and state law requirements. Shareholder liquidity occurs through Securities and Exchange Commission Rules 144 or 701, an IPO, other public offerings or other exempt sales.



TiE Institute – Legal Education Series

February 21, 2007

Term Sheets and Early Stage Financing Terms For Private Companies

(Presentation Slides)

Samuel Angus
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Term Sheets and Early Stage Financing Terms For Private Companies

Private Company Financing Types

1) Seed Financings
2) VC Financings:
   - Process and Overview
   - VC/Preferred Stock Model
3) Private Company Liquidation Exits
   - Acquisition Scenarios
4) Conclusion

2

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Private Company Financings (Types)

- Seed Financings
  - Founder
  - Friends, Family, Angels
  - Early Stage VCs
  - Type of Security – convertible notes/series A Preferred Stock?
- Venture Capital
- Corporate Partner
  - Valuation
  - "Strings attached"
- Debt Financing

3

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Private Company Financings – Founder Financing

- Very early stage of the Company – Usually less than $250,000; Types:
  - Note (simple debt)
  - Convertible Notes with a kicker (discount or warrant coverage)
    - Debt that converts into stock sold in a "qualified financing"
  - Series A Preferred Stock (do not issue common stock)
- Advantages:
  - Founder initially gets to set terms
  - Founder can receive vested shares
- Disadvantages:
  - Treatment of debt in next serious financing
  - Overreaching on terms of convertible notes/Series A Preferred Stock
  - Valuation issues

4

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Private Company Financings – Angels/Friends & Family Financing

- Generally between $250,000 to $1,500,000; Types:
  - Convertible Notes with a "kicker" (discount or warrant coverage)
    - Discount off of the price of the Preferred Stock sold in a Qualified Financing – Typically 10% to 30% discount
    - Warrant coverage typically 10% to 30% depending on the company and timing of the next financing
    - Warrant Coverage Formula: Warrant to purchase X shares of common stock, where X = (warrant coverage percentage x principal amount note) ÷ conversion price of shares
    - Warrant coverage percentage can be capped, and/or scale based upon investment amount or how long the note is outstanding
  - Series A Preferred Stock financing – More likely to get company favorable terms, but:
    - Future approval rights
    - Valuation issues

5

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Private Company Financings – Early Stage VC Financing

- Early stage VC seed investments in the $500,000 to $2,000,000 range.
  - Typical structure – convertible notes with a kicker (discount or warrant coverage)
    - Often financing will include a right to lead the next "qualified financing" at a certain minimum investment level
    - The VC may also receive certain management rights (such as a board seat, protective provision rights) while the notes are outstanding
  - Quick and results simple capital structure (one or two investors)
  - Can limit alternative investors on next financing

6

Private Company Financings – Classic VC Financing

- Classic VC Financing: Series A Preferred Stock
  - Typical valuation ranges: $4.0 million to $10.0 million (pre-financing)
  - Minimum ownership: 20% (post-financing, including option pool), but can be higher if multiple VCs are involved (40% to 60%)
  - Other Key Terms:
    - –Liquidation Preference – Standard, 1x with participation (capped)
    - –Board composition – Standard, 5 directors, with two common (one of which is the CEO), two investor directors, and one independent director
    - –Protective provisions – Standard, any change to rights of the Series A Stock, merger/sale of the company, dividends, sale of additional Preferred Stock
    - –Other terms – Anti-dilution protection, drag along rights, new founder vesting

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7

Venture Capital Financings – VC/Preferred Stock Model

- VC/Preferred Stock Model
  - Cheap Common Stock (for Founders and Employees)
  - Expensive Preferred Stock (for Investors)
  - Investors Get Additional Rights to Hedge Operating and Financial Risks
- Privileges of Preferred Stock
  - Liquidation and Dividend Preferences
  - Voting (Board) Rights
  - Protective Provisions (veto rights)
  - Conversion Rights/Antidilution Protection
  - Redemption
  - Registration Rights
  - Information Rights
  - Participation Rights

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8

Private Company Liquidation Exits

- IPO – Unlikely at this time
  - Public market currently very weak for tech companies
  - Minimum market cap of $150 - $200 million
  - Heightened regulatory requirements and costs
- Acquisition – Most likely liquidity event for private companies
  - M&A market is strong, with large premiums being paid for companies with large user/customer base and/or strong products
  - Faster liquidity/exit timing
  - Subject to post-closing terms (escrows, earnouts, non-competes, etc.)

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9

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Acquisition Scenarios

Company Type	Capitalization at Exit	Exit Amount	Return on Exit
Founder Financed	▪ Founder – 2,000,000 CS shares ▪ Employees* – 500,000 CS shares	$7.0M	Founder – $5.6M Employees – $1.4M
Angel Financed	▪ Founder – 2,000,000 CS shares ▪ Employees* – 600,000 CS shares ▪ Angels** – 333,333 PS shares + 66,667 CS shares (warrants)	$15.0M	Founder – $9.67M Employees – $2.9M Angels - $2.43M
VC Financed	▪ Founder – 2,000,000 CS shares ▪ Employees* – 1,333,333 CS shares ▪ VC*** – 3,333,333 PS shares	$50.0M	Founder – $13.5M Employees – $9.0M VC – $27.5M

Assumptions:

*** Assumes 20% stock option pool at each exit.**

**** Assumes that the angels have previously invested $500K in the form of notes which converted into shares of Series A PS (with same terms as the VC received below). Warrant coverage is 20%.**

***** Assumes that the VC had previously invested $5.0 at a $5.0M pre-financing valuation into shares of Series A PS with a 1x liq. pref. that fully participates with the CS.**

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Conclusion

- Current financing environment strong and improving
  - Valuations continue to improve (along with VC investment, which increased to $6.4B (Q3'06), vs. $6.8B (Q2'06) and $6.0B (Q3'05) – on track for largest investing year since 2001
  - Web 2.0/Media space strong with large exits (YouTube, My Space)
  - IPO market still weak for tech/web companies
  - To build interest
    - –Demonstrate customers/revenue product achievement
    - –Show company's progress/milestones will be when the funding is spent
    - –Demonstrate large addressable market
- Negotiate the important stuff, skip the small stuff
  - Valuation/Dilution, but don't let it kill the deal
  - Liquidation Preferences
  - Protective Provisions
  - Board Control
- Materials
  - Fenwick & West Financing Materials
  - Sample Venture Capital Term Sheet (annotated)
  - Q3 2006 Quarterly Venture Capital Terms Survey & Glossary

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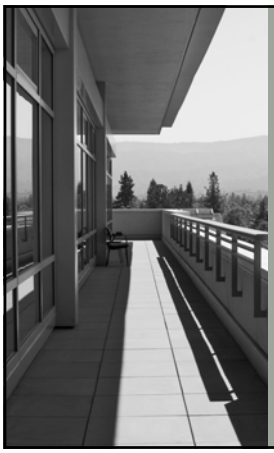

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Venture Capital Term Sheet Fundamentals

(Detailed Slides)

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Venture Capital / Angel Term Sheet Fundamentals

1) Seed Investing Overview
2) VC Financing: Process and Overview
3) Term Sheet Valuation Issues
4) Preferred Stock Privileges
5) Investor Protections and Rights
6) Stock Purchase Terms
7) Conclusion

2

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Preparing Your Company For Investment

- Look "conventional"
- Complete founders stock purchases
- Founders should have vesting but with acceleration provisions
- Adopt California compliant stock option plan
- Avoid previous employer and other IP issues

3

Private Company Financings (Types)

- Seed Financings
  - Founder
  - Friends, Family, Angels
  - Early Stage VCs
  - Type of Security – convertible notes/series A Preferred Stock?
- Venture Capital
- Corporate Partner
  - Valuation
  - "Strings attached"
- Debt Financing?
- Role of a Term Sheet
- Securities Laws

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4

Seed Stage Financings: Common Stock?

- Pricing of common stock must be same for all sales at or about the same time. Cannot grant options to employees for $0.01 and sell shares of common stock to seed investors for $1.00 at the same time
- Selling common stock is not generally used because of the dilutive effect and impact on stock options
  - Consider number of shares at $0.01 per share needed to be sold to raise even $100!
- Objective is to keep the common stock price low as long as possible to motivate employees and other service providers with stock options
- Interplay of recent tax regulations on Common Stock valuation (IRC 409A)

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5

Seed Stage Financings: Use Of Preferred Stock

- Requires a pre-money valuation for the company. Investors will buy a percentage of the company
- Series A round can be complicated and expensive even if raising a small amount of money. Cost may be disproportionate to amount raised
- Defer a preferred stock financing if possible

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6

Seed Stage Financings: Convertible Notes

- Issue convertible notes for "next financing" preferred stock
- Defers valuation decision and keeps the financing simple and low cost
- Discount on conversion rate (or warrants) is often used as a "sweetener" for the investors to take the risk

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7

Venture Capital Financings Process And Overview

Venture Capital Financings – Process & Timetable

- Step 1: Meetings with Investors; Investor High-Level Due Diligence
- Step 2: Decision by Investor to invest
- Step 3: Term Sheet negotiation (0-2 weeks)
- Step 4: Financing Documentation and Diligence (4-6 weeks)
  - Conduct legal and business due diligence
  - Ascertain compliance with securities laws
  - Draft definitive agreements (purchase agreement, Articles, voting agreements)
  - Prepare closing deliveries (Schedule of Exceptions, consents, opinions, government filings)
- Step 5: Sign and close
- Step 6: Additional closings / Milestones (?)

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8

Process And Overview

Preferred Stock Model [2]

- VC/Preferred Stock Model
  - Cheap Common Stock (for Founders and Employees)
  - Expensive Preferred Stock (for Investors)
  - Investors Get Additional Rights to Hedge Operating and Financial Risks
- Privileges of Preferred Stock
  - Liquidation and Dividend Preferences
  - Voting (Board) Rights
  - Protective Provisions (veto rights)
  - Conversion Rights/Antidilution Protection
  - Redemption
  - Registration Rights
  - Information Rights
  - Participation Rights

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9

Term Sheet Valuation Issues [1, 3]

- Context
- Methodology for Valuation (Pre-Financing)
  - Discounted Cash Flow
  - Multiple of Revenues/Sales
  - Multiple of Earnings
  - Real World – Private Company Factors
    - Customers
    - Revenues / Earnings
    - Product Development
    - Management
- How Much to Raise?
- How is Per Share Price Calculated?

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10

Term Sheet Valuation Issues

Definitions

"Outstanding Securities"= Issued Common and Preferred Stock, options, warrants and convertible notes, and any other rights to equity that have been granted and paid for

"Option Pool" = Options that have been reserved for issuance but have not yet been granted

"Fully-Diluted Shares" (FDS) = Outstanding Securities plus Option Pool

"Pre-Money Valuation" = Set by Investor-Founder negotiation

"Per Share Price" = Pre-Money Valuation divided by FDS

"Post-Money Valuation" = Pre-Money Valuation plus New Money Raised

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11

Term Sheet Valuation Issues

Valuation Example

Founders - 5,000,000 shares at $0.01 = $50,000 valuation

Option Pool Required = 2,500,000 shares

Pre-Money Valuation = $3,000,000

FDS Pre-Series A = 7,500,000 shares

Per Share Price = $3,000,000/7,500,000 shares = $0.40

Series A Investment = $4,000,000

Series A Stock Issued = $4,000,000/$0.40 = 10,000,000 shares

FDS Post-Series A = 17,500,000 shares

Founders 28.58%, Option Pool 14.28%, Investors 57.14%

Post-Money Valuation = $7,000,000

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12

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Preferred Stock Privileges

- Liquidation Rights [6]
- Conversion Rights [10, 11]
- Pay to Play Provisions
- Redemption Rights [7]
- Dividends [5]
- Protective Provisions [13]

13

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Preferred Stock Privileges

Liquidation Rights [6]

- Preference (Investors get "off the top")
  - Available for merger / acquisition / sale of assets (not just liquidation)
  - Return of initial investment BEFORE common holders get paid
- Preferences Senior or Pari Passu with Other Series
- Multiple Preference
- Participation with Common (After Preference):
  - None: Investors DO NOT share with Common
  - Full Participation: Investors share PRO RATA with Common (as-if converted)
  - Capped Participation: Investors share Pro Rata with Common UNTIL [3x] return received
- Investors can convert to common

14

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Participating Preferred Example

Assume $3M preferred investment for 60% of Company

Sale of Co. @	Pref. 1X	Common (40%)	Pref. 2X	Common
$3M	$3M	0	$3M	0
$6M	$4.8M	$1.2M	$6M	0
$10M	$7.2M	$2.8M	$8.4M	$1.6M
$15M*	$10.2M*	$4.8M	$11.4M*	$3.6M
$25M	$16.2M	$8.8M	$17.4M	$7.6M

***If 3X cap., Preferred would max. out here**

15

Preferred Stock Privileges

Conversion Rights [10, 11]

- Optional Conversion
  - Holders can convert to Common at any time
  - Lose all rights of Preferred Stock
- Automatic Conversion – must convert to Common if:
  - "Approved" IPO ($10-20M)
  - Majority (or 2/3) elect to convert (written)
- Conversion Ratio (initially 1:1)
  - Event-Based changes
    - Stock splits, stock dividends, reverse stock splits
    - Retain same percentage ownership
  - Price-Based changes (Dilutive Financing)
    - Anti-dilution Protection
    - Pay to Play

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16

Preferred Stock Privileges

Anti-dilution Protection [12]

- Weighted Average
  - Mechanics:
    - Weights the difference in price (prior round and current) by proportion of shares (pre-financing and post financing)
    - The fewer the "new dilutive" shares sold (relative to number in prior rounds) the less the reduction in conversion price
  - Narrow Based – include only Preferred shares outstanding in count (or Preferred and Common)
  - Broad Based – includes Preferred/Common outstanding and granted options / warrants (reduces effect of proportion)

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17

Preferred Stock Privileges

Anti-dilution Protection [12]

- Ratchet – reduce conversion price to new sale price
  - Full Ratchet – very harsh
    - Can cause great dilution for relatively few shares sold at lower price
  - Capped or Limited
    - Limit duration of ratchet, or extent
    - Ratchet is removed upon completion of performance targets
    - Ratchet is removed upon subsequent non-dilutive round

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18

Preferred Stock Privileges

Anti-dilution Protection [12]

Carve-outs from Anti-dilution

- Options grants to employees, consultants (any vs. only for authorized Pool)
- Warrants to lenders, equipment liens
  - Any vs. limited amount
  - Majority vs. unanimous board approval
- Warrants to service providers, suppliers, strategic partners (any/limited, BOD approval)
- Shares issued in mergers / acquisition
- Exercises or conversions of current stock or grants

Preferred Stock Privileges

Pay to Play

- Dilutive Financing ("down round") ➔
  - Investor must purchase his pro-rata share
  - otherwise:
    - Investor loses all anti-dilution protection ➔convert Investor's Preferred Shares to Shadow Preferred (without anti-dilution)
    - Investor loses ALL Preferred Stock privileges ➔ convert Investor's Preferred Shares to Common Stock
  - Avoid "free riding" by non-paying investors

Preferred Stock Privileges

Redemption Rights [7]

- Optional (Company Option: "Call")
  - Company can repurchase stock if Investors won't convert to Common (after x years)
- Mandatory (Investor Option: "Put")
  - Investor can force Company to repurchase shares
    - after [5-7] years – in installments over [3] years
    - get liquidity if no public market
    - But, Company must have funds legally available
  - If not paid when due
    - Investors may take over control of Board
    - Resign / Replace board seats held by Common

Preferred Stock Privileges

Redemption Rights [7]

- Redemption amount typically includes accrued, unpaid dividends → Redemption Premium
- Redemption price
  - Original purchase price
  - Premium return (FMV)

Preferred Stock Privileges

Dividends [5]

- Preferred has Priority
  - Preferred paid before Common (as-converted)
  - Preferred may participate with Common
- Discretionary vs. Mandatory
  - Discretionary: no obligation to pay ever
    - "when, as and if declared by the Board"
  - Mandatory: must pay if legally available funds exist
- Non-cumulative vs. Cumulative
  - Non-cumulative: disappears if not declared (not due)
  - Cumulative: unpaid dividends accrue (still due)
    - Cumulate: annually, bi-annually, quarterly, or monthly

Preferred Stock Privileges

Dividends [5]

- Watch out for Mandatory, Cumulative Dividends
  - Dividend may be payable in cash, or in <u>additional preferred shares</u>
  - Accrued dividend may be added to liquidation preference, if not paid when due
  - Compounds effect of participating liquidation preference

Preferred Stock Privileges

Protective Provisions [13]

- Purpose: Requires the company to seek investor approval before taking certain actions
- Series vs. Class
  - Class – need approval of [majority / some %] of all holders of Preferred Stock (all series voting together)
  - Series – need approval of [majority / some %] of all holders of an individual Series
    - May need separate approvals from other Series
    - Terminate if Series holds less that minimum % of original purchase (5-20%)

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25

Preferred Stock Privileges

Protective Provisions [13]

- Typical Preferred Stock approvals:
  - Amend Articles / Certificate (or Bylaws)
    - Alter /change rights, preferences of Series A
    - [materially and] adversely affect Series A
  - Reclassify outstanding securities into series senior or parity with Series A
  - Authorize new series – senior or parity to Series A
  - Increase / decrease authorized shares Preferred Stock
  - Merger / acquisition, sale of substantially all assets
  - Liquidation / dissolution
  - Declare or pay dividend
  - Change authorized number of Board Directors

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26

Key Control Terms

- Founder / Employee Vesting
- Board Representation
- Preferred Protective Provisions

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27

Control Terms

Vesting [24, 25]

- Required by Investors to properly motivate the Employees and Founder(s) and protect Investor's investment.
- Rank & File Employees [24]
  - 4-year vesting: one year cliff and monthly thereafter.
- Founder [25]
  - X% fully vested upon Closing, a cliff period and monthly thereafter for total of 4 years
  - Change of Control & Termination without Cause/Constructive Termination

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28

Control Terms

Board Representation [9]

- Representatives
  - Company representative (CEO)
  - Founder (if not Company representative)
  - Preferred Stock Representatives (Investors)
  - Independent Directors (industry specialist – appointed by all outstanding stock or other board members) – key issue
- Common Series A Board Makeup
  - Founder, CEO, Series A Rep (3-person Board)
  - Founder, Founder (CEO), Series A Rep, Series A Rep, Independent Rep (5-person Board)
- Non-Voting Board Observers

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29

Investor Protections And Rights

- Rights of First Refusal and Co-Sale Rights
- Information Rights
- Registration Rights

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30

Investor Protections And Rights

Rights of First Refusal (ROFR) [14, 26]

- New issuances by Company [14]
  - Investor right to purchase shares in new round
  - Up to pro-rata share of Company
  - Carve-outs for certain sales/transfers
  - Terminate: IPO, acquisition, sale of assets
- Sales by Founders [26]
  - Investor right to purchase Founder's shares (take deal offered by outside buyer to Founder)
  - Keep stock "in the family"
  - Carveouts: Gifts to Immediate Family
  - Exclusions: minimal sales allowed (5-10%)
- Rare: Cross-rights over other investors

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31

Investor Protections And Rights

Drag-Along and Tag-Along

- Drag-Along – Forced Sale Provision
  - Offer to shareholders by outside party to purchase all shares
  - If high % of shareholders accept, force remaining "holdouts" to sell
  - % required to trigger (high – e.g., 75%)
- Tag-Along (Co-Sale) [27]
  - Founder wants to sell shares and has a buyer
  - Investors have right to sell their shares (pro-rata) to Founder's buyer (instead of Founder)
  - Exclusions: minimal sales allowed (5-10%)
- Termination
  - IPO, acquisition, sale of assets, dissolution
  - Investor owns less than [5-15%] of purchased shares
  - [3-5] years after close financing
  - Majority Investors agree to terminate

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32

Investor Protections And Rights

Information Rights and Covenants

- Information Rights – Financials [15]
  - What and When?
    - Annual statements – [120 days]
    - Quarterly financials – [45 days]
    - Monthly statements – [45 days (possibly)]
    - Budgets/Plan – [30 days after close fiscal year]
  - Audited (costly, annual statements only)
  - Who gets rights (minimum holdings/transfer) – 25%
  - Termination - at IPO, acquisition, sale of assets
- Market Standoff Restriction [20]

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33

Investor Protections And Rights

Registration Rights [16, 17, 18, 19]

- Demand Registration [16]
  - Require Company to Register Investor Shares
  - IPO or Subsequent Offering (S-1 "long form")
- S-3 Registration [18]
  - "Short-form" Registration
  - Available after 1 year (if required filings made)
  - Much simpler, quicker, and cheaper

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34

Investor Protections And Rights

Registration Rights [16, 17, 18, 19]

- Issues for IPO Demand
  - Demand IPO after how many years? (3-5)
  - Minimum Offering for IPO? ($5-10M)
- Issues for all Demands
  - Number Demands allowed
    - S-1: 1-2
    - S-3: unlimited (but only 1-2 per year)
    - Minimum Offering for S-3 demand ($1-3M)
  - Minimum % Investor shares to require Demand
    - 25-40% Investor Shares
  - Can Company Delay Registration?
    - 90-120 days / strategic or market reasons

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35

Investor Protections And Rights

Registration Rights [16, 17, 18, 19]

- Piggyback Registration [17]
  - Require Company to Include Investor's Shares in Company's Subsequent Offerings (not IPO)
- Issues for Piggyback Registrations
  - Underwriter Cutbacks (up to 20-25%)
  - No piggyback on demand, S-3, benefit plans, reorganizations

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36

Investor Protections And Rights

Registration Rights [16, 17, 18, 19]

- Issues for ALL Registrations
  - Who Pays for Registration? [19]
    - Company pays (except underwriting commissions)
    - Including costs for counsel for selling shareholders
  - Minimum holding by Investor to have rights
  - Minimum amount for rights to transfer
  - Termination of rights
    - Some years after IPO (e.g., 7 years)
    - To the extent shares that can be sold under SEC Rule 144

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37

Conclusion

- Current financing environment strong and improving
  - Valuations continue to improve (along with VC investment, which increased to $6.7B (Q2'06), vs. $6.2B (Q1'06) and $6.4B (Q2'05 – on track for largest investing year since 2001)
  - Web 2.0 space very strong with large exits (YouTube, My Space)
  - IPO market still very weak for tech/web companies
  - To build interest
    - Demonstrate customers/revenue product achievement
    - Show company's progress/milestones will be when the funding is spent
    - Demonstrate large addressable market
- Negotiate the important stuff, skip the small stuff
  - Valuation/Dilution, but don't let it kill the deal
  - Liquidation Preferences
  - Protective Provisions
  - Board Control
- Materials
  - Fenwick & West Financing Materials
  - Sample Venture Capital Term Sheet (annotated)
  - Q3 2006 Quarterly Venture Capital Terms Survey

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38

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39

THIS TERM SHEET SUMMARIZES THE PRINCIPAL TERMS OF THE PROPOSED FINANCING OF _____ (THE "COMPANY"). OTHER THAN THE PROVISIONS LABELED "CONFIDENTIALITY" AND "EXCLUSIVITY", THIS TERM SHEET IS FOR DISCUSSION PURPOSES ONLY. OTHER THAN THE PROVISIONS LABELED "CONFIDENTIALITY" AND "EXCLUSIVITY", THERE IS NO OBLIGATION ON THE PART OF ANY NEGOTIATING PARTY UNTIL A DEFINITIVE STOCK PURCHASE AGREEMENT IS SIGNED BY ALL PARTIES. THE TRANSACTIONS CONTEMPLATED BY THIS TERM SHEET ARE SUBJECT TO THE SATISFACTORY COMPLETION OF DUE DILIGENCE. THIS TERM SHEET DOES NOT CONSTITUTE EITHER AN OFFER TO SELL OR AN OFFER TO PURCHASE SECURITIES.

