FENWICK & WEST LLP

Start-up Legal Resource Guide

Prepared for the TiE Early Stage Financing Workshop

INDEX	TAB

Early Stage Financing Workshop

The Indus Entrepreneur

Seed and Venture Capital Financing Terms

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Early Stage Financing Workshop

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

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

Early Stage Financings (Types)

- Product validation in the market and scalability
- Seed Financing
  - Friends, Family, Angels
  - Quick, Simple, Cheap
  - Type of Security –what the investor requires
- Venture Capital
- Corporate Partner
  - Valuation
  - "Strings attached"
- Debt Financing?
- Role of a Term Sheet
- Securities Laws

Seed Financings: Use Of 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

Seed 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

Seed Financings: Use Of 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

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 (2-4 weeks)
- Step 4: Financing Documentation and Diligence (4-12 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 (?)

Process And Overview

Preferred Stock Model [2]

- Venture Capitalist 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 Rights
  - Conversion Rights/Antidilution Protection
  - Redemption
  - Registration Rights
  - Information Rights
  - Participation Rights

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?

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

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

Preferred Stock Privileges

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

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

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

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

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)

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

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 additional preferred shares
  - 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%)

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

Key Control Terms

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

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

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

Investor Protections And Rights

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

Investor Protections And Rights

Rights of First Refusal (ROFR) [14, 26, 27]

- 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 [27]
  - 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 [26]

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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) [28]
  - 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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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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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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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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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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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

Conclusion

- **Current financing environment continues to improve, but mixed signals persist**
  - Valuations continue to improve (though VC investment decreased by 10% - 15% in Q4'05 vs. Q5'04)
  - To build interest
    - Be able to demonstrate customers/revenue product achievement
    - Be able to show where the company will be when the funding is spent
- **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**
  - Sample Venture Capital Term Sheet
  - Q1 2005 Quarterly Venture Capital Terms Survey
  - Q1 2005 PWC Money Tree

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THIS TERM SHEET SUMMARIZES THE PRINCIPAL TERMS OF THE PROPOSED FINANCING OF _____ (THE "*COMPANY*"). THIS TERM SHEET IS FOR DISCUSSION PURPOSES ONLY. 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

[*DATE*]

[1] Amount of Financing: Four Million Dollars ($4,000,000)

[2] Type of Security: Ten Million (10,000,000) shares of Series A Preferred Stock (the "***Purchased Shares***"), initially convertible into an equal number of shares of Common Stock.

[3] Purchase Price: Forty Cents ($0.40) per share (the "***Purchase Price***").

[4] Closing: Approximately _____ (the "***Closing***"). Additional closings may be held at the option of the Company within _____ days after the initial Closing, at places selected by the Company, as will be further described in the Stock Purchase Agreement.

Projected Post-Financing Capitalization:

	Number of Shares	**%**
Common Stock	5,000,000	28.58%
Series A Preferred	10,000,000	57.14%
Equity Incentive/Stock Option Pool:		
Outstanding Grants:	0	0%
Future Grants:	2,500,000	14.28%
Warrants	0	0%
Total:	17,500,000	100.00%

*The Series A Preferred Stock shall be collectively referred hereinafter to as the "***Preferred Stock***".

[Bridge Loans: **Prior to closing, the Investors will loan the Company up to _____ Dollars ($_____) evidenced by convertible promissory notes (the "*Bridge Notes*"), bearing interest at a rate of _____ percent (_____%) secured by a security interest in the Company's assets and payable on the earlier of: (i) _____; or (ii) the Closing. All indebtedness under these Bridge Notes will be converted into Purchased Shares upon Closing of this financing.**

Conversion of Bridge Loans: **The current outstanding Bridge Notes in the amount of _____ Dollars ($_____) will automatically convert into _____ (_____) Shares of Series _____ 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:

[Blank-Check Provisions: **The Articles shall contain a blank check provision providing the Board with authority to create an additional Series of Preferred Stock consisting of up to _____ million (_____,000,000) shares with rights and preferences superior to existing classes and series without further approval by the outstanding Preferred Stock and Common Stock.]**

[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 _____ Dollars ($_____), 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 solely on the Common Stock.

[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 _____ Dollars ($_____) 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 shareholders will be distributed **[pro rata among the holders of the Preferred Stock and the**

Common Stock on an as-converted basis] [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 Preferred Stock, then the assets of the Company will be distributed ratably to the holders of the Preferred Stock 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 shareholders 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**: Subject to any legal restrictions on the Company's redemption of shares, beginning on _____ **[*FIRST REDEMPTION DATE*]** upon receiving written request from **[two thirds (2/3)/majority]** of the Preferred Stock at any time after _____ **[*DATE*]** (the "***Initial Redemption Date***") and at the close of each successive calendar quarter thereafter, the Company shall redeem _____ percent (_____%) of the number of shares of Preferred Stock outstanding on the Initial Redemption Date until all outstanding shares shall have been redeemed or converted into Common Stock. The redemption price for each Purchased Share will be _____ Dollars ($_____) plus all declared but unpaid dividends thereon. If on any scheduled redemption date, the number of Purchased Shares that may then be legally redeemed by the Company is less than the number of such shares then scheduled to be redeemed, then the shares then scheduled to be redeemed that may not be legally redeemed shall be carried forward and redeemed on the next scheduled redemption date to the extent of the Company then has legally available funds therefor.

[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 Articles of Incorporation and Bylaws shall provide for a Board of Directors consisting of _____ (_____) members. The number of directors cannot be changed except by amendment of the Articles of

Incorporation by a vote of holders of at least a **[majority/two thirds (2/3)]** of the outstanding Preferred Stock.

With respect to the election of the Board, so long as at least _____ shares of Preferred Stock are outstanding: (a) the holders of Series **[_____]** Preferred will be entitled to elect ____ member**[(s)]** of the Board; (b) the holders of the Common Stock, voting together as a single class, will be entitled to elect _____ member**[(s)]** of the Board; 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**[(s)]** of the Board. The Company, the holders of the Preferred Stock and _____ (the "***Shareholders***") shall enter into a voting agreement setting forth such an arrangement.

At the Closing, the Board of Directors shall consist of _____, _____, _____, _____ and _____.

Visitation Rights: So long as at least _____ shares of Preferred Stock are outstanding, the holders of Series **[_____]** Preferred will be entitled to appoint one person to obtain visitation rights to attend the non-executive portion of Board meetings.

[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 _____ Dollars ($_____) per share for a total public offering price of not less than (before payment of underwriters' discounts and commissions) _____ Dollars ($_____) _____ Million Dollars ($____000,000) (an "***Approved IPO***"), or (ii) upon the written consent of holders of not less than **[two-thirds (2/3)/a majority]** 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]/[full ratchet] 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; except, however, that without triggering antidilution adjustments: (1) shares of Common Stock issued or issuable upon conversion of the Preferred Stock; (2) **[up to _____] [any]** 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) **[up to _____] [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 **[any] [_____]** shares of the Preferred Stock remain outstanding, the consent of the holders of **[a majority/two-thirds (2/3)]** of the outstanding Preferred Stock **[voting as a single class on an as converted to Common Stock basis] [voting as a separate series]** 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 materially and 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 shareholders 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 _____ shares of Preferred Stock (and/or Common Stock issued upon conversion of such shares), the Company shall deliver: (i) audited annual financial statements to the Investor within 120 days after the end of each fiscal year; and (ii) unaudited quarterly financial statements within 45 days of the end of each fiscal quarter. So long as a holder of Purchased Shares continues to hold at least

_____ shares of Preferred Stock and/or Common Stock issued upon conversion of such shares, the Company shall deliver 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 ___ years following the closing, holders of at least _____ 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 _____ Dollars ($_____), 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 "***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 _____ percent (_____%) 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 shareholders in such registered offering is less than _____ Dollars ($_____); (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 $50,000 and exclusive of underwriting discounts and commissions but including the fees of one counsel for the selling shareholders, 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 _____ 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, shareholder, 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-shareholders]** 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 _____ percent (_____%) of the Registrable Securities then outstanding. The Company agrees to keep the registration statement effective for up to _____ (_____) days. Other provisions shall be included with respect to registration rights as are reasonable, including cross-indemnification.

Termination: These registration rights will terminate _____ (_____) 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 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 _____ percent (_____%) 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**.**

An opinion of counsel for the Company.

On and after the Closing Date, the Board of Directors shall consist of _____ (___) directors, consisting of _____, _____ and _____, and _____.

A minimum of _____ shares of Purchased Shares shall be purchased.

