Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

THE ENTREPRENEURS REPORT
Private Company Financing Trends

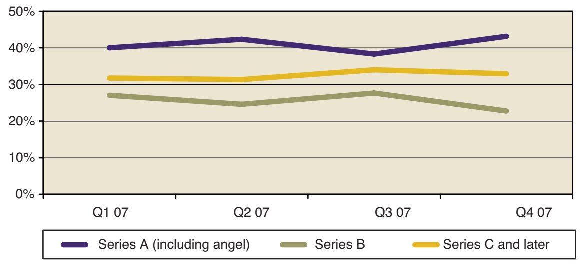
Winter 2007

The Data Set, WSGR Financings:
January 1, 2005 – December 31, 2007

In This Issue

DISTRIBUTION BY SERIES. The distribution of equity financings among Series A, Series B and Series C and later rounds has remained relatively stable on a year-to-year basis from 2005 through 2007, although each of these years has witnessed some quarterly fluctuation. This continuity suggests a continuing interest on the part of the venture capital community in seeking out and funding new companies, both at the start-up and later stages of development.

Distribution by Series



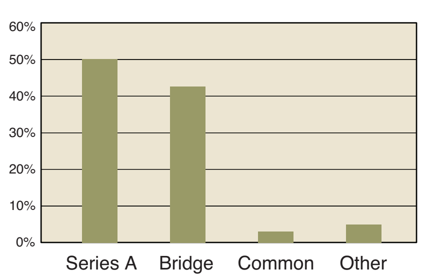
	2005	2006	2007
Series A (including angel)	44%	41%	41%
Series B	25%	26%	25%
Series C and later	29%	31%	32%

INITIAL FINANCINGS. If the long-range business objectives of a start-up company include significant growth supported by institutional venture capital, a capital structure must be implemented that will provide a platform for this growth and the attendant need for investment. The first financing for a start-up company is important because it establishes the first building block for this platform, and the founders and the initial investors must determine whether the first financing should be structured as debt or equity. If they agree on an equity structure, the investment normally would be transacted through the issuance of Series A Preferred, and the founders and investors would have to agree upon a "pre-money valuation" of the company; that is, the value of the company immediately prior to the investment. This pre-money valuation is important because it determines the allocation of equity ownership of the company that results from the cash funding put up by the investors. In many seed and early-stage companies, in particular, establishing a valuation is conjectural at best, since there is typically little industry or operational data at this stage on which to negotiate the pre-money valuation. For this reason, many founders and initial investors agree that a bridge-note structure may make more sense, with the objective of deferring the valuation exercise until the first institutional financing.

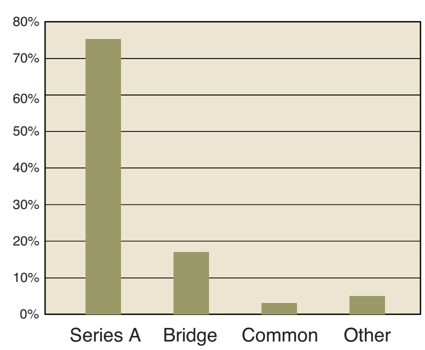
In a bridge financing, the founders and investors agree that the investment will be transacted through the issuance of convertible notes (see our Fall 2007 *Entrepreneurs Report* for a discussion on bridge notes). These notes typically convert into the first equity round of financing, at the same price and on the same terms as are negotiated with the investors involved in the equity round. It is common for bridge notes either to be accompanied by warrants or structured with a discounted conversion price as an equity incentive for the investors.

For companies in the seed stage of organization, the data to the right indicates that approximately 42% of initial financings are transacted through the issuance of bridge notes, based on our data for 2006 and 2007. For companies that have evolved from seed to early-stage development, the dominant form of financing structure used is equity, transacted typically through the use of Series A Preferred; in these circumstances, bridge note structures declined to 17%. This data would appear to confirm the general belief that the use of an equity financing structure at seed stages, and the need to establish a pre-money valuation and the attendant allocation of equity ownership between founders and investors, may be problematic.

Seed Investments 2006-2007



Early-Stage Investments 2006-2007



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The Data Set *(continued from page 1)*

TRENDS IN VALUATION AND AMOUNTS RAISED. Although average pre-money valuations may not be useful for pricing individual deals, they are pertinent as an indicator of industry trends, as well as the health of the community of emerging growth companies and the venture capital base that supports them. Over the three years 2005, 2006 and 2007, pre-money valuations for Series A, Series B and Series C and later rounds appear relatively stable, with a slight bias toward higher valuations in more recent periods.

Series A rounds typically have been priced based on pre-money valuations in the $8 to $10 million range, while the average amount of equity raised in these financings over the three-year period was approximately $5 to $6 million.

More than later stages of financing, Series A financings embrace a broad range of organizational development in early-stage companies, from the embryonic seed-stage company to the company that is still early stage but has evolved to a higher level of operations.

For purposes of this trend analysis of valuation and amounts raised in Series A rounds, we have excluded Series A financings involving only individual angel investors or organized angel groups, and included only Series A financings involving institutional venture capital investors and/or corporate strategic investors.

In many cases, these Series A financings follow an intense "bootstrapping" period of start-up operations, frequently lasting many months or even years, in which the company seeks to validate its business plan through product development, customer acquisition and other operational and marketing activities. By the time the company is in a position to seek its first institutional financing, in some cases it may have its first products already in beta, its market strategy in place, or even its first customers.

The data in our report is from angel and venture financings in which WSGR represented either the company or the investor. This data consists of more than 600 financings in each of 2005, 2006 and 2007. Data is reported on financings throughout the United States, without distinction by geography.

In our descriptions of this data, we refer to the average numbers for certain periods. We use a truncated average, discarding from the calculation the highest and lowest figures for the period (and in some cases the top and bottom two figures.) This eliminates from the calculation of the average the effect of financings that, in our judgment, are unusual and therefore should be excluded.