[*COMPANY NAME*]

SERIES A PREFERRED STOCK FINANCING

SUMMARY OF TERMS

November __, 2006

[1] Amount of Financing: Five Million Dollars ($5,000,000), including the conversion of outstanding convertible notes in the amount of $500,000.

[2] Type of Security: Eight Million Six Hundred Seventeen Thousand, Eight Hundred Eighty-Six (8,617,886) shares of Series A Preferred Stock (the "***Purchased Shares***", or the "***Preferred Stock***"), initially convertible into an equal number of shares of Common Stock.

[3] Purchase Price:* $0.5802 per share (the "***Purchase Price***"), based upon a Five Million ($5,000,000) pre-financing valuation of the Company, calculated on a fully-diluted pre-financing capitalization of the Company (including a 15% post-financing stock option pool).

[4] Closing: On or around November __, 2006 (the "***Closing***").

Investors: $2.25 million each from Tech Venture Partners, LLC, and Big Returns Capital, L.P., and the holders of existing convertible notes.

Capitalization:

	Pre-Financing Shares	***%***	***Post-Financing Shares***	***%***
Common Stock:	5,000,000	58.02%	5,000,000	30.54%
Series A Preferred Stock:	0	0%	8,617,886	52.63%
Convertible Notes:	861,789	10.0%	0	0%
Common Stock Warrants:	100,000	1.16%	100,000	0.61%
Current Available Stock Option Pool:	300,000	3.48%	300,000	1.83%
Current	200,000	2.32%	200,000	1.22%

Outstanding Stock Options:				
New Future Grants:	2,156,098	25.02%	2,156,098	13.17%
Totals:	**8,617,886**	**100%**	**16,373,984**	**100%**

* Please see the attached Sample Series A Preferred Stock Financing Analysis.

Conversion of Convertible Notes: The current outstanding Convertible Notes in the amount of Five Hundred Thousand Dollars ($500,000) will automatically convert into 861,789 shares of Series A Preferred Stock at the Closing. This number of shares is included in the total number of Purchased Shares to be issued, as set forth above under "Type of Security."

Rights and Preferences of Purchased Shares:

[5] Dividend Rights: The holders of the Purchased Shares shall be entitled to receive, out of any funds legally available therefor, noncumulative dividends at a rate of eight percent (8%) of the original Purchase Price per share of the Purchased Shares, prior and in preference to any payment of any dividend on the Common Stock in each calendar year. Such dividends shall be paid when, as and if declared by the Board of Directors.

The dividend rights and preferences of the Purchased Shares shall be senior to the Common Stock.

After the dividend preferences of the Purchased Shares has been paid in full for a given calendar year, all remaining dividends in such calendar year will be paid on the Preferred Stock and the Common Stock (on an as converted basis).

[6] Liquidation Preference: In the event of any liquidation, dissolution or winding up of the Company, the holders of the Purchased Shares will be entitled to receive an amount equal to the original Purchase Price per share of the Purchased Shares, plus an amount equal to all declared but unpaid dividends thereon (the "***Preference Amount***"). After the full liquidation preference on all outstanding shares of Preferred Stock has been paid, any remaining funds and assets of the Company legally available for distribution to stockholders will be distributed pro rata solely among the holders of the Common Stock.

The liquidation rights and preferences of the Purchased Shares shall be senior to the Common Stock.

If the Company has insufficient assets to permit payment of the Preference Amount in full to all holders of Purchased Shares, then the assets of the Company will be distributed ratably to the holders of the Purchased Shares in proportion to the Preference Amount each such holder would otherwise be entitled to receive.

A merger or consolidation of the Company in which its stockholders do not retain a majority of the voting power in the surviving corporation, or a sale of all or substantially all the Company's assets, will each be deemed to be a liquidation, dissolution or winding up of the Company.

[7] **Redemption**: The Preferred Stock shall not be entitled to Redemption rights..

[8] **Voting Rights**: Each share of Preferred Stock carries a number of votes equal to the number of shares of Common Stock then issuable upon its conversion into Common Stock.

The Preferred Stock will generally vote together with the Common Stock and not as a separate class, except as provided below.

[9] **Board of Directors**: Board of Directors: The Company's Certificate of Incorporation and Bylaws shall provide for a Board of Directors consisting of five (5) members. The number of directors cannot be changed except by amendment of the Certificate of Incorporation by a vote of holders of at least a two thirds (2/3) of the outstanding Preferred Stock.

With respect to the election of the Board, so long as at least 1,000,000 shares of Preferred Stock remain outstanding, then: (a) the holders of the Preferred Stock will be entitled to elect two members of the Board; (b) the holders of the Common Stock, voting together as a single class, will be entitled to elect two members of the Board, one of whom shall be the current CEO of the Company; and (c) the holders of the Preferred Stock and Common Stock, voting together as a single class, will be entitled to elect the remaining member of the Board, whom shall be an independent director with industry experience. The Company, the holders of the Preferred Stock and the founders and other holders of Common Stock (the "***Stockholders***") shall enter into a voting agreement setting forth such an arrangement.

At the Closing, the Board of Directors shall consist of founder, founder-CEO, representative of Tech Venture Partners, representative of Big Returns Capital and industry expert.

Visitation Rights: So long as at least 1,000,000 shares of Preferred Stock remain outstanding, in the event that either Tech Venture Partners or Big Returns Capital does not have a representative on the Board of Directors, then such party (so long as it holds at least 20% of the Purchase Shares issued to it in the financing) will be entitled to appoint one person to attend the non-executive portion of Board of Directors meetings, subject to the right of the Board of Directors to exclude such observer for confidentiality or attorney-client privilege purposes.

[10] **Optional Conversion**: The holders of the Purchased Shares shall have the right to convert the Purchased Shares into shares of Common Stock at any time. The initial conversion rate for the Purchased Shares shall be 1-for-1. All rights incident to a share of Purchased Shares (including but not limited to rights to any declared but unpaid dividends) will terminate automatically upon any conversion of such share into Common Stock.

[11] Automatic Conversion: The Purchased Shares shall automatically be converted into Common Stock, at the then applicable conversion rate, upon: (i) the closing of an underwritten public offering of shares of Common Stock of the Company at a public offering price of not less than three times the original Purchase Price per share of the Purchased Shares for a total public offering price of not less than (before payment of underwriters' discounts and commissions) Ten Million Dollars ($10,000,000) (an "***Approved IPO***"), or (ii) upon the written consent of holders of not less than two-thirds (2/3) of the Preferred Stock then outstanding.

[12] Antidilution Protection: Proportional antidilution protection upon stock splits (subdivision or combination) or stock dividends or distributions on outstanding Common Stock (the "***Common Stock Event***").

The conversion price of the Purchased Shares shall be subject to adjustment to prevent dilution on a price-based broad-based weighted average basis in the event that the Company issues additional shares of Common Stock or Common Stock Equivalents at a purchase price less than the then-effective conversion price; <u>except</u>, <u>however</u>, that <u>without</u> triggering antidilution adjustments: (1) shares of Common Stock issued or issuable upon conversion of the Preferred Stock; (2) up to 2,010,345 shares of Common Stock (and/or options, warrants or rights therefor) that may be granted or issued to employees, officers, directors, contractors, consultants or advisors of the Company (or any subsidiary) pursuant to incentive agreements, stock purchase or stock option plans, stock bonuses or awards, warrants, contracts or other arrangements, as approved by the Board, (Such number of shares to be calculated net of any repurchases of such shares by the Company and net of any such expired or terminated options, warrants or rights and to be proportionally adjusted to reflect any subsequent Common Stock Event; (3) any shares of Common Stock or Preferred Stock (and/or options or warrants therefor) issuable or issued to parties that are (i) actual or potential suppliers or customers, strategic partners investing in connection with a commercial relationship with the Company or (ii) providing the Company with equipment leases, real property leases, loans, credit lines, guaranties of indebtedness, cash price reductions or similar transactions, under arrangements, in each case approved by the Board; or (4) shares of Common Stock or Preferred Stock may be issued pursuant to the acquisition of another corporation or entity pursuant to a consolidation, merger, purchase of all or substantially all the assets of such entity, or other reorganization in which the Company acquires, in a single transaction or series of related transactions, all or substantially all of the assets of such entity or fifty percent (50%) or more of the equity ownership in such entity, provided that such transaction or series of transactions has been approved by the Company's Board of Directors; (5) shares of Common Stock or Preferred Stock issuable upon exercise of warrants outstanding as of the Closing; (6) shares of Common Stock issued pursuant to a Common Stock Event; and (7) shares of Common Stock issued or issuable in a public offering prior to or in connection with which all outstanding shares of Preferred Stock will be converted to Common Stock (all of the exceptions listed as (1) through (7) above are hereinafter referred to as the "***Antidilution Exceptions***").

[13] Protective Provisions:

So long as 500,000 shares of the Preferred Stock remain outstanding, the consent of the holders of two-thirds (2/3) of the outstanding Preferred Stock shall be required for: (i) any amendment or change to the Articles of Incorporation or Bylaws that alters or changes the rights, preferences, privileges or the restrictions provided for the Preferred Stock so as to adversely affect such Preferred Stock; (ii) any reclassification of outstanding shares or securities into shares having rights, preferences or privileges senior to or on a parity with the preferences of the Preferred Stock; (iii) authorization of shares of any class of stock having rights or preferences superior to or on a parity with the Preferred Stock as to dividend rights, liquidation, redemption or voting preferences; (iv) any increase or decrease (other than by redemption or conversion) to the total number of authorized shares of Preferred Stock; (v) any merger or reorganization or consolidation of the Company with or into one or more other corporations in which the stockholders of the Company immediately prior to such event hold, immediately after, stock representing less than a majority of the voting power of the outstanding stock of the surviving corporation (other than for the purpose of changing the Company's domicile) (an "***Acquisition***"); (vi) the sale of all or substantially all the Company's assets; (vii) the liquidation or dissolution of the Company; (viii) the declaration or payment of any dividend on the Common Stock (other than a dividend payable solely in shares of Common Stock; or (ix) amend the Bylaws to change the authorized number of members of the Board of Directors.

Investors' Rights Agreement:

[14] Right of First Refusal:

Each holder of Preferred Stock shall be given the right of first refusal to purchase up to its pro rata share (based on its percentage of the Company's outstanding common shares, calculated on a Common Stock equivalent and an as-if-converted basis) of any equity securities offered by the Company (other than any issuances which are Antidilution Exceptions (as defined above)) on the same price and terms and conditions as the Company offers such securities to other potential Investors. This right of first refusal will terminate immediately prior to: (a) the Company's initial underwritten public offering of its Common Stock if it qualifies as an Approved IPO; or (b) an Acquisition or sale of all or substantially all the assets of the Company.

[15] Information Rights:

So long as a holder of Purchased Shares continues to hold at least 20% of shares of Preferred Stock (and/or Common Stock issued upon conversion of such shares) acquired by such holder in the financing, the Company shall deliver: (i) audited annual financial statements to the Investor within 120 days after the end of each fiscal year; (ii) unaudited quarterly financial statements within 45 days of the end of each fiscal quarter; and (iii) monthly unaudited financial statements within 45 days after the close of each month and as soon as practicable, 30 days after the close of the fiscal year, a copy of the Annual Operating Plan and the budget. These information rights shall terminate upon (a) the Company's initial public offering or (b) Acquisition or sale of all or substantially all the assets of the Company.

Registration Rights:

[16] Demand Rights: If after three years following the closing, holders of at least forty percent (40%) of the "Registrable Securities" (defined below) request that the Company file a registration statement covering the public sale of Registrable Securities with an aggregate public offering price of at least Five Million Dollars ($5,000,000), then the Company will use its reasonable, diligent efforts to cause such shares to be registered under the Securities Act of 1933 (the "***1933 Act***"); provided, that the Company shall have the right to delay such a demand registration under certain circumstances for a period not in excess of one hundred twenty (120) days each in any 12 month period.

"***Registrable Securities***" will include the Common Stock issuable on conversion of the Purchased Shares and all shares of Common Stock held by the two founders of the Company (the "***Founders***") for purposes of "piggyback" registration rights only. Only Common Stock may be registered pursuant to the registration rights to be granted hereunder.

The Company shall not be obligated to effect more than two registrations under this demand right provision and shall not be obligated to effect a registration during the six (6) month period commencing with the effective date of the Company's initial public offering or any registration under the 1933 Act in which Registrable Securities were registered.

[17] Piggyback Rights: The holders of the Registrable Securities shall be entitled to "piggyback" registration rights on all 1933 Act registrations of the Company (excluding any demand registration, S–3 registration or registrations relating to employee benefit plans and corporate reorganizations), subject, however, to the right of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions. However, the underwriters' "cutback" right shall be restricted so that (a) all shares held by Company employees or directors which are not Registrable Securities shall be excluded from the registration before any Registrable Securities are so excluded, and (b) the number of Registrable Securities in such registration shall be no less than 20% of the shares to be included in the Registration (except for a registration relating to the Company's initial public offering or a registration pursuant to the exercise of a demand registration, from which all Registrable Securities, not holding demand rights may be excluded).

[18] S-3 Rights: Upon a written request received from holders of twenty percent (20%) of the Registrable Securities, such holders of Registrable Securities shall be entitled to registrations on Form S-3 (if available to the Company) unless: (i) the aggregate public offering price of all securities of the Company to be sold by stockholders in such registered offering is less than Two Million Dollars ($2,000,000); (ii) the Company certifies that it is not in the Company's best interests to file such Form S-3, in which event the Company may defer the filing for up to One hundred twenty (120) days once during any 12 month period; (iii) the Company has already effected two registrations on Form S-3 during the preceding 12 months; or (iv) the registration is in any jurisdiction in which the Company would be

required to qualify to do business or execute a general consent to service of process to effect such registration; or (v) the Form S-3 is not available for such an offering.

[19] **Expenses:** The Company shall bear the registration expenses (up to a maximum of $30,000 and exclusive of underwriting discounts and commissions but including the fees of one counsel for the selling stockholders, who may be Company counsel) of all such demand and piggyback registrations, and for the first S-3 registration.

Transfer of Rights: The registration rights may be transferred to transferees acquiring at least 100,000 shares of Registrable Securities. Assignments may be made without the Company's consent and without regard to the minimum number of shares of Registrable Securities noted above if the assignment is to a partner, stockholder, parent, child or spouse of the holder, or a trust for the benefit of such individuals or to the holder's estate.

[20] **Market Standoff Provisions:** No holder will sell shares within such period requested by the Company's underwriters (not to exceed one hundred eighty (180) days after the effective date of the Company's initial public offering); provided, however, that such agreement is not applicable to Registrable Securities included in such registration statement; and provided further, that all executive officers, directors and employee-stockholders of the Company holding more than one percent (1%) of the outstanding shares enter into similar standoff agreements with respect to securities of the Company they hold that are not included in such registration. Holders agree to enter into any agreement reasonably required by the Underwriters to implement the foregoing.

Other Provisions: Registration rights provisions may be amended with the consent of the holders of more than two-thirds (2/3rds)of the Registrable Securities then outstanding. The Company agrees to keep the registration statement effective for up to ninety (90) days. Other provisions shall be included with respect to registration rights as are reasonable, including cross-indemnification.

Termination: These registration rights will terminate five (5) years after the closing of the Company's initial public offering and will not apply to any shares that can be sold in a three (3) month period without registration pursuant to Rule 144 promulgated under the 1933 Act.

[21] **Stock Purchase Agreement:** The purchase of the Purchased Shares shall be made pursuant to a Stock Purchase Agreement drafted by Company counsel reasonably acceptable to the Company and the Investors, which agreement shall contain, among other things, customary representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein, and appropriate conditions of Closing. The Stock Purchase Agreement shall provide that it may be amended by, or that any waivers thereunder shall only be made with the approval of, the holders of more than a majority of the Purchased Shares (and/or Common Stock issued upon conversion thereof).

[22] Restrictions on Sales:

The Investors will make customary investment representations, including verification of status as an "accredited Investor" within the meaning of Regulation D under the 1933 Act. The Investors agree to provide the Company with completed Investor Suitability Questionnaire to verify such status.

[23] Conditions to Closing:

Each officer and employee of the Company shall have entered into acceptable confidentiality and invention assignment agreements.

The completion of the investors due diligence of the Company.

An opinion of counsel for the Company.

[24] Covenant regarding Vesting:

Stock sold and options granted to employees will normally be subject to vesting as follows, unless otherwise approved by the Board of Directors: (a) vesting over four (4) years – twenty-five percent (25%) of the shares vest at the end of the first year, with 1/36th of the remaining shares vesting monthly thereafter over the next three years, and (b) a repurchase option shall provide that upon termination of the employment of the stockholder, with or without cause, the Company retains the option to repurchase at cost any unvested shares held by such stockholder.

[25] Covenant regarding Founder Vesting:

Stock sold and options granted to Founders will be subject to vesting as follows: (a) twenty-five percent (25%) of the shares shall be fully vested at the closing, and (b) the balance of the shares vesting monthly thereafter over the next three years, and (b) a repurchase option shall provide that upon termination of the employment of the stockholder, with or without cause, the Company retains the option to repurchase at cost any unvested shares held by such stockholder; *provided* that in the event that the Founders employment with the Company is terminated without cause or by the Founder for good reason in connection with or within twelve (12) months of an Acquisition of the Company or a sale of all or substantially all the Company's assets, then all shares then unvested shall fully vest. “Cause” and “good reason” will be defined in the definitive financing agreements.

The Company and the Investors shall each indemnify the other for any finder's fees for which either may be responsible.

Legal Fees & Expenses:

At the Closing, the Company shall pay the reasonable fees and expenses of Investors' counsel up to a maximum of Thirty Thousand Dollars ($30,000).

[26] Right of First Refusal and Co-Sale Agreement:

Right of First Refusal:

Only after the Company has exercised its right of first refusal, the holders of Preferred Stock (the "***Refusal Holders***"), shall have, on a pro rata basis, calculated based on the Refusal Holders' holdings of Preferred Stock only, a right of first refusal on the sale of current shares of Common Stock held by the Founders (the "***Transferor***"), as of the date of the transfer (the

"***Stock***") which are not purchased by the Company pursuant to its rights of first refusal. The Investor's right of first refusal shall not apply to five percent (5%) of the Stock or 250,000 shares of Stock held by each Transferor (the "***Excluded Stock***") and the term "Transfer" or "Transferred" shall not include: (i) any pledge of Stock pursuant to a bona fide loan transaction which creates a mere security interest, (ii) any gift during Transferors' lifetime or upon death or intestacy to "Immediate Family" provided such transferee agrees to be bound by the terms of the Rights of First Refusal and Co-Sale Agreement. Immediate Family shall mean the Transferor's spouse, lineal descendants or antecedents (natural or adopted), brothers, sisters or spouse of any of the foregoing, (iii) any transfer pursuant to a merger, consolidation or winding up and dissolution of the Company or an initial public offering of the Company's shares, (iv) any transfer to an Investor pursuant to the Co-Sale Rights or Right of First Refusal and (v) any transfer of Stock upon Company's exercise of its right of first refusal or right of repurchase pursuant to an agreement between the Transferor and the Company, entered into at the time of purchase of the Stock (the "***Permitted Exemptions***").