[24] Covenant regarding Stock sold and options granted to employees will normally be subject to vesting as follows, unless otherwise approved by the

Vesting: Board of Directors: (a) vesting over _____ (_____) years - _____ percent (_____%) of the shares vest at the end of the first year, with _____ percent (_____%) of the balance vesting monthly thereafter, and (b) a repurchase option shall provide that upon termination of the employment of the shareholder, with or without cause, the Company retains the option to repurchase at cost any unvested shares held by such shareholder.

[25] **Covenant regarding Founder Vesting:** Stock sold and options granted to Founders will be subject to vesting as follows: (a) vesting over _____ (_____) years - _____ percent (_____%) of the shares vest at the end of the first year, with _____ percent (_____%) of the balance vesting monthly thereafter, and (b) a repurchase option shall provide that upon termination of the employment of the shareholder, with or without cause, the Company retains the option to repurchase at cost any unvested shares held by such shareholder.

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 _____ Dollars ($_____).

[26] **Right of First Refusal By the Company:** The Company shall have a right of first refusal to purchase any of the Purchased Shares that Investor proposes to sell, transfer, gift, pledge, assign, distribute, encumber or otherwise dispose of to a third party, except for transfers which are part of an inheritance or to an affiliate of the Investor.

[27] **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 who hold no less than _____ (_____) shares of the 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 _____ percent (_____%) of the Stock or _____ (_____) 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 who hold no less than _____ (_____) shares of 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 _____ percent (_____%) of the Preferred Stock; or (vi) _____ (_____) years after the effective date of the Closing.

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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.

FENWICK & WEST LLP

Venture Capital

for High Technology Companies

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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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 $20,000.

Counsel to the Company

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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.

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Raising Initial Funding for High Technology Companies in the San Francisco Bay Area

BY FRED GREGURAS AND BLAKE STAFFORD

Introduction

This is a brief summary of the process for raising initial funding in the Bay Area for high technology companies. We hope to help entrepreneurs seeking initial funding understand the alternatives, identify potential funding sources and, most importantly, understand the practical realities of raising initial funding in the Bay Area.

Although a number of business forms exist (*e.g.*, limited liability companies, limited partnerships, general partnerships, S-Corps), we assume that your high technology enterprise will be formed as a C-Corp. The C-Corp form is almost always selected for many good reasons. Nonetheless, under some particular circumstances, one of the other forms may be chosen. Again, the following discussion assumes that you will form a C-Corp.

Although we touch upon initial funding from the entrepreneur and "friends and family", the primary focus of the following discussion is how you can maximize your probability of obtaining initial funding from institutional angels and/or VCs. Both of these groups are sophisticated investors that insist upon thoroughly vetting your company. We want to prepare you to achieve success in this vetting process by getting the attention of institutional angels and VCs and by performing well when you are "on stage."

Seed Capital Financings

Seed capital is primarily available from the entrepreneur, "friends and family", an institutional angel investor and/or a prospective customer. Seed capital financing is needed to form the C-Corp, clear its name, create its by-laws and other corporate documents, create a stock option plan and complete other preliminary matters as well as to satisfy the validation requirements for a VC financing. "Friends and family" investors invest basically because they trust the entrepreneur, and thus the polished materials (discussed below) you will prepare to attempt to get the attention of institutional angels and VCs often are not required. Many institutional angels approach these initial financings much like a VC and want the validation required by a VC. Major Bay Area angel groups include the Angels Forum, Band of Angels, International Angels, Keiritsu Forum, Sandhill Angels and Tenex.

Seed financing usually comes in the form of the purchase of common stock, preferred stock or notes convertible into common or preferred stock. Selling common stock often is not useful for the seed financing because of the dilutive effect. Consider the number of shares at $0.01 per share needed to be sold to raise even $100. A low price of common stock, however, is useful to motivate employees and other service providers who will be granted attractively priced options or shares of common stock. Pricing of common stock must be same for all sales at or about the same time.

If preferred stock is used for the seed financing, the company must be valued. Preferred stock can be complicated and expensive to use even if raising a small amount of money. The cost of raising money should be proportionate to amount raised.

Convertible notes for "next financing" preferred stock are often used for seed capital financings. This approach defers the valuation determination and keeps the financing simple and low cost. A discount on the conversion price in the "next financing" (or warrants) is often used as a "sweetener" for taking added risk.

First VC Round

VCs generally invest via the purchase of preferred stock that is convertible into common stock. On occasion they may purchase convertible notes. VCs will thoroughly vet your company scrutinizing the materials described below if you can get their attention.

Defining the Business and Communicating its Value

Preparing and refining an elevator pitch, executive summary and power point presentation for institutional angels and/or VCs to fully understand the business, its value proposition and the execution steps is a critical part of the initial fundraising process. The following materials should be prepared for communicating with prospective investors and others. They need to be clear, concise and persuasive **because if you are unable to create high quality versions of these materials, you almost certainly will be unable to attract the attention of institutional angels and VCs:**

- 30 second elevator pitch
  This is your "attract" mode for the purpose of persuading the target person to take the next step of asking questions

- 2 page executive summary which covers the following business points:

  The Problem and Solution
  What is the pain point and how are you solving it? The product must be "need to have."

  Market Size
  How big is the market? Is it at least $1B?

  Sales Strategy and Channels
  How will you acquire customers?

  Intellectual Property Position
  Do you have protectible IP and how will you protect it? For example, have you filed provisional or full patent applications?

  Competition
  What is your "unfair" competitive advantage?

  Management Team
  Can the initial team execute at least through product development?

  Pro-Forma Financials for 3-5 years
  What initial valuation will the projected revenue numbers justify?

- 8-12 slide PowerPoint presentation
  The first bullet point of the first slide is the most important.

Be prepared to give the 30-second elevator pitch when meeting potential investors (or people who can introduce you to investors), potential customers or people who might join your team. Even your lawyer will want to hear it. Bay Area networking events provide access to potential investors, team members, customers and others who can help build a business. Make sure there is a clear "unfair" competitive advantage in the 30-second pitch — why is your company "special"? Being a cheaper alternative to a larger, better financed competitor is unlikely to be persuasive.

You will need validation of the technical feasibility of the product and its market need in order to get VC investment. This requires credible referenceable customers who will actively support the product in discussions with potential investors. You need one or more Fortune 100 type customers or a critical mass group of smaller customers. It is very difficult to raise venture capital without market validation. Validation is a "chicken and egg" problem in some spaces. In a chip business, for example, validation requires money while a software business may be able to reach validation with mostly "sweat" equity.

You will also need to demonstrate the market size is large enough (generally at least $1B) to provide investors with an acceptable ROI through an "exit event" (IPO or acquisition). Even if the product works and you have referenceable customers, most venture capitalists do not want to invest in a small business. This does not mean it isn't a good business, only that it has to be financed in another way.

Forming the Team

Your team can be assembled from friends and other business contacts and through meeting people at Bay Area networking events. In most cases, the technical founder must be from and have credibility in the business space of the company. The initial team needs to include someone who can credibly identify market requirements. Investors don't invest in technology; they invest in companies with a product that the market wants that generates scalable revenues. Defining and refining product requirements is a continuous task.

Meeting Angels and VCs

Many Bay Area marketing events provide an opportunity to meet institutional angels and venture capitalists and to learn their business segments of interest and investment criteria. There are usually a number of VCs at AAMA events and BASN, SVASE and other organizations offer small group meetings with VCs.

The best route to an institutional angel or a VC is through an introduction from someone they know such as a lawyer, accountant or another institutional angel or VC. This approach usually results in the institutional angel or VC reading at least the pain point/solution paragraph of the executive summary. The Silicon Valley Bank Venture Exchange program provides a good way to be introduced to potential investors.

In determining which institutional angels and VCs to try to meet, you should review a potential institutional angel's or VC's portfolio to make sure there is no competitive investment.

Company Presentation Events

There are several organizations in the Bay Area, which provide regularly scheduled (usually monthly) opportunities for entrepreneurs to present their companies to potential investors. These are so-called "amplification" events because an entrepreneur can reach more prospective investors with a single presentation. Each organization has a screening process and some charge entrepreneurs to present. Several of the organizations focus on a single business segment in each meeting since investors interested in the space will be more likely to attend if there will be a number of companies of interest presenting.

Two places you can meet institutional angels are:

- International Angels (angelinvestors.org) — This is an angel group primarily in seed capital investment. Investors are spread over a variety of business segments including some non-traditional technology businesses.