The graph lines on pages 2-3 are moving averages based on 120-180 day intervals.

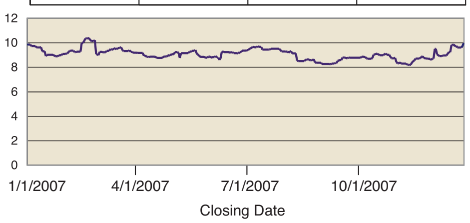
SERIES A

$(M)

Pre-Money Valuation

2005	2006	2007
$8.3	$10.0	$9.6

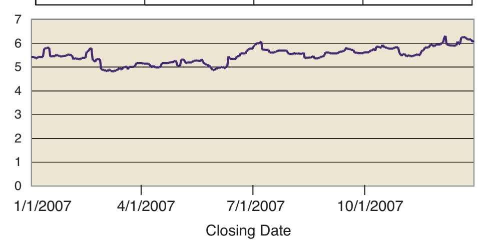
Q1 07	Q2 07	Q3 07	Q4 07
$9.3	$8.9	$7.1	$10.4



Amount Raised

2005	2006	2007
$5.7	$5.7	$6.0

Q1 07	Q2 07	Q3 07	Q4 07
$6.3	$5.0	$5.4	$6.0



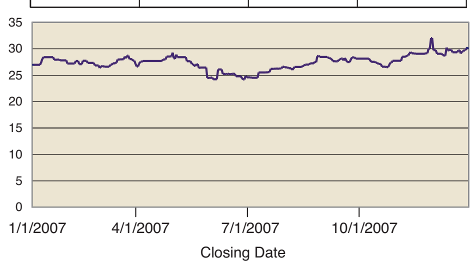
SERIES B

$(M)

Pre-Money Valuation

2005	2006	2007
$21.3	$25.9	$28.2

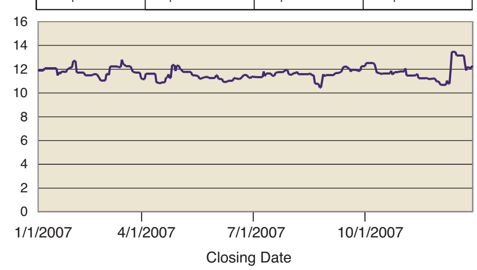
Q1 07	Q2 07	Q3 07	Q4 07
$17.2	$28.7	$27.3	$32.2



Amount Raised

2005	2006	2007
$9.9	$10.6	$11.8

Q1 07	Q2 07	Q3 07	Q4 07
$9.6	$10.8	$12.8	$11.3



Pre-money valuations for Series B and Series C and later rounds over the three-year period show a more definitive upward trend. The average pre-money valuations for Series B rounds have increased by 32% from 2005 to 2007, from approximately $21 million to $28 million. Average amounts raised over the same period increased by 19%, from approximately $10 million to almost $12 million.

continued on page 3 . . .

The Data Set *(continued from page 2)*

Similarly, the median pre-money valuations for Series C and later rounds have increased by 25% from 2005 to the end of 2007, from approximately $48 million to $60 million, although the amount of capital raised during this period declined from an average of $15.4 million to approximately $13 million. It is likely that the increases in the average pre-money valuations experienced in Series B as well as Series C and later rounds during the three-year period are attributable to the continued recovery of the industry from earlier periods, as well as to the significant levels of venture capital that are available to support successful emerging growth companies.

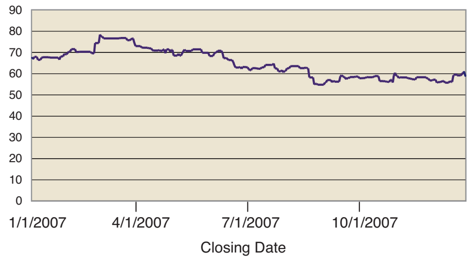
SERIES C AND LATER

$(M)

Pre-Money Valuation

2005	2006	2007
$48.2	$56.8	$60.3

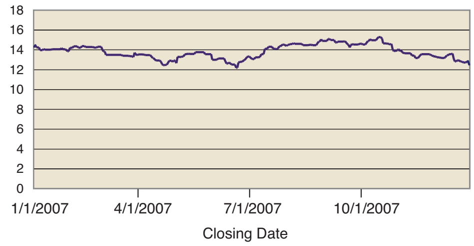
Q1 07	Q2 07	Q3 07	Q4 07
$62.3	$53.5	$55.3	$58.3



Amount Raised

2005	2006	2007
$15.4	$14.4	$13.1

Q1 07	Q2 07	Q3 07	Q4 07
$11.4	$13.5	$14.6	$10.4



DILUTION. Equity capital raised by series, when considered in the context of the average pre-money valuation data discussed above, provides clear guidance as to the amount of equity of the company that typically is allocated to investors at each stage of financing. For example, the average amount raised for Series A financings in 2007 was $6.0 million. Based on the average pre-money valuation of $9.6 million shown by our data for 2007, this would indicate that the average company gave up 38.5% of its fully diluted capital to the investors in the Series A round.

The dilution and percentage ownership associated with Series A and later rounds of financing are shown in the table to the right.

On a related note, we are seeing a number of start-up companies pursuing Web 2.0 and similar online business models that do not require any significant amount of initial equity financing. In these cases, seed capital is all that is required to establish the viability of the business model, and the amount of equity ownership conferred upon the initial investors is, therefore, substantially less.

From the perspective of the founder who begins with 100% ownership of the company before seeking investors for growth capital, and whose business plan contemplates three rounds or more of equity capital from institutional investors, the table below shows a total cumulative dilution factor of 86%, i.e., the founder's initial 100% ownership position in the company would diminish to 14% (without taking into account other factors, such as employee stock plans, that would affect this dilution). Of course, the data in the top half of the table also contemplates ever-increasing valuations based on successful execution of the business plan. In fact, this type of growth scenario, accompanied by dilution that corresponds with fundraising at ever-increasing valuations, is the model that most entrepreneurs pursue.

The dilution table also illustrates how costly the dilution factor is in the context of "down-round" financings, where successive rounds of financings are priced at valuations that are less than the preceding round. Even though the amount of capital raised in these distress circumstances is less than for "up rounds," the average pre-money valuation for companies that have to work through a down-round financing is punishing, usually at the expense of the employees and managers and the non-participating investor stockholders.

FINANCING AND DILUTION IN 2007

Round	Average Amount of Capital Raised	Average Pre-Money Valuation	Dilution / % Ownership to Investors
Series A all rounds	$6.0 million	$9.6 million	38.5%
Series B all rounds	$11.8 million	$28.2 million	29.5%
Series C and later all rounds	$13.1 million	$60.3 million	17.8%
Series B and later down rounds	$7.0 million	$9.3 million	42.9%
Series C and later down rounds	$9.1 million	$23.6 million	27.8%

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Insight Corner:

Strategic Investors in the Early-Stage Company

By ***Allison Spinner***, *Partner, Palo Alto Office. Email: aspinner@wsgr.com*

Many large public companies have established affiliated venture capital funds or divisions to invest in technology start-ups. Companies such as Cisco, Motorola and Intel Capital are well-known players in this space. In many cases, the investment is made in conjunction with, or contemplation of, a commercial relationship between the parties. The value proposition is often quite attractive on both sides. The strategic investor has an opportunity to invest in an early-stage company with potential for high growth, while getting a foot in the door to develop or enhance a commercial relationship that may lead to a long-term partnership. The start-up hopes that the value provided by a strategic investor will far exceed the funds provided, as the relationship may be tied to a commercial deal that could drive the start-up's revenues and give it credibility and exposure in the marketplace. The start-up also may seek to get unique access to the strategic investor's leaders, who could take on an advisory role and participate in board meetings. Down the road, the relationship may even lead to an acquisition by the strategic investor.

Unlike a VC investor whose sole goal is to maximize the value of its investment in the company, the strategic investor may have its own set of motivations, and its interests may not always align with the company's. At the outset of the relationship, if the strategic investor is eager to invest, the start-up may try to use its leverage to condition the financing on the execution of a commercial agreement. The start-up should consider what effect any announcement of the investment or commercial relationship will have on its efforts to build relationships with other industry players. In some cases, the start-up or the strategic investor may seek to keep the investment confidential.

As they consider the many benefits of a strategic investment, start-ups should prepare themselves to carefully negotiate the key terms of the deal. In starting discussions with a strategic investor, the start-up will quickly realize that the process will be different from a venture investment. The first step with a strategic investor should be the negotiation of a non-disclosure agreement between the parties. For obvious reasons, the concern regarding confidentiality and non-use of information is much greater when talking with a strategic investor than with a traditional VC. VCs rarely enter into non-disclosure agreements, as they see countless business plans and will not be bound to the requirements of an NDA. The start-up will want the term of the NDA to be as long as possible in order to limit the strategic investor's ability to use or disclose confidential information after the expiration. The start-up may be concerned about the ability of the investing entity or division to share information with the business or technology teams within the company. These discussions can be challenging and can set the tone for the dynamics of the rest of the negotiations. The company may be well served to limit the types of highly sensitive information provided until the

continued on page 10 . . .

The Data Set *(continued from page 3)*

UP VS. DOWN ROUNDS – BY QUARTER. Up rounds (that is, financing rounds at a company valuation above the valuation of the preceding rounds) continue to substantially outpace the number of down rounds over the three years 2005, 2006 and 2007, confirming the continued health of the sector when compared against earlier periods.

% OF TOTAL FINANCINGS (POST SERIES A)

	2005	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07
Down	21%	21%	14%	20%	9%	7%	23%
Up	65%	65%	73%	73%	76%	78%	64%

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Quarterly Deal Highlights:

Corporate Structure Considerations for Companies Doing Business in China

*By **Su Ping Lu**, Associate, Palo Alto and Shanghai Offices. Email: slu@wsgr.com*

Many venture-backed start-ups with plans to establish significant operations in China have adopted offshore structures involving a Cayman Islands parent company, a wholly-owned subsidiary in Hong Kong (or another favorable jurisdiction) and a wholly-foreign-owned enterprise (WFOE) in China that is 100% held by the Hong Kong company. In addition to providing comfort to investors, offshore structures like these provide flexibility with respect to exit strategies and tax planning and have become standard practice for Chinese businesses with global investors.

Offshore Parent Company. The parent company in a typical offshore structure is the entity into which investments are made and from which shares and options are issued to founders, employees and investors. It is also the entity that ultimately becomes listed in an IPO outside of China. Offshore parent companies are generally established in tax-favorable jurisdictions like the Cayman Islands, the British Virgin Islands and Bermuda. Unlike U.S. companies, companies incorporated in tax-favorable jurisdictions are not subject to taxation in their jurisdiction of incorporation, although depending on the nature of their operations, they may be taxed on their earnings in higher tax jurisdictions. In addition, companies operating primarily in China should note that the tax benefits of incorporating in a tax-favorable jurisdiction may be diminished by recently promulgated PRC tax laws, which impose a 25% tax on the global income of companies established outside of China with "de facto management bodies" in China. U.S. tax considerations (including the 2004 Tax Act's anti-inversion rules) also can come into play when forming an offshore parent company where there

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The Basics:

Liquidation Preferences: What They Really Do

*By **Craig Sherman**, Partner, Seattle Office. Email: csherman@wsgr.com*

One of the fundamental terms of any preferred stock venture capital financing is the liquidation preference—the right of the investors to receive distributions in a sale of the company prior to the holders of common stock (typically founders and employees). The liquidation preference is one of the most important and often one of the most heavily negotiated terms contained in the term sheet proposed by the investors. The basic concept is intuitive and seems fundamentally fair: that investors receive back their invested capital before the founders, who normally paid a much lower price for their common stock. There are, however, a number of variations on liquidation preferences that should be negotiated carefully, as they can have a significant impact on the allocation of the proceeds resulting from a sale of the company.

The first issue is the amount distributed to the investors "off the top," before any distributions are made to the holders of common stock. In a typical West Coast financing, the investors receive as their initial liquidation preference the amount of their original investment. Sometimes in financings led by East Coast investors or in later-stage financings for troubled companies, there will be a "super" liquidation preference, where the investors receive more than their initial investment, sometimes 1.5 or 2 times their initial investment, before the common stockholders

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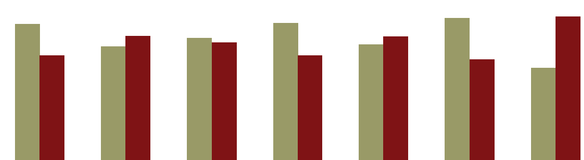
The Data Set *(continued from page 4)*

LIQUIDATION PREFERENCES: SENIOR VS. *PARI PASSU*. The liquidation preference represents the right of preferred stockholders, upon a sale or liquidation of a company, to be paid in preference to common stockholders. Liquidation preferences also may establish a priority among multiple series of preferred stock. The table below shows the percentage of financings in which the latest series of preferred stock is senior to the prior series of preferred, and the percentage of financings in which the latest series is on par *(pari passu)* with prior series. Quarter-to-quarter data does not appear to be indicative of industry trends. The use of senior liquidation preferences is likely to increase in difficult financing environments and on a company-specific basis, when a company is challenged in its ability to find next-round investors and has few alternatives among interested venture capital firms.



	2005	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07
Senior to prior round	55%	46%	50%	55%	47%	57%	38%
Pari Passu	43%	50%	48%	43%	50%	41%	57%

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Companies Doing Business in China *(continued from page 5)*

is an existing U.S. entity or if intellectual property is originating in the United States.

The Cayman Islands as the Preferred Jurisdiction of Incorporation. Among the traditional tax-favorable jurisdictions, the Cayman Islands have become the jurisdiction of choice for many Chinese companies. The principal reasons for this are:

- Hong Kong IPO: Increasingly stringent U.S. corporate governance and disclosure requirements have caused some China-based companies to look to the Hong Kong Stock Exchange as an IPO exit strategy. Currently, only companies established in the Cayman Islands, Bermuda, China and Hong Kong are pre-approved for listing on the Hong Kong Stock Exchange. Incorporating in the Cayman Islands (as opposed to the British Virgin Islands, for example) preserves a company's ability to pursue an IPO in Hong Kong as a practical alternative.
- General Familiarity and Acceptance: Cayman Islands corporate law has the built-in flexibility to allow companies to establish U.S.-style corporate governance and capitalization structures with which investors are familiar. Investments in Cayman companies can be structured as typical preferred stock financing arrangements that provide investors with the rights, preferences and privileges that they would typically expect when investing in a U.S. company. More and more companies have chosen the Cayman Islands as their place of incorporation, and over time, investors and their legal counsel have become increasingly familiar with Cayman Islands corporate law and the standard set of corporate documents that are used for investments in Cayman companies. In addition, enough Cayman companies now have gone public in the U.S., Hong Kong and elsewhere that they are generally well understood and accepted by securities regulators, analysts and the market in general.
- Cost and Administrative Burden: Compared to Bermuda, the only other tax-favorable jurisdiction whose companies are pre-approved for listing in Hong Kong, it is relatively inexpensive and administratively less burdensome to incorporate and maintain a company in the Cayman Islands. For example, the initial incorporation and ongoing annual fees for Cayman companies are approximately one-third of the fees paid by Bermuda companies. In addition, unlike Bermuda companies, Cayman companies are not required to obtain approval from governmental authorities for share issuances and transfers. Cayman companies are also not required to have company representatives (i.e., a company secretary, directors and/or a corporate representative) resident in the Cayman Islands or to maintain minute books and a share register at its registered office in the Cayman Islands.

PRC WFOE. Typically, a company's operations in China are run through a WFOE – a Chinese company that is wholly owned by foreign investors. The WFOE is the entity that enters into labor contracts with Chinese employees, signs facilities leases, holds the company's operating assets in China and enters into commercial contracts with Chinese suppliers, vendors and customers.

Hong Kong or Other Intermediate Holding Company. As a tax-planning matter, many companies with Chinese operations invest through an intermediate holding company. For example, having a Hong Kong subsidiary to hold the equity interests of a PRC WFOE may be advantageous. With the promulgation of China's new Enterprise Income Tax Law in 2007, dividends from PRC subsidiaries to their foreign shareholders are subject to taxation at a rate of 10%. This rate is reduced to 5% if companies take advantage of a tax agreement between China and Hong Kong that provides for a 5% tax rate on dividends paid by Chinese companies to a Hong Kong shareholder.

Restricted Businesses. Certain industries, like the telecommunications, Internet and advertising industries, are considered restricted industries under PRC law. Foreign ownership of businesses that operate in these industries (other than minority holdings in a Sino-foreign joint venture) make it difficult, if not impossible, for companies to obtain necessary approvals, licenses and permits from governmental authorities. It also prevents companies from receiving government grants and from entering into commercial contracts with government-controlled enterprises. Nevertheless, some offshore companies have managed to take part in restricted industries by entering into contractual arrangements with domestic PRC companies that are 100% held by PRC citizens. These contractual arrangements essentially enable offshore parent companies to exert de facto financial and operational control over domestic PRC companies and to consolidate these "captive" companies' financial statements into their own. The specifics of these contractual arrangements vary from company to company, but a typical set of contracts might include the following:

- Loan Agreement: These agreements provide for loans to the shareholders of the domestic company for the purpose of funding or acquiring the domestic company.
- Option Agreement: In connection with the loan agreements, the PRC shareholders of the domestic company enter into option agreements that provide the Cayman company, the WFOE or a designee thereof an exclusive and irrevocable option to purchase the PRC shareholders' equity interests in the domestic company. This option is transferable and can be assigned to a PRC citizen, who can exercise the option if necessary.
- Powers of Attorney: To provide the Cayman company with voting and effective operational control over the domestic company, the PRC shareholders execute irrevocable powers of attorney that empower the Cayman company or

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The Data Set *(continued from page 5)*

PARTICIPATING VS. NON-PARTICIPATING VS. CAPPED LIQUIDATION PREFERENCES. Since the liquidation event for most venture-backed companies is an acquisition, the details of the liquidation preference often substantially affect the economics for both the founders and employees with common stock and the investors with preferred stock. In many cases, the type of liquidation preference available to the investors in the company, once negotiated at the time of the Series A financing, is replicated in successive rounds of financing.

- A participating preferred stock has the right to the return of its original investment from the acquisition proceeds and also the right to share in the remaining proceeds pro rata with the holders of the common stock. This is the most advantageous form of liquidation preference for the investors, and therefore more costly to the common stockholders. In this formulation, the preferred stockholder never has to decide whether it is more advantageous to convert its stock to common, since the preferred stock by definition is entitled to both the return of the original investment plus a right to participate in any remaining proceeds.

- In contrast, a non-participating preferred stock must choose between the return of its original investment—with no right to participate in remaining proceeds—or converting its preferred stock to common shares at the time of the acquisition and thereby sharing in the acquisition proceeds with all the other common shareholders.

- As a middle ground, companies often negotiate to "cap" the total return to investors in an acquisition (liquidation preference plus participation right), thus limiting the amount of acquisition proceeds that would automatically be paid out to the preferred stockholders without having to decide whether to convert their preferred shares to common. This cap is often negotiated in a range between 1.5x and 4x the original investment of the preferred stockholder.

The type of liquidation preference that is used in a financing is often determined by leverage in negotiation. For more information on liquidation preferences, see "Liquidation Preferences: What They Really Do" on page 5 of this report.

Our data indicates that participating preferred stock (including participation rights that are capped) is used in nearly two-thirds of financings, without much fluctuation over annual periods, and that approximately half of the financings with participating liquidation preferences are structured with a cap.

	2005	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07
Participating -- cap	32%	30%	29%	32%	28%	27%	28%
Participating -- no cap	33%	35%	32%	32%	35%	25%	35%
Non-participating	35%	34%	40%	37%	37%	48%	37%

PARTICIPATING LIQUIDATION WITH CUMULATIVE DIVIDENDS. In some cases, the investors will negotiate to include a right to payment of a cumulative dividend with the form of liquidation preference that is negotiated in the term sheet. A cumulative dividend functions much like an interest rate on a loan; it provides that a percentage of the original investment price of the preferred stock, usually in the 8-10% range, accumulates on a quarterly or other periodic basis until the liquidation preference is triggered. Usually, this trigger is the occurrence of an exit event such as a sale of the company or an IPO. This feature provides a significant benefit to the investors, since the dividend is payable on top of all other required preference payments. Many venture capital firms in the East Coast or with East Coast origins favor this kind of provision.

Our data indicates that only about 15% of all financings over the three years 2005, 2006 and 2007 included fully participating liquidation preferences with a cumulative dividend.

	2005	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07
Participating with cumulative dividends	14%	17%	16%	15%	22%	7%	15%

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Regulatory Developments:

SEC Amends Rule 144

*By **Mark Baudler**, Partner, Palo Alto Office. Email: mbaudler@wsgr.com,* and ***Herb Fockler**, Partner, Palo Alto Office. Email: hfockler@wsgr.com*

SEC Amends Rule 144

The SEC has amended to Rule 144 to shorten the holding periods for restricted securities of public companies, significantly reduce the conditions applicable to sales of restricted securities by non-affiliates and modify other aspects of the rule. The amendments became effective February 15, 2008.

Summary of Rule 144 in Effect Prior to the Amendments

Rule 144 provides an exemption from registration for resales by holders of "restricted securities" (i.e., securities acquired directly or indirectly from the issuer or an affiliate of the issuer in a transaction or chain of transactions not involving a public offering) and for resales of "control securities" (i.e., securities held by affiliates, regardless of how they acquired them). The rule contains five conditions:

- *Current Public Information.* There must be adequate current public information available about the issuer for the 90 days preceding the sale.
- *Holding Period.* Restricted securities must be held for at least one year before they may be sold.
- *Volume Lmitations.* In any three-month period, resales may not exceed specified sales volume limitations.
- *Manner-of-Sale Requirements.* Resales must be made in unsolicited "brokers' transactions" or transactions directly with a "market maker" and must comply with other specified manner-of-sale requirements.
- *Filing of Form 144.* The selling security holder must file a Form 144 if the amount of securities being sold in any three-month period exceeds 500 shares or $10,000 in aggregate sales price.

Prior to the amendments, non-affiliates could sell their restricted securities freely without complying with the foregoing restrictions if they had held their securities for more than two years.

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Companies Doing Business in China *(continued from page 6)*

the WFOE to vote on their behalf with respect to all domestic company matters such as the appointment of officers and directors, charter document amendments and equity transfers.

- Services/Licensing Agreements: These agreements create a web of rights, responsibilities and payment obligations between the Cayman company (including its subsidiaries) and the domestic company that simulates the economics of a parent-subsidiary relationship. For example, if the domestic company holds a license required to operate the business, then these operational/licensing agreements could allow for technical services, trademark licenses, other IP licenses and/or administrative and marketing services to be provided by the Cayman company to the domestic company in return for service, license and/or royalty fees.
- Equity Pledge Agreements: To provide for additional control over the domestic company, the PRC shareholders sign equity pledge agreements, in which their ownership of the domestic company is pledged to the WFOE. These pledge agreements are an enforcement mechanism that the company can use vis-à-vis the services/licensing agreements.

Arrangements like these do not have the formal approval of PRC governmental authorities but are seldom challenged. However, companies that are considering this arrangement should be aware that there have been instances in which the PRC government has scrutinized and disapproved of this arrangement; this is a factor that needs to be considered when planning the corporate structure.

SAFE Registration. Regulations promulgated by China's State Administration of Foreign Exchange (SAFE) require PRC residents to register direct or indirect offshore investment activities with SAFE. These regulations become a concern when establishing an offshore structure because founders and other investors who are PRC residents generally are required to pre-register their investment in the offshore parent company before acquiring shares. PRC residents also are required to register material changes in their investments (including share transfers and the creation of any security interests). If any PRC shareholder fails to comply with SAFE registration requirements, the company could become subject to penalties and sanctions. For example, the company could be prohibited from distributing profits from its onshore subsidiaries to its offshore entities. The company also could be prohibited from injecting offshore capital into its PRC subsidiaries. Currently, the interpretation and implementation of SAFE registration rules is unclear and varies among SAFE authorities in different localities. This is especially the case for PRC residents who are not Chinese citizens. To minimize the potential impact of noncompliance with SAFE requirements, entrepreneurs and investors should discuss local SAFE registration practices with legal counsel before shares in the offshore parent company are issued to PRC residents.

Corporate structure plays an important role for companies doing business in China. Taking corporate structure into account early on can save time and money down the road with respect to navigating China's regulatory regime, tax planning and pursuing an optimal exit strategy.

SEC Amends Rule 144

(continued from page 8)

Summary of Amendments to Rule 144

- *Holding Periods*. Holders of restricted securities of reporting companies (generally, public companies) now will be able to sell their securities after holding them for only six months. Holders of restricted securities of non-reporting companies will continue to be subject to a one-year holding period.
- *Relaxed Conditions for Sales by Non-Affiliates under Rule 144.* After six months but prior to one year from the date of acquisition, non-affiliates of reporting companies may sell their restricted securities under Rule 144 subject only to the current public information requirement. After holding their securities for one year, non-affiliates of both reporting companies and non-reporting companies may sell freely without any additional conditions under Rule 144.
- *Changes under Rule 144 for Sales by Affiliates.* In general, affiliates will remain subject to all of the current requirements under Rule 144, subject to certain changes.
- *Current Public Information.* The current public information requirement remains unchanged.
- *Holding Period.* The holding period for restricted securities of reporting companies has been shortened to six months, but the holding period for restricted securities of non-reporting companies remains at one year.
- *Volume Limitations.* The volume limitations for equity securities remain unchanged; however, the volume limitations for debt securities have been relaxed.
- *Manner-of-Sale Requirements.* The manner-of-sale requirements for equity securities have been modified to permit "riskless principal transactions" and have been eliminated for debt securities.
- *Filing of Form 144.* The threshold for filing a Form 144 has been raised to the lesser of 5,000 shares or $50,000 in aggregate sales price.

Potential Effects of the Rule 144 Amendments

The possible effects of the amendments to Rule 144 are somewhat uncertain, but may include:

- Increased transfers among private company stockholders prior to any public offering, given that the stock can be resold freely by non-affiliates after only one year rather than two years.
- Greater risks that a company will inadvertently become a public company merely because of the size of its stockholder base. Companies that have 500 or more stockholders and total assets exceeding $10,000,000 at the end of a fiscal year are required to become public reporting companies, even though they have not engaged in a public offering. Companies may wish to consider contractual or bylaw provisions to reduce these risks, including possibly rights of first refusal or other transfer restrictions on rank-and-file stockholders, including investors (it is not unusual currently for investors not to be subject to rights of first refusal on proposed transfers of stock).
- Possible greater negotiating leverage against investors to drop heretofore standard registration rights (although most current registration rights terminate automatically once a stock may sell off its securities in a single three-month period under Rule 144 anyway).
- Possible increased viability of private company stock as an acquisition currency, given that the stock can be resold freely by non-affiliates after only one year rather than two years.

The Data Set *(continued from page 7)*

ANTI-DILUTION PROVISIONS. In almost all venture financings, each share of preferred stock on its original issuance is convertible, either at the election of the holder or on a mandatory basis in specified circumstances, into common stock on a one-for-one basis. The use of a price-based anti-dilution clause will adjust this conversion ratio in favor of the investor if the company issues shares in the future at a lower price than the price paid by the investor. The objective of price-based anti-dilution is to provide the investor a measure of compensation for the reduced valuation through a slightly improved ownership position in the company. Formulas range from "broad-based" and "narrow-based" weighted-average formulas to "ratchet-based" anti-dilution. Broad-based weighted-average anti-dilution is the least protective to the investor, and ratchet clauses are the most protective. There is a strong market convention favoring broad-based weighted-average formulas, which our data indicates were used in 88% of all equity financings in 2007.

	2005	2006	2007	Q1 07	Q2 07	Q3 07	Q4 07
Weighted average -- broad	84%	82%	88%	92%	86%	86%	90%
Weighted average -- narrow	6%	3%	3%	4%	2%	8%	0%
Full ratchet	4%	6%	4%	1%	7%	2%	2%
Other (including blend and none)	6%	8%	5%	4%	5%	4%	7%

continued on page 11 . . .

Strategic Investors *(continued from page 4)*

end of the diligence and negotiation process, when there is greater certainty that a deal will be reached.