[28] **Right of Co-Sale:** The holders Preferred Stock (the "***Co-Sale Holders***"), shall have, on a pro rata basis, calculated based on a numerator which is the number of Preferred Shares owned by such Investor and the denominator which includes the Co-Sale Holders' holdings of Preferred Shares and the Transferor's holdings of Stock calculated on as-converted to common stock equivalent basis, a Right of Co-sale on the Stock which is not otherwise sold to the Company or an Investor. This Right of Co-Sale shall not apply: (1) to any Excluded Stock, plus any transfers which are Permitted Exemptions.

Termination: This Right of First Refusal and Co–Sale Right of the holders of Preferred Stock will terminate upon the earlier of (i) agreement by the Company and holders of a majority of the voting power of the Preferred Stock, or (ii) immediately prior to the close of the sale of the Company's stock in an initial public offering, or (iii) dissolution of the Company, or (iv) an Acquisition, or a sale of all or substantially all the Company's assets, or (v) the date the Investors own less than twenty percent (20%) of the Preferred Stock; or (vi) eight (8) years after the effective date of the Closing.

Counsel to the Company: Fenwick & West LLP

Confidentiality: No announcement regarding the Investors or the financing may be made without the prior consent of Tech Venture Partners and Big Returns Capital; *provided* that foregoing is not intended to prohibit (a) the Company from disclosing any of the financing terms (including information regarding investors or the financing) to its current or bona fide prospective investors, employees, investment bankers, lenders, accountants, and attorneys; or (b) disclosures deemed legally advisable under applicable governmental orders, laws, rules or regulations. This paragraph is intended to be legally binding.

Exclusivity: By accepting this Summary of Terms, and in consideration for the efforts of Tech Venture Partners and Big Returns Capital in evaluating and pursuing the transactions contemplated hereby, the Company agrees (i) not to discuss, negotiate or otherwise interact with any other persons or entities relating to the financing, recapitalization or sale of assets or business of the Company until November __, 2006, and (ii) to keep the existence and terms of this Summary of Terms confidential (except for disclosure to the Company's professional advisers and current stockholders and lender on an as-needed basis). This paragraph is intended to be legally binding.

This Summary of Terms will expire if not accepted by 5pm PST November __, 2006.

Accepted by:

Tech Ventures Partners, LLC

By: _____

Name:_____

Title: _____

Date:_____

Big Returns Capital, L.P.

By: _____

Name: _____

Title: _____

Date: _____

Accepted by:

[Company], Inc.

By: _____

Name:_____

Title: _____

Date:_____

Other than the provisions labeled "Confidentiality" and "Exclusivity", this Summary of Terms and the proposed terms set forth above do not constitute a binding agreement or commitment of the Investors, the Company or any of their affiliates. Any such agreement or commitment will only be contained in definitive agreements (containing the usual representations, warranties, conditions and covenants for this type of transaction) to be negotiated, executed and delivered, if at all, after the completion of appropriate due diligence and approval of the Company's Board of Directors. Either party to the negotiations may terminate negotiations at any time for any reason and each party will bear its own expenses if a definitive agreement is not signed.

Sample Series A Preferred Stock Financing Analysis

Series A Financing Calculation

	Pre-Financing Shares	*% of Cap*	*Post-Financing Shares*	*% of Cap*
Capital Stock				
Series A Stock	0	-	8,617,886	52.63%
Common Stock	5,000,000	58.02%	5,000,000	30.54%
Convertible Securities				
Convertible Notes (included in pre-financing)(1)	861,789	10.00%	0	-
Common Stock Warrant(2)	100,000	1.16%	100,000	0.61%
Existing Option Shares (currently available)	300,000	3.48%	300,000	1.83%
Existing Option Shares (currently outstanding)	200,000	2.32%	200,000	1.22%
New Reserved Option Shares (included pre-financing)	2,156,098	25.02%	2,156,098	13.17%
Total Option Shares (available and outstanding)	2,656,098	30.82%	2,656,098	16.22%
Totals	**8,617,886**	**100%**	**16,373,984**	**100.00%**

No. of Shares of Series A Stock		**8,617,886**
Price of Series A Stock	**$**	**0.5802**
Pre-Financing Valuation	**$**	**5,000,000**
Investment Total	**$**	**5,000,000**

Notes

Note (1): Includes shares issuable upon conversion of convertible notes with an aggregate principal amount outstanding of $500,000.

Note (2): Reflects warrants to purchase Common Stock to be issued upon conversion of the convertible notes at the closing of the Financing.

Note (3): Reflects additional shares to be reserved under the Company's Equity Incentive Plan in connection with the Financing.

Venture Capital for High Technology Companies

Fenwick

FENWICK & WEST LLP

About the Firm

Fenwick & West LLP provides comprehensive legal services to high technology and biotechnology clients of national and international prominence. We have over 250 attorneys and a network of correspondent firms in major cities throughout the world. We have offices in Mountain View and San Francisco, California.

Fenwick & West LLP is committed to providing excellent, cost-effective and practical legal services and solutions that focus on global high technology industries and issues. We believe that technology will continue to drive our national and global economies, and look forward to partnering with our clients to create the products and services that will help build great companies. We differentiate ourselves by having greater depth in our understanding of our clients' technologies, industry environment and business needs than is typically expected of lawyers.

Fenwick & West is a full service law firm with "best of breed" practice groups covering:

- Corporate (emerging growth, financings, securities, mergers & acquisitions)
- Intellectual Property (patent, copyright, licensing, trademark)
- Litigation (commercial, IP litigation and alternative dispute-resolution)
- Tax (domestic, international tax planning and litigation)

Corporate Group

For 30 years, Fenwick & West's corporate practice has represented entrepreneurs, high technology companies and the venture capital and investment banking firms that finance them. We have represented hundreds of growth-oriented high technology companies from inception and throughout a full range of complex corporate transactions and exit strategies. Our business, technical and related expertise spans numerous technology sectors, including software, Internet, networking, hardware, semiconductor, communications, nanotechnology and biotechnology.

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For more information about Fenwick & West LLP, please visit our Web site at: www.fenwick.com.

Venture Capital for High Technology Companies

Introduction

Founding your own high-growth, high technology company, financing it with venture capital and successfully bringing a product to market is a challenging experience. Entrepreneurs are dynamic people, motivated by their vision of a unique product concept and the drive to make that product a successful reality. Because founding a successful high tech company is so different from working in a large company, many new entrepreneurs are unfamiliar with the legal issues involved in creating a high tech start-up.

This booklet introduces new entrepreneurs to a variety of legal and strategic issues relating to founding and financing a start-up company, including determining your product and market, assembling the right founding team, choosing your legal structure, making initial stock issuances to founders, obtaining seed financing, negotiating the terms of your venture financing and the pros and cons of being acquired or taking your company public.

At the end of the booklet, we provide two Appendices. The first Appendix offers a set of financing scenarios that illustrate typical amounts of venture capital raised, company valuations at different stages of a company's existence and how ownership changes over time — first with a company that is successful and second with a company that undergoes a "down round" of financing. The second Appendix is a sample Series B Preferred Stock Term Sheet, illustrating the type of provisions you might see requested by a venture capitalist.

Of course, no two companies are identical and, accordingly, not all issues encountered are discussed, nor will every start-up face all of the issues discussed below. However, they are typical of the start-up companies Fenwick represents.

The following are other available Fenwick booklets:

- Acquiring and Protecting Technology: The Intellectual Property Audit
- Annual Update: International Legal Protection for Software
- Copyright Protection for High Technology Companies
- Corporate Partnering for High Technology Companies
- International Distribution for High Technology Companies
- Mergers and Acquisitions for High Technology Companies
- Patent Protection for High Technology Companies
- Patent Licensing for High Technology Companies
- Structuring Effective Earnouts
- Trademark Selection and Protection for High Technology Companies
- Trade Secrecy: A Practical Guide for High Technology Companies

Typical Start-Up Questions

What is "vesting"? "Vesting" requires founders to earn their stock over time. The company retains aright to buy back unvested stock at the original purchase price on termination of employment. In contrast to founders stock, stock options typically become exercisable as they vest.

Why do I want vesting? Vesting protects founders who remain with the company from an ex-founder becoming wealthy on their efforts if that ex-founder quits before he or she has earned his or her stock. Venture capitalists require vesting as a condition to funding your company.

How do I avoid tax liability on the receipt or vesting of founders' stock? Incorporate early and issue founders' stock at a low price to the founding team before you bring in outside investors. File your 83(b) election with the IRS within 30 days of purchase.

How are venture financings structured? Companies sell convertible preferred stock to outside investors. Employees continue to buy common stock at a fraction of the price paid by the outside investors. The price differential starts at 10 to 1 and then declines as the company nears an IPO or acquisition.

What do I have to give away in negotiations with venture capitalists? Typical deals include basic preferred stock liquidation and dividend preferences, weighted average antidilution protection and registration rights. You'll also have to agree to certain restrictions on how you run your company. Actual terms will vary depending on the quality of your company and the current financing environment.

What should I try to avoid in negotiations with venture capitalists? Avoid ratchet antidilution protection, mandatory redemption, redemption premiums, super liquidation preferences and excessive restrictions on how you run your company.

How do I protect my technology? Use nondisclosure and assignment of invention agreements and consider patent, trademark, trade secret and copyright protection at an early stage.

How do I choose a lawyer? Choose one with substantial start-up experience working with your type of business. It is also helpful if the lawyer's firm has the intellectual property, corporate and securities laws, domestic and international tax and litigation expertise that your company will need as it grows.

Threshold Issues When Starting Your Business

Identifying a Market Need

The first step in starting your new business venture is to identify a market need and the product or service that will meet that need. Too often, high tech products and businesses are launched because the founders become fascinated by their new technology without first determining whether the technological advance will cost-effectively meet customers' needs. Your products and services should be defined and shaped in response to real problems being experienced by real customers. In tough markets, you may have to show customer acceptance of your product or revenue in order to raise venture capital or angel funding.

Product Definition

You must determine the competitive edge that will make your proposed product preferable to comparable products currently used in the target market. Will your product accomplish the job faster, or be easier to use, more reliable and cheaper to produce or service? Will these advantages be long- or short-term? Critically evaluate your plan to ensure that your technological advances will provide cost-effective and reliable solutions to the customer's problem or fill new market requirements and will allow your company to become profitable.

Market Evaluation

Once you have defined your product in terms of a market need, you should evaluate that market. What types of customers will need the benefits your product offers over competing products? Is it a product that will be used by individuals, by small businesses, by Fortune 500 companies, by the government or by foreign customers? The customer base frequently dictates the distribution channels best used to reach your customers. A direct sales force may be required to reach the Fortune 500 market, while a low-priced consumer product generally will be sold through retail distribution or for end-use software via Internet downloads. How large is the market today and how large will it be in five years? A large and growing potential market is essential to obtaining venture capital. Most venture capitalists look for companies that can become profitable and attain at least $100 million a year in revenues in the next 10 years (possibly longer for bioscience companies). Knowing your customer base is a prerequisite to knowing what skills, experience base and connections you will need from your founding team and advisors.

Capital Needs

Once you have assessed your product and its market, you should determine the capital needed to fund its development and commercial exploitation. To avoid excessive dilution, the best approach is to stage the capital raised by development milestones, making sure that you raise enough money at each stage to attain your milestone with some cushion. Milestones met reduce investment risk and increase the company's valuation. Milestones missed increase investment risk and reduce the company's valuation. You also need to evaluate how quickly you want to grow the company and what capital would be needed for

slow and fast growth scenarios. Finally, consider currently available sources of capital and their expected financing terms and rates of return on their investment. Your company's capital needs will be a fundamental issue for investors, and should be presented clearly in the company's business plan.

Recruiting Your Team

Composition of the Team

After you have defined the product, its market and the skills needed to bring the product to market, the next step is to put together a founding team. The people you select to make up the founding team are vital to the success of the company. While you may not be comfortable with sharing control of ideas and profits with others, your success will depend on recognizing your strengths and weaknesses early on and recruiting people with skills to complement your own. Ideally, a well-rounded founding team should include the following key managers:

- Chief Executive Officer
- Vice President of Research and Development
- Vice President(s) of Sales and/or Marketing
- Chief Financial Officer/VP Administration

Quality Leadership

You may not be able to recruit all the members of your founding team at once. Take time to recruit the best possible people who are experienced at doing the things your business will need to succeed. Be realistic about your own skills. If you have not had direct experience in managing and growing an organization, recruit a strong CEO who knows how to build a company and translates ideas into successful products. Your ability to obtain funding and the ultimate success of your business depends on the excellence of the people you recruit for your founding team.

Inexperienced key managers in a start-up are more likely to fail and need to be replaced as the company grows. Hiring key replacements is disruptive to your organization and will result in additional dilution of the ownership interests of the original founders. The percentage of the company that the founders will be able to retain is a direct function of their ability to handle key management roles well throughout the company's growth. The financing scenario at the end of this booklet, which shows the founders retaining 22 percent of the company's stock at the initial public offering, assumes a strong founding team in a company needing relatively little outside capital. A weaker team or one that requires larger capital infusions could retain less than 3-5 percent of the company's equity by the initial public offering.

Board of Directors

In addition to recruiting your founding team, you will need to recruit people to serve on your company's board of directors. The board of directors is the governing body of the

corporation, owing fiduciary duties to all shareholders. It elects the company's officers and approves all major decisions. The board takes action by majority vote.

As a result, a founder-CEO-director, who owns a majority of the shares, can still be outvoted on the board on such important matters as sales of additional stock and the election of officers. Thus, careful selection of an initial board is essential. You want board members whose judgment you trust (even if they disagree with you) and who can provide you with input and resources not available from your management team. You might also consider recruiting industry experts to serve on an advisory board to assist you with technology and marketing issues.

Legal Structure

The next step is selecting the legal structure for your company. You have a choice among the following structures:

- Proprietorship
- Partnership or LLC
- Corporation
- S Corporation

Although most high tech companies are corporations, it is sometimes preferable to organize your business as a proprietorship or partnership. Before choosing your legal structure, consult with legal and accounting advisors. The following summary can help you select the right structure for your business.

Proprietorship

A proprietorship is simple. You own your own business. You and your business are considered one and the same — there is no legal distinction. All income received by the business is taxable to the individual proprietor, and the proprietor has unlimited liability for all obligations and debts of the business. Although this structure is not recommended for high-growth companies, it may be beneficial for inventors who wish to license their technology for royalties. Typically, an inventor will pay far less income tax as a proprietorship than as a corporation.

Partnership

In a partnership, two or more people operate a business together and divide the profits.

General Partnership: In a general partnership, any partner can bind all other partners for actions within the scope of the partnership's business. All partners have equal management rights and unlimited liability for partnership obligations.

Limited Partnership: In a limited partnership, there are two types of partners, passive and active. The passive or limited partners have no say in day-to-day management. Their liability,

like that of shareholders in a corporation, is limited to their investment in the partnership. The active or general partners act as they would in a general partnership.

In both types of partnerships, profits and losses can be allocated among the partners in varying ways and are taxable to the partners when recognized by the partnership. The ability to allocate initial losses to limited partners, within IRS limits, makes partnerships attractive for financing tax-advantaged research and development transactions. While investors in a corporation generally cannot deduct money invested until the stock is sold or becomes worthless, partners can currently deduct their share of a partnership's losses. Limited liability companies (LLCs) are similar to limited partnerships, but are typically inappropriate for fast growth companies since, unlike corporations, they do not easily accommodate employee option plans and a corporation cannot do a tax-deferred acquisition of an LLC.

Corporation

The most common structure used by high tech companies is the corporation.

A corporation is a legal entity that is separate from the people who own and operate it. The shareholders own the corporation and elect a Board of Directors. The Board of Directors governs the corporation and appoints the officers who manage its day-to-day business.

A corporation pays income tax on its income, while its shareholders generally pay income tax only on dividends received. Shareholder liability for corporate obligations is generally limited to their investment in their shares.

One advantage of a corporation is that it can have different classes of stock with different rights. In addition to common stock, it can create and sell preferred stock, having preferences over the common stock. The preferences justify selling common stock to employees who provide "sweat equity" in the business at a substantial discount from the price paid by outside investors for the preferred stock. If your company will need substantial capital, intends to grow rapidly and/or will have substantial numbers of employees requiring equity incentives, you should probably incorporate.

S Corporation

If you won't seek venture capital immediately, but want a corporate structure, you should consider electing to be treated as an S corporation. An S corporation is treated much like a partnership for tax purposes. Corporate income and losses will pass through to the shareholders, enabling the founders to offset their other personal income with the corporation's initial losses.

There are strict rules regarding S corporations. An S corporation can have only one class of outstanding shares and no more than 75 shareholders. Shareholders must be U.S. resident individuals or trusts (not partnerships or corporations). These rules make it impractical for

most high-growth start-ups to remain S corporations. For example, upon the sale of common stock to a corporate investor or a venture capital partnership or the sale of preferred stock to any investor, S corporation status will automatically be lost. You can, however, start as an S corporation and later elect to be treated as a C (or normal) corporation.

Initial Stock Issuances to the Founders

If you select the corporation as your form of business entity, the next step is to incorporate the company and issue stock to the founders. You will need to consider stock valuation, income tax considerations, vesting and buy-back rights, the availability of seed financing and compliance with securities laws.

How do You Value Founders' Stock?

It is often difficult to estimate the value of a start-up since it has no business or earnings history. Typically, there is no readily ascertainable value for the stock issued, so founders' stock is usually issued at a nominal price, such as $0.001 per share, paid in cash. However, if you or other founders contribute property or rights to previously existing technology or inventions, you must value the property contributed in exchange for the stock.

It is important to make founders' stock issuances as early as possible to avoid potential adverse income tax consequences. If stock is issued to employees at a low price at the same time that it is issued to outside investors at a higher price, the IRS will treat the difference between the two prices as taxable compensation to the employee.

How do Founders Avoid Income Tax Liability?

There are several ways to avoid income tax on founders' shares when selling equity to other investors.

- Issue the founders' stock early and allow time to pass before issuing stock to outside investors at a higher price.
- Create value in your company between the issuance of founders' stock and issuances to investors. You can create such value by writing a business plan, creating a product prototype or signing a letter of intent with a prospective customer.
- Create a two-tiered capital structure of common and preferred stock. Preferred stock preferences justify charging outside investors a higher price than employees who purchase common stock.

Vesting Schedules and Buy-Back Rights

Because founders buy their initial equity at a nominal price, they should "earn" their stock over a "vesting" period based on their continued service to the company. A typical vesting arrangement would provide that shares vest over four years, with no shares vesting in the first year of employment, 25 percent of the shares vesting at the end of that year, with two percent of the shares vesting monthly thereafter. Since there is a risk of job loss in an

acquisition, some vesting arrangements accelerate the founders' vesting by 12 months or more if the company is acquired.

Your company should retain the right to repurchase an employee's unvested shares at the original purchase price on termination of employment. A minority of companies also retain the right to repurchase vested shares on termination of employment at the then-current fair market value of the company's stock although that has adverse accounting implications. In addition, most private companies retain a right of first refusal on shareholder resales of their stock, primarily to keep stock from falling into unfriendly hands.

Why Have Vesting and Buy-Back Rights?

Vesting is important, even though many founders dislike it. Best intentions notwithstanding, all the original members of a founding team may not remain with the company. Some conflict may arise causing one or more team members to leave the venture. If this happens in a company without vesting, enormous resentment results towards the ex-founders who keep their stock and "free-ride" on the efforts of those who continue to build the company.

With vesting and buy-back provisions, an ex-founder is allowed to keep only those shares that vested during his or her tenure. This is more fair and reflects the ex-founder's actual contribution to the company's success.

On a more pragmatic note, if you and the other founders do not impose vesting, the venture capitalists will. Since venture capitalists generally bring the first substantial capital to most start-ups, they will insist that the founders earn the value contributed by the financing over a standard-vesting period before they invest.

What is an 83(b) Election?

Whenever your company reserves the right to buy back stock at the original purchase price on termination of your employment, you should consider filing a Section 83(b) election with the IRS. By filing this election, you, as the purchaser, are electing to be taxed immediately on the difference between the fair market value of the stock and the price you paid for it. If you paid fair market value for the stock, then you will not pay any taxes as a result of the election.

If you do not file a Section 83(b) election within 30 days of your stock purchase, you will be taxed on each vesting date on the difference between the fair market value of the shares vesting on that date and the price paid for them. That difference could be substantial if the company's stock value substantially appreciates, and the tax may be payable before the shares can be sold.

How do you Protect Your Company's Technology?

