

THE ENTREPRENEURS REPORT: Private Company Financing Trends

Fall 2008

Taking Advantage of the Downturn

By Greg Gottesman, Managing Director, Madrona Venture Group

Unless you have been avoiding your in-box in the past month or so, you probably got the widely circulated email containing “the world is coming to an end” slide deck from a major venture capital firm. The essence of the presentation is that if you survive the current economic meltdown, you win. That means cutting heads and getting to cash-flow break-even as soon as possible. The advice is well timed and important, but incomplete. The winners will not just survive this recession—they’ll need to take full advantage of it, strategically and tactically.

On the strategic front, companies should revisit the basic questions they answered when drafting their initial business plans, this time with the words “in this market” at the beginning:

- In this market, who are our customers?

- In this market, what is our value proposition?
- In this market, what is our business model/how do we make money?
- In this market, who are our competitors?
- In this market, what is our competitive advantage?
- In this market, how do we differentiate our product?
- In this market, what are our core assets?

The answers to all of the above (and many more) questions may have shifted in the last three months. If your customers were small start-ups, you may need to adjust your focus to a customer base that has money to spend.

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A Price on Carbon: Managing Risks and Opportunities

By Aleka Seville, Manager, First Climate LLC

The results of the recent U.S. election acknowledged the need for federal leadership on many issues. This includes climate change, as an overwhelming majority of Americans voted for a candidate who pledged not only to take decisive action to curb the country’s greenhouse-gas (GHG) emissions, but also to support clean technology, ensure energy security, and create millions of new jobs. President-elect Barack Obama has promised to implement federal legislation that ultimately would reduce GHG emissions generated in the United States to 1990 levels by 2020, and 80

percent below that by the year 2050. These are incredibly ambitious goals that will not be achieved without translating the cost of a changing climate into a price on carbon emissions.

Early-stage companies are particularly well positioned to

successfully respond to the challenges posed by future climate legislation, as they have the opportunity to build rather than refine processes to function in a low-carbon economy. While running lean is a benefit for most businesses, it is nothing less than an imperative for the early-stage entrepreneur. Emission-reduction measures, combined with a strategic

President-elect Obama’s incredibly ambitious goals will not be achieved without translating the cost of a changing climate into a price on carbon emissions.

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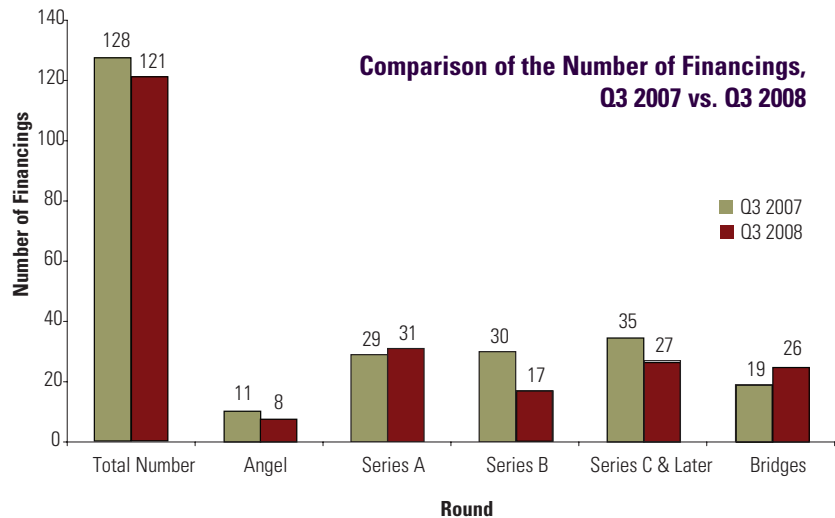
From the WSGR Database: Financing Trends

For this report, we continue to evaluate relevant trends in activity and valuation levels for the U.S. venture capital industry. During this period of extreme volatility in the public trading markets and continuing instability in all sectors of the economy, activity levels in the U.S. venture capital industry through the third quarter of the year have been relatively stable in comparison with prior periods.

This is not to say that the venture capital industry has been immune from the financial storms. Reports are appearing in the financial press of institutional investors quietly engaging in the secondary sale of their existing portfolio investments at highly discounted prices, or even defaulting on their capital commitments to venture firms. In addition, with the virtually complete shutdown of the public equity markets as a source of capital over the first three quarters of 2008, it currently appears that any reasonable prospect of an IPO as an exit for most VC-backed companies has been eliminated for the foreseeable term. And the time horizon for the start-up company from first funding to exit continues to grow, with the average exit now at 8.3 years, as reported by Dow Jones VentureSource—a trend that potentially impacts the return on investment for investors evaluating venture capital as an asset class.

However, the indications within our database of financing transactions for the third quarter of 2008, as well as for the first nine months of this year, support the conclusion that venture capital activity continues at substantial levels and, for the most part, compares favorably with the same periods in 2007.

For the third quarter and the first nine months of 2008, there were a total of 121 and 399 financing transactions, respectively, compared to 128 and 388 in 2007. The quarter-to-quarter comparison, reflecting a modest decline of 5% between the two years, may be an indicator of increasing stress in the sector that has yet to be fully realized. In looking at each of the completed quarters for 2008, we reported in



sequence 144 transactions, 134 transactions, and 121 transactions, confirming a gradual downward trend in financing transactions in general.

In terms of dollar amounts, the aggregate level for all financing transactions in the third quarter of 2008 was \$1.115 billion, down only 2% from the comparable figure of \$1.143 billion in 2007. The nine-month figures for aggregate dollars raised comparing 2008 with 2007 actually showed an increase in 2008: \$3.553 billion for the current nine months, compared with \$3.255 billion for 2007.

However, it should be noted that there were four sizable financings—each \$100 million or more—in the first nine months of 2008 that had a significant impact on the totals. These four transactions are unusual for their magnitude in terms of dollars raised by private venture-backed companies; most financing

transactions are for substantially smaller amounts, even for Series C and later rounds (i.e., mezzanine rounds). It is too soon to know whether the closure of the IPO market for venture-backed companies, the extended period of time required to achieve an exit, and the prevailing uncertainty in the economy were influential factors behind the decisions of these companies and their investors to raise such large amounts of capital in a single round of financing.

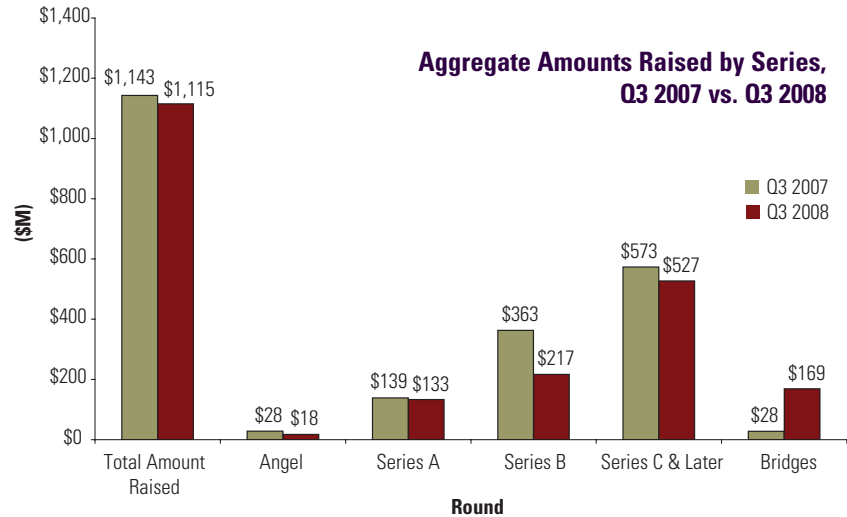
If these unusual transactions are eliminated from the data for aggregate dollar amounts raised for all financings, the third-quarter and nine-month 2008 totals fall to \$793 million and \$2.931 billion, respectively—reflecting declines of 31% and 10% from 2007. In evaluating the data with unusually large financings excluded, this pattern of decline may portend a period of contraction in venture capital investments in general.

For purposes of the statistics and charts in this report, our database includes all venture financing transactions in which Wilson Sonsini Goodrich & Rosati represented either the company or one or more of the investors (although we do not include venture debt or venture leasing transactions, or facilities involving venture debt firms). In some cases, for data involving averages, we use a truncated average, discarding the two or three highest and lowest figures to exclude the effect of transactions that are, in our judgment, unusual.

As illustrated by the chart on the right, there are other trends and observations that may be relevant to entrepreneurs and managers evaluating the current climate in venture financing transactions.

Although the number of angel financings in the third quarter of 2008 fell compared with the same quarter of last year, it is a hopeful sign that the number of Series A financing transactions—which, in almost all cases, involve institutional venture firms—have remained at very stable levels, both on a quarter-to-quarter and a nine-month-to-nine-month comparison. Since Series A financings frequently represent the first infusion of institutional investment capital in a start-up company, this stability is one of the key indicators of the continuing rate of innovation in the sector, and clearly a positive sign in the face of the ongoing economic turmoil impacting world markets. The aggregate amounts raised for Series A financings also remained relatively flat in comparing the third quarter of 2008 with 2007—\$133 million and \$139 million, respectively. It is also interesting to note that the average dollar amount raised in a Series A financing transaction (i.e., the first financing involving the investment of institutional venture capital) continues to be in the neighborhood of \$4-6 million, whether looking at the third-quarter or the nine-month data for 2008 and 2007.

The number and dollar amounts invested in Series B financings have declined noticeably in the current periods. Series B financings typically represent the second round of institutional financing, frequently in support of companies making the transition from product development to first product sales. The current trend in this stage of financing transactions may indicate that venture investors are moving cautiously in supporting their portfolio companies and taking every opportunity to conserve cash in existing funds, thus ensuring the adequacy of future capital for their more successful portfolio companies. The number of Series B financings declined from 30 to 17—a



decline of 43%—in the quarter-to-quarter comparison between 2008 and 2007, with an equally marked decline in the aggregate amount of dollars raised, from \$363 million to \$217 million. The declines for the nine-month data for Series B financings are more muted.

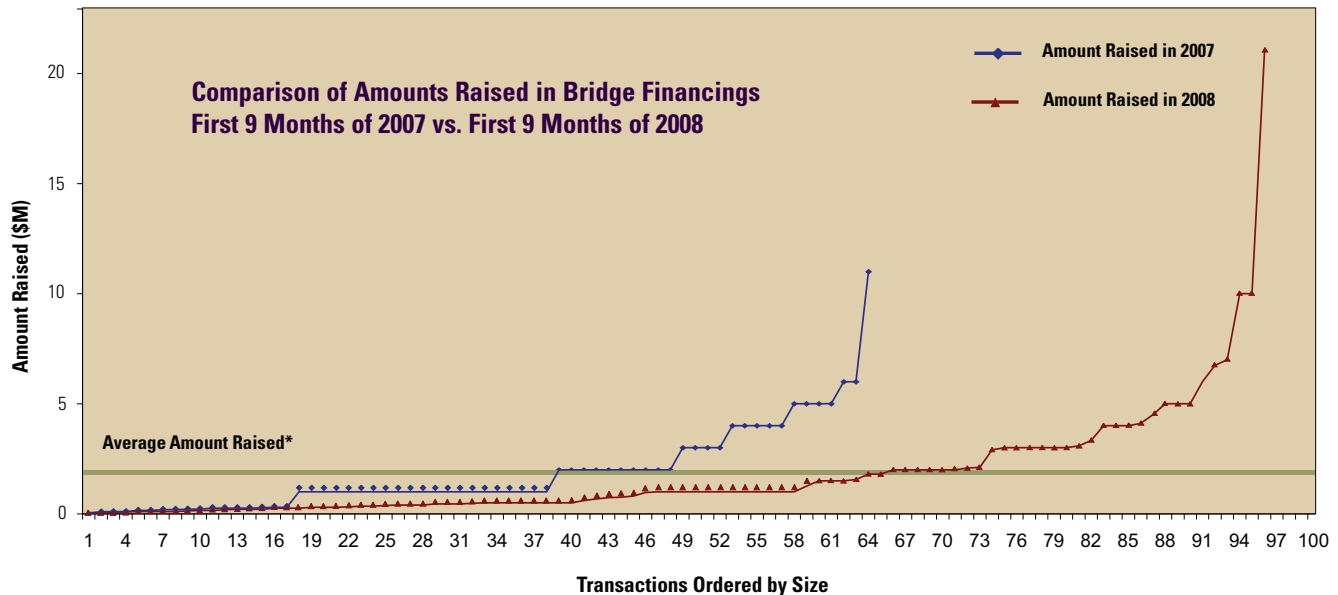
Similar observations can be made for Series C and later financings for the current periods. This phase of financing transactions—which includes mezzanine-stage financings—is intended to support companies that successfully have introduced products to market and are looking for growth capital to ramp revenues and market share. The number of Series C and later financing transactions for the third quarter of 2008 declined to 27, with an aggregate of \$527 million invested, down from 35 financings, with an aggregate investment of \$573 million in the same quarter of 2007. If two financing transactions with unusually large investment amounts—each in excess of \$100 million—are removed from this category for the third quarter of 2008, the aggregate amount invested for this period drops from \$573 million in the third quarter of 2007 to \$324 million in 2008, a decline of 43%.

Finally, the data relating to the number of bridge transactions for the three- and nine-month periods in 2008 compared with 2007 is revealing. Bridge financing transactions for raw start-up companies may be nothing more

than a preferred choice of financing structure; this form of financing temporarily obviates the need to establish a company valuation as the basis for the investment. For a later-stage company, however, a bridge financing is usually a form of debt financing funded by existing investors when a new lead investor cannot readily be brought in to establish valuation and other investment terms.

As shown on the chart on the next page, for the third quarter of 2008, the number of bridge transactions increased from 19 to 26; for the nine-month period, the number increased from 64 to 96. The dollar amounts for each bridge financing transaction averaged for all periods between \$1.5 million and \$2.0 million, but with a wide deviation from transaction to transaction. We believe that the increase in the number of bridge transactions, coupled with the data that reflects a decline in the number of Series B and Series C and later equity financings, may be indicative for later-stage companies of the increasing difficulty in finding new investors willing to invest in these later rounds. It also may signal increasing competition among companies for new investors at a time when venture funds are becoming more conservative in their investments. In some cases, the decision to proceed with a bridge financing may result from a determination to forego another round of equity financing (and the resulting

From the WSGR Database: Financing Trends *(continued from page 3)*

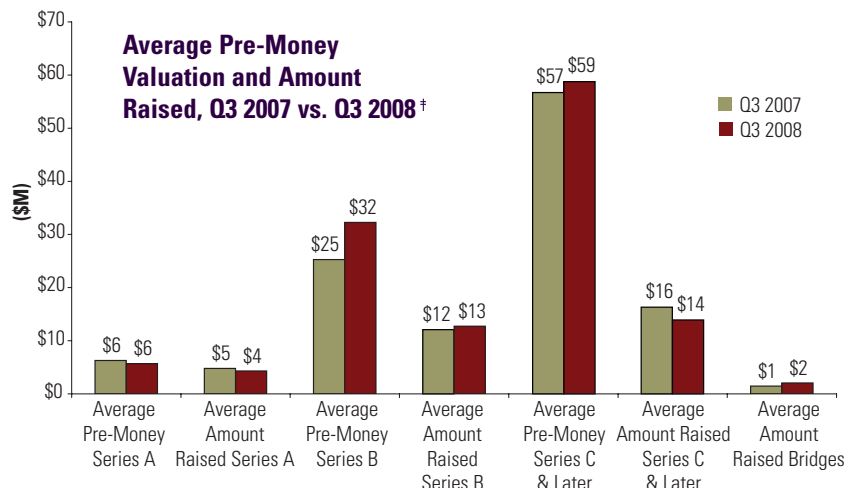


*This line represents the average amount raised in bridge financings in both 2007 and 2008. More precisely, for the first nine months of 2007, the average was \$1.86 million; for the first nine months of 2008, the truncated average was \$1.89 million. (This excludes a \$119 million mezzanine financing in the third quarter of 2008.)

shareholder dilution) in the interest of closing on a near-term exit through a sale or merger of the company.

The chart on the right suggests that pre-money valuations and average amounts raised changed little during the third quarter of 2008 as compared with the prior year. Pre-money valuations for Series B financings have increased the most.

In light of the current state of uncertainty in our financial markets and the general economy, many entrepreneurs express concerns about the "right" timing in starting a company or the availability of funding to take their new business to the next phase of growth. However, even in difficult times when venture activity levels are below historical norms, venture investors are more eager than ever to invest in great management teams with great ideas; entrepreneurs are finding a larger pool of talented managers and consultants as candidates for hire; and new companies are able to command greater resources and mindshare from vendors and suppliers.



*For purposes of normalizing the data, four transactions in 2008 involving investments in excess of \$100 million have been excluded.

Venture investors also recognize recessionary periods as a time of opportunity. According to a recent survey, the predominant view among venture capital firms—close to 80% of those responding—is that the turmoil in the capital markets and national economy is not expected to slow their pace of investment.

Although it is clear that the challenges to the entrepreneur in the current environment can be significant, it is equally clear that the investment climate for the start-up company with a compelling business model offers significant opportunities.

Taking Advantage of the Downturn *(continued from page 1)*

Are there certain companies that might find your value proposition more compelling *because* of the downturn? Should you refocus your value proposition and messaging around helping customers cut costs? If your business model was based on certain advertising CPM (cost per thousand impressions) rates, those may no longer apply. Your list of competitors may have shrunk or changed, so rethinking what you need (and don't need) in your competitive feature set is now relevant. Is the next version of your product really what your existing customers want, or is it what potential customers wanted but no longer can afford to buy? Your existing customer base now may be your core asset, rather than your intellectual property.

To win, your strategy needs to be appropriate for the new market dynamics. Big companies cannot be as nimble as small ones, so smart entrepreneurs should be able to take advantage of thoughtful, but swift, changes in strategy.

Tactics are also critically important, but shouldn't be confused with strategy. Cutting your burn rate is a tactic in a downturn, but it doesn't lead to success unless the company also has the right strategy to go along with it. The companies that came roaring out of the last technology downturn not only had exceptional survival skills but, more important, they had a superior product focus and business model.

On the tactical front, the much-circulated VC presentation mentioned earlier pinpointed the major one: cost-cutting. Financing in this market will be much tougher, so increasing your runway is essential for survival. CEOs

should scrutinize every expense item and try to renegotiate every contract. That said, cost-cutting is only one of many tactics that companies should consider. Tactical opportunities exist on the upside in this market as well.

- **Hiring.** There will never be a better opportunity to upgrade the quality of your team. Start-ups that are well funded and well positioned should have the pick of the litter when it comes to new hires and upgrading talent. Employees may be more flexible on compensation packages than they were several months ago.

- **Marketing.** Media always gets cheaper in a downturn, which presents a unique opportunity to acquire customers profitably. If the lifetime value of your customers has remained stable and now you are able to acquire customers for less than their lifetime value (through inexpensive media), you can make a killing in a difficult economy. Classmates.com is a wonderful case study. When the technology bubble burst in 2000, Classmates.com was able to buy Internet display inventory for a fraction of what it had cost earlier. The company knew what a customer was worth (more specifically, what a customer would pay for a subscription) and, therefore, how much

it could spend to acquire that customer. The team at Classmates.com was maniacal about tracking conversion rates and focused on

buying display media only if it met company goals for conversion. Does your business model enable you to take advantage of less-expensive media? Publishers with undifferentiated inventory should have an especially difficult time selling

inventory. Look for screaming deals!

- **Tying Expenses to Performance.** In a down market, you may have the opportunity to link your cost structure specifically to performance. Tying employee compensation to performance criteria is the obvious example. On the marketing side, as publishers lose leverage, they, too, are more willing to sign performance-based or CPA (cost per action) deals, instead of CPM deals. No publisher is going to announce it, but companies should be persistent in asking for it.
- **Pricing.** Aggressive pricing can be an important weapon against weaker competitors who cannot match your prices or will eat into their cash balances if they do.
- **Mergers and Acquisitions.** Even some attractive companies with strong IP or a large customer base will struggle to make it in this environment. Banks are not the only ones who will be looking for good M&A deals. As a buyer, some questions that you might ask include: Would an acquisition be

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relevant to your new strategic focus, or would it dilute your focus? How long will it take this acquisition to get to positive cash flow? Are you buying people, technology, revenue, or customers? How hard have you scrubbed the projections? How will you finance an acquisition in this market?

No doubt the current market presents added challenges, but it also offers new opportunities for those companies looking to do more than just survive. The companies that refocus their strategies in light of market

realities and creatively consider the tactics they employ will be in the best position to win when the economy starts moving again.

Greg Gottesman is a managing director of Madrona Venture Group, a leading venture capital firm based in Seattle, Washington. Founded in 1995, Madrona funds start-ups based in the Pacific Northwest in the consumer Internet, commercial software and services, digital media and advertising, networking and infrastructure, and wireless industries. The firm currently has more than \$650 million under

management. Greg joined Madrona in 1997 and currently serves on the boards of AdReady, Bocada, BuddyTV, Intrepid Learning Systems, Physware, SchemaLogic, SourceLabs, ThinkFire, and WildTangent. He graduated Phi Beta Kappa with honors and distinction from Stanford University, with honors and distinction from Harvard Business School, and with honors from Harvard Law School, where he was an editor of the Harvard Law Review.

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Venture Capital at a Glance

- In the last 35 years, venture capitalists invested more than \$441 billion in over 57,000 companies in the United States.
- For every \$25,000 of venture capital invested between 1970 and 2006, one new job was created in the United States.
- In 2007, more than 1,400 seed and early-stage companies received venture capital investments.
- Among all sectors for investment, clean technology has seen the most venture investment growth in the last five years.
- There are approximately 800 venture capital firms in the United States.
- The majority of venture capitalists had prior experience in their careers as entrepreneurs, scientists, or engineers.

Source: National Venture Capital Association, <http://www.nvca.org/index.html>

A Price on Carbon: Managing Risks and Opportunities *(continued from page 1)*

carbon-offset investment strategy, will enable early-stage companies to capitalize on their size and agility while hedging against the risks posed by climate change.

The investment community already is demanding that businesses factor in more sophisticated risk analysis taking into account the regulatory, litigation, reputational, and physical risks associated with climate change. In September 2007, a broad coalition of respected investors filed a petition asking for interpretive guidance on climate-risk disclosure. The petition states that "climate change now has material financial consequences" for many businesses and highlights that "companies' financial condition increasingly depends upon their ability to avoid climate risk and to capitalize on new business opportunities by responding to the changing physical and regulatory environment."

The success and popularity of the Carbon Disclosure Project (CDP), an independent nonprofit organization based in the U.K. that gathers and discloses GHG emission data from the world's largest corporations, illustrates both this increasing concern and the benefit of addressing these issues for businesses in any stage of development. A recent CDP report included responses from 321 of the S&P 500's U.S.-headquartered companies and concluded that "more companies are viewing climate change risk not simply as an environmental or public relations issue, but as a game-changing set of business imperatives."

Climate-Change Legislation and Your Business Plan

Since January 2007, nine legislative proposals that would require reductions in the amount of GHG emissions created nationally have been introduced in the Senate. While there are

many differences between these proposals, all propose mandatory emission caps designed to decrease allowed emissions over time as the key policy mechanism to achieve GHG reductions (the so-called cap-and-trade approach). The momentum created by these proposals, regional and state leadership, and a supportive federal administration ultimately will translate into the introduction of similar legislation and, effectively, a price on carbon in the U.S. It is critical for businesses operating in this country to understand potential policy implications not only to develop an effective carbon-reduction plan, but to ensure that this strategy is integrated into the overall business planning process by outlining implications related to risk management, the ability to raise capital, and shareholder value.

Development of state and regional programs designed to meet aggressive GHG reduction targets already is underway and most likely will play a large role in shaping the development and design of federal policy. California specifically leads in this area with the passage of Assembly Bill (AB) 32: the California Global Warming Solutions Act of 2006, which requires the state to aggressively reduce greenhouse-gas emissions to 1990 levels by 2020, approximately 30 percent below projected levels for that year. The scoping plan focuses on identifying the state's largest sources of GHG emissions and detailing comprehensive reduction solutions to meet targets through various market mechanisms, including a statewide cap-and-trade program. The California Air Resources Board (CARB), the lead agency tasked with

implementing AB 32, is working to ensure that the state's strategy aligns with other complementary regional efforts such as the Western Climate Initiative (WCI). Currently, WCI is comprised of seven western U.S. states (including California) and four Canadian provinces committed to launching a

multisector cap-and-trade system by January 2012, with an overall goal of reducing regional GHG emissions 15 percent below 2005 levels by 2020.

According to a recent report by The Climate Group, a statewide cap-

and-trade program under AB 32 will create price signals that "will increase the wholesale price of fossil-fuel-fired electricity, petroleum-based transportation fuels and natural gas, and would therefore affect [businesses] investment decisions, energy use and fuel choices." The AB 32 scoping plan recommends that GHG emissions from the following sectors be capped to achieve emissions-reduction goals: electricity, transportation fuels, natural gas, and large industrial sectors. The first step in reaching this conclusion was a comprehensive evaluation aimed at identifying the exact sources of the state's GHG emissions. Establishing this baseline enabled lawmakers to set concrete goals and outline strategies to meet targets.

In a similar manner, every early-stage company should establish a baseline that will allow it to set organizational boundaries outlining its emission sources, reduction targets based on this data, potential policy implications, and sustainability goals. A company's ability to translate these findings into emission-reduction opportunities should be a key focus of its GHG reporting and clearly

Early-stage companies are particularly well positioned to successfully respond to the challenges posed by future climate legislation.

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outlined for potential investors. These reduction initiatives should be centered on goals based on a company's initial baseline numbers and, like California's plan, should target its largest sources of emissions first while detailing the risk and value of each initiative (e.g., cost of implementation vs. total reductions achieved over time). Depending upon the scope of each initiative, businesses can expect to see real cost savings both before and then increasingly after implementation of a legislated price on carbon. It is only once they have calculated their emissions and implemented strategic reduction efforts to decrease emissions wherever possible that they then should look to carbon offsets to reduce or eliminate the unavoidable emissions that result from business operations.

Carbon offsets play a role in virtually all of the recently proposed national cap-and-trade proposals, as well as current international cap-and-trade systems such as the European Union Emissions Trading Scheme. Both the WCI and AB 32 look to offsets as one of the tools to be used to reach emission-reduction goals and will require that these reduction credits meet strict, internationally recognized standards of environmental integrity. When purchasing offsets, it is imperative that a company demand this same level of integrity from its suppliers by supporting clean technology projects that are independently verified and meet high-quality standards, such as the Voluntary Carbon Standard (VCS) or the Gold Standard. Incorporating carbon offsets into a corporate carbon-management strategy is an effective

way to reach emission-reduction targets, support clean technologies, and gain valuable experience navigating carbon markets. These benefits are derived from exercising due diligence in the selection of offsets to ensure that a company meets internationally accepted standards that guard against double-counting and guarantee that its purchase resulted in emission reductions beyond "business as usual."

Opportunities for the Early-Stage Entrepreneur

Emission-reduction measures mandated by AB 32 will be in full effect by January 1, 2012, which means that companies that prepare for these policy implications now will be in much better shape than competitors who simply wait for legislation to require a reconfiguration of their business model.

Anticipating price fluctuations in a carbon-constrained economy is key to gaining the top-level support needed to assign the necessary capital and resources to implement an effective corporate carbon-management strategy. However, the scope of the problem demands innovation and a willingness to think "outside the box." This challenge will not be met without the leadership of the

entrepreneurial business community and a commitment to changing the way it defines success in business.

Responses to the CDP's most recent questionnaire demonstrate that successful communication with stakeholders is increasingly dependent upon a business' ability to accurately calculate and disclose its

GHG emissions. Early-stage companies and entrepreneurs should capitalize on the opportunity to incorporate a comprehensive GHG calculation and reporting process as an essential element of their overall growth strategy. Without this level of disclosure, early-stage companies will find themselves increasingly disadvantaged when communicating with investors looking to make both short- and long-term commitments. Concurrently, absent this disclosure, potential carbon-policy implications cannot be accurately anticipated or prepared for—a huge red flag for the savvy investor. Finally, a solid GHG reporting system will enable an early-stage organization to set ambitious yet tangible GHG reduction goals that will demonstrate its sophisticated risk-assessment modeling and assure potential investors of the value of its brand and longevity in a carbon-constrained economy.

Aleka Seville manages communications and marketing activities for First Climate LLC and has extensive experience collaborating with businesses to incorporate and effectively communicate sustainable corporate processes. As a global leader in carbon asset management with offices on four continents and more than ten years of experience in international carbon markets, First Climate is one of the few intermediaries to cover the entire carbon-credit value chain. First Climate's carbon-reduction project portfolio consists of high-quality emission-reduction credits that are verified by international carbon market standards. This objective third-party quality assurance creates the transparency that safeguards First Climate credibility as well as the integrity of their clients' environmental engagement.

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Control: The Critical Issue in Negotiating Financing Terms

By Caine Moss, Partner (Palo Alto Office)

It is not an overstatement to say that *the* critical issue in a financing round is the issue of control. When negotiating the terms of a financing, both entrepreneurs and investors are focused on how much control over the company they will have post-financing, how long they can maintain that level of control, and in what circumstances they can exercise control. It is often the give and take between entrepreneurs and investors around the issue of control that determines how deals are structured.

While virtually every deal term could at some level be reduced to a control issue, generally speaking, there are five principal control issues: (1) ownership, (2) protective voting provisions, (3) board composition, (4) “drag-along” rights, and (5) founders’ stock vesting provisions.

Ownership

The most basic control issue is the percentage of the company the investor(s) will own post-financing. The language of ownership in financings is expressed in terms of the company’s pre-money enterprise valuation and the size of the investment. Rational entrepreneurs in normal economic environments seek to maximize valuation and to raise only the amount of money they need to minimize the dilution they suffer. Conversely, investors want to take as much ownership as they can by investing at low valuations and putting more money to work. The size of the unallocated option pool plays into these negotiations as well, because financings usually are structured such that increases in the size of the option pool dilute the existing owners (e.g., the founders) but not the new investors. Ownership-based control is principally a business issue, but it does have other non-economic implications. Under Delaware law and absent any contractual voting rights, any action that requires

stockholder approval, including authorizing financings or approving M&A exits, can be approved by 50 percent of the outstanding share capital. Accordingly, founders who retain 50 percent ownership control may have a block on these actions even if they lose control at the board level. Ownership control often carries strong emotional significance for founders. However, founders need to be realistic about their ownership levels, because if they require outside funding to grow their business, they should expect to give up majority control of the company over the course of one or more financing rounds.

Protective Voting Provisions

Protective voting provisions are contained in almost every venture capital term sheet. Protective voting rights give the holders of preferred stock (i.e., the investors) the right to approve specified acts undertaken by the company, and represent a set of blocking rights for investors. First-time entrepreneurs may be disappointed to learn that the corporate actions over which they desire the most control—such as raising future financing rounds, M&A events, or changing the size of the board or the identity of the CEO—are customarily subject to approval by the holders of preferred stock. In practical terms for founders, it means that they need to get their investors (or lead investor) to agree with them that it is a good idea to sell the company, incur large amounts of debt, or raise a new

financing round. Beyond a handful of generally accepted core protective provisions, much of the negotiation of these provisions in term sheets involves determinations of what corporate actions are purely within the purview of management (and therefore shouldn’t be subject to protective voting) as compared to those properly subject to a veto by the preferred stockholders in circumstances in which they disagree with management.

Board Composition

Board composition also can be heavily negotiated in term sheets, and the outcome of these negotiations often is dictated by the perceived leverage of the parties. If there are multiple parties interested in investing in the company or if the company is in a “hot” space, investors typically are more willing to compromise on the level of board control they require. While it is hard to speak in broad terms on this subject, when negotiating board composition there are a couple of rules of thumb entrepreneurs should bear in mind. First, try to keep the board size as small as practically possible in the early funding stages (e.g., three to five directors). At each subsequent round of financing, chances are good that one or more directors will be added, and large boards can be unwieldy and unproductive. Second, try to maintain board control or neutrality for as long as possible by having at least as many common directors as preferred directors, and

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Control: The Critical Issue in Negotiating Financing Terms *(continued from page 9)*

by having any mutual or independent directors subject to the approval of the common stockholders (voting a separate class). Board control is important because every material corporate action requires board approval, as do more mundane yet important matters such as option grants, annual budgets and forecasts, executive compensation, and venture loan transactions.

Drag-Along Rights

“Drag-along” rights come in a variety of flavors, but in their strongest form, they are rights given to major investors to force a vote by the holders of common stock and minority investors in favor of an M&A transaction that has been approved by the investors. Drag-along provisions strip entrepreneurs of the right to block an M&A transaction they might otherwise have by statute or by virtue of their ownership of the company. It should be noted that although Delaware courts seem to have upheld drag-along agreements among shareholders, questions remain as to the enforceability of contractual rights such as those that purport to force shareholders to sell their shares without any ability to exercise their statutory dissenters’ rights.

Fairness issues aside, drag-alongs are common in deals in which the company has limited leverage, in later-stage deals in which investors anticipate friction with entrepreneurs (or earlier investors) over possible future exit valuations, or in East Coast deals in which investors often demand a higher level of control. Entrepreneurs should reject drag-alongs whenever possible. However, negotiations over drag-alongs don’t always have to be binary. For example, entrepreneurs can negotiate for a drag-along

to be applicable only after several years so that it isn’t triggered for any near-term exit; to be subject to a “return ceiling” so that it doesn’t apply to exits above a specified return for investors; or to require founder approval in order to be triggered (approval may apply only if the founders are still employed with the company). Drag-alongs aren’t ideal for the entrepreneur from a control standpoint, but there are strategies to employ to make them manageable.

Founder Vesting

Most investors make it a condition to their investment that founders subject their stock to time-based vesting. For many founders, this can feel uncomfortable because they worry about getting fired and having their company-ownership stake taken away from them. On the other hand, investors view vesting as the most effective means to align founders’ interests with theirs in order to maximize shareholder value.

Over the years, the market has evolved for founder vesting provisions such that the possible range of packages is fairly limited. However, within the range, levers can be pulled to optimize founder packages and protect founder shares in termination scenarios. Examples include eliminating cliff vesting for founders, having a portion of founders’ shares vested up front as “credit for time served,” or negotiating a vesting term shorter than the standard four years.

Moreover, to protect founders from being fired or marginalized after a sale of the company, it is common for the vesting on their stock to accelerate in the event that the founder is terminated or his or her duties are materially and detrimentally changed within a specified time period after the sale (so-called “double-trigger” vesting acceleration). In addition, some investors will agree to limited but immediate vesting acceleration upon the sale of the company; full acceleration at the time of a sale can be perceived as an acquisition deterrent for a potential acquirer, however, and is therefore uncommon. Severance-based acceleration measures also can be introduced for employment terminations that occur during the vesting cycle, although these can be more difficult to negotiate.

Over the years, the market has evolved to include vesting provisions that optimize founder packages and protect founder shares in termination scenarios.