- Bay Area Startup Network (basn.org) — These events have both angels and VCs in attendance. Investors attend for both seed capital and initial VC fundings.

The following organizations have only VCs in attendance and pre-qualification of companies is rigorous. Companies presenting need to have the product and customer validations necessary for first round VC financing:

- IDB Network (idbnetwork.com)

- Right Hand Partners (rhpartners.com)

- Deloitte & Touche Accelerator Sessions

Use of Finders

You may be approached by a "finder" who offers to help you raise money through introductions to prospective investors. Do a reference check on the finder's track record. If the finder is asking for a "success fee" then the finder needs to be a registered broker dealer under federal and state securities laws. Institutional angels and VCs will not look kindly upon the use of a finder who has a claim to cash from the proceeds of the investment. Introductions to institutional angels and VCs can usually be arranged without the use of a finder.

Venture Lending

Once a first VC round has closed that includes material VC participation, it may be possible to obtain additional financing from institutions that specialize in venture lending to early stage companies, which may be pre-revenue. These financings help extend the companies cash. A critical factor in the decision of these lenders to enter into a financial arrangement is the quality of the VCs in the first VC round. Inevitably these lenders will receive an equity "kicker" usually in the form of company warrants. The lenders are banks (*e.g.*, Comerica Bank, Silicon Valley Bank, Bridge Bank) or funds (Western Technology, Lighthouse Capital, Gold Hill Capital, Pinnacle). The banks and funds tend to have somewhat different deal terms and deal size limitations.

Basic Legal Issues

Federal and state securities laws need to be complied with in selling securities to investors. Investors have, in effect, a money-back guarantee from the company and possibly its officers if you do not comply. Borrowing money from persons not in the business of making loans is a security under these laws. You should seek investment only from accredited investors or a tight circle of friends and family.

Due diligence by both professional angels and VCs includes a hard look at intellectual property ownership. An initial focus will be the relationship of the technical founders to their prior employers' technology. In California, even if the technical founder has not used any of his prior employer's resources, trade secrets or other property, the prior employer may have a claim to any inventions that relate to the prior employer's business or actual or demonstrably anticipated research or development. In today's difficult financing environment, there is much tension on this issue

because entrepreneurs are reluctant to give up their jobs without funding. This means there may be a "hot" departure of the technical founder from the old employer and a "hot" start at the new company without any cooling off period or, even worse, an overlap of the technical founder working for both companies at the same time. Some entrepreneurs underestimate this risk since their perception is that many Bay Area companies have been started in the past by entrepreneurs who leave a company and start a company in the same space. Trying to delay a departure until funding is imminent is very risky and may in fact materially reduce the probability of funding. Investors will not want to buy into a lawsuit.

Another key due diligence item is rights to stock and other equity. The entrepreneur needs to have discipline in promising stock both to reduce claims to stock and to comply with securities laws. Adopting a proper stock option plan at the time of incorporation provides a securities law exemption for providing equity incentives to team members and others.

We hope this summary will help you understand the realities of raising initial financing in the Bay Area. Now go get your money!

If you have any questions about this memorandum, please contact Fred M. Greguras (fgreguras@fenwick. com) or Blake Stafford (bstafford@fenwick.com) of Fenwick & West LLP (telephone: 650.988.8500).

FENWICK & WEST LLP

Venture Financing Terms Survey

1st Quarter 2005

FENWICK & WEST LLP

Trends in Legal Terms in Venture Financings in the San Francisco Bay Area (First Quarter 2005)

- **Background** – We analyzed the terms of venture financings for 89 technology companies headquartered in the San Francisco Bay Area that reported raising money in the first quarter of 2005.
- **Overview** – The results of the 1Q05 survey showed a continuation of the positive trend in venture terms. The highlights of the quarter were as follows:
  - Up rounds outpaced down rounds for the fifth quarter in a row. The ratio of 59% up rounds versus 31% down rounds was similar to 4Q04.
  - The Fenwick & West Venture Capital Barometer™ showed a 24% average price increase for companies receiving venture capital financing in 1Q05 compared to such companies previous financing round. This increase was lower than the 36% increase recorded in 4Q04, but 4Q04 was our largest increase to date, and the 1Q05 increase was higher than the 17% increase recorded in 3Q04.
  - Non-price terms continued to trend to the pre-bubble norm, with the use of multiple liquidation preference at the lowest level since we began the survey in 2002.

Although these are positive indications, there is reason for some caution as other 1Q05 venture capital indicators were more mixed. These included the following:

- The amount invested by venture capitalists in the U.S. in 1Q05 decreased when compared to 4Q04 by 10-15% in dollar terms, as reported by industry publications. The sector seeing the largest decline was life sciences.
- There were only eight venture backed IPOs in the U.S. in 1Q05, only one of which was from the IT industry.
- NASDAQ was down 7% in 1Q05.
- However, on a positive note, the aggregate dollar volume of acquisitions of venture backed companies and the amounts paid on average for acquired companies were up significantly in 1Q05, according to industry publications.

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

Series	Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
A	24%	18%	14%	17%	16%	16%	20%	20%
B	29%	24%	29%	28%	27%	27%	30%	24%
C	16%	28%	20%	25%	21%	30%	19%	29%
D	22%	18%	20%	15%	15%	15%	18%	12%
E and higher	9%	12%	17%	15%	21%	12%	13%	15%

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

Price Change	Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
Down	31%	28%	32%	21%	30%	45%	53%	56%
Flat	10%	12%	15%	12%	19%	13%	12%	4%
Up	59%	60%	53%	67%	51%	42%	35%	40%

The percentage of down rounds by series were as follows:

Series	Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
B	19%	24%	12%	16%	29%	31%	46%	26%
C	36%	25%	32%	25%	30%	34%	44%	59%
D	30%	28%	52%	18%	21%	75%	53%	64%
E and higher	62%	42%	42%	29%	38%	62%	82%	93%

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 Q1'05 and is provided on an aggregate basis for comparison purposes for Q1'04, Q2'04, Q3'04 and Q4'04. 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.

Q1 '05

Percent Change	Series B	Series C	Series D	Series E and higher	Combined total for all Series for Q1 '05	Combined total for all Series for Q4 '04	Combined total for all Series for Q3 '04	Combined total for all Series for Q2 '04	Combined total for all Series for Q1 '04
Up rounds	+76%	+67%	+51%	+37%	+66%	+84%	+66%	+58%	+67%
Down rounds	-48%	-58%	-29%	-65%	-49%	-54%	-59%	-48%	-56%
Net result	+52%	+13%	+14%	-27%	+24%	+36%	+17%	+28%	+17%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
50%	46%	54%	56%	52%	57%	57%	55%

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

Series	Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
B	38%	32%	33%	45%	47%	38%	50%	43%
C	57%	39%	59%	50%	44%	59%	56%	59%
D	55%	72%	61%	59%	58%	62%	60%	55%
E and higher	62%	50%	74%	82%	62%	85%	73%	64%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
12%	24%	31%	25%	27%	33%	21%	44%

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

Range of multiples	Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
> 1x – 2x	100%	89%	75%	84%	60%	76%	88%	78%
> 2x – 3x	0%	0%	6%	8%	27%	18%	12%	11%
> 3x	0%	11%	19%	8%	13%	6%	0%	11%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
73%	60%	74%	64%	70%	74%	68%	81%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
51%	60%	63%	47%	57%	61%	66%	59%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
9%	9%	9%	6%	6%	7%	12%	4%

- **Antidilution Provisions** – The uses of antidilution provisions in the financings were as follows:

Type of Provision	Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
Ratchet	9%	9%	14%	9%	5%	9%	8%	10%
Weighted Average	87%	85%	85%	87%	93%	89%	87%	88%
None	4%	6%	1%	4%	2%	2%	5%	2%

- **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.

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
17%	12%	16%	20%	17%	20%	12%	20%

  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.

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
93%	75%	72%	77%	67%	81%	80%	84%

  - Shadow Preferred Stock.

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
7%	25%	28%	23%	33%	19%	20%	16%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
30%	28%	30%	28%	27%	32%	29%	40%

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

Q1 '05	Q4 '04	Q3 '04	Q2 '04	Q1 '04	Q4 '03	Q3 '03	Q2 '03
13%	8%	20%	12%	17%	11%	21%	19%

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. The contents of this report are not intended, and should not be considered, as legal advice or opinion. Information on aggregate dollar venture investment and aggregate dollar M&A activity was obtained from publications by the Dow Jones VentureSource Survey and/or the Pricewaterhouse Coopers/Thomson Venture Economics/National Venture Capital Association Moneytree™ Survey.