Next to your people, your company's inventions and technology may be its most precious assets. A few simple steps are necessary to protect that technology. If the founders have

developed technology prior to incorporating the company, have them assign the intellectual property rights to the company. From the very beginning, all company employees should sign the company's standard form of confidentiality and assignment of inventions agreement. Have third parties sign a nondisclosure agreement before giving them access to your confidential technology. Consult competent intellectual property counsel to find out if your technology qualifies for copyright or patent protection. Rights can be lost if notice and filing requirements are not met in a timely fashion. Consult trademark counsel before you select your company, product and domain names to find out if they infringe someone else's trademarks and to take the steps necessary to obtain exclusive rights to those names. (See the Fenwick booklets on Copyright, Trade Secrecy, Trademark and Patent Protection for a detailed discussion of these issues.)

Preparing a Business Plan

A business plan is an excellent tool for planning your business and assessing your performance. It also can help sell your company to potential investors. The time invested in developing a good business plan will have major long-term returns.

The business plan should be no more than 25 to 30 pages long. It should be prefaced by a two-page "executive summary" highlighting the following topics that should be set forth in greater detail in the actual business plan:

- Company description, location, and history;
- Product(s) to be developed and underlying technology;
- Size and growth rate of the market;
- Competition;
- Company's competitive advantage;
- Management team;
- Financial summary of projected revenues and income, balance sheets and cash flow statements for five years, with monthly detail for the first two years and
- Amount and structure of the proposed financing.

The bulk of the business plan should focus on the issues the venture capitalists are most interested in: the size and growth rate of the market, your targeted customers, competitors and your competitive advantage and the background of the management team. The business plan should not be a technical treatise on product development or market analysis. You should address these issues, of course, but it is preferable to compile an appendix to the business plan containing that information to be provided to investors who show serious interest. If you have never written a business plan, consult some of the detailed materials provided by many major accounting firms. Before presenting it to the venture capitalists, have it reviewed by counsel experienced in venture capital investments.

Seed Financing

What is Seed Financing?

Some founding teams with strong track records can raise venture capital without a business plan or a product prototype. Most people, however, find it necessary to seek a small amount of "seed" money from friends, relatives, angels or "seed round" venture capitalists. This seed money is used to support the fledgling company while a business plan is written or a product prototype is developed.

Where can you Find Seed Money?

Obtaining capital from outside investors during the early stages of your company's development may be difficult. Since only small amounts of money are usually required at this early stage, friends and family may be a realistic source of seed money. Accept money only from those who are sophisticated enough to understand the risk and who can afford to lose their investment. Doing so helps you comply with securities laws and maintain good relations if your company does not succeed.

Few start-ups can obtain seed money from the venture capital community. For an as yet unproven start-up, it can take six to eighteen months to build venture capital contacts, educate them about your product idea and convince them of the strength of your founding team.

Given these difficulties, it may be better for your start-up to try to attract "angels" or "advisory investors," such as a successful entrepreneur with self-generated wealth in a related industry. This type of investor will understand the merits and weaknesses of your business idea. More important still, these investors can be invaluable in helping you pull together the company and in introducing you to the venture community.

Compliance with Securities Laws

Although your company's initial resources will probably be limited, you must comply with federal and state securities laws when issuing stock or granting employee stock options. At a minimum, noncompliance gives purchasers a rescission right that can compel your company to refund the entire purchase price of the stock. You and your company might also be subject to fines and criminal liability. Meeting the legal requirements is not necessarily expensive if you have competent legal counsel to advise you before you offer to sell the stock. Exemptions from the costly process of registration with the Securities and Exchange Commission (SEC) will usually be available if you are careful in selecting the investors to whom you offer the securities and in making the offer. Filings with federal and state securities agencies may also be required.

What do the Venture Capitalists Want?

Most venture capitalists are looking for a company that can be profitable and grow to at least $100 million or more in revenues in 10 years (possibly more for bioscience companies). They are looking for large and growing markets where there is a demonstrable need for the product the company plans to develop. Many venture capitalists say that they would rather take a technology risk (can the product be developed?) than a market risk (will people want the product?). Technology risks are generally eliminated earlier when the capital needed and the company's valuation are less, while market risks will not be eliminated until after the product has been completed and introduced into the market. Venture capitalists also tend to "invest in people" rather than in ideas or technologies. Hence the strength of the management team is the most crucial element in raising money.

Financing—the First Round

How Should you Select a Venture Capitalist?

Selecting the right venture capitalist is as important as picking the right founding team. Take the time to talk to the venture capitalist to ensure that you can work well together. Look for someone who knows your industry. An ideal candidate would be someone who knows your product or market and is located close enough to your company to be available when you need help. It is also important as you launch your business to get people who have the depth and breadth of experience that you may initially lack.

If chosen correctly, venture capitalists can provide a wealth of information on management techniques, problem solving and industry contacts. They also can offer a broader perspective on your product's market fit, as well as additional funding as your company grows.

If, on the other hand, a venture capitalist is incorrectly chosen, you may find that the capital invested is tied to needless operating restrictions and monthly headaches at board meetings where you will regularly be asked why you are not "on plan." Where funding is available from several venture firms, ask the CEOs of their portfolio companies about their experience with the respective venture capitalists.

How do you Find Venture Capitalists?

There are many sources of basic information about venture capital firms. Some of the published sources include Pratt's Guide to Venture Capital Sources and the Directory of the Western Association of Venture Capitalists. Venture One has the best database on venture capitalists and the companies they fund. Through it you can find out which venture capital firms invested in similar companies and which partners of those firms sit on their Boards of Directors. While this database is not available to the public, most major law firms with a startup focus have licenses to it.

The best way for you to meet venture capital investors is to be introduced to them through successful entrepreneurs who have been funded by them. Other good sources include lawyers, accountants and bankers who focus in working with high tech companies. If at all possible, make sure that you are introduced or have your business plan forwarded to the venture capitalist by one of these people. While your business plan has to stand on its own merits, an introduction from a credible source can ensure it more than a cursory review and can result in useful feedback if the venture capitalist decides not to invest.

How Much Money Should you Raise?

In the first round of venture capital financing, you should try to raise a sufficient amount of capital to fund product development. The business plan usually will set a demonstrable risk-reducing milestone, such as having a working product ready for production. Given the seemingly inevitable delays in product development and the time it takes to arrange the next round of financing (at least two to six months), you should build some cushion into the amount you raise.

How Much is Your Company Worth?

Determining the value of your company at this early stage is more of a "mystic art" than a calculated formula. In theory, investors attempt to estimate the value of the company at some time in the future (say 10 to 20 times earnings in year five). They then discount that value to a present value with a desired rate of return. If the investor is looking for a tenfold return in five years and the company is expected to be worth $50 million in five years, it may be worth $5 million today.

In practice, however, venture capitalists seem to estimate the amount of cash required to achieve some development milestone and, often without regard to how much that is, equate that amount to 50 to 60 percent of the company (fully diluted for employee shares — see Employee Stock Plans below). The best way to find out how your company is likely to be valued is to look at what valuations venture capitalists are giving to other companies at the same development stage and in the same general market area.

Venture Capitalists will give your company a "pre-money" valuation based on its stage of development. Your pre-money valuation is the price per share that they are offering you times all of the outstanding stock, options and pool reserved for future employees. When discussing a pre-money valuation, remember to clarify the size of pool contemplated by the venture capitalists. Adequate shares for one year is typical. After the venture funding, your "post money" valuation is easy to determine. Just multiply the fully diluted outstanding capital of your company by the price per share paid by the last round investors.

The Structure of a Typical Venture Financing

Why Have Preferred Stock?

Companies typically sell convertible preferred stock to venture investors at a substantial premium over the price charged to the founders or the seed investors. At a minimum, the preferred stock gives the investors a liquidation preference in the event the company fails or is acquired. In addition, they usually obtain certain other preferential rights over the holders of common stock. From your company's point of view, these preferences justify a fair market value differential between the preferred stock and the common stock. This enables your company to continue to sell common stock to your employees at a lower price than is paid by the preferred investors.

Typical Preferred Stock Preferences

There are six basic types of preferences granted to preferred stock.

Liquidation Preference. Upon liquidation of the company, the preferred stock has the right to receive a fixed-dollar amount before any assets can be distributed to the holders of common stock. Typically, the liquidation preference is the purchase price plus accrued but unpaid dividends. A "participating" preferred stock also participates with the common stock in the distribution of any assets left after payment of the liquidation preference. In addition to actual liquidations, venture capitalists also want to receive their liquidation preference on a company merger. This provision will give the preferred shareholders the right to receive at least their original investment back in the event of a merger and sometimes a multiple return on their money before the common shareholders will participate.

Dividend Preference. Most preferred stock is given a dividend preference over the common stock. There are two types of dividend preferences. A "when, as and if declared, noncumulative" dividend preference means that the company cannot declare dividends on the common stock until a specified dividend is paid on the preferred stock. By contrast, a "mandatory, cumulative" dividend preference is more like an interest provision, since it requires the company to set aside and pay dividends on the preferred stock at a designated rate. Most high tech companies do not pay dividends, and by agreeing to mandatory, cumula-tive dividends you may adversely affect your company's cash flow and put it at a competitive disadvantage. Mandatory dividends are not frequently used, but if they are, it is usually in conjunction with mandatory redemption by investors.

Redemption. There are two kinds of redemption provisions. An "optional" redemption provision lets the company repurchase or redeem the preferred stock at its purchase price plus a redemption premium. The company can thus force the preferred stock to convert to common stock or face redemption. A "mandatory" redemption provision lets the investors require the company to repurchase the investors' preferred stock at its purchase price plus a redemption premium. Investors may want the right to recover their initial investment, plus a

profit, if the company fails to meet expectations. Companies dislike mandatory redemption because the investment is more like debt than equity. Under current tax rules, excessive redemption premiums can result in imputed income to the holder of the preferred stock even if the premium is never paid by the company. To avoid this problem, it is prudent to follow the IRS safe harbor provisions by limiting any redemption premium to 1/4 percent per year.

Conversion Rights. Preferred stock issued in venture financings is almost always convertible into common stock at the holder's option. There is also a provision for automatic conversion upon the initial public offering of the company's stock or upon the vote of a majority of the preferred stock. To encourage investors to support the company when it is forced to raise money at a lower price than its previous round, you could have a provision that automatically converts preferred stock to common if the holder declines to purchase his or her pro rata share of a lower priced offering. This is referred to as a "pay to play" provision. Another form of "pay to play" provision will have such holder's shares automatically convert to a "shadow" preferred — identical to the original series of pre-ferred, but without antidilution protection. Typically, the preferred stock will be initially convertible on a one-to-one ratio. The conversion ratio is actually calculated by taking the original purchase price and dividing it by the conversion price. The initial conversion price is normally the original purchase price. The conversion ratio is adjusted for dilutive events or issuances, as discussed in Antidilution Protection below.

Antidilution Protection. Convertible preferred stock always contains provisions protecting it against dilution from stock splits and stock dividends, sometimes called "event protection." Frequently, there are also provisions protecting it against future sales of stock at lower prices, called "price protection." The most common price protection and that are most favorable to your company is a "weighted-average" adjustment of the conversion price. The weighted-average formula adjusts the conversion price by means of a weighted formula based upon both the sale price and number of shares sold. There are two types of weighted average antidilution: "broad based" and "narrow based." Broad-based protection includes preferred and options as well and stock dividends, sometimes called "event protection." Frequently, there are also provisions protecting it against future sales of stock at lower prices, called "price protection." The most common price protection and that are most favorable to your company is a "weighted-average" adjustment of the conversion price. The weighted-average formula adjusts the conversion price by means of a weighted formula based upon both the sale price and number of shares sold. There are two types of weighted average antidilution: "broad based" and "narrow based."

Broad-based protection includes preferred and options as well as common stock in the calculation and will result in a smaller adjustment if there is a "down" round of financing. Narrow-based protection may exclude options or the preferred and is less favorable to the company. If the investors think they are paying too much for the preferred, they may insist on "ratchet" antidilution protection, which drops the conversion price to the most recent

lower price at which stock was sold, regardless of how many shares were sold at that price. This protects investors who decline to participate in lower-priced offerings. The second scenario in Appendix A illustrates the effect of antidilution protection as converted to common-percentage stock ownership. In both cases, you should ensure that employee stock issuances and stock issued in mergers and lease financings are excluded from the definition of "dilutive issuances." Some venture capitalists won't include price-based antidilution protection so as to put more pressure on investors to support the company in bad times.

Voting Rights. Preferred stock typically votes with the common stock, on an "as if converted" into common stock basis. In addition, the preferred stock may be given the right to elect a certain number of directors to the company's Board of Directors, with the common stock electing the remainder. Applicable corporate law also gives the preferred stock class voting rights on certain major corporate events, such as mergers or the creation of senior preferred stock. Investors may wish to expand the items requiring a separate class vote. It is generally preferable to avoid series-voting rights since that gives a given series a veto right over items that might otherwise be approved by the shareholders as a whole and by each class of shareholders.

Registration Rights

In addition to the preferences discussed above, venture capitalists require an avenue to liquidity. This is usually achieved by a registration-rights agreement giving the investors the right to require your company to go public and register their shares with the SEC. These registration rights are called "demand rights." The investors may also have the right to require your company to register their shares with the SEC when the company decides to go public. These rights are referred to as "piggyback rights." In both cases, the company usually pays related expenses.

Typical Restrictions Imposed on Management

Venture capitalists generally require certain commitments from your company about its post-financing management. The covenants that you are likely to encounter are affirmative and negative covenants, rights of first refusal and co-sale rights.

Affirmative covenants generally require your company to provide the investors with ongoing financial information and access to the company's records and management and may grant the investors the right to board representation or board visitation rights.

Conversely, investors may also require negative covenants or company agreements not to take specified actions without the investors' consent. Your management must carefully evaluate these covenants to ensure that they will not unduly interfere with your board's ability to manage the company.

Investors also may obtain a "right of first refusal" on further stock issuances by your company. Typically, these provisions will give the investors the right to buy their proportionate share of any new stock offerings prior to the public offering. You should avoid a right of first refusal giving investors the right to buy all of a new issuance because that could make it hard for the company to attract new investors. In addition, certain types of offerings (such as stock issued in mergers, lease financings and to employees) should be excluded from the investors' right of first refusal.

In addition to these restrictions, the venture capitalists may require that the founders personally sign a co-sale agreement. A co-sale agreement gives the venture capitalists the right to participate in any proposed sale of the founder's stock to third parties. The reason for a co-sale agreement is that the investors generally do not want the founders to "cash out" without giving the investors the same opportunity. Both the right of first refusal and co-sale agreement should terminate upon a public offering or the company's acquisition.

Employee Stock Plans

Companies typically establish employee stock option plans to provide equity incentives for employees. Start-up companies are high risk and cash-flow constraints often mean that employees may be asked to accept below-market salaries to conserve cash in the start-up phase. Consequently, equity plans are essential to attract and retain top quality people in a start-up. The number of shares reserved for employee plans is typically 10 to 20 percent of the outstanding shares. It is typical for early stage companies (though not approved by the IRS) to establish a fair market value for common stock for such employee plans within a range of 10 to 20 percent of the most recent value of the preferred stock. This price differential must disappear as you approach a public offering or acquisition of the company or the company may be required to take a "cheap stock" charge to earnings by the SEC.

Corporate Partnering

As your company completes product development and moves into manufacturing and distribution, you should consider structuring some kind of partnering arrangement with one or more major corporations in your field. A strategic alliance with a major corporation can sharply accelerate your growth by providing you with an established manufacturing or distribution infrastructure, credibility, influence and immediate access to both domestic and international customers. (See the Fenwick booklet on Corporate Partnering for High Technology Companies for a detailed discussion on finding and negotiating partnering arrangements.)

When Should you Consider an Acquisition?

Many good companies discover after a number of years of effort that it is going to be difficult (if not impossible) to attain the level of revenues and profits set forth in their initial business plan. The product development cycle may be longer than anticipated, the market too small, the barriers to entry too great, distribution channels may be clogged, the company may not be able to develop follow-on products or the management team may not be up to the challenge of growing the company beyond a certain size. While any of these difficulties may restrict the company's future growth, the company's product or management team could still be highly valuable in the hands of a strategic buyer. For such companies, an acquisition may give investors a quicker and more certain path to liquidity. Alternatively, many technology companies have used acquisitions of related products or companies as a means to accelerate their own growth to the critical mass necessary for success. Since change seems to be the only constant in the life of a high tech company, you need to keep an open mind about the advisability of being acquired or acquiring other companies. (See the Fenwick booklet on Mergers and Acquisitions for High Technology Companies for a detailed discussion on issues and negotiating strategies in technology company acquisitions.)

Financing—the Second Round

At the next appropriate financing "window," or as your company begins to run out of cash, you may seek a second round of venture capital to start the next milestone of your business plan or to adapt to changed market conditions. How much control you are able to exercise during subsequent rounds of financing depends largely on how successful you have been in managing the planned development and growth of the company with previous funding and the degree to which investment capital is available.

Successful Companies

If your company has proven its ability to "execute" its business plan, you should be able to raise money at a substantial premium over the first-round, perhaps one and one-half to two and one-half or more times the first round price. The first-round venture investors will participate in the second round financing, typically providing one quarter to one half of the money in the second round. A lead investor representing the "new money" generally will set the second-round price and its terms and conditions. If the company runs out of cash before the lead investor is found, the current investors may "bridge" the gap by giving the company a bridge loan that will automatically convert into the next round series of preferred stock. Investors typically receive market rate interest and warrants for making bridge loans.

Unsuccessful Companies

If your company has fallen measurably short of its plan, finding new investors will be a problem and your existing investors may need to fund a greater percentage of the round.

Since the company will be in a weaker bargaining position, it may have to raise money at a lower price than the first round, triggering antidilution protection and causing significant dilution to the founders. More onerous preferred stock terms are likely, including pay-to-play provisions, ratchet-antidilution protection and multiple-liquidation preferences. In addition, the venture capitalists may force you to change management, replace the CEO, impose more rigorous controls over the company's management or force personnel layoffs.

When the existing investors lead a "down" round financing, it raises conflict of interest and fiduciary duty issues since the investors who are pricing the deal offered to the company are the same people who are approving the deal on the company's board of directors. Down-round financings should be structured to minimize the risk of liability to the board and its investors and maximize the fairness to the company's shareholders. For example, the company should conduct a "rights offering," permitting all company shareholders who are qualified investors for securities law purposes to participate in the offering and it could obtain an independent appraisal of the pre-money valuation of the company. Because down-round financings raise so many legal issues, consult your corporate counsel on how to best address these issues.

The Initial Public Offering

What are the Prerequisites for Going Public?

In order to go public, your company should establish a consistent pattern of growth and profitability and a strong management team. Your company's ability to go public will depend on market factors, as well as the company's revenue and profitability rate, its projections for future revenue and profit and the receptivity of the securities market. When market interest in technology is high, companies can be valued at levels that seem unrelated to their balance sheets or income statements. There is enormous pressure on companies to go public during these market windows. However, the IPO market is volatile and reacts to factors that are outside your company's control. Even if your company has met the profile described above, you may find that the IPO market window is effectively closed. If that happens, your only options may be self-funding, seeking additional venture funding or a sale to an established company.

Advantages of Going Public

There are two principal advantages to going public. First, the company can raise a larger amount of capital at a higher valuation than it could obtain from private investors because "public" shares can be freely resold. Second, going public can boost your company's sales and marketing by increasing its visibility. From the individual's point of view, some venture capitalists and key managers may sell a small portion of their stock in the initial public offering (IPO) or a follow-on offering, giving them liquidity.

Beyond these advantages, the founders achieve a psychological sense of financial success. Before the IPO, they owned shares with no market and no readily ascertainable price. After the offering, the public market sets the price and provides them liquidity.

Disadvantages of Going Public

There are a number of disadvantages to going public. A public offering is expensive. For example, if your company wanted to make a $40 million offering, the underwriters typically would take a seven percent commission on the stock sold, and the legal, accounting and printing fees would exceed $1.2 million. Once public, your company must publish quarterly financial statements and disclose information you previously considered confidential. The SEC is increasing the scope of information public companies must make available to the public and holding the CEO and CFO responsible for the accuracy of the information provided to the public. In making business decisions, your company's Board of Directors will have to consider the effect on the company's stock price. Failing to meet analysts' expectations can lead to a dramatic drop in the company's stock price. In a very real sense, entrepreneurs tend to feel that they lose control of "their" company after the IPO.

Conclusion

For many high technology start-ups, a venture capital financing strategy is the only realistic way that their new product ideas can be successfully developed and introduced into the marketplace. Without the capital infusions and the management assistance of venture capitalists, many of these companies' products simply would not make it to the public market. Entrepreneurs have an abundance of good ideas and the drive to realize them. The management and market experience they may lack can be provided by the relationships they develop with experienced venture capitalists, accountants and lawyers who focus in working with high technology companies.

Appendix A: Illustrative Financing Scenarios

In order to give you a better idea of what you can expect in the way of share ownership or company valuation if you decide to pursue a venture capital financing strategy, we have prepared two illustrative financing scenarios. Both assume that the company was able to raise the necessary funding to develop and bring its product to market and that the company's product was ultimately accepted by the marketplace. The first scenario assumes a strong, experienced founding team, with strong and continuous growth in product development, marketing and sales, while the second assumes a less experienced team that stumbles, but does not fail, in its objectives, but faces the effects of a down-round financing.

It is difficult to generalize about the percentage ownership founders may retain by their company's IPO. While these scenarios provide some realistic parameters, actual valuations will depend on the attractiveness of the given investment and market conditions at the time.