Control issues relating to ownership, voting, board composition, drag-along rights, and founder vesting are critical to virtually every venture financing. Much of what we as lawyers do in these transactions, whether on the company or

investor side, involves negotiating control issues. An entrepreneur’s ability to “win” on these points with an investor usually will help determine whether or not he or she regrets taking money from that investor. It is important that entrepreneurs calibrate these control issues properly at the outset, because it becomes increasingly difficult with each successive round of financing to alter these key deal terms.

Navigating Down-Round and Dilutive Financings

By Yokum Taku, Partner (Palo Alto Office)

When raising money becomes more difficult, as it is in these challenging economic times, deal terms typically become more favorable to investors. In many cases, existing investors are left to fund the company if new investors cannot be identified.

The structures and terms of down-round financings are highly variable, unlike up-round financings, which have a fairly predictable range of terms. In a down-round financing, a company issues securities to investors at a purchase price less than that paid by prior investors. Absent anti-dilution protection, a down-round financing will dilute both the economic and voting interests of the prior stockholders. A "washout," or highly dilutive financing, is an extreme form of down-round financing that significantly reduces the percentage ownership of prior stockholders.

Here are some of the features of down-round and highly dilutive financings:

Liquidation preference. Liquidation preferences are typically more favorable to investors than in previous rounds. These financings may involve the issuance of participating preferred stock, with senior liquidation preferences at multiples of the purchase price. Please keep in mind that the liquidation preference may be the most important right of the preferred stock, as the percentage ownership that the preferred stock represents upon conversion into common stock may become meaningless from a practical perspective if the common stock is worthless.

Full-ratchet anti-dilution protection. Investors in risky financings may request "full-ratchet" anti-dilution protection to protect against future down-round financings.

Aggressive convertible debt terms. Many investors in highly risky financings will prefer

senior secured convertible debt over equity securities in the event the company has to file for bankruptcy. These financings may involve the issuance of secured convertible debt (sometimes coupled with warrants) senior to other debt with a payment of a multiple of the principal amount on a sale of the company (or conversion into equity securities at a multiple of the principal amount). Three-to-five-time multiples were not uncommon during the post-dot-com era. In these situations, voting control, as reflected by percentage ownership and affected by valuation, is a secondary concern to the financial return on a sale of a company and protection in bankruptcy.

Milestone-based or tranching financings. Investors may be reluctant to invest large amounts of money in a risky financing. Instead, they may provide enough money for a company to complete a merger or an asset sale or achieve a particular milestone to raise additional funds. These financings may provide up to a few months of operating cash.

Conversion of preferred stock and recapitalizations. Some financings involve a conversion of a previous series of preferred stock into common stock in order to decrease the aggregate liquidation preference. In some companies, previous financings may have resulted in an aggregate amount of liquidation preferences that may render the common stock worthless. For example, due to investor-friendly liquidation preferences or raising multiple rounds of financing, a company that has raised \$50 million in financing may have

\$100 million in aggregate liquidation preferences. However, the company may realistically have a problem getting sold for greater than \$100 million in poor economic conditions in which company valuations are low.

Pay to play. Many dilutive financings implement a pay-to-play mechanism through which stockholders not participating in the financing are penalized by being forced to convert to common stock or losing certain rights such as anti-dilution protection. Absent a pay-to-play mechanism, stockholders may not have an incentive to risk additional investment into a company.

Enhanced rights for participating investors. In some down-round financings, existing stockholders who participate in the financing may receive additional benefits over non-participating stockholders. This is similar to pay-to-play provisions that penalize existing stockholders for not participating in the financing. For example, existing stockholders who participate in a financing may have their preferred stock repriced via an adjustment to the conversion ratio, which would effectively give them the benefit of a lower valuation for their original investment. Alternatively, participating stockholders may have the opportunity to exchange their existing preferred stock for new preferred stock with more favorable rights, such as a senior liquidation preference.

Expanded investor protections. Some investors may request more extensive representations and warranties, broader indemnification protection, D&O insurance, and other similar investor-favorable protections.

The structures and terms of down-round financings are highly variable, unlike up-round financings, which have a fairly predictable range of terms.

Navigating Down-Round and Dilutive Financings *(continued from page 11)*

Drag-along rights. Investors may require drag-along provisions that require existing investors to vote in favor of a future sale of the company or an amendment of the certificate of incorporation to create a new series of preferred stock to facilitate a future financing (even before the terms of the preferred stock have been established).

Employee-retention plans. Some financings may involve large stock-option grants to offset the dilutive effects of the financing for employees. In some companies, aggregate liquidation preferences or returns of multiple principal amounts on convertible debt may render the common stock worthless. In these situations, stock options may not be adequate to hire and retain employees. Instead, companies may implement retention plans in which employees receive a certain percentage of proceeds upon a sale of the company.

The role of the participating inside investors, who have the ability both to set the investment terms and make the investment, creates tension between management and minority stockholders on one hand, and the participating inside investors on the other. In addition, former founders or early investors not participating in the financing may perceive the participating inside investors as attempting to secure control of the company by diluting their equity position.

Furthermore, the directors affiliated with the participating inside investors are often regarded as having a conflict of interest with regard to their approval of the down-round financing. This conflict of interest creates a difficult legal environment surrounding the actions of the board members and the company. In this situation, there are a number of steps that a board of directors and the company may consider to reduce the risk of litigation from disenchanted stockholders

when faced with a dilutive financing driven by inside investors:

Keep a compelling board record. Board minutes reflecting the board's thinking and analysis are important. Board members typically should meet in person or by telephone conference call as opposed to taking action by written consent, and should devote more than a single meeting to decide whether to proceed with a down-round financing. The minutes should reflect the board's rationale for considering a down-round financing and its efforts to recruit potential third-party investors.

Diligently assess the alternatives. The board should attempt to demonstrate that it has considered all reasonable alternatives to the insider-led round. Although actual contacts and presentations with possible new investors are not legally required, if the company has not attempted to engage with new investors, there should be a plausible reason in the record for the board's decision.

Secure approval by independent directors. Approval of the financing terms by independent directors, or by a special independent committee of the board empowered to authorize the financing, may allow the board to take advantage of the business judgment rule. This rule creates a presumption that business decisions made by a board of directors will be given deference by the courts if the board's judgment is exercised diligently and in good faith. Where the board's decision may be influenced by conflicting financial interests of the directors (a so-called interested transaction), as in a down-round financing, the favorable presumption of the business judgment rule falls away. Independent director approval may not be practical, however, in many circumstances.

Earn approval from disinterested stockholders. Down-round financing structures typically require stockholder approval. Securing the approval of the stockholders who are disinterested helps the company defend against an attempt to void the transaction by disenchanted stockholders.

Fully disclose the terms. Complete disclosure of financing terms is essential in a down round, with particular consideration of the benefits of the financing terms to the inside investors, the likelihood of replenishment of equity incentives to management and employees following completion of the financing, and factors that would adversely impact non-participating stockholders.

Offer rights as appropriate. Perhaps one of the most important steps in an insider-led down-round financing is a rights offering that accompanies or follows the financing. All stockholders of the company, frequently including employees with vested options and warrant holders with "in the money" rights, should be permitted the right to participate in the financing on substantially the same terms as the inside investors. The disclosure or information statement provided to all stockholders of the company can serve to summarize the financing terms while soliciting the interest of potential investors. The rights offering should be structured in a manner to comply with applicable state and federal securities laws and should allow sufficient time for potential investors to respond to the offer.

Unfortunately, there is no single step, or even combination of steps, that can completely remove the risk of legal exposure in a down-round financing. Board members may be faced with the difficult decision of proceeding with a financing that may result in litigation or shutting down the company.

The Do's and Don'ts of Compensation for Early-Stage Company Employees

By *Kristen Garcia Dumont, Partner (San Francisco Office), and Jennifer Martinez, Associate (Palo Alto Office)*

For more than 10 years, Steve Jobs has taken a \$1 annual salary at Apple, Inc. Of course, Jobs didn't begin this practice until he returned to Apple in 1997, long after it had outgrown its humble beginnings in the Jobs' family garage. Still, Jobs' compensation package has become popular lore among early-stage companies. The result has been a misperception that paychecks are optional when a company is just starting out, particularly for the founders themselves. This article will outline some cardinal "do's and don'ts" that start-ups should follow when trying to balance the need for legal compliance with the need for preserving precious cash flow.

The Don'ts

Start-ups are often comprised of a small group of workers dedicated to the ideas and cause of the company. As such, there is often a desire on the part of both the company and its employees to either defer or not pay the wages of early-stage employees as a way of cutting costs. Mutual wishes aside, California law is very clear—and very strict—with respect to the forms of employee compensation that are and are not permissible. Not running afoul of these laws is crucial for start-up companies, as violations can create significant liability in the form of class action lawsuits, wage audits, and even criminal charges.

1. DO NOT Have Workers Volunteer Their Time or Labor

Many start-ups have the founders and their initial employees work for some temporary period on a voluntary basis. This is impermissible in California. Regardless of how willing they are, employees simply are not permitted to volunteer their time unless they are doing so for a public agency or private nonprofit company.

2. DO NOT Offer Stock in Lieu of Wages

In an effort to keep costs under control, many start-ups with large upside potential try to set up arrangements in which early-stage employees are paid in equity instead of wages. Such strategies are not permissible in California. While employees may receive incentive compensation in the form of stock options, their "wages" may not be paid in stock. California law requires that employees be paid at least the minimum wage, in cash. Since employees must receive at least minimum wage, they cannot be compensated *solely* in stock; however, an alternative approach of offering employees a combination of wages and stock and/or bonuses is discussed below.

3. DO NOT Defer Wages

Because of the unique dynamic between start-up personnel, quite often employees (and executives in particular) will agree to forego a salary for a certain time period pending a financing, acquisition, or other transaction. Generally speaking, deferred wages are simply *not* permissible in California. Under California law, nonexempt employees must be paid at least semimonthly and exempt employees must be paid at least once monthly. Employers who do not pay wages on time can be subject to misdemeanor criminal charges in addition to the wage liability. Furthermore, there can be personal liability for penalties. For those employers who want to defer wages for a select group of top executives, there are formal benefit programs that can be put into place. However, these plans are highly technical and the assistance of able legal counsel is a must.

4. DO NOT Misclassify Workers as Independent Contractors

One of the most common wage-and-hour mistakes that companies make is the misclassification of workers as "independent contractors" or "consultants" rather than as "employees." Under both federal and California law, independent contractors and consultants are exempt from minimum wage and overtime laws; thus, it is tempting for companies to label workers as independent contractors in an effort to avoid the cost of complying with these laws. However, simply paying a worker a consulting or project fee rather than hourly compensation or entering into a contract designating the worker as a consultant is not enough. Courts always will look beyond such arrangements and independently apply a multifactor analysis to determine the true status of any individual worker, as discussed further below.

In misclassification scenarios, the back pay and penalties owed to misclassified employees can be significant, and employers also can be found liable for engaging in unfair business practices. For example, in the recent case of *Cappa v. CrossTest, Inc.*, a disgruntled employee brought suit against his former employer, a start-up, for failure to pay overtime wages, violation of minimum-wage laws, and unfair business practices, among other issues. When he began working for the employer, the employee signed an agreement that expressly stated he would be working as an independent contractor; as such, the agreement dictated that his only compensation would be in the form of stock

There has been a misperception that paychecks are optional when a company is just starting out, particularly for the founders themselves.

The Do's and Don'ts of Compensation *(continued from page 13)*

options to vest on the achievement of certain milestones. The appellate court ignored the parties' contract altogether, finding that the employer exercised sufficient control over the employee's work for him to be considered an employee, not an independent contractor. As a result, the appellate court also found the employer liable for engaging in unfair business practices by failing to pay wages and misrepresenting the employment status of the employee.

The Do's

It is easy to see why all of the "don'ts" can be frustrating for start-up companies and their employees. It is often the case that the employees truly want to work for equity or for free, for the sake of the company.

However, the above discussion is not to say that start-ups have

no flexibility when it comes to compensating early-stage employees—this section will outline some creative approaches companies can use while still keeping costs low.

1. You DO Have the Option to Pay Minimum Wage plus Bonuses and/or Stock

As discussed above, California law requires that all employees receive at least a minimum wage, which must be paid in cash. Thus, start-up companies *can* legally structure employee compensation to be a combination of the minimum wage, in cash, in addition to bonuses or stock. For example, an employer could give a full-time employee a semimonthly paycheck for \$640.00 (\$8.00 per hour minimum wage multiplied by 40 hours per week, for two weeks) and then provide a bonus or additional

stock option awards when the employee or the company hits certain time or task milestones.

In the *Cappa v. CrossTest, Inc.* case mentioned above, for instance, the employer paid the computer programmer in stock options that would vest quarterly after he began working, plus additional stock options to vest on the achievement of three mutually agreed-upon product milestones. Beyond the stock option

awards, however, the employer did not compensate the programmer in any other way. The court held that, because the programmer was an employee and not an independent contractor, this compensation arrangement violated California's wage laws. However, it was not the compensation with stock options itself that was illegal,

but the fact that the company stock was the programmer's *sole* form of compensation. As mentioned above, employers may not compensate workers with stock *in lieu of* wages. If, however, the employer also had provided the programmer with cash payment at a minimum-wage rate for his hours worked (including overtime), the arrangement likely could have been upheld.

Keep in mind, however, that hourly employees in California must be paid overtime wages for more than 8 hours of work in a day or 40 in a week. So, it is imperative that employers keep track of all hours worked and comply with California's meal-and-rest-time requirements for hourly employees. Counsel can assist start-up clients in understanding these requirements to ensure full compliance.

2. DO Classify Workers as Independent Contractors if They Truly Meet the Test

Classifying workers as independent contractors or consultants is particularly tempting for start-ups seeking to cut costs and bootstrap their way forward, since independent contractors and consultants are exempt from minimum-wage and overtime laws. Having independent contractors and consultants on the payroll is, of course, permissible, but because of the potential liability associated with misclassification, start-ups should take care to ensure that workers truly meet the test for independent contractors.

Whether a worker is an independent contractor or an employee is determined by a multifaceted analysis. A worker's job title and the worker's and the employer's intent in creating the employment relationship are only two of several factors to consider. Other factors that courts will look at in determining employment status include whether the employment relationship may be terminated at will; the skill required to perform the work; who provides the instrumentalities and place of work; whether payment is by time, piece, rate, or job; and whether the services are part of the employer's regular business. The most important factor, however, is the extent of the employer's right to control the "manner and means" of the worker's performance.

For example, *Desimone v. Allstate Insurance Co.* addressed whether insurance agents at Allstate's branch offices were employees or independent contractors. Although Allstate set certain business hours for branch offices, required attendance at certain meetings, required participation in training, established a dress code, and conducted annual evaluations of branch offices, the court held that the agents were independent contractors. The court based this determination on the fact that

Allstate could not unilaterally change agents' hiring agreements, agents had the power to hire and fire their own subordinates and had sole responsibility for their compensation, agents chose their own office locations and negotiated their own lease terms, and the agents had substantial control over the time, place, and manner in which they performed their work. The *Desimone* case turned on the factual circumstances of the agents' day-to-day work activities, illustrating that courts will

look far beyond the words of an consulting agreement, the existence of salary vs. hourly compensation, or the parties' intent in forming the relationship.

Conclusion

It can be comforting to know that most start-up companies face a similar dilemma—namely, they have good ideas and good people, but they don't have much money.

Getting creative with compensation is certainly a way for such companies to cut costs in their early stages. However, in structuring uncommon compensation packages, start-ups must be aware of the various ways they unwittingly can expose themselves to liability. Following the do's and don'ts outlined in this article is a good starting point to make sure that a company keeps its precious resources devoted to the enterprise, rather than to defense costs.

Events

ENTREPRENEURS COLLEGE

In 2006, Wilson Sonsini Goodrich & Rosati launched its Entrepreneurs College seminar series. Presented by our firm's attorneys, the seminars in each session address a wide range of topics designed to help entrepreneurs focus their ideas and business strategies, build relationships, and access capital. In response to attendee demand, there also are occasional additional sections that address issues of concern to particular industries.

Currently offered every spring, the sessions are held at our Palo Alto campus and are webcast live to our national offices. These events are available exclusively to entrepreneurs and start-up company executives in the Wilson Sonsini Goodrich & Rosati network, which includes leaders in entrepreneurship, venture capital, angel organizations, and other finance and advisory firms.

As part of our services to attendees and other entrepreneurs, we offer archived webcasts of the seminars, as well as a collection of PowerPoint presentations and supporting materials. For more information about our Entrepreneurs College and other programs, please contact Tni Newhoff (email: tnewhoff@wsgr.com).

SPRING 2009 SESSION

The Spring 2009 session of the Entrepreneurs College will begin in mid-April. Proposed seminars include the following (dates and presenters to be announced at a later date):

Overview & Valuation

An overview of the start-up process and the financing of new entrepreneurial ventures, including methods commonly used to value companies and how investors apply these methods to early-stage companies and technology projects.

Business Plans & Fundraising

Practical guidance for organizing a business plan as a critical planning tool and preparing executive summaries, including financial projections and budgets. Also includes strategies for approaching the investment community and exploring alternative sources of funding.

Forming & Organizing the Start-Up & Founders Stock

An exploration of the decision-making process in forming a start-up, including timing, documents, and the issues involved in determining the capital structure of the business organization. Also covers strategies

regarding the allocation of founders stock and the composition of the board of directors.

Compensation & Equity Incentives

An overview of the compensation and equity incentive structures available to founders to attract and retain new talent. Discusses the general mechanics of creating and issuing these awards, as well as the legal and tax consequences involved in the execution of compensation and equity programs.

Intellectual Property

A discussion of the importance of developing an IP strategy tailored to your particular business and the relationship between IP protection and the commercialization objectives of your business. Also covers the available forms of IP protection and their benefits and liabilities.

Events *(continued from page 15)*

Term Sheets

An overview of term sheets and the due diligence necessary before signing. Helps provide an understanding of investor expectations, including board seats, liquidity, registration rights, and non-compete agreements. Discusses key provisions to include in term sheets and negotiation strategies for achieving the best-case investment scenario.

Clean Tech Session

An in-depth discussion of the important issues that entrepreneurs need to master in order to grow their clean tech ventures. Whether you have a developed technology or are merely interested in getting involved in the clean tech industry, this session will guide you through the stages in the life cycle of financing your venture and bringing your ideas to the marketplace.

Exits & Liquidity

A discussion of recent developments in exit events, including the IPO process and M&A trends. Provides an understanding of the expectations of investors and the public capital markets and covers the recent corporate governance and regulatory issues involved in liquidity events.

Biotech Session: Acquiring a Core Technology

An in-depth discussion of the issues that biotech entrepreneurs should consider when starting their ventures. Explores the process for acquiring a core technology, from both universities and big biotech and pharmaceutical companies. Discusses how these agreements will affect your ongoing business operations, partnering activities, and exit and acquisition opportunities.

FALL 2008 HIGHLIGHTS:

15TH ANNUAL PHOENIX CONFERENCE

On October 3 and 4, 2008, the firm co-hosted Phoenix 2008, a two-day medical device and diagnostic conference for chief executive officers that examined key issues facing the industry. The event was held in Scottsdale, Arizona, with more than 160 medical device CEOs in attendance, and was co-hosted by PricewaterhouseCoopers, Versant Ventures, and Windhover Information. The conference featured a discussion with Bill Hawkins, president and chief executive officer of Medtronic, in which he explored such issues as healthcare reform, the future of innovation, and the changing regulatory landscape; a presentation by Alexander Tsiaras of Anatomical Travelogues, a developer of scientific visualization software; and a presentation by Tommy Thompson, former U.S. Health and Human Services Secretary, on Medicare policy reform. Other highlights of the two-day conference included a retrospective case study of Guidant and interactive breakout sessions addressing such topics as companies' relationships with healthcare professionals, proposed Democratic and Republican healthcare reforms, and successful financial strategies for medical device start-ups.

SECOND ANNUAL ALGAE BIOMASS SUMMIT

On October 23 and 24, 2008, the firm co-hosted the second annual Algae Biomass Summit in Seattle, Washington. More than 650 CEOs, start-up executives, scientists, educators, and investors from 25 countries attended the summit, at which technologists, producers, scientists, investors, and policymakers explored the emerging use of algae as feedstock for biofuels and other sustainable commodities. The event featured a keynote address from venture capitalist Vinod Khosla of Khosla Ventures, who spoke about the market potential of algae production for biofuels. In addition, Congressman Jay Inslee (D-Washington), a member of the House Energy and Commerce Committee, encouraged attendees to engage with their congressional representatives to help educate them on the potential of algae to serve as a renewable energy source. Rounding out the two-day event, numerous panels of experts addressed such topics as U.S. government laboratory and university algal-based research, factors considered by venture capitalists when deciding whether to invest in a company, and the prospects for algal-based jet fuel in the commercial aviation market.

Wilson Sonsini Goodrich & Rosati co-hosted the Algae Biomass Summit with Byrne & Company. The event also served as an official conference of the Algal Biomass Organization.

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