As part of the financing, the strategic investor will in some cases request a seat on the company's board of directors. In most cases, however, the strategic investor prefers to negotiate the right to attend board meetings as an observer, in a non-voting capacity, thus avoiding the fiduciary-duty issues and potential conflicts that can arise if serving as an actual member of the board. Inviting a representative from the strategic investor into the boardroom is often highly desirable for the start-up, as its board and management will get the benefit of the investor's knowledge of the industry and market trends. At the same time, negotiating the parameters of the observer's rights can be difficult and time-consuming, and certain issues are likely to be heavily debated.

There may be situations in which the company will want to exclude the strategic investor from a board discussion. While it is typical to provide that the company may exclude the representative in order to preserve the attorney-client privilege or to avoid conflicts of interest, in practice, however, it may be awkward to ask an observer to leave the meeting. As a result, the observer's presence may limit the discussion at the board level. The parties often negotiate extensively regarding the designation of the observer and whether the strategic investor's choice will be subject to the company's approval. The parties also will need to set parameters for the type of information the strategic investor will have the right to receive, and the company may seek the right to terminate the observer agreement if the board determines that the observer's ongoing participation may be detrimental to the company.

Some strategic investors will seek a "right of first negotiation" in the event the company engages in discussions regarding a sale. The investor's "wish list" for this right may require the company to notify the investor if it receives an acquisition proposal and to provide the name of the potential buyer and its proposed terms. It also may restrict the company from entering into any sort of binding agreement with any other party, including a "no shop" or exclusivity agreement, for a period of time after the company provides notice of the proposal to the strategic investor. The company likely will seek to limit the nature of this right to a "right of notice," pursuant to which the company would be required simply to notify the strategic investor if it decided to sell the company or if it received an acquisition proposal. In that case, the company would not be restricted from negotiating with or entering into agreements with another potential buyer. Properly structured, a "right of notice" may facilitate a bidding war and a quick sale of the company to a motivated strategic investor.

Strategic investors also may object to certain terms agreed to by venture investors in prior rounds. For example, a strategic investor may argue that it is a one-time investor and should not be subject to a "pay-to-play" provision that could negatively impact the rights of its preferred stock if it does not participate in future financing rounds. Strategic investors also may object to a "drag-along" provision that would require them to vote in favor of, and receive stock in connection with, a sale of the company.

On the other hand, strategic investors are often less sensitive to price and may invest at higher valuations than VCs. While this may be a benefit in the short term, it can prove problematic down the road, as a strategic investment at a high valuation may be followed by a VC investment at a lower price in a down round. Additionally, if the strategic investor is the only investor, or is the majority investor, in a particular series of preferred stock, the company will want to carefully consider situations where the strategic investor may have a controlling or blocking vote.

The process of negotiating and closing a deal with a strategic investor may take longer than a VC round, as the investment is often subject to many levels of approval within the strategic investor's organization. Start-ups will need to be patient with this process, as the strategic investor's deal team may have little control over their timing. On the other hand, in some cases a strategic investor is able to invest quickly as a "second closing" to a VC round.

At the end of the day, many start-ups find that a well-structured deal is worth the effort, as the strategic investor adds unique perspective and value to the company.

Liquidation Preferences *(continued from page 5)*

receive a distribution. Many East Coast transactions also have a "cumulative dividend," where an annual dividend (often 8% or higher) accrues and becomes payable on a sale of the company. This cumulative dividend also increases the amount payable to the investors as part of the initial liquidation preference prior to any distributions to the holders of common stock.

There are three fundamental types of liquidation preferences that are typically negotiated in connection with a financing involving the issuance of preferred stock to investors. These consist of non-participating preferences, participating preferences and participating preferences that are "capped." The general differences between these three categories of preferences are discussed on page 7 of this report.

To demonstrate the impact of the various types of liquidation preferences, let's take a simple example of a company that sells 5 million shares of Series A Preferred Stock, equal to 1/3rd of its outstanding stock following the financing, to a venture capital firm for $5 million ($1.00 per share). For the sake of simplicity, we'll assume that the remaining 2/3rd of the company's equity (10 million shares) is in the form of common stock, and that there are no outstanding options or warrants. If that company is subsequently sold for $20 million, the distributions will vary significantly depending on the structure of the liquidation preference:

- *Participating Preferred*: The first $5 million would be distributed to the holders of preferred stock, and the remaining $15 million would be distributed based on the pro rata ownership, with 1/3rd ($5 million) to the holders of preferred stock and 2/3rd ($10 million) to the holders of common stock. Therefore, the holders of preferred stock would receive $10 million total ($2.00 per share), and the holders of common stock would receive $10 million total ($1.00 per share).

- *Non-Participating Preferred*: The first $5 million would be distributed to the holders of preferred stock, and the remaining $15 million would be distributed to the holders of common stock. Therefore, if the preferred stock chose not to convert, the holders of preferred stock would receive $5 million total ($1.00 per share), and the holders of common stock would receive $15 million total ($1.50 per share). However, the

continued on page 12 . . .

The Data Set *(continued from page 9)*

BRIDGE FINANCINGS: WARRANT COVERAGE. In bridge-note financings, there is a strong convention that recognizes the additional risk faced by the seed investor in a start-up company at its first stage of growth. This risk is typically recognized either in the form of "warrant coverage" or a discounted conversion rate on the bridge note issued in the financing, with the objective of providing an added equity incentive to the early-stage investor. For example, where an investor provides a $100,000 loan to the company on the basis of the bridge note that converts automatically into the Series A round of financing, that note might include 20% warrant coverage on the loan. This means that if the company successfully completes a Series A round of financing at $2 per share, the bridge investor's note would include a separate instrument known as a warrant, exercisable over a period of, say, five years, for the purchase of $20,000 worth—or 10,000 shares—of Series A Preferred at the Series A Preferred purchase price. Warrant coverage may be structured using either the common stock or the preferred stock as the basis of the warrant.