Highly Successful Team

If you gathered a very strong management team, developed a product with strong market acceptance and were both lucky and particularly successful at executing your business plan, your company's valuation round-by-round and the distribution of your company's outstanding shares at the IPO might be similar to that set forth below:

Shareholders	No. Shares	Purchace Price	Dollars Invested	Company Valuation	% Ownership at IPO
Founders (Common)	4,250,000	$ 0.001	$ 4,250	$ 4,250	22 %
Seed Investors (Preferred)	1,000,000	0.50	500,000	2,625,000	5
Round 1 Inv. (Preferred)	3,500,000	2.00	7,000,000	17,500,000	18
Employees (Common)	1,750,000	0.20	350,000	21,000,000	9
Round 2 Inv. (Preferred)	5,000,000	4.50	22,500,000	69,750,000	26
Employees (Common)	2,000,000	0.45	900,000	78,750,000	10
Public (Common)	2,000,000	20.00	40,000,000	390,000,000	10
Total	19,500,000				100 %

Less Experienced Team

The scenario can be very different if you are unable to attract a highly experienced management team. Inexperienced managers may fail to meet the intensive demands of a high-growth start-up. For this scenario, we have assumed that the company fails to complete product development on time and has to raise additional capital without a completed product. As a result, two of the five founders are replaced with more experienced management before the second round of venture financing. The number of founders' shares at the IPO is less than in the first scenario because the company repurchased the ex-founders' shares on termination of employment. While more capital was needed to complete the product and launch it into the market, the second round financing was done at a lower price per share than the first round because the company had not yet removed the product development risk and the doubts that created about management. In addition, the "As Converted Ownership % @ IPO" column reflects the effect of ratchet or weighted-average-antidilution protection triggered by the "down" round. After the "down" round of financing, the company is then able to get back on track and raise the additional private capital needed at a step-up in valuation. The additional dilution from the lower valuation of the round two financing and the resulting increase in the number of shares of common stock into which the round one preferred stock will convert, dilutes the founders' percentage ownership far more than in the first scenario. Under this scenario, the company's valuation round-by-round and the distribution of the company's outstanding shares at the IPO might be similar to that set forth below:

Shareholders	No. Shares	Purchace Price	Dollars Invested	Company Valuation	% Ownership at IPO (no Anti-dilution protection)	As Converted Ownership % at IPO	
						Ratchet	Weighted Average
Founders (Common)	2,000,000	$ 0.001	$ 2,000	$ 2,000	6.8%	6.1 %	6.5%
Seed Investors (Preferred)	1,000,000	0.50	500,000	1,500,000	3.4	3.1	3.3
Round 1 Inv. (Preferred)	3,500,000	2.00	7,000,000	13,000,000	11.9	21.3	15.7
Employees (Common)	1,750,000	0.20	350,000	16,500,000	6.0	5.3	5.7
Round 2 Inv. (Preferred)	0,000,000	1.00	10,000,000	18,250,000	34.1	30.5	32.6
Employees (Common)	1,750,000	0.20	350,000	20,000,000	6.0	5.3	5.7
Round 3 Inv. (Preferred)	6,000,000	4.00	24,000,000	104,000,000	20.5	18.3	19.6
Public (Common)	3,333,334	12.00	40,000,000	352,000,008	11.4	10.2	10.9
Total:	9,333,334					100 %	

Appendix B: Series B Preferred Stock Term Sheet

Amount of Financing:	$7,000,000		
Type of Security:	3,500,000 shares of Series B Preferred Stock ("Series B Preferred")		
Purchase Price:	$2.00 per share (a $14 million pre-money company valuation)		
Projected Postfinancing Capitalization:		**Number of Shares**	**%**
	Common Stock	4,250,000	40%
	Series A Preferred	1,000,000	10%
	Series B Preferred	3,500,000	33%
	Employee Options	1,750,000	17%
	Total:	10,500,000	100%

Rights and Preferences of Series B Preferred

Dividend Rights The holders of the Series A and Series B Preferred Stock (collectively the "Preferred Stock") shall be entitled to receive, out of any funds legally available therefore, dividends at a rate of eight percent per year (i.e., $.04 and $.16 per share for the Series A and B Preferred, respectively) prior and in preference to any payment of any dividend on the Common Stock. Such dividends shall be paid when, as and if declared by the Board of Directors and shall not be cumulative.

Liquidation Preference In the event of any liquidation, dissolution or winding up of the Company, the holders of the Preferred Stock will be entitled to receive an amount equal to their original issue price per share, plus an amount equal to all declared but unpaid dividends thereon (the "Preference Amount"). If there are insufficient assets to permit the payment in full of the Preference Amount to the preferred shareholders, then the assets of the Company will be distributed ratably to the holders of the Preferred Stock in proportion to the Preference Amount each holder is otherwise entitled to receive.

After the full Preference Amount has been paid on all outstanding shares of Preferred Stock, any remaining funds and assets of the Company legally available for distribution to shareholders will be distributed ratably among the holders of the Preferred and Common Stock on an as-converted basis.

A merger or consolidation of the Company in which its shareholders do not retain a majority of the voting power in the surviving corporation, or sale of all or substantially all the Company's assets, will be deemed to be a liquidation, dissolution or winding up.

Conversion Right The holders of the Preferred Stock shall have the right to convert the Preferred Stock at any time into shares of Common Stock. The initial conversion rate for each series of Preferred Stock shall be 1-for-1.

Automatic Conversion The Preferred Stock shall be automatically converted into Common Stock, at the then applicable conversion rate, upon the closing of an underwritten public offering of shares of Common Stock of the Company at a public offering price of not less than $6.00 per share and for a total public offering amount of not less than $10 million.

Antidilution Provisions Stock splits, stock dividends and so forth shall have proportional antidilution protection. The conversion price of the Preferred Stock shall be subject to adjustment to prevent dilution on a weighted average basis in the event that the Company issues additional shares of Common Stock or Common Stock Equivalents at a purchase price less than the applicable conversion price; except that shares of Common Stock sold or reserved for issuance to employees, directors, consultants or advisors of the Company pursuant to stock purchase, stock option or other agreements approved by the Board and certain other issues customarily excluded from triggering antidilution adjustments may be issued without triggering antidilution adjustments.

Voting Rights Each share of Preferred Stock carries a number of votes equal to the number of shares of Common Stock then issuable upon its conversion into Common Stock. The Preferred Stock will generally vote together with the Common Stock and not as a separate class except that, with respect to the election of the Board of Directors, the holders of Preferred Stock may elect three of the five members of the Board. The holders of the Common Stock, voting together as a single class, shall be entitled to elect the two remaining Board members.

Board Representation At the Closing Date, the Board of Directors shall consist of Joe CEO, Industry Luminary, Bill VC, Tom VC and Michele VC.

Protective Provisions Consent of the holders of a majority of the outstanding Preferred Stock shall be required for: (i) any action that materially and adversely alters or changes the rights, preferences or privileges of any series of Preferred Stock; (ii) any action that authorizes or creates shares of any class of stock having preferences superior to or on a parity with any series of Preferred Stock; (iii) any amendment of the Company's Articles of Incorporation that materially and adversely affects the rights of any series of the Preferred Stock; (iv) any merger or consolidation of the Company with or into one or more other corporations in which the Company's shareholders do not retain a majority of the voting power in the surviving corporation or (v) the sale of all or substantially all the Company's assets.

Rights of First Refusal So long as an investor holds at least five percent of the Company's outstanding capital, that holder of Preferred Stock shall be given the right of first refusal to purchase up to its pro-rata portion (based on its percentage of the Company's outstanding common shares, calculated on an as-if-converted basis) of any equity securities offered by the Company (other than shares offered to employees, in a merger or in connection

with a lease line or line of credit, etc.) on the same terms and conditions as the Company offers such securities to other potential investors. This right of first refusal will terminate immediately prior to the Company's initial underwritten public offering of its Common Stock at a public offering price of not less than $6.00 per share and for a total public offering amount of not less than $10 million.

Information Rights So long as an investor continues to hold at least 5 percent of the Company's outstanding Common Stock (calculated on an as-converted basis), the Company shall deliver to the investor: (i) audited annual financial statements within 90 days after the end of each fiscal year; (ii) unaudited quarterly financial statements within 45 days of the end of each fiscal quarter and (iii) unaudited monthly financial statements within 30 days of the end of each month. These information rights shall terminate upon the Company's initial public offering.

Registration Rights

(1) *Demand Rights* If at any time after the third anniversary of the closing holders of at least 30 percent of the "Registrable Securities" (defined below) request that the Company file a registration statement covering the public sale of Registrable Securities with an aggregate public offering price of at least $5 million, then the Company will use its best efforts to cause such shares to be registered under the Securities Act of 1933 (the "1933 Act"); provided, that the Company shall have the right to delay such registration under certain circumstances for up to 90 days during any 12-month period. "Registrable Securities" will mean the Common Stock issuable on conversion of the Preferred Stock.

The Company shall not be obligated to effect more than two registrations under this demand right provision and shall not be obligated to effect a registration during the six-month period commencing with the date of the Company's initial public offering or any registration under the 1933 Act in which Registrable Securities were registered.

(2) *Piggyback Rights* The holders of Registrable Securities shall be entitled to "piggyback" registration rights on all 1933 Act registrations of the Company or on any demand registration (except for registrations relating to employee benefit plans and corporate reorganizations).

(3) *Cutback* The investors' registration rights are subject to the right of the Company and its underwriters to reduce the number of shares proposed to be registered pro rata in view of market conditions. The underwriters' "cutback" right shall provide that at least 25 percent of the shares included in the Registration must be Registrable Securities (except for the Company's initial public offering, from which all Registrable Securities may be excluded).

(4) *S-3 Rights* Investors shall be entitled to registrations on Form S-3 (if available to the Company) unless: (i) the aggregate public offering price of all securities of the Company to be sold by shareholders in such registered offering is less than $500,000; (ii) the Company certifies that it is not in the Company's best interests to file a Form S-3, in which event the Company may defer the filing for up to 90 days once during any 12-month period or (iii) if the Company has already effected two registrations on Form S-3 during the preceding 12 months.

(5) *Expenses* The Company shall bear the registration expenses (exclusive of underwriting discounts and commissions, but including the fees of one counsel for the selling shareholders) of all such demand and piggyback registrations and for the first S-3 registration.

(6) *Transfer of Rights* Registration rights may be transferred to (i) transferees acquiring at least 100,000 shares of Registrable Securities with notice to and consent of the Company or (ii) any partner, shareholder, parent, child or spouse of the holder or to the holder's estate.

(7) *Market Standoff* No holder will sell shares within such period requested by the Company's underwriters (not to exceed 180 days) after the effective date of the Company's initial public offering; provided, however, that such restriction does not apply to Registrable Securities included in such registration statement; and provided further, that all officers, directors and holders of more than 1 percent of the outstanding capital stock of the Company enter into similar standoff agreements with respect to such registration.

(8) *Cross-Indemnification Provisions* The parties will provide each other with reasonable cross-indemnification.

(9) *Termination* The registration rights will terminate five years after the closing of the Company's initial public offering and will not apply to any shares that can be sold in a three-month period pursuant to Rule 144 without registration.

Board of Directors The Articles of Incorporation and Bylaws shall provide for a five-person Board of Directors.

Stock Purchase Agreement The investment shall be made pursuant to a Stock Purchase Agreement reasonably acceptable to the Company and the investors, which agreement shall contain, among other things, appropriate representations and warranties of the Company, covenants of the Company reflecting the provisions set forth herein, and appropriate conditions of closing, including an opinion of counsel for the Company. The Stock Purchase Agreement shall provide that it may be amended by or that provisions may be waived only

with the approval of the holders of a majority of the Series B Preferred (and/or Common Stock issued upon conversion thereof). Registration rights provisions may be amended with the consent of the holders of a majority of the Registrable Securities.

Stock Vesting Stock sold and options granted to employees will be subject to the following vesting, unless otherwise approved by the Board of Directors: (i) Vesting over four years — 24 percent of the shares vest at the end of the first year, with two percent of the shares vesting monthly thereafter; or (ii) Upon termination of the shareholder's employment, with or without cause, the Company shall retain the option to repurchase at cost any unvested shares held by such shareholder.

Restrictions on Sales The investors will make the customary investment representations.

Invention Assignment Agreement: Each officer and employee of the Company shall have entered into an acceptable confidentiality and invention assignment agreement.

Finders The Company and the investors shall each indemnify the other for any finder's fees for which either is responsible.

Legal Fees and Expenses The Company shall pay the reasonable fees and expenses of Investors' counsel up to a maximum of $30,000.

About the Author

Jacqueline A. Daunt retired from Fenwick & West LLP in 2003 after more than 21 years in the firm's Corporate Group. Her practice focused on representing high technology clients in domestic and international transactions, including venture financings, mergers and acquisitions, partnering arrangements, distribution and licensing agreements and international protection of proprietary rights. Ms. Daunt received her B.A. in economics and her J.D. from the University of Michigan. She also attended the Université Libre de Bruxelles and L'Institut D'Études Européennes, where she studied comparative commercial law and European antitrust law. In addition to frequent speaking engagements, Ms. Daunt has authored during her career a series of booklets on strategic issues for high technology companies, including Venture Capital, Corporate Partnering, Mergers and Acquisitions, Structuring Effective Earnouts, International Distribution and Entering the U.S. Market. Ms. Daunt's booklets have been distributed to tens of thousands of entrepreneurs, students, venture capitalists and journalists and are widely regarded as the most useful and straightforward reference materials of their type. Fenwick is deeply indebted to Ms. Daunt for her tireless efforts in writing and maintaining these invaluable resources.

Trends in Terms of Venture Financings in the San Francisco Bay Area

Fourth Quarter 2006

Fenwick

FENWICK & WEST LLP

FENWICK & WEST LLP

Trends in Terms of Venture Financings
in the San Francisco Bay Area
(Fourth Quarter 2006)

Background

We analyzed the terms of venture financings for 113 technology companies headquartered in the San Francisco Bay Area that reported raising money in the fourth quarter of 2006.

Overview

The results of the 4Q06 survey showed a continuation of the strong positive trend in venture valuations. The highlights of the quarter were as follows:

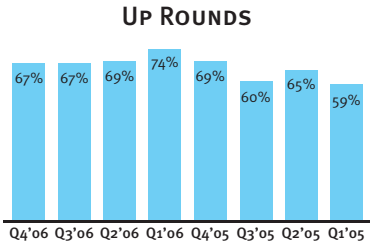
- Up rounds exceeded down rounds for the twelfth quarter in a row (67% up vs. 22% down, with 11% flat).
- The Fenwick & West Venture Capital Barometer showed a 69% average price increase for companies receiving venture capital in 4Q06 compared to such companies' previous financing round. This was the largest increase since the survey began. This increase was driven in significant part by nine 4Q06 financings in which the purchase price of the stock sold in the financing was at least three times higher than the prior round. Of these nine financings, most were Web 2.0 and related fields.

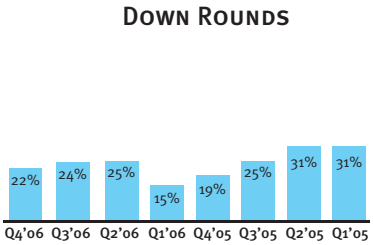
Other U.S. venture industry related results for the quarter and the year included the following:

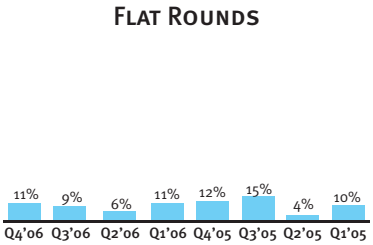
- The amount invested by venture capitalists in the U.S. in 4Q06 was approximately $5.8 billion. Although this amount was approximately 15% less than the amounts invested in 3Q06 and 2Q06, it fell solidly within the $5-7 billion quarterly range seen since the end of 2003. Overall the amount invested by venture capitalists in the U.S. in 2006 was up approximately 8% over 2005.[1]
- Acquisitions of venture backed companies in the U.S. fell in 4Q06 with 75 transactions totaling $7.3 billion, compared to 112 transactions totaling $7.7 billion in 3Q06. However 2006 in general was the best acquisition year for venture backed companies since 2000, both in terms of aggregate amount paid ($31.2 billion) as well as median amount paid per transaction ($52 million).[1]
- IPOs of venture backed companies improved noticeably in 4Q06, with 18 IPOs raising $1.2 billion in 4Q06. 2006 was the second best IPO year since 2000, with 56 venture backed IPOs raising $3.7 billion.[1]
- Healthcare companies had another good year, with venture investment increasing to $8.25 billion, up 12% over 2005, and the industry accounting for 28 of the 56 IPOs. Information services (which includes Web 2.0 companies) also had a good year with investment increasing to $2.4 billion, up 27% from 2005. Alternative energy had a substantial increase in activity with investment at $537 million being close to three times higher than 2005.[1]
- Nasdaq was up 2.0% in 4Q06, was up 9.5% for 2006, and is up 3% in 1Q07 to date.

Price Change

The direction of price changes for companies receiving financing this quarter, compared to their previous round, were as follows:







The percentage of down rounds by series were as follows:

Series	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
B	6%	13%	16%	12%	10%	16%	12%	19%
C	15%	24%	32%	12%	5%	35%	32%	36%
D	42%	38%	14%	27%	46%	33%	37%	30%
E and higher	53%	33%	57%	12%	35%	23%	60%	62%

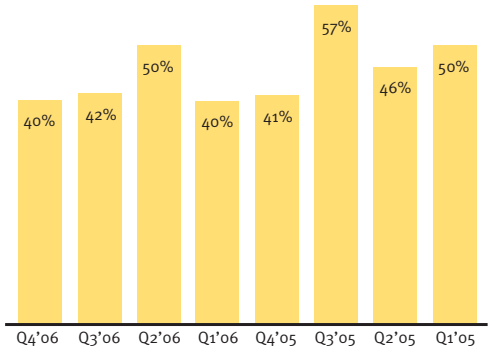
The Fenwick & West Venture Capital Barometer™ (Magnitude of Price Change) –Set forth below is (i) for up rounds, the average per share percentage increase over the previous round, (ii) for down rounds, the average per share percentage decrease over the previous round, and (iii) the overall average per share percentage change from the previous round for all rounds taken together. Such information is broken down by series for 4Q06 and is provided on an aggregate basis for comparison purposes for the prior five quarters. In calculating the "net result" for all rounds, "flat rounds" are included. For purposes of these calculations, all financings are considered equal, and accordingly we have not weighted the results for the amount raised in a financing.

Q4'06 Percent Change	Series B	Series C	Series D	Series E and higher	Combined total for all Series for Q4'06	Combined total for all Series for Q3'06	Combined total for all Series for Q2'06	Combined total for all Series for Q1'06	Combined total for all Series for Q4'05	Combined total for all Series for Q3'05
Up rounds	+152%	+113%	+46%	+32%	+119%	+86%	+69%	+95%	+81%	+88%
Down rounds	-42%	-33%	-59%	-53%	-49%	-35%	-57%	-49%	-56%	-60%
Net result	+124%	+82%	+9%	-15%	+69%	+49%	+34%	+64%	+45%	+38%

Financing Round – The financings broke down according to the following rounds:

Series	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
A	22%	23%	14%	11%	22%	18%	15%	24%
B	31%	31%	34%	40%	35%	31%	26%	29%
C	23%	24%	28%	17%	17%	23%	27%	16%
D	11%	17%	16%	15%	11%	15%	21%	22%
E and higher	13%	5%	8%	17%	15%	13%	11%	9%

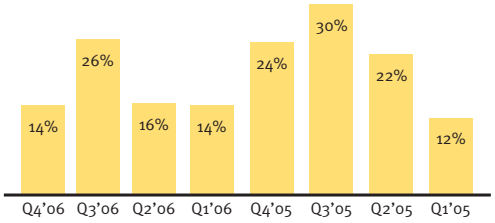
Liquidation Preference – Senior liquidation preferences were used in the following percentages of financings:



The percentage of senior liquidation preference by series was as follows:

Series	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
B	23%	30%	35%	29%	22%	42%	25%	38%
C	38%	41%	76%	47%	40%	48%	40%	57%
D	58%	57%	36%	60%	69%	87%	68%	55%
E and higher	67%	67%	57%	41%	65%	77%	70%	62%

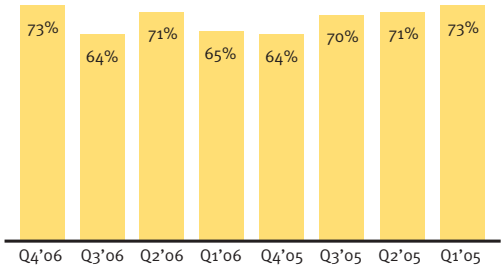
Multiple Liquidation Preferences – The percentage of senior liquidation preferences that were multiple preferences were as follows:



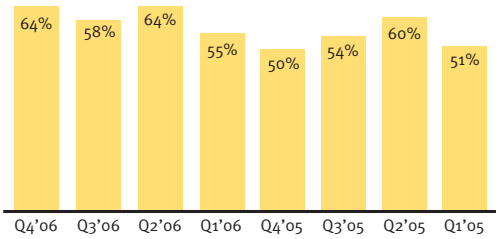
Of the senior liquidation preferences, the ranges of the multiples broke down as follows:

Range of multiples	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
>1x – 2x	40%	90%	83%	80%	67%	93%	88%	100%
>2x – 3x	60%	10%	0%	20%	33%	7%	0%	0%
> 3x	0%	0%	17%	0%	0%	0%	12%	0%

Participation in Liquidation – The percentages of financings that provided for participation were as follows:



Of the financings that had participation, the percentages that were not capped were as follows:



Cumulative Dividends – Cumulative dividends were provided for in the following percentages of financings:

Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
4%	7%	8%	3%	4%	3%	4%	9%

Antidilution Provisions – The uses of antidulition provisions in the financings were as follows:

Type of Provision	Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
Ratchet	4%	4%	2%	4%	9%	7%	8%	9%
Weighted Average	95%	95%	97%	92%	85%	92%	88%	87%
None	1%	1%	1%	4%	6%	1%	4%	4%

Pay-to-Play Provisions – The use of pay-to-play provisions in the financings was as follows:
Percentages of financings having pay-to-play provisions.

Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
10%	10%	16%	11%	16%	8%	16%	17%

The pay-to-play provisions provided for conversion of non-participating investors' preferred stock into common stock or shadow preferred stock, in the percentages set forth below:

- Common Stock

Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
73%	50%	86%	73%	89%	88%	87%	93%

- Shadow Preferred Stock

Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
27%	50%	14%	27%	11%	12%	13%	7%

Redemption – The percentages of financings providing for mandatory redemption or redemption at the option of the venture capitalist were as follows:

Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
22%	29%	33%	27%	31%	32%	29%	30%

Corporate Reorganizations – The percentages of post-Series A financings involving a corporate reorganization were as follows:

Q4'06	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05
6%	5%	12%	9%	11%	17%	15%	13%

For additional information about this report please contact Barry Kramer at 650-335-7278; bkramer@fenwick.com or Michael Patrick at 650-335-7273; mpatrick@fenwick.com at Fenwick & West. To be placed on an email list for future editions of this survey please go to www.fenwick.com/vctrends.htm.

[1] Information in this paragraph obtained from Dow Jones VentureSource.

Explanation of Certain Terms Used in Venture Financing Terms Survey

Fenwick

FENWICK & WEST LLP

THIS SUPPLEMENT TO THE FENWICK & WEST VENTURE FINANCING TERMS SURVEY EXPLAINS THE MEANING OF KEY TERMS USED IN THE SURVEY.

Common Stock

Common stock is the basic equity interest in a company. It is typically the type of stock held by founders and employees.

Preferred Stock

Preferred stock has various "preferences" over common stock. These preferences can include liquidation preferences, dividend rights, redemption rights, conversion rights and voting rights, as described in more detail below. Venture capitalists and other investors in private companies typically receive preferred stock for their investment.

"Series" of Preferred Stock

When a company raises venture capital in a preferred stock financing, it typically designates the shares of preferred stock sold in that financing with a letter. The shares sold in the first financing are usually designated "Series A", the second "Series B", the third "Series C" and so forth. Shares of the same series all have the same rights, but shares of different series can have very different rights.

Liquidation Preference

"Liquidation preference" refers to the dollar amount that a holder of a series of preferred stock will receive prior to holders of common stock in the event that the company is sold—or the company is otherwise liquidated and its assets distributed to stockholders. For example, if holders of preferred stock have a liquidation preference equal to $30 million and the company is sold, they will receive the first $30 million before common stockholders receive any amounts. The liquidation preference amount can be paid in cash or stock of an acquiror.

Senior Liquidation Preference

A series of preferred stock has a "senior" liquidation preference when it is entitled to receive its liquidation preference before another series of preferred stock. All series of preferred stock will, of course, be "senior" to the common stock simply by virtue of having a liquidation preference. For example, if the Series B has a $30 million senior liquidation preference and the Series A has a $25 million liquidation preference and the company is sold for $40 million, the Series B will receive $30 million and the Series A will receive $10 million.

Multiple Liquidation Preference

The amount of liquidation preference that a given series of preferred stock has is usually equal to the amount paid for the stock. However, in certain financings new investors may require that their liquidation preference amount be equal to more than the amount they originally invested—often referred to as a "multiple" liquidation preference. Multiples tend to be one and one-half to three times the purchase price. A multiple liquidation preference will almost always also be a senior liquidation preference as well. For example, if the Series B was purchased for $30 million, but has a senior liquidation preference equal to two times the purchase price, then the Series B investors will receive the first $60 million on any sale of the company before the Series A or common stockholders receive any amounts.

Participation

Preferred stock is said to "participate" or to have "participation" rights when, after the holders of preferred stock receive their full liquidation preference amount, they are then entitled to share with the holders of common stock in the remaining amount being paid for the company, or otherwise distributed to stockholders.

For example, if the company is sold for $200 million, the preferred stock has a liquidation preference of $30 million and the preferred stock represents 40% of the total number of outstanding shares of the company, then the $200 million would be distributed among stockholders as follows:

1. First $30 million—paid to holders of preferred stock per their liquidation preference
2. Remaining $170 million:
    - Preferred stock holders receive their 40% pro rata share ($68 million) per their participation rights
    - Common stock holders receive remaining 60% ($102 million)

Totals: Preferred stock holders—$98 million
Common stock holders—$102 million

Capped Participation

Participation rights are described as "capped" when the participation rights of the preferred stock are limited so that the preferred stock stops participating in the proceeds of a sale, or other distribution, after it has received back a pre-determined dollar amount—caps typically range from three to five times the original amount invested.

Building on the previous example, if the participation rights of the preferred stock were capped at a 3x multiple of their liquidation preference amount—3x includes the amount of liquidation preference—then the result would be that the preferred stock would receive only an additional $60 million in participation in step (2) above. Thus, the total amount received by the holders of preferred stock would be $90 million—down from $98 million without a cap—and the amount received by the holders of common stock would increase to $110 million—up from $102 million.

Note: If the price paid for the company in this example were substantially higher (e.g., $275 million) then the holders of preferred stock would convert to common stock, thereby giving up their liquidation preference, in order to eliminate the 3x cap, because 40% of $275 million equals $110 million, which is $12 million more than the preferred would receive if they did not convert and were subject to the 3x cap.

Cumulative Dividends

Holders of preferred stock having a cumulative dividend right are entitled to be paid, in addition to a liquidation preference, an amount equal to a certain percentage per year of the purchase price for the preferred stock—typically five to eight percent. For example, if the preferred stock purchase price was $20 million, and the stock had a 1x liquidation preference and a six percent cumulative dividend, and if the company was sold after three years, then the preferred stock holders would be entitled to $23.6 million before anything was paid on the common stock. In some circumstances cumulative dividends must be paid annually, but this is unusual in venture financed companies.

Conversion Rate

Almost all preferred stock issued in venture financings can be converted into common stock at the option of the holder of preferred stock. The typical initial conversion rate is one share of preferred stock converts into one share of common stock. However, the conversion rate can change for a number of reasons, such as stock splits or antidilution adjustments.

Antidilution Provisions

Antidilution provisions retroactively reduce the per share purchase price of preferred stock if the company sells stock in the future at a lower prices. This is effected by increasing the conversion rate of the preferred and accordingly increasing the number of shares of common stock into which a share of preferred stock converts.

There are two main types of antidilution protection: weighted average antidilution protection and ratchet antidilution protection.

Weighted Average Antidilution

Weighted average antidilution provisions, which are the milder form of antidilution protection, increase the conversion rate of the preferred stock based on a formula that is intended to take into account the overall economic effect of the sale of new stock by the company. The formula includes variables for the price at which new stock is sold, the price at which the old preferred stock was sold, the total number of new shares issued and the total number of shares outstanding.

Ratchet Antidilution

Ratchet antidilution provisions, which are the tougher form of antidilution protection, increase the conversion rate of the preferred stock based on the price per share at which the company sells its stock in a future down round, regardless of how few or how many new shares are sold at the lower price. This has the effect of retroactively reducing the price per share that the preferred was sold in the current round to the new, lower valuation of a future down round.

Pay to Play

Pay to play provisions impose penalties on investors for not investing their full pro rata share in the next round—typically only if the next round is a down round. The more severe version of these penalties is to provide that investors who do not invest their full pro rata amount will have their existing preferred stock converted into common stock, resulting in the loss of their liquidation preference and antidilution protection, among other rights. A less severe version is to convert the preferred stock into a different series of preferred often referred to as "shadow preferred," that retains some or all of its liquidation preference, but loses anti-dilution protection, both for the subject financing and going forward.

Redemption

Redemption provisions allow investors to require the company to repurchase their preferred stock under certain circumstances, typically for the price originally paid. Redemption rights usually cannot be exercised unless the holders of at least a majority, sometimes more, of the preferred stock so request and usually cannot be exercised for four to five years after the financing. In certain circumstances, redemption provisions may provide for a right of exercise more quickly or for a repurchase at more than the original purchase price.

Corporate Reorganization

Corporate reorganizations typically refer to either (a) the conversion of existing preferred stock into common stock, or into a new series of preferred stock with a substantially reduced liquidation preference amount and/or (b) a reverse stock split of outstanding stock. Corporate reorganizations are usually implemented to reset the economic interests of existing stockholders to current economic realities so as to facilitate the company's ability to attract additional investment and to provide appropriate incentive to the management team. The conversion of existing preferred stock into common or a new series of preferred stock has a significant economic effect, as those stockholders will often lose substantial liquidation preferences and other rights. A reverse stock split has no economic effect in and of itself, but is usually undertaken when a company's stock price has fallen significantly and the company wants to raise it to a more typical range.

For additional information about this glossary please contact Barry Kramer at 650-335-7278; bkramer@fenwick.com or Michael Patrick at 650-335-7273; mpatrick@fenwick.com at Fenwick & West. To be placed on an e-mail list for future editions of the Fenwick & West Venture Terms Survey please go to www.fenwick.com/vctrends.htm.

Software Escrows as Part of an Intellectual Property Strategy

BY RAJIV PATEL

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Introduction

For many companies, a key aspect of a comprehensive intellectual property strategy is to identify and enforce mechanisms to protect their investment in software purchased from software developers. One particular tool to guard such investments is the software escrow.

What is a software escrow?

A software escrow is a deposit of source code of software and other materials with a third party escrow agent. Generally, a party licensing the software (the "licensee" or "buyer") requests the software escrow from the owner of the software (the "software developer" or "developer") to ensure maintenance of the software and possibly performance of development obligations under a license.

Why does a software escrow exist?

Software developers typically make a significant portion of their profit on recurring maintenance contracts instead of the basic license fees. Often, software developers will even forego basic license fees and focus instead on ensuring that the licensee is captive for longer periods through the use of maintenance contract, which may include services in addition to maintenance of the code itself. Thus, most developers offer software licenses that only license object code, i.e., the code that can be read by a machine, rather than the source code, i.e., code that can be deciphered and read by a person. Aside from leveraging maintenance contracts to develop longer term relationships with a licensee, software developers also have a vested interest in protecting the source code from risks that directly affect the source code. Examples of such risk include copying or reverse engineering the code to develop a competing product or unauthorized modifications to the source code that may affect performance or operation of other parts of the code. On the flip side, licensees reliant on such software developers want to ensure that their investment in the developer's software is protected and not lost if the developer fails to fix bugs or the like. Hence, such licensees want may need access to the source code in the event that the software developer no longer provides the object code.

In what situations are software escrows requested?

Often, there is tension between the software developer's desire to keep source code confidential and out of the hands of the licensee and others who may gain possession of, or knowledge about, the source code, and the licensee's desire to have access to the source code in the event that the software is not longer available at agreed upon levels of service.

Examples of when a licensees generally request a software escrow include an established company integrating software from a small, relatively unproven company into its product or service offerings or a business integrating a developer's software into its business such that the business could be halted if the software were suddenly unavailable or did not perform to expectation.

Who is likely to agree to a software escrow?

Practically, smaller software developers are more likely to agree to a software escrow than larger software developers. Smaller software developers want to gain the trust and confidence of larger companies in doing business with them. Moreover, they seek to do this without exposing their source code and associated intellectual property to the large company, for obvious business reasons of having the endorsement of a larger client to attract other customers or for having their products bundled with those of larger developers to go to an even larger end-user base.

What types of risks does a licensee seek to minimize by a software escrow?

Generally, are three types of risks that drive creation of a software escrow. The first risk is that the software developer substantially goes out of business or becomes financially unable to perform its development and support obligations. The software developer does not yet file for bankruptcy and still exists as an entity, but fails to provide support or improvements to the software.

The second risk is that the software developer files for bankruptcy and terminates the license in the case. Under the U.S. Bankruptcy Act, if reorganization occurs in a Chapter 11 bankruptcy the software developer is still in business, and the software developer elects to continue performing its license obligations, there may be no significant impact on the licensee of the Chapter 11. If, however, the software developer ceases operations or otherwise fails to provide support at a previously agreed upon level with the licensee, licensee will lose a vital part of its strategy regarding the license software and, absent a triggered source code escrow, may find itself unable to maintain and develop its products.

The third risk is that the software developer is acquired by a competitor of the licensee. In such situations, the software may be altered to the detriment of the licensee, discontinued, or support for it may be dropped altogether. An associated risk is a change in the relationship between the software developer and the acquiring third-party. For example, the acquiring third-party fails to provide support at a level agreed upon with the software developer.

In summary, the risks above highlight for the licensee the issue that business failure, however it occurs, creates the problem that you either have to have the source code deposits and rights to use them under the escrow or resort to more expensive and less reliable approaches such as replacing it with another software component and the consequent reengineering costs, or buying a new license from anyone who comes into possession of the software through acquisition without the support obligations under the old licenses. Moreover, access to the source code and related remedies depend on licensee's ability to replace the software developer's services, for example, either through doing it for itself or getting a third party to replace the software developer.

What type of risks does the software developer seek to minimize?

There are two primary risks that the software developer seeks to minimize through source code escrows. The first is minimizing the risk of losing business. The software developer can use the escrow to remove uncertainty in business dealings between the licensee and them so that the licensee feels comfortable in entering into a deal with the software developer.

The second risk to minimize is the risk of releasing the source code from escrow. As a part of this risk assessment, the software developer will need to maintain flexibility on circumstances in which the source code would not be released from escrow due to appropriate business decisions. For example, if a software product reaches end of life, the escrow agreement should be structured so that it does not trigger a release event, particularly, if there is an available migration or upgrade path available to the licensee.

How does a software escrow work?

Thanks to well established software escrow practices, it is relatively easy to find a base framework creating a commercial software escrow particular for the needs of a deal between two parties. Below are some basis considerations on what such frameworks include and where issues may arise.

Identify a software escrow agent.
Initially, the software developer and the software developer must agree upon a software escrow agent. Key in determining who to select as a software escrow agent is that they are an independent third party unaffiliated with the software developer and that they have experience in administering source code escrows. Examples of established software escrow agents include Iron Mountain Intellectual Property Management, Inc., (www.ironmountain.com), SourceHarbor, Inc. (www.sourceharbor.com), and EscrowTech International, Inc. (www.escrowtech.com).

Negotiate what goes into the software escrow.
The licensee should ensure that the complete source code of the licensed software goes into the escrow, along with associated materials such as documentation, software libraries, appropriate third-party items, and the like. The deposited source code should preferably be in electronic format. In addition, the licensee should consider whether the software developer should also include documentation such as development manuals and the like. In any event, the rights to have possession and use of the deposit materials, whatever they are, should depend on the agreement to deposit them, and not on actual deposit.

Negotiate how often updates go into the software escrow.
The licensee should ensure that the software developer is obligated to update its source code deposits with all-new versions, updates, and new releases of the licensed software. Moreover, the obligation for these additional deposits should be satisfied within a short time period after

the initial distribution of the new version, update, or release. Such time periods are typically within 30 days or less.

Confirm what went into the software escrow.
A key part of the escrow arrangement is ensuring that what goes into the escrow is what the licensee expects. Deposits of incomplete or out-of-date source code do happen, but can be prevented. To avoid such problems, include provisions in the escrow agreement for deposit of new versions, updates and releases as previously described, in addition to the original deposit of code.

Determine release conditions from the software escrow.
A critical aspect of the software escrow is the release provision. The release provision, typically referred to as the release conditions, defines the conditions upon which the source code and associated materials are released by the escrow agent to the licensee As a general matter, release provisions should focus on identifiable, indisputable facts. The easier it is to demonstrate the occurrence of a release condition, the more quickly and cheaply the licensee should be able to get access to the deposit materials. In addition, release conditions must also legally enforceable, an important factor in the context of bankruptcy proceedings (further described below).

Many source code escrows limit the release event to the situation in which the software developer has ceased doing business and, therefore, cannot maintain the software. In this regard, licensee can also ask for conditions related to harbingers of impending failure for release: the appointment of a receiver for software developer's business, the making of a general assignment for the benefit of creditors (an alternative to bankruptcy liquidation), and the announcement to the public in general that software developer is ceasing operations, are examples of such release conditions. Still another release consideration to plan for is a software developer's outright refusal to perform, repudiation of the license, including rejection in bankruptcy.

A licensee may also consider attempting to procure additional release events tied to the software developer's failure to perform its maintenance obligations in a timely or effective manner, e.g., a consistent failure to respond to, or correct, documented errors within a specified number of days of their report by the licensee to the software developer.

The licensee should also consider other release events tied to the practicality of using the software developer for continuing maintenance services. For example, the licensee may use this release when the software developer seeks to increase maintenance costs beyond a specified limit set in the maintenance contract.

Next, avoid relying on "insolvency" as a release condition because its occurrence is difficult to determine with accuracy and it is usually determined only in hindsight through expensive litigation with delay. Finally, note that though the release condition is common, software developer's filing for bankruptcy is not an enforceable release condition.

Determine who pays for the software escrow.
Typically, the software developer will pay for the software escrow, although this point is often negotiable between the parties.

What are key issues faced by the licensee with respect to a software escrow?

The material (i.e., the source code itself) is never deposited, or only partially deposited, into the escrow.
The licensee should also watch for and monitor the escrow account activity, which should include a description of what was deposited and when. In addition, consider a technical verification service offered by independent third parties, including some software escrow agents. These services verify the integrity of the deposited materials and can range from simple tests that confirm the physical content of the media to actual compilation of the code to test functionally. The verification service can be helpful in ensuring that the licensee receives complete and useful source code when the release event occurs.

The occurrence of release conditions is unclear or disputed.
Most escrow agreements allow the software developer to oppose the licensee's release request when a release event allegedly occurs. To address such conflicts, there are options available to write into the release process of an escrow agreement to avoid litigation over source code. The most common escrow provision to resolve a release in dispute is arbitration. Most parties to an agreement prefer this provision because it provides a quick, low-cost, and more importantly, decisive alternative to litigation.

Another approach for disputed releases is to have decision making executives for each party meet and resolve their differences. In this context, the escrow agreement and the

threat of a release act as catalysts to facilitate action and dialogue between the two parties. Still another approach to resolve disputes is to write into the escrow agreement the requirement that disputes be "expedited," including setting forth timetables to complete each step.

More influential licensees may be in a position to negotiate a release-on- demand clause in their escrow agreements. This clause instructs the software escrow agent to release deposit materials immediately after receiving a request from the licensee.

The source code is not helpful in a vacuum.
Ensuring that escrowed source code is complete and useful does not guarantee that the licensee will be able to work with it. To address this issue, consider requesting supporting documentation and a list of technical maintenance personnel from the software developer that can be included as part of the deposit. If the software developer goes out of business, these employees may be available as consultants after the release has occurred, helping to ensure that the licensee has access to support personnel familiar with the software. Be sure they are authorized to assist in the event of a trigger, despite any confidentiality agreements with software developer??

If supporting documentation or a list of technical maintenance personnel is not provided, the licensee should be prepared to hire an outside consultant or dedicate internal personnel to maintain the technology. Here, the licensee's goal would be to use the released source code to have the consultant maintain it for as long as needed or until a suitable replacement technology is available. In some instances, the licensee may desire to incorporate a predetermined number of hours or costs that would be covered under the agreement as it relates to these consulting arrangements. Likewise, a software developer may desire to cap such hours or costs if they end up in the agreement.

The software developer is in bankruptcy.
Bankruptcy is often the most complicated issues in structuring and enforcing an escrow agreement. It is important to understand the underlying principles because the Bankruptcy Code interferes with the parties' ability to strike any bargain they want. Section 365 of the U.S. Bankruptcy Code gives debtor parties to "executory contracts" (those with substantial performance remaining on both sides at the time of filing) a choice of assuming and finishing the contract or "rejecting" it, generally leaving the other party to a damages claim. If debtor is a software developer of certain types of intellectual property (and note the definition of intellectual property in Section 101 of the Bankruptcy Code does not include trademarks, foreign patents or foreign copyrights), and rejects the license, the Congress also allows the licensee to retain certain rights to use the technology as it existed on the date of filing in exchange for paying royalties due under the agreement, AND to have rights under "ancillary agreements," which includes the escrow agreement.