Shaking the MoneyTree™ Q1 2005 Update

PricewaterhouseCoopers/
Thomson Venture Economics/
National Venture Capital Association
MoneyTree™ Survey

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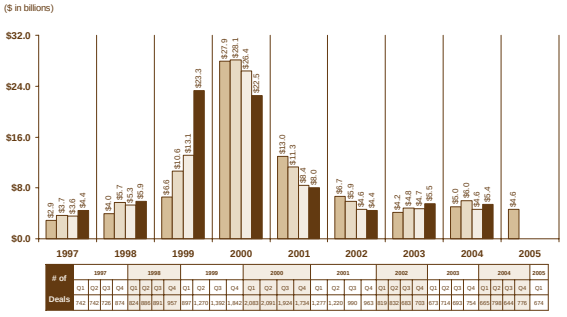
PRICEWATERHOUSECOOPERS

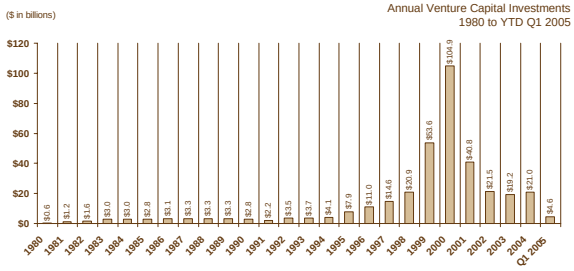
About The Survey

- PricewaterhouseCoopers collaborates with Thomson Financial Venture Economics and the National Venture Capital Association to produce MoneyTree Survey
- 'Core' measure of equity investments in venture-backed companies in the United States
- Companies have received at least one round of financing involving a professional VC firm or equivalent
- Captures: tranches, not term sheets, foreign VCs, qualified private placement
- Excludes: debt, bridge loans, recaps, roll-ups, IPOs, PIPEs, leasing, etc.
- MoneyTree™ Survey in its 11th year
- Results online at:
  - www.pwcmoneytree.com
  - www.ventureeconomics.com
  - www.nvca.org

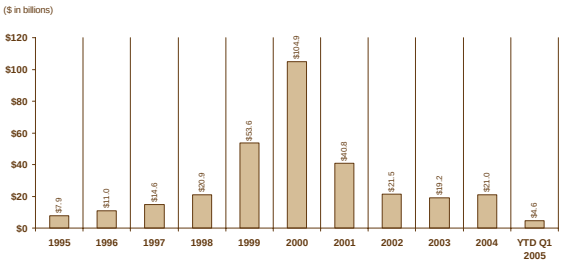
MoneyTree Total Investments: Q1 1997 – Q1 2005



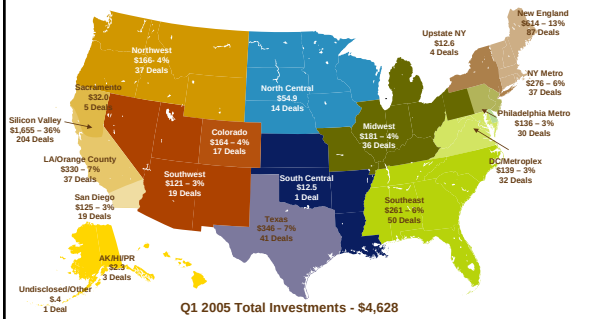
MoneyTree Total Investments: 1980 – YTD Q1 2005



MoneyTree Total Investments: 1995 – YTD Q1 2005

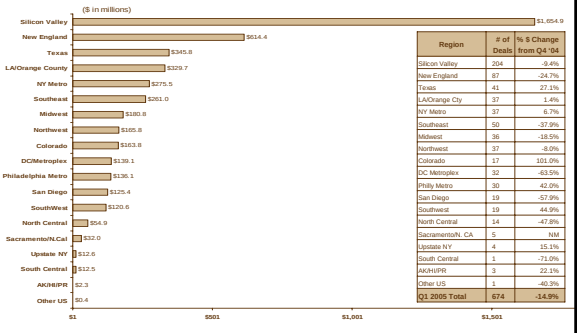


Investments by Region: Q1 2005



Q1 2005 Total Investments - $4,628

Investments by Region: Q1 2005

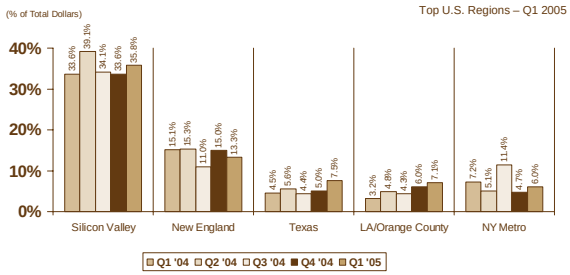


Region	# of Deals	% $ Change from Q4 '04
Silicon Valley	204	-9.4%
New England	87	-24.7%
Texas	41	27.1%
LA/Orange Cty	37	1.4%
NY Metro	37	6.7%
Southeast	50	-37.9%
Midwest	36	-18.5%
Northwest	37	-8.0%
Colorado	17	101.0%
DC Metroplex	32	-63.5%
Philly Metro	30	42.0%
San Diego	19	-57.9%
Southwest	19	44.9%
North Central	14	-47.8%
Sacramento/N. CA	5	NM
Upstate NY	4	15.1%
South Central	1	-71.0%
AK/HI/PR	3	22.1%
Other US	1	-40.3%
Q1 2005 Total	674	-14.9%

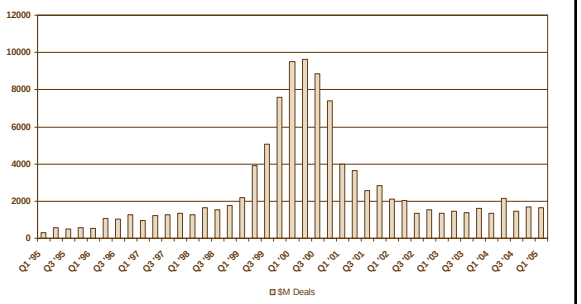
Q1 2005 Total: $4,628

(NM=Not meaningful)

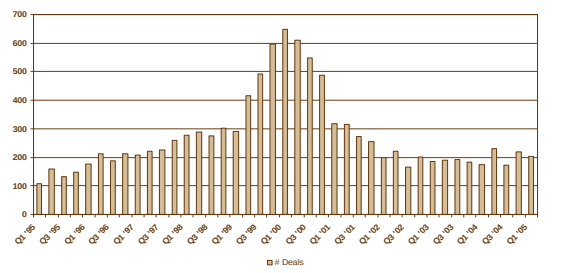
Investments by Region – Quarterly Percent of Total U.S. Investments



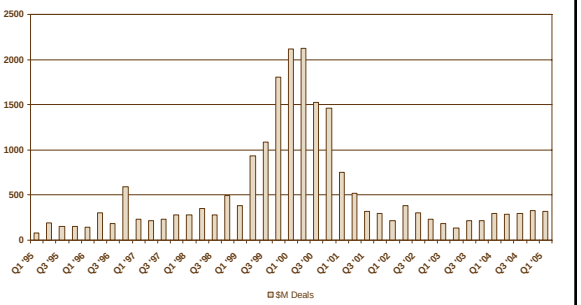
All Deals ($M): Silicon Valley



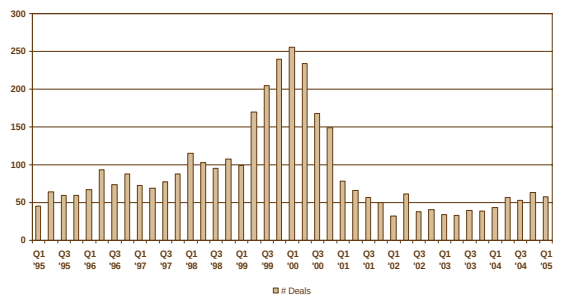
All Deals (#): Silicon Valley



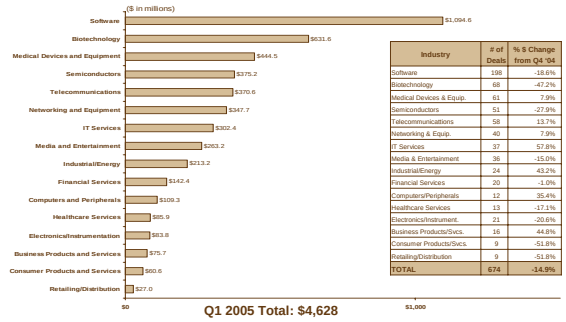
Series A Deals ($M): Silicon Valley



Series A Deals (#): Silicon Valley



Investments by Industry: Q1 2005

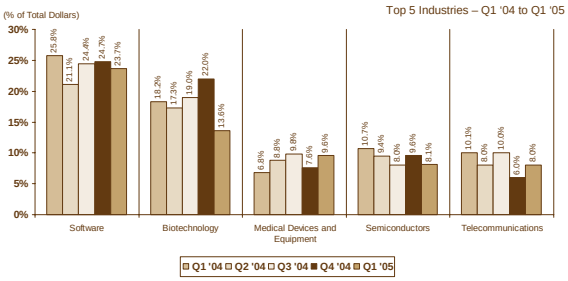


Industry	# of Deals	% & Change from Q4 '04
Software	198	-18.6%
Biotechnology	68	-47.2%
Medical Devices & Equip.	61	7.9%
Semiconductors	51	-27.9%
Telecommunications	58	13.7%
Networking & Equip.	40	7.9%
IT Services	37	57.8%
Media & Entertainment	36	-15.0%
Industrial/Energy	24	43.2%
Financial Services	20	-1.0%
Computers/Peripherals	12	35.4%
Healthcare Services	13	-17.1%
Electronics/Instrument.	21	-20.6%
Business Products/Svcs.	16	44.8%
Consumer Products/Svcs.	9	-51.8%
Retailing/Distribution	9	-51.8%
TOTAL	674	-14.9%

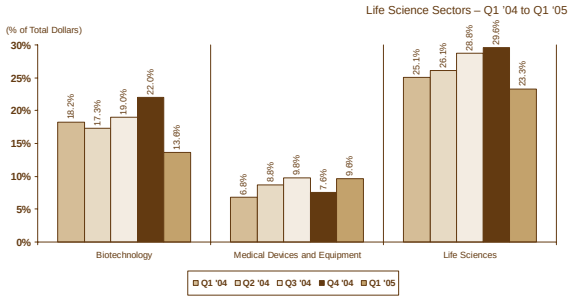
Q1 2005 Total: $4,628

Visit www.pwcmoneytree.com for Industry definitions

Investments by Industry – Quarterly Percent of Total U.S. Investments



Life Science Investments – Percent of Total U.S. Investments



Stage of Development Definitions

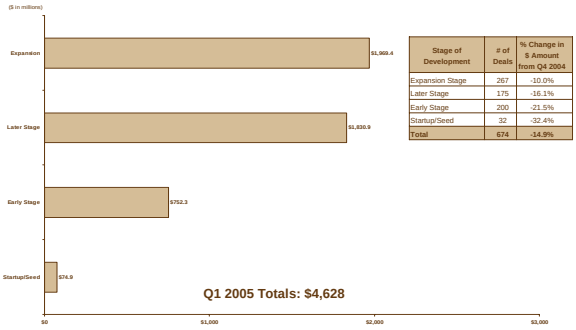
Seed/Start-Up Stage
Company has a concept or product under development, but is probably not fully operational. Usually in existence less than 18 months.

Early Stage
Company has a product or service in testing or pilot production. In some cases, the product may be commercially available. May or may not be generating revenues. Usually in business less than three years.

Expansion Stage
Product or service is in production and commercially available. Company demonstrates significant revenue growth, but may or may not be showing a profit. Usually in business more than three years.

Later Stage
Product or service is widely available. Company is generating on-going revenue; probably positive cash flow. More likely to be, but not necessarily profitable. May include spin-outs of operating divisions of existing private companies and established private companies.

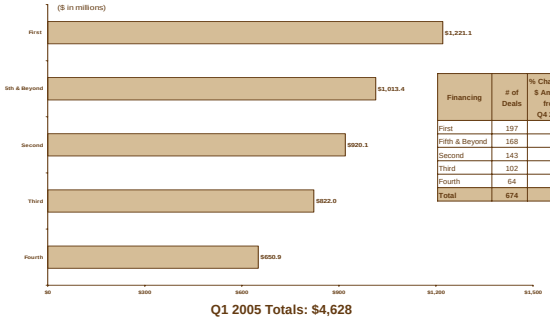
Investments by Stage of Development: Q1 2005



Stage of Development	# of Deals	% Change in $ Amount from Q4 2004
Expansion Stage	267	-10.0%
Later Stage	175	-16.1%
Early Stage	200	-21.5%
Startup/Seed	32	-32.4%
Total	674	-14.9%

Q1 2005 Totals: $4,628

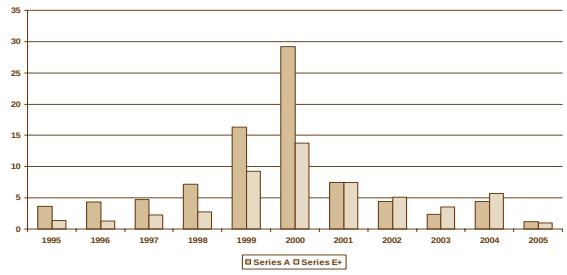
Investments by Sequence of Financing: Q1 2005



Financing	# of Deals	% Change in $ Amount from Q4 2004
First	197	5.9%
Fifth & Beyond	168	-39.5%
Second	143	-10.9%
Third	102	-5.4%
Fourth	64	-8.3%
Total	674	-14.9%

Q1 2005 Totals: $4,628

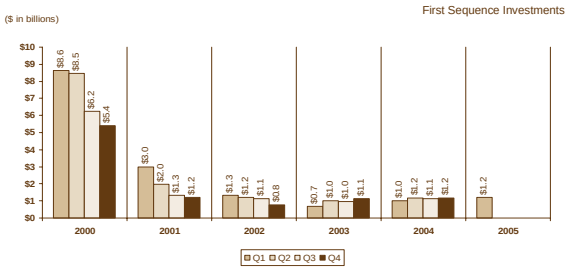
Series A vs E+: '95-'04



Page 19

PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Moneytree Survey

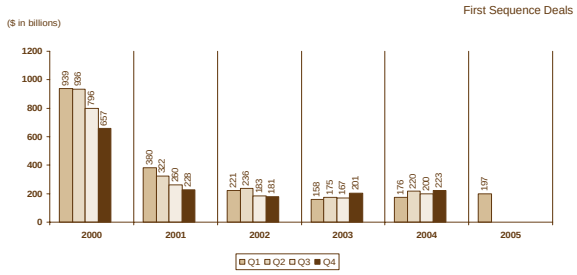
First Sequence Financing – Investment Amount



Page 20

PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Moneytree Survey

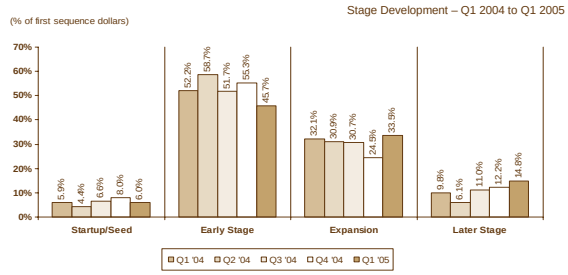
First Sequence Financing – Number of Deals



Page 21

PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Moneytree Survey

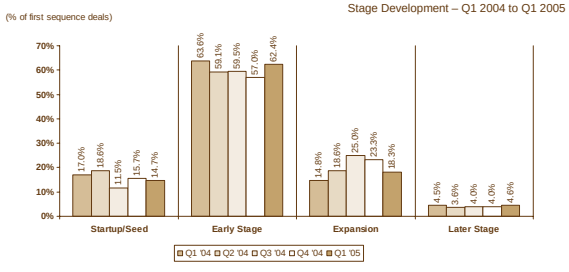
Stage of Development – Quarterly Percent of Total First Sequence Dollars