Where a discounted conversion rate is used in lieu of warrant coverage, the percentage usually equates to the same percentage that would be used in establishing warrant coverage (i.e., in our example, the conversion rate would be discounted 20% off the $2 price per share of the Series A Preferred).

The data below, compiled from financings in our database for most of 2007, provide insights into the amount of warrant coverage provided in bridge financings. As you can see, most of these financings, whether accompanied by preferred or common stock warrant coverage, establish coverage in the 11-30% range. Although this data does not include financings where a discounted conversion rate of the note is used in lieu of warrant coverage, it is reasonable to assume that the percentage discount rate would be the same as the warrant coverage percentage.

WARRANT COVERAGE

	0% - 10%	11% - 20%	21% - 30%	31% - 40%	41% - 50%	51% +
Preferred	18%	33%	30%	6%	9%	3%
Common	0%	25%	42%	8%	0%	25%

Liquidation Preferences *(continued from page 11)*

preferred stock would be better off converting into common stock, because by doing so, the holders of preferred stock would receive $6.67 million total ($1.33 per share), and the holders of common stock would receive $13.33 million total ($1.33 per share).

- *Participating Preferred with a 2x Cap*: The first $5 million would be distributed to the holders of preferred stock, and the remaining $15 million would be distributed based on the pro rata ownership, with 1/3rd ($5 million) to the holders of preferred stock and 2/3rd ($10 million) to the holders of common stock. Therefore, the holders of preferred stock would receive $10 million total ($2.00 per share), and the holders of common stock would receive $10 million total ($1.00 per share). However, if the purchase price of the company increased above $20 million, no further proceeds would be distributed to the holders of preferred stock. If the company were sold for $25 million, the holders of preferred stock still would be capped at the $10 million total ($2.00 per share), and the holders of common stock would receive the remaining $15 million total ($1.50 per share). If the company were sold for $30 million, the holders of preferred stock still would be capped at the $10 million total ($2.00 per share), and the holders of common stock would receive the remaining $20 million total (also $2.00 per share). At a purchase price above $30 million, the holders of preferred stock will be better off converting to common stock, in order to receive the same value per share.

Our data (see page 7) shows that roughly two-thirds of preferred stock financings have a participating liquidation preference, with roughly half of those capped and half uncapped. The deals without a participation feature and with generally lighter terms on liquidation preference tend to be earlier-stage deals led by West Coast venture capitalists. West Coast term sheets may be more favorable to the common stockholders, with a "1x" initial liquidation preference, no cumulative dividends and no participation. In particular, entrepreneurs may find that some of the better-known so-called "first tier" venture capitalists on the West Coast will offer the "softest" term sheets (though frequently coupled with a lower valuation), because these investors are the most focused on making their returns from "home run" investments.

It is critical to carefully negotiate the liquidation preference in the first preferred stock investment in the life of the company. In an early-stage financing, the investors often will be willing to agree to terms, including terms of liquidation preference, that are relatively favorable to the company's founders. Because the terms of a subsequent venture financing typically will follow closely the terms of previous financings (and, of course, the terms of later financings rarely are more favorable to the founders than the terms of the earlier financings), the early investors believe that they will benefit in the future by not subjecting their own preferred stock to burdensome liquidation preferences and other onerous terms of the later financings.

As the company raises additional rounds of preferred stock financing, or if the already outstanding preferred stock has a multiple liquidation preference or cumulative dividend, the liquidation preferences quickly add up, creating what is commonly referred to as a preference "overhang." As a result, the holders of common stock (typically founders and management) may become disincentivized if the common stock would have little to no value in a sale of the company. Holders of common stock may demand a "recapitalization" of the company, where some or all of the outstanding preferred stock is converted to common stock in order to reduce or eliminate the liquidation preference overhang. Frequently, the liquidation preference is left in place but a "management retention plan" is layered on top of the liquidation preference to provide the key members of management with bonus payments that are paid prior to the liquidation preference if the company is sold. Disputes between management and investors over preference overhangs that are not resolved through a recapitalization or management-retention plan have led in some cases to business deadlocks and actual shutdowns of venture-backed companies.

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 2008 SESSION

April 16: *Overview & Valuation*
Doug Collom, *Presenter*
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.

April 30: *Business Plans & Fundraising*
Presenter TBD
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.

May 14: *Forming & Organizing the Start-Up & Founders Stock*
Mario Rosati, *Presenter*
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.

May 28: *Compensation & Equity Incentives*
Donna Petkanics *&* ***Scott McCall***, *Presenters*
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.

June 11: *Intellectual Property*
Suzanne Bell, *Presenter*
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.

June 25: *Term Sheets*
Craig Sherman, *Presenter*
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.

July 9: *Clean Tech Session*
Mike Danaher, *Presenter*
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.

July 22: *Exits & Liquidity*
Aaron Alter, *Presenter*
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.

August 6: *Biotech Session*
Presenter TBD
An in-depth discussion of the issues that biotech entrepreneurs should consider when starting their ventures. Explore the process for acquiring a core technology, from both universities and big biotech and pharmaceutical companies. Discuss how these agreements will affect your ongoing business operations, partnering activities and exit and acquisition opportunities.

Editorial Staff: **Doug Collom, editor-in-chief (Palo Alto Office); Mark Baudler (Palo Alto Office), Herb Fockler (Palo Alto Office), Craig Sherman (Seattle Office), Yokum Taku (Palo Alto Office)**
Contributing Staff: **Allison Spinner (Palo Alto Office), Su Ping Lu (Palo Alto and Shanghai Offices)**
Knowledge Management Staff: **Eric Little, Heather Crowell**

650 Page Mill Road, Palo Alto, California 94304-1050 | Phone 650-493-9300 | Fax 650-493-6811 | www.wsgr.com
Austin New York Palo Alto San Diego San Francisco Seattle Shanghai Washington, D.C.

For more information about this report, please contact Eric Little (elittle@wsgr.com).