Section 365(e) generally disables certain contract clauses and provisions in some non-bankruptcy law that permit the non-debtor's termination of an agreement because of a debtor's bankruptcy filing or its financial condition upon filing. These so-called ipso facto clauses are not enforceable in licenses where the debtor is a software developer. Hence, special crafting is required for the escrow release triggers to be sure that if the license occurs, and the licensee makes the Section 365(n) election, the escrow release will occurred and be effective. Specifically, Section 365(n) grants the licensee absolute entitlement to retain rights to intellectual property (despite the debtor-software developer rejection of the license agreement) with some conditions. The licensee cannot also enforce exclusivity against the debtor or its assignee if the license is exclusive, but it cannot compel further performance (such as development or maintenance) otherwise provided under the license. Therefore, when drafting agreements for the U.S. the licensee should structure the licensing agreement to fall under the scope of 365(n).

There are a number of things a licensee can do to increase the probability of having the agreement fall under the scope of 365(n), including using executory contracts (which include software licensing agreements) that call for continuous performance over time by both sides. Because the rights that can be retained upon rejection are those which existed at the time of the bankruptcy petition, license grants must be present grants, not those which spring into existence upon bankruptcy. Specifically, escrow agreement should be drafted as a present grant to use the escrowed materials and not just a license right becoming effective upon bankruptcy. If the license makes the escrow agreement effective upon bankruptcy, then that does not fall under the section of the code that says the license must be in effect in order to be valid, e.g., reciting "software developer hereby grants" instead of "software developer grants."

The right to the deposit materials should also be without regard to whether the software developer actually made the deposit required under the license. That way, if the software developer did not do so and the escrow is triggered, the licensee will have a legal right to demand that the debtor or its trustee hand over the materials. There may be practical problems in such a situation, and escrows need to be monitored for compliance to avoid them, but at least licensee will have the legal rights to the materials and can work with the debtor or his trustee to find them.

Finally, the parties need to be careful in their license to differentiate which payments are for use of the licensed software and related intellectual property and which for maintenance. Licensees making the Section 365(n) election must pay royalties required under the license to continue using the intellectual property. If the license is not clear, the licensee will end up litigating how much "royalty" must be paid to continue its use rights under Section 365(n) without the support and maintenance of the software developer.

Conclusion

Software escrows can be a vital part of a software purchaser's intellectual property plan and strategy. The ability to access source code in the event of a software developer being unable to further maintain supplied software code can be critical for a licensee.

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Legal FAQ: Introduction to Patent Law

BY ROBIN REASONER AND CHARLENE MORROW

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1. What is a patent?

A patent is a legal right to exclude others from practicing the patented invention for a limited period of time in exchange for disclosing the details of the invention to the public. An owner of a United States patent can exclude others making, using, offering for sale, or selling their invention in the United States, importing their invention into the United States, exporting a substantial portion of the invention for assembly into the invention overseas, or exporting components overseas that were especially made or adapted for use in a system that infringes and those components are not staple articles of commerce suitable for substantial non-infringing use.

There are several different types of patents in the United States. Utility patents are the most common, and they cover processes, machines, articles of manufacture, and compositions of matter. Design patents cover the ornamental features (i.e., appearance) of a product. Plant patents cover newly developed varieties of plants provided they can be reproduced asexually.

2. What can be patented?

The United States Patent Law specifies the broad categories of what can be patented. Any useful, new and nonobvious process, machine, article that is made, or chemical composition, or improvement of any of the above can be patented. Business methods and software can also be patented, but laws of nature and abstract ideas cannot be patented. (For more information on what "useful, new, and nonobvious" means, see "Is my invention patentable?".)

3. Is my invention patentable? What are the standards my invention has to meet?

Not all inventions are patentable. In the United States, an invention has to be useful, new, and not obvious. An invention generally is assumed to be useful unless there is some reason to believe that it will not work. It is new if it differs from previously existing technology. It is nonobvious if the differences from the previously existing technology would not be obvious to ordinary practitioners in the relevant technological field. Patentable inventions need not be pioneering breakthroughs. A patent can be obtained on modest improvements in existing technology as long as the improvements are useful, new, and not obvious.

4. How long does it take to get an issued patent?

The length of time it takes to obtain an issued patent varies significantly depending on the technology area. The backlog of patent applications filed with the United States Patent and Trademark Office ("PTO") and waiting for examination is considerable. Some technology areas are appreciably slower than others. For software and financial inventions, the PTO predicts that the delay between an application being filed and when an Examiner reviews the patent application for the first time could exceed five years. In other technology areas, such as optics, an Examiner may review the patent application within one to two years of the filing date. Typically, after the Examiner has reviewed a patent application for the first time, it may take one to two additional years of back and forth communications with the Examiner to come to an agreement as to the scope and wording of the patent claims and get the patent issued. There are some provisions for speeding up review when there is active infringement by others of the invention.

5. What are the parts of a patent application?

A United States patent application typically contains the following sections: Background, Summary of the Invention, Brief Description of the Drawings, Detailed Description, Claims, Abstract, and Drawings. These sections are briefly described below.

The Background identifies and describes some of the problems solved by the invention. This section may also describe conventional solutions to the problems and the shortcomings of such solutions. The Summary of the Invention briefly describes the structure and operation of at least one embodiment of the invention. The Detailed Description describes in detail the structure and operation of one or more embodiments of the invention. From a legal perspective, it is essential that this section adequately describes the invention, enables a person skilled in the relevant art to make and use the claimed

invention, and describes the best mode known to the applicant for carrying out the claimed invention. The Claims identify the exact scope of the rights provided by the patent. The Claims of a patent are analogous to the legal description in a deed to real property. The Abstract presents a one paragraph summary of the subject matter described in the application. The Drawings illustrate the structure and operation of the invention.

6. Is there anything less expensive or faster to file than a full-blown patent application? What is a Provisional Patent Application?

A United States provisional application can be filed when there is either limited time or funding to prepare a full non-provisional utility patent application, or when an applicant wants to wait up to a year to see how the market responds to technology to determine whether to proceed with a full patent application.

A provisional application allows an applicant to get a U.S. filing date without all the formal requirements of non-provisional utility applications, such as claims, formal drawings, an oath or declaration by the inventor, and the higher filing fee. However, the provisional patent application must still describe the invention with the same level of detail that is required for utility patent applications. The provisional application does not receive a substantive examination by the PTO. Instead, the applicant has up to 12 months to file a corresponding complete application with claims. The priority date established by the provisional filing only applies to claims for which there was an enabling disclosure in the provisional application.

Alternatively, inventors can submit Statutory Invention Registrations to the United States PTO. Although these documents are not patent applications and will not issue as patents, they will be published by the PTO. Therefore, they become available as prior art that may block others from subsequently gaining patent rights to the disclosed invention. Note that the tradeoff is that the publishing inventor may be giving up their ability to protect the invention under trade secret law.

7. Do you have to do a prior art search before applying for a patent?

No, an applicant does not need to perform a prior art search at any time during the patenting process. There is, however, an obligation in the United States to disclose to the PTO all material information known to the inventors, and anyone else participating in the application process, during the application process.

8. How does the PTO decide whether to issue a patent?

Once a patent application is filed with the United States PTO, it is assigned to a patent examiner who works in a specific area or areas of technology. Because of the application backlog, one to five years may pass before the examiner actually reviews the application. Typically, after reviewing the application, the examiner sends an "office action" to the patent attorney or agent involved in the application, listing both objections as to the form of the application and to the substance, often including citations to previous patents and other prior art documents that the examiner states raise questions about the patentability of the claims presented to him or her.

A patent applicant can then respond in writing to the office action, offering either arguments as to why the objection should be withdrawn, or amendments to the claims to address the objections raised by the examiner. An applicant may also request an interview with the examiner. The examiner may then either agree with the reasoning in the response and "allow" the pending claims, or send another office action with the same or additional objections.

9. What happens if my patent claims are rejected by the PTO?

If the applicant and the U.S. examiner reach an impasse over an issue, the examiner issues a "final" action. The applicant can then either appeal to a special board of the PTO or decide not to pursue the argument. If the applicant decides not to pursue the argument, the applicant can either abandon the application or start the examination process over by using various "continuation" procedures.

10. What is a restriction requirement in a patent application?

A U.S. patent applicant is entitled to examination of one invention per application. If two or more inventions are claimed in a single application, the Examiner may issue a "restriction requirement" that forces the Applicant to select a single one of the inventions to be examined. The claims to any other invention can be put into a separate application, which if filed while the first application is still pending, should be entitled to the benefit of the filing date of the first application.

11. What do the terms "patent pending" and "patent applied for" mean?

Once a patent issues, one way the patentholder can give notice of its patent rights is to mark products incorporating the invention with the word "Patent" or "Pat." and the patent number. A patent notice must typically be placed directly on the patented article, unless such a marking is not physically feasible. Patent marking is not mandatory but can help the patentee accrue money damages if it pursues litigation against patent infringers. Marking articles with the terms "Patent Pending" or "Patent Applied For" has no legal effect.

12. Can I keep the content of my patent application a secret until it issues? When will a patent application publish?

Until recently, the United States PTO maintained patent applications in strict secrecy until a patent issued. However, the PTO now by default publishes patent applications approximately 18 months from their original priority date. An applicant can opt out of publication by filing an appropriate request at the time the application is filed. However, this option cannot be pursued (and an existing request not to publish must be rescinded) if the applicant pursues any international applications that have a publication requirement, such as a PCT application (discussed below).

Publication can be beneficial to the patent applicant, as provisional enforcement rights for the period between the dates of publication and patent grant are potentially available, so long as the published claims are substantially identical to the claims ultimately granted in the patent.

However, if an application is not published and during prosecution it appears that the PTO will not allow claims or only allow extremely narrow claims, the applicant can still decide to abandon the application in favor of continued trade secret protection.

13. When are patent maintenance fees due?

U.S. maintenance fees on all utility patents that issue from applications filed on or after December 12, 1980, are due at 3.5, 7.5, and 11.5 years from the date the patent is granted. These fees can be paid without a surcharge up to six months before they are due. A six-month grace period after the due date is available upon payment of a surcharge. Failure to pay the current maintenance fee on time may result in the patent expiring.

14. What types of activities before I file an application will prevent me from being granted a patent?

An applicant must file a patent application before or on the date of public use or disclosure anywhere in the world in order to obtain patent rights in many foreign countries.

In the United States, the answer is a bit more complicated. The following table summarizes the types of activities by an applicant or third party that can prevent an inventor from being granted a patent on an invention:

ACTOR	ACTIVITY	TIME	LOCATION
Inventor	abandoned the invention	at any time	anywhere in the world
Inventor	derived or stole the invention from third-party	before the date of invention	anywhere in the world
Inventor	patents the invention in another country	more than one year before filing a US patent application	outside the U.S.
Anyone	patented or described the invention in a printed publication. A reference is a printed publication if it is made available in tangible form and accessible to those interested in the field.	more than one year before the filing date of the patent application	anywhere in the world
Anyone	offered for sale, sold, or publicly used or disclosed the invention	more than one year before filing date of the patent application	U.S.
Third-party	knew or used the invention	before the date of invention	U.S.
Third-party	patented or described the invention in a printed publication	before the date of invention	anywhere in the world
Third-party	filed a patent application that ultimately issues as a patent, or published a PCT application in English, that describes the invention.	before the date of invention	anywhere in the world
Third-party	invented the invention and did not abandon or conceal it	before the date of invention	U.S.

Even if the invention itself was not publicly disclosed, known, or used, in any of the above ways, any information that was publicly disclosed, known, or used as set forth above will still bar a patent if it makes the claimed invention obvious. The above chart is

not exhaustive. Particularly since engaging in certain activities may destroy the ability to patent an invention, it is strongly recommended that you consult with legal counsel prior to engaging in conduct concerning your invention.

15. Can I change the content of my patent application after I file it?

In the United States, an applicant can make only limited changes to the patent application after it is filed. An applicant can correct typographical errors, submit formal versions of informal drawings, and amend the claims if there is support for the claim amendments in the originally filed patent application. No new information can be added to a patent application after it is filed. If you want to add new information or material to the description of the invention, you must file a new patent application that will lose the benefit of the earlier filing date for at least the new information and material.

16. How do I correct a mistake in an issued patent?

If a clerical error was made by the United States PTO, such as typographical errors made in printing the patent, the PTO may issue a Certificate of Correction upon the applicant's request. Some minor typographical errors made by the applicant may also be corrected by submitting a request for a Certificate of Correction and a fee.

A patent holder may request a "reissue" of a patent to correct mistakes in the scope of the U.S. claims. A reissue that broadens the claims must be filed within 2 years after the issuance of the patent. A reissue that narrows the claims can be filed at any time during the life of the patent.

A request by a patent holder or a third party for a "reexamination" by the United States PTO can be made if prior art is uncovered that raises a substantial new question as to the patentability of the claims in the issued patent. There are two types of reexamination proceedings, each with their own rules. They are increasingly popular as part of a litigation strategy. (See patent litigation FAQ)

17. How do I obtain patent rights in foreign countries?

Patent rights are typically granted on a country-by-country basis, and each country has its own rules for determining what is patentable, which may differ significantly from the U.S. rules.

Most of the world's industrialized countries, including, for example, Australia, Canada, China, Germany, India, and Japan, are parties to an international treaty known as the Paris Convention. The Paris Convention gives an applicant one year to file a corresponding patent application in a member country and still obtain an original U.S. priority date.

To obtain patent protection in countries that are not members of the Paris Convention, a patent application must be filed directly in those countries prior to the first public disclosure or sale of the invention, unless there is a legislative agreement with those countries that honors the one-year grace period. For example, Taiwan is not a member of the Paris Convention but has entered into an agreement with the United States that recognizes the grace period and grants priority rights based upon U.S. filings.

In addition to the Paris Convention, there are other international treaties that seek to harmonize patent protection among countries. For instance, the Patent Cooperation Treaty (PCT) provides a two-stage examination process for applications: first at an international level, and then in the individual countries from which patents are sought. Filing a PCT application only defers filing in the individual countries, and it does not replace these filings and associated costs. The principal reason for filing a PCT application is to defer deciding in what countries to seek patent protection and the expenses of regional or national patent filings. By 30 months from the earliest priority date asserted in the PCT application, the applicant must file a regional or national patent application in each country or region where protection is sought. The applicant must satisfy the requirements of the respective regional or national patent office to actually obtain the patent.

Another treaty, the European Patent Convention, established the European Patent Office (EPO) that handles applications for over 30 European countries. A single EPO application can be filed for protection in some or all of those countries. The application is examined by the EPO in any of the three official languages and, if granted, the specification is translated into the languages of the designated countries. There is an additional fee for issuance of the patent in each selected country.

If you have any questions about this memorandum, please contact Robin W. Reasoner (rreasoner@fenwick.com) or Charlene M. Morrow (cmorrow@fenwick. com) of Fenwick & West LLP.

Developing a Patent Strategy

A Checklist for Getting Started

BY RAJIV PATEL

Fenwick
FENWICK & WEST LLP

For many technology companies, developing a patent strategy is an important component of the business plan. However, for many the approach for developing a patent strategy is more happenstance than execution of a precisely defined plan. To help develop a patent strategy, this document provides a checklist for getting organized in preparation for developing a comprehensive patent strategy for the company.

A. Business and Patent Portfolio Goals

Starting in the development phase, the patent strategy identifies the key business goals of the company. Clear business goals provide a long-term blueprint to guide the development of a valuable patent portfolio. In particular, the company should:

- ❑ List the business, technology, and product goals for the company.
- ❑ Identify key industry players (competitors, partners, customers).
- ❑ Identify technology directions (within company and within industry).
- ❑ Determine whether a patent portfolio be used offensively (*i.e.*, asserted against others; revenue generation, *etc.*), defensively (*i.e.*, used as a shield or counterclaim against others who file suit first), for marketing purposes (*i.e.*, to show the outside world a portfolio to demonstrate company innovation), or a combination of these.
- ❑ Meet with attorney to align goals, industry information, technology information, and portfolio use core strategy.

B. Evaluation of Company Assets

The evaluation process begins by mining and analyzing intellectual assets within the company. In this process, a company organizes and evaluates all of its intellectual assets, such as its products, services, technologies, processes, and business practices. Organizing intellectual assets involves working with key executives to align the patent strategy with the business objectives. Here, the company should:

- ❑ Identify team members that will lead the mining and analysis process.
- ❑ Identify employees that create intellectual assets for the company.
- ❑ Identify the intellectual assets. To help determine this, gather and organize documented materials. Examples of documented materials include business plans, company procedures and policies, investor presentations, marketing presentations and publications, product specifications, technical schematics, and software programs. It may also include contractual agreements such as employment agreements, assignment and license agreements, non-disclosure and confidentiality agreements, investor agreements, and consulting agreements.
- ❑ Identify the anticipated life span for each intellectual asset.
- ❑ Identify the market for each intellectual asset.
- ❑ Identify products/product lines incorporating each intellectual asset.
- ❑ Identify those intellectual assets best suited for patent protection.
- ❑ Review risk analysis with attorney involving competitor studies.
- ❑ Prepare budget for patent strategy and patent procurement.

C. Procurement Phase

While the evaluation phase is in progress, the company can move into the procurement phase. In the procurement phase of the patent strategy, a start-up company builds its patent portfolio to protect core technologies, processes, and business practices uncovered during the evaluation phase. Typically, a patent portfolio is built with a combination of crown-jewel patents, fence patents, design-around patents, and portfolio enhancing patents. Each patent may have a unique value proposition for the company.

- ❑ Establish a budget for patent portfolio development.
- ❑ Draft invention disclosures (see attorney for Invention Disclosure Form).
- ❑ Critically evaluate each invention disclosure in the context of the patent strategy.
- ❑ Weigh risks vs. reward of a prior art search.
- ❑ Evaluate benefits and risk of provisional vs. utility patent application with attorney.
- ❑ Forward invention disclosure to attorney for patent application drafting.
- ❑ Over time, determine whether to conduct further competitive analysis to study industry trends and technology directions and identify patent portfolio coverage in view of same.
- ❑ Over time, evaluate risk vs. reward of studying patent portfolios of competitors and other industry players to identify how to further strengthen its patent portfolio.

D. Deployment Phase

A company that values its intellectual assets may set aside time, money and resources to further enhance its patent portfolio. To do this a company may move to the deployment phase. The deployment phase may include licensing all or part of a patent portfolio to others in the industry or to alternative applications for the technology. Alternatively, it may include asserting rights established by its patents, such as through litigation. The deployment stage often includes high-level management involvement. In this stage a company should consider:

- ❑ Review patent portfolio to identify those assets that company can sell for cash or use to spin out new business.
- ❑ Study competitor products for infringement considerations and determine risks vs. rewards of cease and desist strategy or licensing strategy.
- ❑ Evaluate the strength of competitor patent portfolios to access the potential for counter-attacks.
- ❑ Determine risks and benefits of various enforcement options (cease & desist; cross-license; *etc.*).

The outline above gives a just one overview of a potential patent strategy. With any patent strategy, some key considerations will include commitment from all levels of management and execution of the strategy once it is assembled. Companies that take the time and effort to develop a patent strategy will be reap many rewards for the time, money and effort spend early on as their business continues to grow and prosper.

Rajiv Patel (rpatel@fenwick.com) is a partner in the intellectual property group of Fenwick & West LLP. His practice includes helping companies develop, manage and deploy patent portfolios. He is registered to practice before the U.S. Patent and Trademark Office. Fenwick & West LLP has offices in Mountain View, CA, San Francisco, CA and Boise, ID.

FENWICK & WEST LLP

Fenwick & West Firm Overview

FENWICK & WEST LLP PROVIDES COMPREHENSIVE LEGAL SERVICES TO HIGH TECHNOLOGY AND LIFE SCIENCES COMPANIES OF NATIONAL AND INTERNATIONAL PROMINENCE. MORE THAN 250 ATTORNEYS OFFER CORPORATE, INTELLECTUAL PROPERTY, LITIGATION AND TAX SERVICES FROM OUR OFFICES IN MOUNTAIN VIEW AND SAN FRANCISCO, CALIFORNIA.

Corporate Group

We service high technology and life sciences companies, from early start-ups to mature public companies.

Start-Up Companies. We have represented hundreds of growth-oriented companies from inception through maturity. Our attorneys understand what it takes to start with only an idea, build a team, found a company, raise venture capital funding and grow a business. We have represented many of the nation's leading venture capital firms and do multiple deals each year with companies financed by these market leaders.

Mergers and Acquisitions. We are ranked by *MergerMarket* as one of the top five most active legal advisor in the U.S. for technology sector M&A. We understand the problems that arise in technology company acquisitions and focus our efforts on issues that are of the most value to the client. Our expertise spans the entire spectrum of high technology, from life sciences to semiconductors, and our lawyers are equally adept at small private company transactions and multi-billion dollar public transactions. Of particular importance to our high technology client base is the extraordinary acumen of our due diligence mergers and acquisitions teams in locating and documenting intellectual property holdings of buyers and sellers. For clients involved in larger deals, our antitrust lawyers are experienced in working with the Department of Justice and Federal Trade Commission in the pre-merger clearance process. We understand the many issues that can mean the difference between a successful transaction and a broken promise.

Public Offerings and Securities Law Compliance. Our extensive representation of emerging companies has given us substantial depth of experience in public offerings. In recent years, we have represented companies or investment banks in more than 100 initial public offerings, which, combined, have raised over $7 billion dollars. We have helped our clients raise billions more in follow-on debt and equity offerings. Our counseling practice for technology companies regarding ongoing public securities law issues includes extensive Sarbanes-Oxley compliance and board or audit committee counseling.