Page 22

PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Moneytree Survey

Stage of Development – Quarterly Percent of Total First Sequence Deals



Page 23

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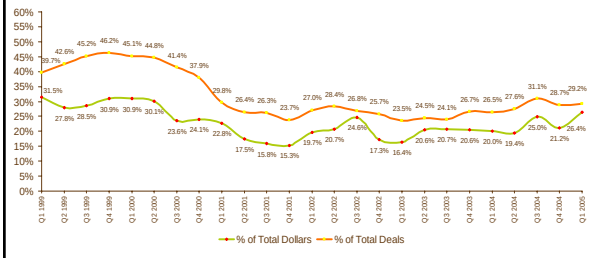
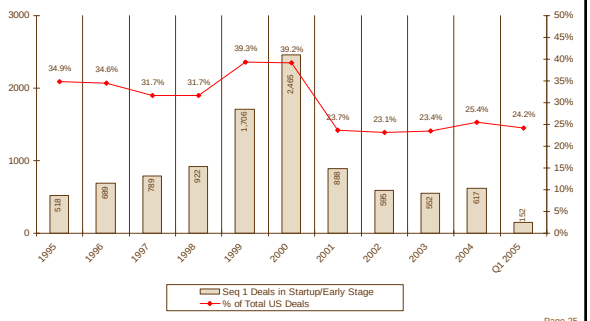
First Sequence Financing – Percent of Total U.S. Investments



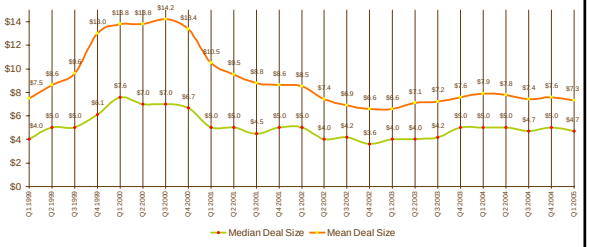
Page 24

PricewaterhouseCoopers/Thompson Venture Economics/National Venture Capital Association Moneytree Survey

First Sequence Deals in Startup & Early Stage Companies

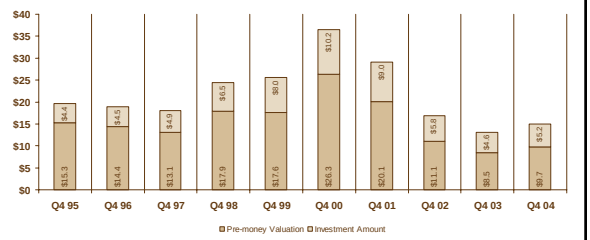


Median Deal Size vs. Mean Deal Size – Quarterly Total U.S. Investments



Post-Money Valuations – Early Stage Companies 1995 to 2004

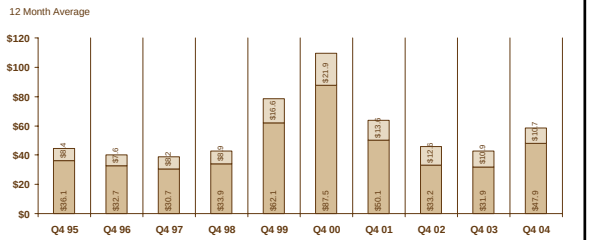
12 Month Average



Q4 Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Post-money Valuation	$19.70	$18.94	$17.97	$24.42	$25.58	$36.52	$29.05	$16.91	$13.03	$14.91

Post-Money Valuations – Expansion Stage Companies 1995 to 2004

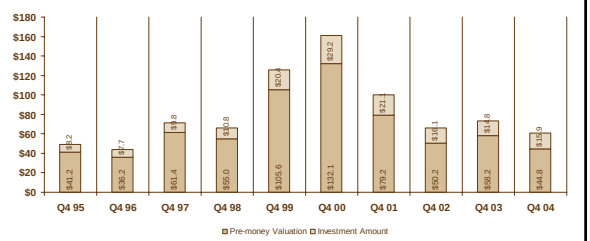
12 Month Average



Q4 Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Post-money Valuation	$44.54	$40.24	$38.88	$42.79	$78.73	$109.42	$63.65	$45.82	$42.88	$58.55

Post-Money Valuations – Later Stage Companies 1995 to 2004

12 Month Average



Q4 Year	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Post-money Valuation	$49.37	$43.91	$71.19	$65.79	$125.97	$161.34	$100.25	$66.34	$73.03	$60.64

Q1 2005 – Most Active Venture Investors

Venture Capital Firm	Location	Total Deals
U. S. Venture Partners	Menlo Park, CA	20
Draper Fisher Jurvetson	Menlo Park, CA	18
TL Ventures	Wayne, PA	15
Accel Partners	Palo Alto, CA	14
Venrock Associates	New York, NY	14
Austin Ventures	Austin, TX	14
New Enterprise Associates	Baltimore, MD	13
Village Ventures	Williamstown, MA	13

Thomson Venture Economics' U.S. Private Equity Performance Index (PEPI)

(Investment Horizon Performance as of 12/31/2004)

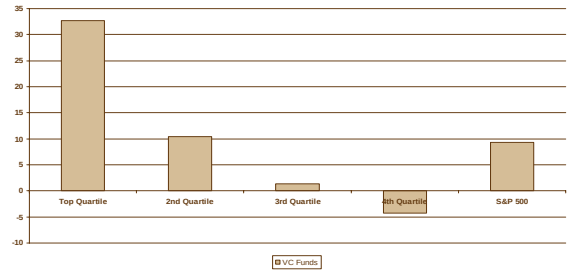
Fund Type	1 Year	3 Year	5 Year	10 Year	20 Year
Early/Seed VC	38.9	-7.7	-1.5	44.7	19.9
Balanced VC	14.7	0	0.4	18.2	13.3
Later Stage VC	10.4	-0.1	-4.7	15.4	13.7
All Venture	19.3	-2.9	-1.3	26.0	15.7
All Buyouts	14.3	6.9	2.3	8.4	12.8
Mezzanine	8.0	3.7	2.9	6.9	9.3
All Private Equity	16.4	3.7	1.5	12.7	13.8
Public Equity Returns					
NASDAQ	8.6	3.7	-11.8	11.2	12.4
S&P 500	9.0	1.8	-3.8	10.2	11.7

Source: Thomson Venture Economics/National Venture Capital Association

Data current as of April 11, 2005

*The Private Equity Performance Index (PEPI) is based on the latest quarterly statistics from Thomson Venture Economics' Private Equity Performance Database analyzing the cashflows and returns for over 1,750 US venture capital and private equity partnerships with a capitalization of $585 billion. Sources are financial documents and schedules from Limited Partners investors and General Partners. All returns are calculated by Thomson Venture Economics from the underlying financial cashflows. Returns are net to investors after management fees and carried interest.

Annual VC Returns (IRR), 1983-2002



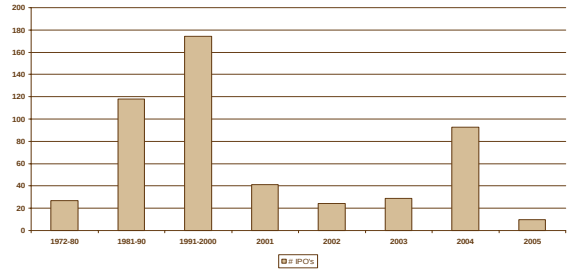
Analysis of Recent Quarters' IPOs

Quarter Ending	Number of IPOs in the U.S.	Number of Venture-Backed IPOs in the U.S.	Total Venture-Backed Offering Size ($M)	Average Venture-Backed Offering Size ($M)	Total Venture-Backed Post Offering Value ($M)	Average Venture-Backed Post Offering Value ($M)
03/31/03	5	1	77.2	77.2	147.8	147.8
06/30/03	5	2	164.0	82.0	695.3	347.6
09/30/03	20	9	732.8	81.4	3,064.5	340.5
12/31/03	52	17	1,048.7	61.7	4,349.9	255.9
03/31/04	42	13	2,721.1	209.3	10,575.0	813.5
06/30/04	58	29	2,077.8	71.6	8,930.4	307.9
09/30/04	64	24	3,225.6	134.4	29,596.8	1,233.2
12/31/04	82	27	2,990.4	110.8	11,985.4	443.9
03/31/05	43	10	720.7	72.1	3,077.5	307.8

Source: Thomson Venture Economics/National Venture Capital Association

**Data current as of April 1, 2005*

Average Venture Backed IPO's Per Year (Yearly Averages)



Venture Capital Fundraising

Year	Venture Capital		Buyouts & Mezzanine	
	Number of Funds	VC Raised ($M)	Number of Funds	Buyout & Mezzanine ($M)
2000	635	106,565.2	161	76,815.2
2001	307	37,997.3	117	44,684.6
2002	171	3,820.8	84	26,621.8
2003	137	10,613.3	88	29,655.5
2004	173	17,324.6	119	51,089.6
Quarter				
Q1 '04	49	2,666.0	25	3,437.8
Q2 '04	53	3,122.6	32	16,670.5
Q3 '04	51	5,372.8	42	15,307.7
Q4 '04	55	6,163.2	47	16,673.6
Q1 '05	48	5,328.7	38	15,794.5

Source: Thomson Venture Economics/National Venture Capital Association

(Figures above do not take into account downsized funds)

Data current as of April 18, 2005

Summary: Best of Times

$21B for full year '04, 6th largest, above any year before 1998

- 12 straight quarters from $4.2-6.0 B
- $ back to '98 levels

$50+ B committed capital unspent-money not the problem

- California 6th largest economy in world
- Silicon Valley still place to be, flight to quality
- Silicon Valley 2.5x vs #2 New England
- California gets roughly 50% US VC investment
- US 20:1 vs #2 Country (UK)

Cisco acquiring again…Okena	$154M
SignalWorks	$14M
Linksys	$500M
Twingo	$5M
Actona	$82M
Parc Technologies	$9M
P-Cube	$200M
NetSolve	$128M
Dynamicsoft	$55M
Perfigo	$74M
Protego Networks	$65M
Airespace	$450M
Topspin	$250M

Summary: Not So Good Times

- $4.6B Q1'05, 28% below Q4'04, 8% below Q1'04
- Fortune 500 IT spending flat with aversion towards startups
- Venture Backed IPO mkt still weak, after market performance uneven
  - Quality of firms in registration declining, most not profitable
  - Warren Buffet and John Bogle both forecast 10 years poor stock market return
  - Jeremy Grantham of Grantham Mayo Van Otterloo says mkt down 30% next 2-3 years
    - **All gains from last 27 bubbles gone before next bull mkt began**
    - **P/E still 20 vs 16 historical average for S&P**
  - Average M&A about $60M
- IT Unemployment at record level – 6% in '03 (1% in '97, 4% in '02)
  - Silicon Valley job levels won't return to bubble levels until 2010
- 52% of employees want to leave job vs 33% in '99
- Average life S&P 500 company: 100 years in '38, 20 years now
- Consumer confidence lowest level in 9 years
  - % Fortune 500 offer health benefits to retirees: 66% in '88, 34% in '02
- 64% college students plan to live with parents after graduation
- Tech Spending as % Capital Budget: 19% in '90, 59% in '00, no upside?
  - Gates says Fortune 500 tech spending won't return to bubble levels in his lifetime

VC Summary/Facts/Predictions

- $300B invested by VC in last 30 years, $250B (80%) '98-'02
- 50% (75% per Forbes' Rich Karlgaard) VC's gone over next 5 years
  - 27% of VC firms formed in last 6 years, most will not raise 2nd fund
  - Corp. VC's dying: Mellon, Dell, Applied Materials, Boeing all closing vc unit
  - Is VC brand tied to individual GP's or firm? Most firms still run by founders
  - Low barriers to entry, high barriers to success
- More disagreements/litigation with LP's, $1B funds history (almost)
  - More "Alantec" lawsuits, e.g. Nishan Systems & Epinions
  - More foreign LP money in US funds
  - More consistent financial reporting to LP's, greater transparency/communication
- Politics intrudes…$50M South Carolina life science fund (governor veto)
  - $200M fund proposed by Illinois governor, $65M tax credits in Wisconsin
  - $310M Biotech research center in Florida
  - 30 states, 20 countries offering incentives for biotech firms to move there
  - New Mexico, Kentucky, & Arkansas started VC funds to promote in state investments

Summary/Predictions

- China based investments with US VC's syndicate local investors
  - Headquarters stays in China, not Israeli model
    - Allegis & PRC Direct
  - China drives some standards
  - China firms drive down worldwide prices
- China bubble bursts by 2007
- No hot sectors - back to basics
- Hundreds of firms "walking dead", will go away (1997-2001 Totals)
  - Series A (9883) - IPO (1676) – M&A (2576) – Bankrupt (953) = 4678 Left
- More M&A with price not disclosed, common (employee) stock worthless
- More interim, rented execs in other functional areas, not just CFO
  - Bus. Dev., Marketing, Engineering, CEO

China – As a Percentage of the World:

Category	2003	1998
People	20.5%	21.2%
Aluminum	18.6	10.3
Beef/Veal	12.6	9.8
Computers	6.1	3.3
Copper	19.7	10.4
Soda	3.9	2.9
Cellphones	20.1	7.5
Cigarettes	34.8	30.8
Coal	31.0	27.2
Cotton	32.7	22.2
Electricity	10.2	8.0

Category	2003	1998
Fish	32.3 %	22.1 %
Hair Products	3.9	3.7
Petroleum	7.7	5.5
Pork	50.8	48.8
Poultry	19.2	18.6
Rice	32.8	34.5
Steel	26.9	16.2
TV	23.2	23.6
Vacuum Cleaners	1.1	1.3
Washing Machines	18.0	10.6

Source: Fortune

Notable Quotes

- "There is clearly too much money relative to the number of great opportunities."
- "Having too much capital will drive down returns in the long term, and that can result in problems for the whole industry." *– Ken Lawler, Battery Ventures*
- "The venture industry has 4 times the amount of money it needs." *– John Doerr, Kleiner, Perkins, Caufield, Byers*
- "It's a shame Nanosys is going public because I don't think they are in a position to be predictable enough. And whether they are doing it knowingly or unknowingly, there is a reasonably high likelihood that they will defraud the public market." *– Vinod Khosla, Kleiner, Perkins, Caufield, Byers*
- "3000 of 8000 VC firms will do productive work in 2004." *– Bob Pavey, Morgenthaler*
- "Do not put money into this industry. You won't get it back. From 1990 to 2003, $218B entrusted to VC, only $179B returned…Any other industry, you'd say this is a Ponzi scheme." *– Paul Ferri, Matrix Partners*
- "I hate to put it this way, but the VC industry needs an enema." *– Todd Dagres, Battery Ventures*

Implications for Entrepreneurs

- Don't rely on VC financing, raise as little as you have to
- Bootstrap, customer financing, get to cash flow break even ASAP
- Keep burn rate down, be cheap, when in doubt don't spend
- Outsource what you can outside Silicon Valley/US
- Focus on sales
- Watch cash balance, know where all cash goes
- Explore "dividend model" for liquidity
- Keep your personal financial expectations low
  - "Win" may be $2-5M for CEO, less for VP's
- Get out of Series C+ companies and into Series A
- You may be working for a salary, you just don't know it!
- Lot of great people taking year(s) off

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PRICEWATERHOUSECOOPERS

FENWICK & WEST LLP

A Patent Portfolio Development Strategy for Start-Up Companies

BY RAJIV P. PATEL

Successful high technology companies recognize that a comprehensive intellectual property portfolio can be of substantial value. One key component of the intellectual property portfolio is patents. A patent is a right granted by the government that allows a patent holder to exclude others from making, using, selling, offering to sell, or importing that which is claimed in the patent, for a limited period of time.

In view of this right many companies recognize that a well-crafted patent portfolio may be used for a variety of business objectives, such as bolstering market position, protecting research and development efforts, generating revenue, and encouraging favorable cross-licensing or settlement agreements. For companies that have developed original technology, a patent provides a barrier against a competitor's entry into valued technologies or markets. Thus, many start-up companies that have developed pioneering technology are eager to obtain patent protection. However, to develop an effective patent portfolio, a start-up company should first devise a patent portfolio strategy that is aligned with the company's business objectives.

A patent portfolio strategy may vary from company to company. Large companies that have significant financial resources often pursue a strategy of procuring and maintaining a large quantity of patents. These companies often use their patent portfolios for offensive purposes, *e.g.*, generating large licensing revenues for the company. For example, IBM generates close to $1 billion dollars a year from licensing its patent portfolio.

In contrast, for most start-up companies, developing and building a comprehensive patent portfolio can be prohibitively expensive. However, with an understanding of some basic principles of patent strategies and early planning, a start-up company can devise and execute a patent strategy to develop a cost-effective patent portfolio. For example, a start-up company can develop an effective patent portfolio by focusing on obtaining a few quality patents that cover key products and technologies, in alignment with their business objectives.

A patent strategy involves a development phase and a deployment phase. The development phase includes evaluation of patentable technologies and procurement of patents. A deployment phase includes the competitive analysis, licensing, and litigation of patents. For most start-ups the initial focus is on the development phase. 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.

With the goals identified, 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 company executives to ensure that the patent strategy closely links with the company's business objectives. Often, these individuals assist with developing a budget for the patent strategy, as well as making arrangements to get access to resources for executing the patent strategy.

Organizing intellectual assets also involves gathering key company 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, license agreements, non-disclosure and confidentiality agreements, investor agreements, and consulting agreements. Such materials provide information used to determine ownership issues and the scope of patent or other intellectual property rights that are available for the company.

Organizing intellectual assets also includes identifying and interviewing all individuals who are involved with creating or managing the company's intellectual assets. These interviews uncover undocumented intellectual assets and may be used to evaluate patent and other intellectual property issues. For example, events and dates that may prevent patentability of some intellectual assets may be identified. Likewise, co-development efforts that may indicate joint ownership of intellectual assets may also be identified. Identifying such issues early on helps prevent wasteful expenditures and allows for effective management of potentially difficult situations.

After organizing information about the intellectual assets, each asset should be evaluated to determine how best to protect it. This evaluation includes determining whether the intellectual asset is best suited for patent protection or trade secret protection, whether it should be made available to the public domain, or whether further development is necessary. It also involves determining whether a patent will be of value when it issues, which is typically approximately 18 to 36 months after it is filed, and whether infringement of that patent would be too difficult to detect.

The evaluation phase may also provide an opportunity to determine whether obtaining protection in jurisdictions outside of the United States is prudent. International patent treaties signed by the U.S. and other countries or regions allow for deferring actual filing of patent applications outside the U.S. for up to one year after the filing of a U.S. application. Thus, planning at this early stage may include identifying potential countries or regions to file in and then begin financially preparing for the large costs associated with such filings.

The evaluation phase also provides an opportunity to determine whether a patentability or patent clearance study is necessary. Such studies are used to determine the scope of potentially available protection or whether products or processes that include or use an intellectual asset potentially infringe third-party rights. This evaluation may also involve identifying company strengths with regard to its patent portfolio as well as potential vulnerable areas where competitors and other industry players have already established patent protection.

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 audit phase. Typically, a patent portfolio is built with a combination of crown-jewel patents, fence patents, and design-around patents.

Crown-jewel patents are often blocking patents. One or more of these patents is used to block competitors from entering a technology or product market covered by the patent. Fence patents are used to fence in, or surround, core patents, especially those of a competitor, with all conceivable improvements so the competitor has an incentive to cross-license its patents. Design-around patents are based on innovations created to avoid infringement of a thirdparty patent and may themselves be patentable.

For most start-ups, costs for pursuing patent protection are a concern because financial resources are limited. Hence, most start-up companies begin the procurement phase by focusing on procuring one or more crown-jewel patents. To do this, the start-up company works with a patent attorney to review the key innovations of the company's product or services as identified during the evaluation phase. The patent attorney and start-up company consider the market for the innovation in relation to the time in which the patent would typically issue. This analysis helps identify the subject matter for the crown-jewel patents.

Once the subject matter is identified, in some instances a prior art search prior to filing provisional or utility patent applications may be conducted to determine what breadth of claim coverage potentiallymay be available. However, a company that considers such prior art searches should first consult with the patent attorney to understand the risks associated with them so that appropriate business decisions can be made.

Next, a strategic business decision is made as to whether to file a provisional patent application or a full utility, or nonprovisional, patent application for the identified subject matter. A provisional patent application is ideally a robust description of the innovation, but lacks the formalities of a full utility patent application.

The provisional application is not examined by the U.S. Patent and Trademark Office ("USPTO") and becomes abandoned 12 months after filing. Within the 12 months, an applicant may choose to file one or more utility applications based on the subject matter disclosed in the provisional application, and therefore, obtaining the benefit of the provisional application filing date. However, the later filed

utility application must be fully supported by the disclosure of the provisional application in order to claim the benefit of its earlier filing date. Under U.S. patent law, this means the provisional application must satisfy the requirements of written description, enablement, and best mode, as is required for the utility application.

If the provisional application is filed with sufficient completeness to support the claims of subsequently filed utility applications, the provisional application provides a number of benefits. First, as previously discussed, one or more utility applications may claim the benefit of the provisional patent application filing date. The early filing date may not only protect the crown jewel subject matter, but may also protect some critical surrounding subject matter, hence increasing the overall value of the patent portfolio. Second, the provisional application provides an earlier effective prior art date against others who may be filing patent applications on similar inventions.

Third, provisional patent application filings costs are currently $80 to $160 versus $370 to $740 for a full utility application. Fourth, inventors often take it upon themselves to draft the core of a provisional application with the guidance of a patent attorney and request that the patent attorney spend time simply to review the application to advise on the legal requirements and potential pitfalls. This means that the attorney fees for a provisional patent application may be substantially less than attorney fees associated with preparing a full utility application.

Fifth, the provisional patent application precludes loss of patent rights resulting from activity and public disclosures related to the target inventions. For example, almost every country except the U.S. has an absolute novelty requirement with regard to patent rights. That is, in these countries, any public disclosure of the target invention prior to filing a patent application results in a loss of patent rights. For many start-ups this can be somewhat disconcerting. On the one hand, the start-up may want to preserve the right to pursue patent protection outside of the U.S. On the other hand, immediate business opportunities and time demands often conflict with the timely preparation and filing of a utility patent application. However, through international treaties, most countries will recognize a filing date of a provisional application filed in the U.S. Thus, the applicant may be able to file for a provisional application and convert it to a utility application that can be filed in the U.S. and other treaty countries within 12 months.

Although the provisional application provides a cost-effective tool for creating a patent portfolio, filing a provisional application does not end the portfolio development process. Once the provisional application is filed, and when finances and time permit, the company should be diligent in filing utility applications that may claim the benefit of the provisional application filing date. This is true for a number of reasons.

First, the provisional application is not examined and will go abandoned 12 months after it is filed. Therefore, the filing of the provisional application provides no more than a filing date placeholder for the subject matter it discloses. Second, the utility application costs more than the provisional applications to prepare and file. Thus, a companymust adequately budget and plan for this expense. Third, as time passes the time available for patent matters may become more difficult in view of product cycles, marketing launches, and sales events. Hence, budgeting time for planning and reviewing filings of subsequent utility applications based on a provisional application becomes important. Fourth, products and technologies continually evolve and change, often soon after the filing of a provisional application. Therefore, a companymust continually revisit their patent portfolio and strategy to reassess whether the provisional application can provide sufficient protection in view of further development.

Over time, companies that value their intellectual assets set aside time, money and resources to further enhance their patent portfolio. To do this a company may move to the deployment phase. In the deployment phase, the company begins the competitive analysis process to study industry trends and technology directions, especially those of present and potential competitors. The company may also evaluate patent portfolios of competitors and other industry players.

Also in the deployment phase, the company may incorporate the licensing process. Here, the company determines whether to license or acquire patents from others, particularly where the patent portfolio is lacking protection and is vulnerable to a third-party patent portfolio. Alternatively, in the licensing process the company determines whether to license or cross-license its patent portfolio to third parties. The deployment phase may also include the litigation process. Here, the company determines whether to assert patents in a lawsuit against third party infringers.

In summary, for most start-up companies, devising a patent portfolio development strategy early on can be a wise investment to help the company develop and build a strong foundational asset on which to grow. This investment will likely reward the companywith positive returns for years to come.

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.

It is on the web at *www.fenwick.com*.

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 225 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. Our mergers and acquisitions practice is ranked among the top 25 practices in the nation according to the American Lawyer. 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 $6 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 40 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, 34 of which are in the Fortune 100. In recent surveys of 1,500 companies published in International Tax Review, Fenwick & West was selected as the top tax adviser in the Western 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, Inc.)
- Sapias, Inc.
- Blue Lava Wireless
- @Home Corporation
- FT Ventures
- Junglee Corp.
- Merant plc (formerly Micro Focus plc)
- Burntsand Inc.

Mr. Angus is co-chair of the firm's Nano-Technology Practice Group. 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.

Associate

Intellectual Property Group

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Emphasis:

Patent Prosecution

Patent Analysis

Patent Counseling

Patent Litigation

Intellectual Property Due Diligence

Narinder S. Banait is an associate in the Intellectual Property Group of Fenwick & West LLP, a law firm specializing in high technology and bioscience 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. Among the clients Dr. Banait has represented are:

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

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 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

Fred M. Greguras

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Licensing Practice Groups

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Emphasis:

Startups and Venture Capital Financings

Licensing

Intellectual Property Protection

Fred M. Greguras is of counsel in the corporate, Internet and licensing practice 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:

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:

- Alibris
- Cisco Systems, Inc.
- Morgan Stanley
- Shopping.com

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.

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Partner

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Emphasis:

Patent Counseling

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

Rajiv P. Patel

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.
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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