Strategic Alliances. For many high technology companies, the path to financing and commercialization begins with their first collaboration or joint venture with an industry partner. These agreements can often make or break a young technology company. We help clients think through the business, intellectual property, tax and other legal issues that arise in their corporate partnering transactions and joint ventures.

Executive Compensation. As an integral part of the corporate practice, we counsel clients on a wide range of employee benefits and compensation matters. We assist companies in establishing and administering employee benefit arrangements. Our lawyers help define and structure stock or other equity plans and arrangements, as well as tax qualified and fringe benefit plans, that meet the companies' needs and comply with ever-changing regulatory requirements. In the context of public offerings and acquisitions, our attorneys handle the issues that regularly arise with equity plans or other employment benefit arrangements.

Intellectual Property Group

We deliver comprehensive, integrated advice regarding all aspects of intellectual property protection and exploitation. Fenwick & West has been consistently ranked as one of the top five West Coast firms in intellectual property litigation and protection for the past 10 years by Euromoney's *Managing Intellectual Property* publication. From providing sophisticated legal defense in precedent-setting lawsuits, to crafting unique license arrangements and implementing penetrating intellectual property audits, our intellectual property attorneys have pioneered and remain at the forefront of legal innovation. We are continually in sync with our clients' technological advances in order to protect their positions in this fiercely competitive marketplace.

The Intellectual Property Group is comprised of approximately 80 lawyers and other professionals. A significant number of the lawyers in the group and other practice groups in the Firm have technical degrees, including advanced degrees, and substantial industry work experience. More than 35 attorneys are licensed to practice before the U.S. Patent and Trademark Office. Our lawyers' technical skills and industry experience help us render sophisticated advice with respect to novel technologies and related intellectual property rights issues. Attorneys in the group have lectured and published widely on emerging issues raised by the development, application and commercialization of technology.

Litigation Group

Litigation is an unfortunate fact of life in business today. Our Litigation Group has the range of experience and critical mass to protect our clients' interests in virtually any type of dispute, large or small. We are experienced in all methods of alternative dispute resolution and find creative ways to resolve cases short of trial. However, we are trial lawyers first and foremost; and the presence of our lawyers in a case signals to the other side that we are ready and willing to try the case aggressively and well, a message that itself often leads to a satisfactory settlement. While we have extensive litigation experience in a wide range of industries, we have exceptional depth and breadth in the areas of the law critical to our high technology clients. Those clients are leaders in such sectors as software and programming; Internet and entertainment; computer hardware; semiconductors and life sciences. We are regularly involved in significant cases involving intellectual property (patents, copyright, trademarks and trade secrets), employment disputes, corporate governance, securities, antitrust and general commercial litigation. In addition to civil litigation, our attorneys are experienced in representing clients in civil and criminal government investigations. Using a network of experienced local counsel, we routinely represent clients in cases throughout the United States. To support our lawyers, we have created a first-class litigation infrastructure of experienced legal assistants and computerized litigation support systems capable of handling everything from relatively small and simple cases to the largest and most complex "bet-the-company" mega-cases.

Tax Group

Fenwick & West has one of the nation's leading domestic and international tax practices. The Tax Group's unusually exciting and sophisticated practice stems from a client base that is represented in every geographic region of the United States, as well as a number of foreign countries, and has included approximately 100 Fortune 500 companies, 38 of which are in the Fortune 100. In recent surveys of 1,500 companies published in *International Tax Review*, Fenwick & West was selected as one of only seven First Tier tax advisors in the United States.

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Emphasis:

Start-Up/Venture-Backed Companies

Equity and Debt Financings

Mergers & Acquisitions

Securities Matters

Intellectual Property Licensing

Samuel B. Angus is a partner in the Corporate Group of Fenwick & West LLP, a law firm specializing in high technology matters. Mr. Angus is resident in the San Francisco office and his practice concentrates on the formation of start-up companies, venture capital and debt financings, mergers and acquisitions, intellectual property licensing, joint ventures and general corporate matters.

Mr. Angus represents a broad range of companies from privately held start-up companies to publicly traded corporations. His practice also includes advising entrepreneurs and investors.

Mr. Angus served as counsel for In-System Design, Inc. in connection with its acquisition by Cypress Semiconductor Corporation. He also counseled Naxon Corporation (Wineshopper.com) on its acquisition of Wine.com, Inc., Micro Focus Group on its $500 million merger with Intersolve, Inc., Junglee Corp. on its $300 million acquisition by Amazon.com, Inc., and Blue Lava Wireless on its $140 million acquisition by JAMDAT Mobile. Among the clients Mr. Angus has represented are:

- Ingenio, Inc. (formerly Keen)
- Adaptec, Inc.
- Revver, Inc.
- JotSpot, Inc. (acquired by Google)
- Vibrant Media
- @Home Corporation
- Blue Lava Wireless (acquired by JAMDAT Mobile)
- Junglee Corp. (acquired by Amazon.com)
- Lightspeed Venture Partners
- Khosla Ventures
- Steamboat Ventures
- Adteractive, Inc.

Mr. Angus received a Bachelor of Arts degree in law and society from the University of California at Santa Barbara. He received a J. D. from University of California Hastings College of the Law in 1993. At Hastings, he was the Executive Articles Editor for the *Hastings International and Comparative Law Review*. Mr. Angus is a member of The Bar Association of San Francisco, the State Bar of California and the American Bar Association. Prior to joining Fenwick & West, Mr. Angus practiced commercial lending law at the law firm of Lillick & Charles. Prior to becoming a lawyer, Mr. Angus was a founder and the chief executive officer of Design Look Publications, Inc., an international publisher of fine art calendars and other published gift products.

Mr. Angus sits on the advisory board of the Lester Center for Entrepreneurship & Innovation at the University of California, Berkeley. He is also a frequently lecturer at the HAAS School of Business and the Stanford Technology Ventures Program.

Narinder S. Banait, Ph.D.

Of Counsel

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Emphasis:

Patent Prosecution

Patent Analysis

Patent Counseling

Patent Litigation

Intellectual Property Due Diligence

Narinder S. Banait is of counsel in the Intellectual Property Group of Fenwick & West LLP, a law firm specializing in technology and life sciences matters. Fenwick & West is headquartered in Mountain View and San Francisco, California.

Dr. Banait has legal, and technical experience representing companies in pharmaceutical, biotechnology, and high technology areas that include pharmaceuticals, polymer based inks, photomasks, nanotechnology, chip manufacture, microfluidics, microarray, and genomics. Dr. Banait has represented clients including:

- AGY Therapeutics
- Admunex Therapeutics
- Agilent Lifesciences
- Granite Global Ventures
- Incyte Genomics
- Iconix
- Quantum Dots
- Vanguard Ventures

Dr. Banait has published over a dozen scientific papers in peer reviewed journals. In addition, he has written and prosecuted patent applications related to polymers, peptides, carbon nanotubes, photochemistry, chemical processes and method of manufacture, small molecule and oligonucleotide drug candidates for the treatment of CNS disorders, telomerase inhibitors, treatment for cancer and osteoporosis, and applications on synthetic methods.

Organization and Community Participation

- American Bar Association
- California Bar Association
- EPPIC

Dr. Banait received his undergraduate education at University of Toronto, graduating with a B.S. in chemistry and biochemistry. He received a M.S. in synthetic chemistry and a Ph.D. in organic chemistry, both from the University of Toronto. Dr. Banait was a Post-doctoral fellow at Brandeis University, and at University of California. In addition, he worked as a research scientist at Syntex Research, a pharmaceutical company that was acquired by Roche, where he primarily focused on 5-HT3 antagonists for the treatment of emesis and anxiety disorders. He received his J.D. from the Santa Clara University in 1997.

Dr. Banait is a member of the State Bar of California and is registered to practice before the U.S. Patent and Trademark Office.

Fred M. Greguras

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Emphasis:

Startups and Venture Capital Financings

Licensing

Intellectual Property Protection

Fred M. Greguras is of counsel in the corporate and technology transactions groups at Fenwick & West LLP, a law firm specializing in high technology matters. He practices out of the firm's Mountain View, California, office. Mr. Greguras focuses on strategic legal issues for software, semiconductor-related and life sciences companies. His practice includes start-up issues and financings in both domestic and international transactions. He has represented a wide range of companies in financing, M&A, licensing and other commercial transactions, from privately held start-ups to publicly traded companies. Mr. Greguras has also been a venture capitalist and a general counsel and CFO for a startup. Some of the clients he has represented are:

- BioMarker Pharmaceuticals, Inc.
- Excite@Home
- Exodus Communications, Inc.
- Kintana, Inc.
- Speedera Networks, Inc.

Mr. Greguras has authored many articles on start-up, financing, outsourcing, Internet and international legal issues, which are available at www.fenwick.com.

He received a Bachelor of Arts in mathematics from University of Omaha in 1966, a Masters of Science in mathematics and computer science in 1968, and his J.D. in 1975 from the University of Nebraska. Mr. Greguras is a member of the State Bar of California.

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Emphasis:

Litigation

Gaurav Mathur is an associate in the Litigation Group of Fenwick & West LLP, a law firm specializing in technology and life sciences matters. Fenwick & West is headquartered in Mountain View, California, with an office in San Francisco. Mr. Mathur's practice focuses on intellectual property litigation.

Mr. Mathur received his J.D. from Northwestern University School of Law, Chicago in 2005. He received his B.S. in chemical engineering and Business Foundations Certificate from the University of Texas at Austin, in 2001.

Mr. Mathur is a member of the State Bar of California.

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ERISA

Executive Compensation

Mergers and Acquisitions

Stock Plans

Tahir J. Naim is an associate in the Corporate Group of Fenwick & West LLP, a law firm specializing in high technology matters. Fenwick & West has offices in Mountain View and San Francisco, California. Mr. Naim's practice focuses on executive compensation, stock plans and ERISA issues as they arise in mergers, hirings, layoffs, benefits administration and the general course of business. Among the clients he has represented are:

- Barclays Global Investors, N.A.
- Cisco Systems, Inc.
- DexCom, Inc.
- Diamond Foods, Inc.
- Intuit Inc.

Mr. Naim received his undergraduate education at Macalester College, St. Paul, graduating with a B.A. in political science in 1987. He attended law school at Golden Gate University (in part on a Rensch Scholarship for persuasive writing), graduating with a J.D. in 1992. Mr. Naim received his LL.M. (Tax) from Golden Gate University, with an emphasis on benefits and executive compensation, in 1995.

Mr. Naim is a member of the Santa Clara County Bar Association, the South Asian Bar Association of Northern California, the Asian Pacific Bar Association of Silicon Valley and the Asian American Bar Association of Greater Bay Area.

Experiences and Accomplishments

- Drafter of State Bar of California Conference of Delegates proposal to amend Cal. Corp. Code Sec. 25102(o) to ease stock administration. Testified before Assembly and Senate committees in favor of bill's passage. The bill passed without opposition and became law January 1, 2002.
- Law Clerk in the Environmental Enforcement Section of the U.S. Dept. of Justice.
- Two-term President of the South Asian Bar Association of Northern California.
- One of several organizers/sponsors of the 2003 Conference of the Indo-American Leadership Initiative.
- Legal Clinic Volunteer through the Santa Clara County Bar Association.
- 2004 Chair of the Minority Access Committee of the Santa Clara County Bar Association.

Articles

- "Another 409A-Related Deadline: California Developments Linked to Backdated Options and Section 409A," Tahir Naim, *TheCorporateCounsel.net*, March 5, 2007.
- "The NEO Changes—Effect on Code Section 162(m) Covered Executives?", Tahir Naim, *The Corporate Executive*, pgs. 8-9, September-October 2006. Law Clerk in the Environmental Enforcement Section of the U.S. Dept. of Justice.
- "Time to Share: A Basic Guide to Stock Options in China", Tahir Naim, *The Recorder: Doing Business in China* supplement guide, July 24, 2006.
- Contributor to "Statutory Stock Options" vol. 381-2nd of the Tax Management Portfolio series published by the *Bureau of National Affairs*, 2001 (a later edition has since been published to which Mr. Naim did not make an additional contribution, though his prior work continues to be incorporated therein).

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Emphasis:

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Patent Analysis

Patent Prosecution

Patent Litigation

Intellectual Property Counseling

Intellectual Property Licensing

Intellectual Property Audits

Intellectual Property Due Diligence

Rajiv P. Patel is a partner in the Intellectual Property Group of Fenwick & West LLP. His practice includes patent portfolio development and management, patent enforcement, and patent and high technology transactions. His practice also includes intellectual property ("IP") audits and strategies to help companies identify, evaluate and protect key intellectual assets.

In patent portfolio development and management, Mr. Patel has counseled, prepared and prosecuted patents in a wide range of technology areas including wireless communications, electronics, network processors, complex hardware architecture, complex software architecture, electro-mechanical devices, and business methods. He has advised and initiated patent reissue and reexamination strategies and proceedings. He has also partaken in appeals before the Board of Patent Appeals and Interferences. In addition, Mr. Patel is active in developing and overseeing strategies involving foreign patent prosecution and procurement, including for Europe, Japan, China, Taiwan, and India.

In patent enforcement, Mr. Patel litigated in technology areas that include solid-state memories, electronic gaming, Internet delivery networks, and interactive television. In patent and IP transactions, he has negotiating large patent and other IP portfolios, evaluated IP portfolios for acquisition, and conducted diligence for venture funding, mergers & acquisitions, and initial public offerings.

Among the clients Mr. Patel has represented are:

- Logitech, Inc.
- Compuware Corporation
- Fujitsu Ltd.
- Magma Design Automation
- Plaxo, Inc.
- Canon Research Americas, Inc.

Mr. Patel is an Adjunct Professor of Law at the University of California, Hastings College of the Law where he teaches a course on patents. Mr. Patel is also on the faculty of Practising Law Institute and Law Seminars International. In addition, Mr. Patel has authored articles in the field of patent and IP portfolio development and management strategies.

Mr. Patel received his Bachelor of Science (with high honors) in Electrical Engineering from Rutgers University (NJ). He received his Juris Doctor and Master of Intellectual Property from Franklin Pierce Law Center (NH). He is a member of the California Bar and is registered to practice before the U.S. Patent and Trademark Office.

Highlighted Legal Experience:

Patent Strategy and Portfolio Development

- Created patent strategy and developing patent portfolio for $500 million plus product line of a computer peripheral manufacturer.
- Created patent strategy and advised on patent portfolio for on-line auction company. Patent portfolio sold for over $750,000.
- Evaluated patent portfolio for nanotechnology company in conjunction with industry trends and directions in new technology space where company was shifting focus to and advise on new patent strategy.
- Developing patent strategy and foundational patent portfolio for start-up and early stage and start-up companies in technology fields such as network storage, business process software, and web services.
- Developing and managing patent portfolio for emerging mid-size and large companies in technologies fields such as electronic design automation, processor technology, wireless data communications, optical data processing, and enterprise software tools.
- Sample Patents:
  - U.S. Patent No. 6,246,294 Supply Noise Immunity Low-Jitter Voltage-Controlled Oscillator Design
  - U.S. Patent No. 5,909,151 Ring Oscillator Circuit
  - U.S. Patent No. 5,948,083 System and Method for Self-Adjusting Data Strobe
  - U.S. Patent No. 5,748,126 Sigma-Delta D/A Conversion System and Process Through Reconstruction and Resampling
  - U.S. Patent No. 5,991,296 Crossbar Switch with Reduced Voltage Swing and No Internal Blocking Path
  - U.S. Patent No. 6,055,629 Predicting Branch Instructions in a Bunch Based on History Register Updated Once
  - U.S. Patent No. 6,052,033 Radio Frequency Amplifier System and Method
  - U.S. Patent No. 5,835,852 Integrated Electronic Communication Device and Clip
  - U.S. Patent No. 6,389,405 Processing System for Identifying Relationships Between Concepts
  - U.S. Patent No. 5,995,955 System and Method for Expert System Analysis Using Quiescent and Parallel Reasoning and Set Structured Knowledge Representation
  - U.S. Patent No. 6,275,622 Image Rotation System
  - U.S. Patent No. 6,246,016 Optical Detection System, Device, and Method Utilizing Optical Matching

Highlighted Legal Experience:

Patent and Intellectual Property Transactions

- Led intellectual property audit for Fortune 500 communication company's intellectual property in wireless technology and advised on intellectual property issues in context of tax framework.
- Led intellectual property audit for electronic gaming company and developed intellectual property management structure for company.
- Conducted numerous intellectual property due diligence for high-technology investments by venture capital companies.
- Conducted numerous intellectual property due diligence on behalf of target companies or acquirer companies in high-technology merger and acquisition matters.

Patent Litigation

- *ICTV, Inc. v. Worldgate Communications, Inc.* – advised on patent litigation strategy in interactive television market.
- *SanDisk Corporation v. Lexar Media, Inc.* – patent litigation involving flash memory consumer products.
- *GameTech International, Inc. v. Bettina Corporation* – patent litigation involving electronic gaming.
- *Planet Bingo, LLC v. GameTech International, Inc.* – patent litigation involving casino style games on electronic devices.
- *Akamai Technologies, Inc. v. Speedera Networks, Inc.* – patent litigation involving Internet content delivery services.

Teaching Experience

- Adjunct Professor of Law for "Patent Practice" at University of California, Hastings College of the Law (2001 to present).
- Faculty Member for Practising Law Institute for "Advanced Patent Prosecution," "Fundamentals of Patent Prosecution," and "Patent Law for the Non-Specialist" courses (2002 to present).
- Faculty Member for Law Seminars International for "Defending Against Patent Infringement Claims" (2004).
- Course Instructor in "Laws and Emerging Technology" for O'Reilly Emerging Technologies Conference (April 2003).
- Course Instructor in "Intellectual Property Strategies and Management for Federal Publication Seminars (May 2002).

Publications

- Software Escrows as Part of an Intellectual Property Strategy," Computer Law Association First Asian Conference, Bangalore, India, 2005.
- "Underutilized Patent Reexaminations Can Improve Business Strategy," Daily Journal, Vol. 110, No. 75, April 19, 2004.
- "Software Outsourcing Offshore – Business and Legal Issues Checklist," SHG Software 2004 Conference, 2004.
- "A Strategic Look at the Final Rejection," Advanced Patent Prosecution Workshop, Practising Law Institute, No. G0-10A8, 2003 - 2005.
- "Understanding After Final and After Allowance Patent Practice," Fundamentals of Patent Prosecution, Practising Law Institute, No. G0-01EV, 2003 -2005.
- "Think Value, Not Cheap, For Long-Term Success," Succeeding with New Realities, TiEcon 2003, Published by TiE Silicon Valley 2003.
- "The Intellectual Property Audit," Building and Enforcing Intellectual Property Value, An International Guide for the Boardroom 2003, Published by Globe White Page 2002.
- "Patent Portfolio Strategy for Start-Up Companies: A Primer," Patent Strategy and Management, Vol. 3, No. 7, Nov. 2002.
- "Potent Portfolio," Daily Journal, Vol. 106, No. 244, Dec. 15, 2000.
- "Own Idea," Daily Journal, Vol. 105, No. 10, Jan. 15, 1999.
- "Disclose Lite," Daily Journal, Vol. 103, No. 55, Mar. 21, 1997.

Organization and Community Participation

- American Bar Association
- American Intellectual Property Law Association
- TiE ("The Indus Entrepreneurs" / "Talent, Ideas, Enterprise")
- Computer Law Association
- Dean's Leadership Council for Franklin Pierce Law Center
- Dean's Committee for Rutgers University, School of Engineering

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Emphasis:

VC Financings

Mergers and Acquisitions

Public Offerings

Sayre E. Stevick is a partner in the Corporate Group of Fenwick & West LLP, a law firm specializing in high technology matters. Mr. Stevick practices out of the firm's Mountain View, California, office. His practice concentrates on the representation of high technology companies on a variety of transactions, including venture capital financings, mergers and acquisitions and public offerings. Mr. Stevick's practice also includes providing day-to-day counseling to such companies (and their boards of directors) on numerous other corporate matters. Mr. Stevick also represents various investors and underwriters. The following are among the clients he has represented:

- Accel Partners
- Cisco Systems, Inc.
- Crosspoint Venture Partners
- Digeo, Inc.
- eBates.com
- E-Tek Dynamics, Inc.
- Foundation Capital
- Goldman, Sachs & Co.
- Good Technology, Inc.
- InterWest Partners
- Keyhole Corporation (developer of "Google Earth")
- Kintana, Inc. (acquired by Mercury Interactive Corporation)
- Kleiner Perkins Caufield & Byers
- Luxtera, Inc.
- MarketWatch.com, Inc.
- Mendocino Software, Inc.
- NetScreen Technologies, Inc.
- Peribit Networks, Inc. (acquired by Juniper Networks)
- Proofpoint, Inc.
- RGB Networks, Inc.
- Stanford Research Institute
- Tellme Networks
- Torrent Networking Technologies Corp. (acquired by Ericsson Inc.)
- Visage Mobile, Inc.

Mr. Stevick received his undergraduate education at the University of California at Berkeley, graduating with a B.A. degree in political science in 1990. He attended law school at the University of California, Hastings College of the Law where he was a member of the Thurston Honor Society and the *Order of the Coif*, graduating second in his class and *magna cum laude* in 1997.

Notes: