Wilson Sonsini Goodrich & Rosati
PROFESSIONAL CORPORATION

THE ENTREPRENEURS REPORT:
Private Company Financing Trends

Summer 2008

Is Clean Tech Just an Investment Bubble About to Burst?

By Josh Green, General Partner, Mohr Davidow Ventures

The two questions that I am asked most often are "What is clean tech?" and "Why isn't clean tech just another bubble that is about to burst?" In this brief article, I will endeavor to answer these questions.

At MDV, we define clean tech as being multiple independent value chains tied loosely together by the increasing cost of energy and the challenge of climate change. Greentech Media recently grouped clean tech into the following eight value chains:

- Power generation
- Energy storage
- Energy infrastructure
- Transportation
- Water
- Materials
- Recycling and waste
- Services

While helpful, these definitions remain broad and abstract. The total size of each market exceeds tens of billions of dollars, and in some cases, hundreds of billions of dollars. These are the largest markets on the planet, and the challenge is to identify high-growth opportunities within them.

We believe that there are fundamental structural shifts currently occurring in these value chains caused by the rapid and sustained increase in the cost of energy, a cost that used to be immaterial to many industrial processes. While these costs may swing wildly going forward, we believe that the era of cheap energy is over. Whether it is the ever-increasing demand/supply imbalance or the adoption of cap and trade

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Feature Articles

The Fuss About International Financial Reporting Standards

By Packy Kelly, Partner-in-Charge, Western Area and Silicon Valley Venture Capital Practice, KPMG

During the last 12 months, the buzz in financial-reporting circles has been about International Financial Reporting Standards (IFRS). Many entrepreneurs are asking what are IFRS and what do they need to know about them. IFRS comprise a high-quality, comprehensive, broadly accepted set of accounting standards currently used for financial reporting by companies based in many countries outside of the United States.

> If globally adopted, IFRS's impact will be felt well before a company plans its initial public offering.

IFRS came to the forefront in the U.S. in December 2007, when the Securities and Exchange Commission (SEC) issued a final rule permitting foreign private issuers to file financial statements in accordance with IFRS as issued by the International Accounting Standards Board (IASB) without having to reconcile to U.S. generally accepted accounting principles (U.S. GAAP). Previously, foreign private issuers were required to report either in accordance with U.S. GAAP like domestic filers or provide a reconciliation of IFRS financial information to U.S. GAAP financial information. As a result, IFRS are now acceptable alternatives to U.S. GAAP for foreign private issuers for their filings with the SEC.

On the heels of this action, discussion ensued about whether domestic companies should be given this same opportunity. In ongoing

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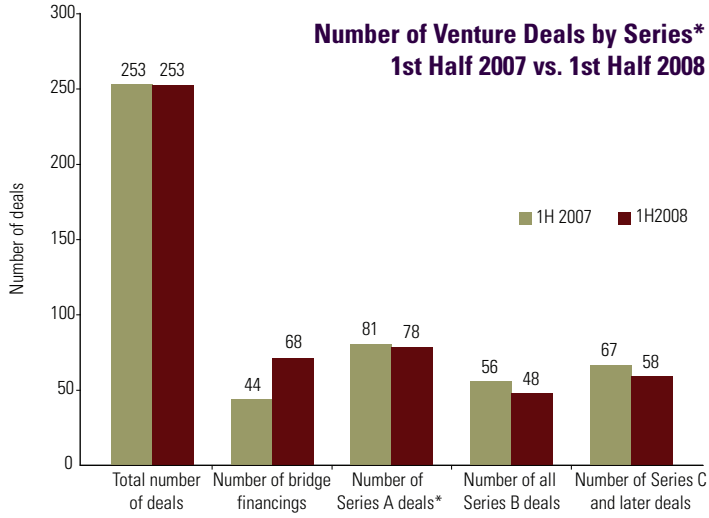
From the WSGR Database: Financing Trends

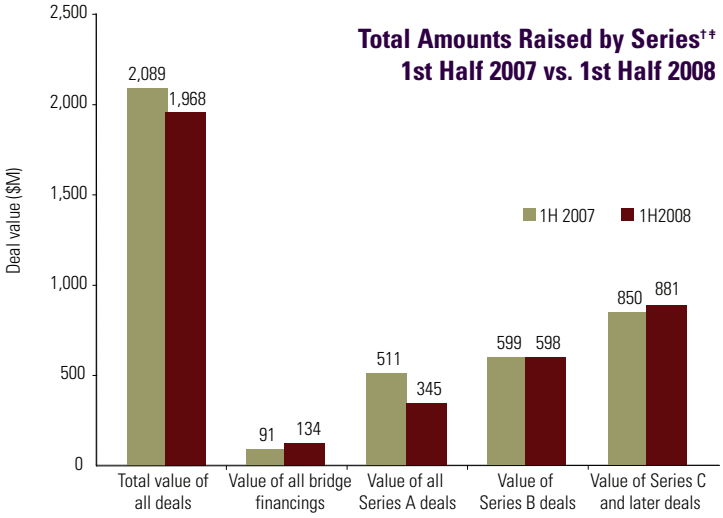
For this report, we have compiled a range of data on financing transactions for the first six months of 2008, with the objective of identifying relevant trends in activity and valuation levels for the U.S. venture capital industry in general. The first half of 2008 is notable as a turbulent period that has severely buffeted the national and world economies. Against this backdrop, we have compared the first half of 2008 with the comparable period in 2007. Surprisingly, the U.S. venture capital industry has shown remarkable resilience during this time, based on indications within our database. We offer some observations and interpretations of this information that may be useful to our audience of entrepreneurs and investors.

For purposes of the charts in this report, our database includes all venture financing transactions in which Wilson Sonsini Goodrich & Rosati represented either the company or the issuer (although we do not include venture debt or venture leasing transactions, or facilities involving venture debt firms). 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.

Total activity levels for the first and second halves of 2008 and 2007 were flat; there were a total of 253 financings reported in the first half of both years. When broken down by quarter for the first half of 2008, our internal data indicates a 17% decline in the second quarter—115 financings in the second quarter compared to 138 financings in the first quarter of the year. By aggregate amount of invested capital, the first half of 2008 decreased to approximately $2.0 billion compared to an aggregate of $2.1 billion in the first half of 2007 (but see the footnote relating to the exclusion of an unusual financing transaction). We believe that the economy in general continues to be a factor in the modest decline in activity level. In addition, the complete disappearance of the IPO market for venture-



*The number of Series A deals reflected in this chart includes financings led by angel investors as well as institutional venture capital funds.



† The value of all Series A deals reflected in this chart includes the value of financings led by angel investors as well as institutional venture capital funds.

‡ The total value of all deals reflected in this chart, as well as the value of Series C and later deals, has been revised to exclude a single financing in the first half of 2008 involving an investment of $300 million. This exclusion was made so that the data in this chart is consistent with the data we used in calculating the average pre-money valuation and the average amount raised for Series C and later deals shown on the next page.

The data in our reports is derived from financing transactions for the period from 2004 to the present in which Wilson Sonsini Goodrich & Rosati represented either the company or the investor. This data consists of more than 400 financing transactions in 2004, more than 600 transactions in each of 2005 and 2006, and more than 800 transactions in 2007. Data is reported on financings throughout the United States, without distinction by geography.

backed private companies in the second quarter of 2008 and the continued sober outlook for the U.S. public equity markets in technology represent a challenge for companies seeking working capital, as well as a concern for investors who traditionally have relied upon the domestic public equity markets for liquidity.

In our database, there are diverging trends in first-round financing transactions involving the sale of Series A Preferred to institutional investors. This is a particularly important component of the venture industry, since these financings are an indicator of innovation and growth. Although the total number of Series A Preferred financings has declined modestly in the first half of 2008 compared to 2007—78 compared to 81 financings, a 4% decline—the average pre-money valuation negotiated by early-stage venture-backed companies engaged in institutional Series A-round financings increased 15%—from $9.25 million to $10.62 million—when comparing the first half of 2007 to the first half of 2008. This increase in pre-money valuation may be attributable to a basic imbalance in supply and demand, i.e., the substantial amount of money available for investment by the venture industry against a relatively smaller number of companies that merit venture capital.

Finally, we note that the number of bridge financings—financing transactions involving the issuance of promissory notes convertible into the first/next round of equity—increased by 55% in the first half of 2008 in comparison with last year, from 44 to 68 transactions. Bridge transactions are useful as a temporary financing tool for a number of reasons, including the speed with which they can be completed, the senior protection they offer to investors, and, in the case of initial start-ups, avoidance of the need to establish any company pre-money valuation as the basis for the investment.

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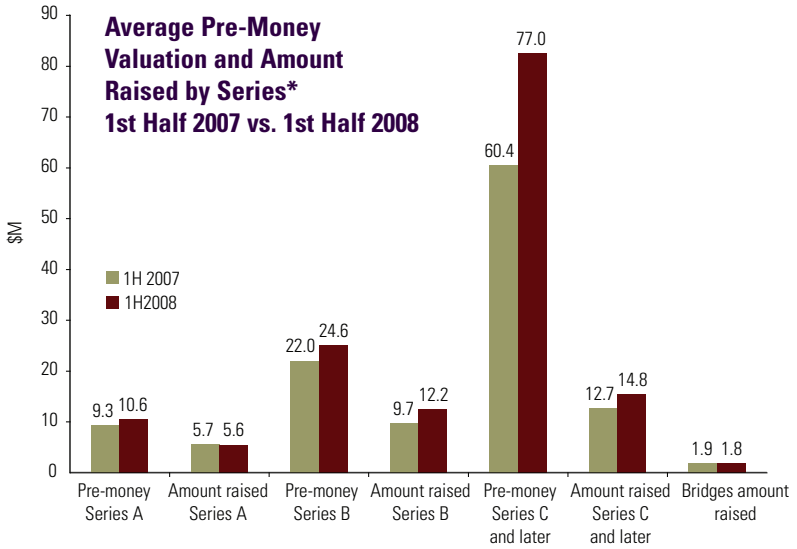
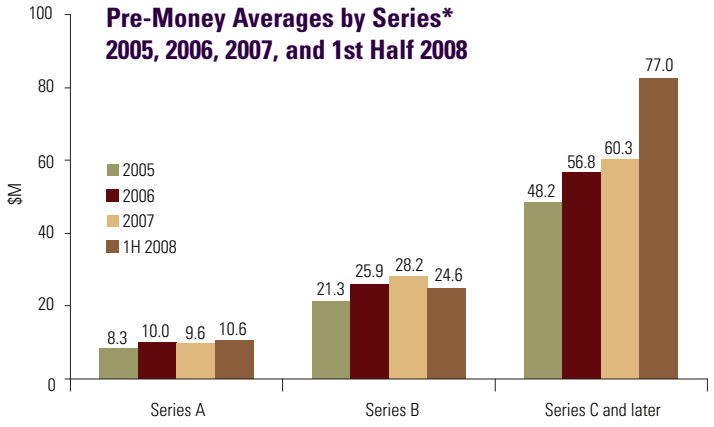


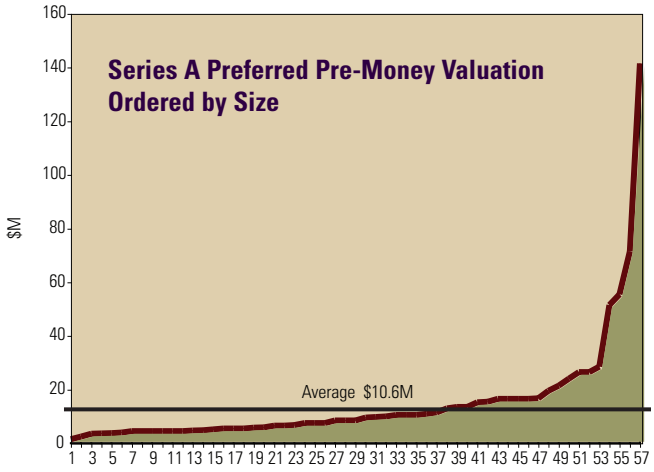
The period-to-period increase in pre-money valuation is dramatically true for later rounds of financing involving the sale of Series B Preferred or Series C Preferred and later. In the Series C Preferred and later rounds, the increase in the size of the financing and the pre-money valuation are even more pronounced, as investors continue to support their company portfolios.

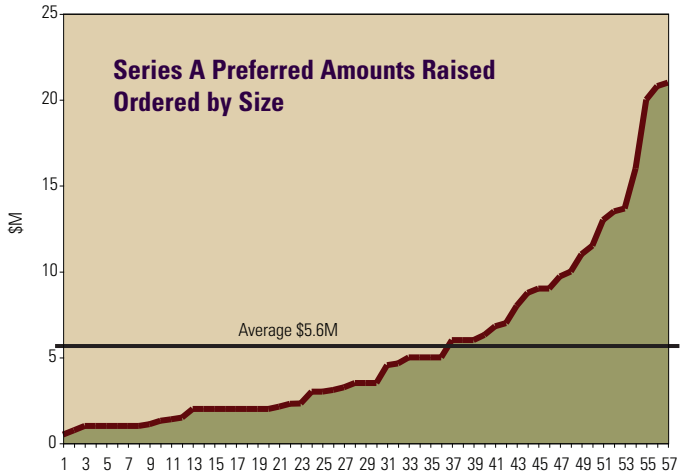
*The data shown in both charts on this page is based on averages that (i) exclude data resulting from financings led by angel investors, and (ii) exclude a single financing in the first half of 2008 involving an investment of $300 million, which we considered anomalous for purposes of the charts.



For purposes of comparison, the chart above compares pre-money valuation averages for the first half of 2008 against averages for each of the full years of 2005, 2006, and 2007, broken out by stage of financing.

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





The first equity financing round is a critical step for every start-up company seeking to launch its business plan, and entrepreneurs characteristically have placed great emphasis on the pre-money valuation of their company as the foundation on which the investment is made. For this reason, industry statistics on average pre-money valuation, the average dilution to the founders and early employees that results from the investment, and related statistics are scrutinized with great interest. However, it is important to realize that statistics based on averages provide only general insights into industry trends. We include on this page two charts reflecting pre-money valuations and amounts raised for a total of 57 Series A financing transactions for the first half of 2008, in each case with values in the data ordered from lowest to highest. The point of both of these charts is to illustrate the enormous range of values in the data that provide the basis for the average reflected in the charts. Thus, even in times of economic turbulence, key factors relevant to the intrinsic value of a business—such as the experience of the management team, the disruptive nature of the technology, the size of the markets, and the barriers to entry, among others— are likely to be far more important than external economic factors on the pre-money valuation that forms the foundation for an investment.

As the community of entrepreneurs and venture investors continues to closely monitor economic and political developments for the balance of 2008, our data supports the belief that activity levels for venture investments in the broad technology arena continue at a vibrant pace.

FYI . . .

In an article published by the San Jose Mercury News *on July 8, 2008, the Cleantech Group, a San Francisco-based research firm, reported that worldwide funding for clean technologies reached $2 billion for the second quarter of 2008, an all-time record, up 58% from the same period in 2007, and up 48% from the first quarter of 2008. It also reported that Silicon Valley continues to be the leading source of investment into the various technologies in the clean tech segment.*

Is Clean Tech Just an Investment Bubble About to Burst? *(continued from page 1)*

regimens to deal with climate change, higher conventional energy costs are a fact of life causing significant dislocation. Individual businesses and entire industries must account for this new reality, and in some cases, this means changing their way of doing business for the first time since their industries began over 100 years ago.

How will this change be accomplished? In one word: technology. Without technology coming to the rescue, much as it did for information technology and life sciences, these industries will be forced to pass along higher costs and become less competitive. It will be technology that frees them from this dilemma, and also enables them to meet the important societal goal of combating climate change. Thus, clean tech can be defined as technology enabling massive transformation of the planet's largest industries.

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Technology is also the reason that we believe that clean tech will not be a bubble, even though it will undoubtedly have its ups and downs. Technological advancements are carefully measured and monetized with questions such as: "How much will this process increase productivity, decrease costs, and increase my bottom line?" Unlike Internet companies during the bubble, clean tech performance is being objectively measured. The markets for clean tech products already exist, so there is an existing standard against which performance can be judged. This is not to say that there will be no downward cycles for clean tech. Similar to other technologies, we expect that clean tech will go through its own periods of being in favor and out, and some value chains may experience severe and extended downturns. However, it is important to note the possibility that while one value chain may be in a down cycle, others may be in an up cycle. This distinguishes it from information technology and life sciences. While all of the value chains enjoy current opportunities, we think that high-efficiency solar, energy efficiency, building materials, algae as a feedstock, storage, water, and lighting are particularly interesting at this time.

We believe that clean tech is an exciting new arena in which Silicon Valley can once again change the world. With the new reality of higher energy costs and greater awareness of our environment, technological advances are regarded as having great value. This makes it a perfect scenario for tried and true entrepreneurs to have a positive impact on our planet and build an attractive business.

Josh Green is a general partner at Mohr Davidow Ventures, and has more than 25 years of experience working with companies from start-up phase to large public company. MDV partners with entrepreneurs and takes a hands-on approach to architect and help build successful companies. MDV's team and the firm's extended network of industry experts bring years of real-world experience to accelerate each company's time to market and optimize its long-term success. The firm has $2 billion under management.

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FYI . . .

In a release published July 19, 2008, by the National Venture Capital Association and PricewaterhouseCoopers, it was noted that venture capitalists invested $7.4 billion in 990 deals in the second quarter of 2008, compared to activity levels for the first quarter that witnessed $7.5 billion invested in 977 deals. According to Mark Heesen, the president of the NVCA, "The relatively stable level of venture investment this [second] quarter across a broad swath of industries and all stages of development evidences that there are no shortages of opportunities for innovative companies."

The Fuss About IFRS *(continued from page 1)*

deliberations, a consensus appears to be emerging that a single set of high-quality global standards should eventually be used by all listed companies. Last month the SEC communicated that it will issue a proposed "roadmap" that identifies measures of progress that will be monitored between now and 2011, when the SEC plans to consider requiring U.S. public companies to file their financial statements using IFRS as issued by the IASB. The roadmap will be proposed in a release that addresses when and how the requirement to use IFRS might be phased in and includes a proposed rule that would, if adopted, permit certain large U.S. public companies in industries composed mainly of IFRS-reporting entities to use IFRS as soon as in their 2009 financial statements.

The origins of IFRS date back to the founding of the International Accounting Standards Committee (IASC) in 1973, and the core standards were completed in 1998. In 2001, the IASB assumed standard-setting responsibilities from the IASC. The IASB is based in London and comprises 14 members. In 2002, the European Commission mandated that European Union-listed companies adopt IFRS on or before January 1, 2005. In addition, several other major economies, including Brazil, China, India, Korea, and Canada have commenced IFRS convergence plans.

A switch to IFRS could impact how U.S. companies report their financial position and results of operations. In recent years, the IASB and the Financial Accounting Standards Board (FASB), the standard-setter for U.S. GAAP, have been collaborating on many standard-setting projects with a goal of achieving greater convergence of the requirements of IFRS and U.S. GAAP. While some progress has been made, many differences remain. IFRS comprise a less extensive body of literature than U.S. GAAP, with limited industry-specific guidance and less-detailed application

IFRS	U.S. GAAP
Revenue Recognition	
• Revenue recognition is based mainly on a single standard that contains general principles that are applied to different types of transactions	• Unlike IFRS, there is extensive guidance specific to industry, such as Statement of Position 97-2, *Software Revenue Recognition*, and type of contract
Share-Based Compensation	
• Share-based compensation is measured at fair value and recognized over the service period • Awards with graded vesting are accounted for as separate arrangements	• Like IFRS, share-based compensation is measured at fair value and recognized over the service period • Awards with graded vesting may be accounted for as a separate arrangement, like IFRS; or ratably over the longest vesting tranche, unlike IFRS
Research and Development	
• Internal research expenditure is expensed as incurred, and internal development expenditure is capitalized if specific criteria are met • The capitalization criteria are applied to all internally developed intangible assets	• Unlike IFRS, both internal research and development expenditures are expensed as incurred • Special capitalization criteria apply to direct-response advertising, software developed for internal use, and software developed for sale to third parties, which differ from the general criteria under IFRS
Property and Equipment	
• Property, plant, and equipment may be revalued to fair value if fair value can be measured reliably • All items in the same class are revalued at the same time and the revaluations are kept up to date	• Unlike IFRS, the revaluation of property, plant, and equipment is not permitted

The information in this table is intended to illustrate some of the similarities and differences between IFRS and U.S. GAAP and is not intended to be a comprehensive analysis. For a more complete discussion, please see KPMG's publication *IFRS compared with U.S. GAAP,* available at www.kpmgifrg.com.

guidance. As a consequence, there are more circumstances where application of IFRS requires an exercise of judgment that should be supported by contemporaneous analysis and documentation.

A high-level comparison of some aspects of the guidance provided by IFRS and U.S. GAAP in a few areas of interest to emerging technology companies is presented on the previous page.

Significant benefits are expected from the use of a single global set of high-quality accounting standards, including improved comparability of the financial statements of foreign and domestic companies and easier access to global markets. But conversion presents a number of challenges and can require considerable cost to realize these benefits. The task is not limited to financial reporting but extends to many aspects of the business including training, information technology, internal controls, compensation arrangements, commercial agreements, and communications with internal and external stakeholders. Conversion also may have wide-reaching effects on the financial professions in the areas of training, licensing, and academic curriculum.

A move of listed companies to IFRS has potential implications for emerging privately held companies. The most obvious impact is in respect to those companies that aspire to complete a public offering of their securities through a listing on the U.S. exchanges. These companies will need to prepare their financial statements in accordance with IFRS when going public if they become the required framework for SEC registrants.

Other impacts will be felt well before a company plans its initial public offering. Financial-statement data of comparable publicly traded companies are often used to analyze the performance and valuation of emerging companies and key financial-statement measures can be impacted by the change. Also, financing and commercial contracts can include provisions tied to financial statement elements as determined under U.S. GAAP. If these contracts are modified by counterparties to reflect financial reporting by companies reporting under IFRS, privately held companies that continue to follow U.S. GAAP need to pay particular attention to their contractual arrangements. Because of these potential impacts and the tendency for emerging companies to emulate the public companies in their sector, entrepreneurs may become more acquainted with IFRS in the near future.

Packy Kelly is the Partner-In-Charge of the Western Area and Silicon Valley Venture Capital practice for KPMG. Packy has more than 15 years of experience providing auditing and accounting services, including IPOs for start-ups. Packy's professional experience includes serving venture-backed companies and working on IPOs. He has been the lead engagement partner for several technology companies. Packy holds a B.S. degree in accounting from Fairfield University, an MBA from Columbia University, and an MBA from the University of California, Berkeley. He is a member of the American Institute of Certified Public Accountants.

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FYI . . .

In an article published by The Wall Street Journal *on July 1, 2008: "In the second quarter [of 2008], no companies backed by venture capitalists went public via an initial public offering in the U.S., the first time that has happened since 1978, according to the National Venture Capital Association. There were just five venture-capital-backed stock offerings in the first quarter, compared with 31 in the fourth quarter of 2007."*

Starting Up: Sizing the Stock Option Pool

By Doug Collom, Partner (Palo Alto Office)

One of the most important aspects of organizing a start-up company is setting up a capital structure that will support the key growth objectives of the company. The equity capital of an early-stage company must be structured with a view toward motivating early-stage employees, facilitating outside investment, and establishing strategic and commercial relationships with partners that will complement the growth plan. In the context of the first objective, founders of a new enterprise should understand the factors that relate to the creation of a stock option pool for the hiring and retention of employees.

The need to hire and retain employees is a universal requirement of early-stage companies with growth-oriented business plans. In the technology and biotech sectors, equity participation among the employee ranks at all levels within the enterprise is commonplace, and manager and key employees expect to receive equity as a significant part of their overall compensation. The founders usually address this expectation by creating a stock plan that sets aside, or reserves, a pool of common stock to be used for the grant of stock options or restricted stock (i.e., stock subject to vesting) to employees, consultants, and other service providers.

For purposes of background, founders' stock normally constitutes the first issuance of common stock by a newly organized company. Once this organizational step has been completed and the company is ready to begin hiring its first employees, a stock plan is adopted as an administrative vehicle for the grant of equity incentives—such as stock options and restricted stock—to employees, directors, and consultants. A key provision of every stock plan is the reserve, or pool, of common stock that is set aside for incentive purposes.

> In the technology and biotech sectors, equity participation among the employee ranks at all levels within the enterprise is commonplace.

The usual questions that arise in connection with the creation of a stock plan are:

- How big should the stock pool be? And what factors should be considered in establishing the size of the stock pool?
- Can we implement the stock plan after we have completed our outside financing?
- What is the convention for vesting of employee stock?

Sizing the Stock Pool

Bottoms-up analysis—expected headcount growth and levels of equity. The size of the stock pool should correspond to the expected employee headcount growth of the company as set out in the company's business plan. Although business plans frequently contain projections that extend out three years or more, reasonable business forecasting with any accuracy realistically only extends to a horizon that is roughly 12-18 months distant. In addition, and as a corollary to the headcount growth anticipated within this timeframe, the founder will need to identify the required manager and employee positions—by title and expected contribution to the company—included within the headcount. This information must then be translated roughly into expected levels of equity compensation ranked by title and position, and then aggregated to approximate the likely equity incentive requirements of the company. This bottoms-up approach is probably the best determinant of the size of the stock pool.

As a very rough rule of thumb, the following chart suggests equity incentive levels for early-stage companies by employee title/position:

	Post-Series A Preferred
CEO	**5-10%**
Vice Presidents	**2-3%**
CFO	**1-2%**
Director-level	**<1/2%**
Other	**<1/4%**

The percentages above are calculated on the basis of the company's fully diluted capital structure, i.e., the sum of both the outstanding shares and the full amount of the reserve of common stock included in the stock pool.

In light of these rough guidelines for equity incentive levels in the post-financing company, we hypothetically may assume the usual pyramidal corporate organization that over a 12-18 month period will end up with one CEO, two or three vice presidents, half a dozen or so director-level employees, and an additional number of rank-and-file employees. If competitive levels of equity compensation are awarded to each position, the aggregate number of shares so granted typically ends up roughly in the 20% range of the fully diluted capital of the company.

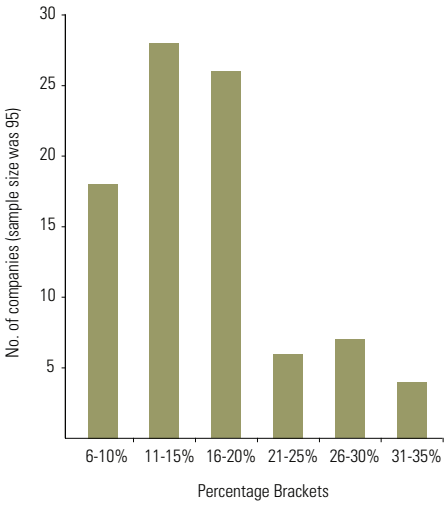
It should be noted that in the table above, the actual aggregate percentage of stock allocated to management and employees is usually impacted by the number of founders and their role within the company. For example, a founder of a company who also serves as its CEO typically will own substantially more than the 10% equity to be expected for a non-founder CEO. Founders' stock normally is not included in the stock pool, nor do early-stage companies as a general rule anticipate granting additional stock to founders beyond their original equity position in the company.

This bottoms-up approach to calculating the size of the stock pool also may correspond loosely to the timeframe within which companies may need to raise the next round of financing. It is not unusual for the board of directors of a company—which typically includes representatives of the venture investors—to evaluate the stock reserve remaining in the pool at the time of each round of financing, and to replenish the pool as necessary to address the hiring and retention requirements of the company.

Top-down analysis. The chart below is based on companies that engaged in a Series A financing in 2006 and 2007 and for which Wilson Sonsini Goodrich & Rosati has acted as a stock transfer agent. It illustrates the amount of stock allocated to the stock pool of early-stage companies immediately following the completion of the first institutional round of investment. Of the 95 companies included in the database, the Series A Preferred financing transactions in almost all cases were led by institutional venture capital investors (as distinguished from angel investors or strategic corporate investors).

The chart indicates that a clear majority of start-up companies established their stock pools in the range of 11% to 20%, expressed as a percentage of the fully diluted capital of the company. (It should be noted that the percentage of stock actually allocated to management and employees in fact may be substantially higher, since common stock issued to the company founders is typically not included in calculating the size of the stock pool.)

Percentage of Stock Allocated to Option Pool after Series A Financing



As a general observation, the percentage of stock that is allocated to the stock pool of the early-stage company, particularly in the technology and biotech sectors, is relatively immutable, even in the face of multiple financing rounds and the dilution to the overall capital structure that each financing entails. This is because the principal factor driving the level of equity incentives granted to management and employees is "competition in the street"—i.e., what it takes to offer a competitive compensation package to employees for hiring and retention purposes. Founders and investors alike discover quickly that employees with below-market levels of equity are more likely to look elsewhere for employment.

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Dilution, Timing, and the Stock Pool

Founders are quick to figure out that it would be to their advantage if the 20% reserve of common stock in the pool could be established *after* the completion of the first round of equity financing. If this could be arranged, then the dilution to the company's capital structure resulting from the creation of a stock pool would be spread equally between the founders and the investors, before any employees were actually hired.

Not surprisingly, the investment community has figured this out, too. And not surprisingly, it is a virtually universal convention that every venture capital term sheet requires an allowance for an appropriately sized stock pool as part of the start-up's stock *before* the investment. Investors don't want their ownership position in a company to be diluted by an employee stock pool, after having spent the time to negotiate the pre-money valuation of the start-up as the foundation of their investment. This convention is a virtually non-negotiable aspect of a venture capital investment, with the result that investors and founders alike will pay careful attention to the anticipated headcount of the company over a 12-18 month period, and to competitive levels of compensation to be provided to the managers and employees within the headcount. This analysis usually leads to an agreement on the right size of the stock pool in advance of any proposed investment.

Vesting Conventions for Employee Stock Incentives

Investors have a strong interest in the vesting requirements of their portfolio companies, since vesting ties directly to employee retention, as well as the "burn rate" of common stock used as equity incentives—and hence the potential for increased dilution.

Stock vesting for equity incentives granted to employees is typically tied to a four-year regime. We looked at the vesting schedules in our sample of 95 companies. Within this base, approximately 82% required four-year vesting, and only 4% required vesting over a term of five years. Companies in the sampling that appeared to require vesting less than four years in most cases provided credit to early-stage employees for personal time spent on the business prior to their joining the company, or prior to the actual formation of the company—thus adhering to the conventional four-year vesting term at least in philosophy.

Does My Start-Up Qualify for Venture Debt Financing?

By John Mao, Partner (Palo Alto Office); Andrew Hirsch, Partner (Palo Alto Office); Christine Foster, Associate (Palo Alto Office)

What is Venture Debt Financing?

Venture debt financing typically provides capital to private venture-backed companies in the form of secured term loans that are often referred to as "growth capital loans." The runway provided by the proceeds of a venture debt financing can provide a company with more time to meet a product/technology milestone a regulatory milestone, or another commercial benchmark, which ultimately can result in a higher valuation in the company's next round of equity financing and less dilution to a company's existing stockholders. In some instances, the resulting cash resources can defer the need to raise additional equity capital before the company reaches a cash-flow break-even point or a liquidity event such as an acquisition or an initial public offering.

Companies that utilize venture debt financing are often pre-revenue or cash-flow negative, so the credit analysis and determination of whether a company can obtain a venture debt financing commitment are quite different than those of a traditional bank financing. Venture lenders typically rely upon subsequent rounds of venture capital equity financing as the primary source of repayment for their loans. As a result, venture lenders' primary focus is upon: (i) a company's relationship with its venture capital investors and the reputation of those investors, (ii) the timing of the most recent equity financing and the amount of the remaining cash proceeds, (iii) a company's cash-flow projections and the anticipated timing of the need to raise additional equity financing, and (iv) the timing of a company's next significant milestone in its business plan.

> A company is often in the strongest position to negotiate and obtain venture debt financing immediately after closing a round of equity financing.

With all of this in mind, a company is often in the strongest position to negotiate and obtain venture debt financing immediately after closing a round of equity financing, when its cash resources are highest and its prospects are most promising. For later-stage companies, there may be a greater focus on financial metrics and business milestones where the purpose of the venture debt financing is to bridge to positive cash flow or a liquidity event.

A typical venture debt financing can range in size from $1 million to $15 million and usually matures in 24 to 42 months. These financings are secured by a lien on all or substantially all of the assets of the company, although sometimes intellectual property is excluded. Venture lenders are compensated for the credit risk associated with these transactions through a mix of interest-rate yield on the principal of the loans and warrant coverage. Typically, venture lenders will receive a warrant to purchase capital stock of the company. These warrants enable the holder to purchase a number of shares of the company's capital stock equal to a negotiated percentage of the principal amount of the loans being provided, divided by the price per share paid by other investors that have purchased such capital stock. The range of warrant coverage is determined primarily by the stage of a company's development, the type of lender providing the venture debt, and competitive market forces.

Key Considerations in Structuring Venture Debt Financing

Runway extension. If a venture debt financing does not extend a company's runway, it may not be achieving the primary goal of such financing. There are a number of different structural elements of a venture debt financing that must be analyzed to ensure that a company is receiving the maximum benefits of the financing within the parameters of the marketplace, including:

- length of the term of the loan facility until maturity;
- interest-only periods that defer the amortization of principal;
- amortization schedules;
- payments made in advance versus in arrears;
- the impact and utility of delayed draw mechanisms;
- final payments that defer payment of a portion of the interest yield;
- subjective defaults, including insolvency defaults and material adverse effect defaults that can result in the acceleration of the outstanding loans; and
- any financial covenants that might effectively "cash collateralize" outstanding loans or otherwise trigger a default prior to maturity, resulting in the acceleration of such outstanding loans.

Economics & scope of collateral. A number of different factors should be considered in negotiating the economic terms of venture debt financing transactions and the scope of the collateral securing such financings, including:

- the impact of a company's stage of development upon the pricing of the transaction;
- the actual all-in yield on the interest component of the loans, taking into account commitment fees, interim interest calculations, and final payments;
- prepayment penalties;
- whether the warrant coverage is fully earned up front or vests with the extensions of loans;
- the exercise price of the warrants and its impact on the warrant coverage;
- whether the warrants survive a liquidity event; and
- the scope of the collateral and whether intellectual property is included in the collateral securing the loan.

Sources of capital. Understanding the reputation of venture lenders in the venture debt financing markets, their typical deal structures, and the stage of development of companies and industries that they typically fund is critical due diligence in this process. In particular, a prospective borrower should consider:

- the distinctions between commercial banks and venture lending funds and the pros and cons associated with each type of lender;
- a venture lender's sources of capital and its ability to control its sources of capital;
- the reputation of specific venture lenders and their track record when dealing with their borrowers in difficult times; and
- a venture lender's legal documentation and its philosophical approach to documentation that can impact both up-front expenses and the relationship between the venture lender and its borrower throughout the term of a venture loan.

FYI . . .

In a July 1, 2008, poll taken of the membership of the National Venture Capital Association that elicited 662 responses, 43% expressed their belief that the IPO window for venture-backed companies would not open for at least 12 months, an additional 32% believe that it will be one to two years before the window reopens, and 5% believe that it will be more than two years before the window opens.

Top 10 Intellectual Property Tips for Early-Stage Companies

By Peter Eng, Partner (Palo Alto Office)

For an early-stage technology company, a strong intellectual property strategy is crucial to attracting investment dollars. Because of small or non-existent revenues, the early-stage company's IP tends to represent a significant portion of its valuation. Accordingly, here are some tips to protect a company's IP:

Tip #1 – Leave the Past Behind

When joining or forming a new company, founders and other employees should make a clean separation from prior employers. If a founder developed IP while employed by a former employer or as a graduate student, that former employer or university may have ownership rights to the IP. Moreover, if the new company relates to the former employer's business, it is even more important to terminate the prior relationship as cleanly as possible. Starting a company by using (or even appearing to use) a prior employer's computers, resources, or proprietary information may lead to serious problems with IP ownership and even litigation.

Starting a company by using a prior employer's computers, resources, or proprietary information may lead to serious problems with IP ownership and even litigation.

Tip #2 – Get It in Writing, Get It in Writing, Get It in Writing

Employers do not always, by default, own the IP developed by their employees. With some forms of IP such as patents, the creator presumptively owns the IP that is developed absent a written agreement. Without proper written agreements, a company may not have clear title to the IP created by its employees or consultants. Therefore, early-stage companies should diligently execute agreements with everyone hired by the company, including founders, employees, consultants, and other third parties. The agreements should assign IP rights to the company, including IP created during the working relationship. Non-disclosure agreements also should be executed to prevent leakage of confidential information and to prohibit misappropriation or misuse of IP.

Tip #3 – File for Patents before Deadlines

Early-stage companies may lose their ability to seek a patent by waiting too long. There is a one-year grace period to file for a patent following a public disclosure or sale of an invention under U.S. patent law. In contrast, most foreign countries require that a patent application be filed before public disclosure of an invention (absolute novelty). Companies therefore should think globally and file for a utility or provisional patent application before the release or public disclosure of their technology in order to preserve their U.S. and international patent options.

Tip #4 – Avoid Pitfalls of Provisional Patent Applications

Provisional patent applications enable inventors to establish an early priority date for their inventions. They are also a favorite among entrepreneurs because they are perceived as a low-cost solution to protect IP. Unfortunately, provisional applications may give the unwary a false sense of security that could lead to loss of patent rights. For example, although provisional applications have the same legal standards of technical disclosure as regular utility patent applications, provisional applications can be hastily prepared without sufficient technical detail. The subsequent public disclosure of an invention that relies upon an inadequate provisional application may irrevocably cause the loss of potential patent rights.

Tip #5 – Develop and Pursue a Patent Strategy

A well-positioned patent portfolio can provide an early-stage company with strategic advantages. Aside from protecting core technologies, a patent portfolio can be used for offensive purposes to block competitors, to generate revenue through licensing, or to encourage favorable cross-licensing arrangements. For example, by obtaining patents on incremental innovations around a competitor's core technology, a company can block the competitor from improving on its original invention. An early-stage company should continually evaluate its business strategy and work with IP counsel to modify its patenting strategy as the company evolves and business conditions change.

Tip #6 – Manage Infringement Risks

Under U.S. patent law, treble damages may be awarded when the infringement is found to be willful or in bad faith. When an early-stage company becomes aware of a problematic third-party patent, there is a duty to reasonably investigate whether the company is infringing. Seeking competent legal advice from counsel is essential to mitigating the risk of enhanced damages for willful infringement. Courts consider the failure to seek and follow the advice of legal counsel when deciding on the issue of willful infringement, making it critical that early-stage companies consult with their IP attorneys before undertaking or continuing activity that is potentially infringing.

Tip #7 –Avoid Joint Ownership

Companies that collaborate in research and development often believe that the resulting work is jointly owned and all parties share equally in the profits. However, joint ownership of IP is anything but simple. The rights and duties of joint owners vary for different types of IP and in different countries, and a failure to understand the complexities of joint ownership could lead to serious unintended consequences. Furthermore, early-stage companies should recognize that joint ownership may arise by default due to the nature of the collaborative activity, even if the inventors or authors do not physically work together, make the same degree of contribution, or intend to be co-owners of the resulting work. If the parties want to avoid the complications of joint ownership, they should expressly address this in a written agreement.

In addition, early-stage companies should consider ownership issues before conducting joint research with universities or accepting governmental funding. Companies should not access university or government resources—such as personnel, laboratories or equipment—without first understanding the IP policies governing their use.

Tip #8 – Manage Risks of Contamination and Blocking

Contamination occurs when a company is exposed to and integrates someone else's IP into its own products without having the right to do so. Blocking can occur when the company is later prevented from using the tainted technology or is otherwise forced to obtain a license from the other party. Although contamination and blocking may be unavoidable dangers that arise when companies interact and conduct business, this risk can be managed by proper documentation of technological developments and carefully controlling the inflow and outflow of shared information. In addition, companies may further protect their technology by filing patent applications before sharing or disclosing their IP under confidentiality agreements.

> Investors view constraints on a company's business operations pessimistically.

Tip #9 – Avoid Restrictive Covenants and Grant Backs

In a rush to get a business up and running, early-stage companies often enter into agreements with provisions that restrict their freedom to carry on business in the future. Investors view constraints on a company's business operations pessimistically. Business models change, and what seems like a logical restriction today may become problematic later. Companies should avoid such restrictive covenants, as it is also very easy to forget about restrictive provisions and breach these contractual obligations.

Tip #10 – Preserve Exit Options in Agreements

Whether the exit strategy is a merger, sale, or an IPO, early-stage companies should preserve their future exit options when entering into IP agreements earlier on in the company life cycle. Decisions that are made now may seem reasonable or insignificant but could materially affect the company's valuation or even prevent the company from completing an exit down the road. For example, investors and acquirers considering a potential merger or acquisition will look at ownership of the company's IP assets when valuating the deal. Has the company obtained the necessary IP assignments? Does the company hold a key IP license that can be easily terminated or cannot be transferred without the licensor's consent? Are there any change of control provisions that would hamper the company after closing? These and other IP obligations could become potential deal-breakers and should be anticipated as the company is forming and growing.

Selecting and Protecting a Company Name

By Aaron Hendelman, Partner (Palo Alto and Seattle Offices)

Among the most important tasks in the founding of a new company are the selection, clearance, and development of a company name. Because ownership rights associated with company names are "first in time" (i.e., belong to the first to file), the sooner a founder takes steps to select and protect a company name, the better.

Founders should consider their company names as carefully as they select key hires and develop core technology. A company's name makes a critical first impression. Over time, the name can pay extraordinary dividends or create unnecessary roadblocks.

As founders start brainstorming potential company names, they should continually focus on a number of important questions: What is the name's desired effect? Should the name say something significant about the company or its product, or is it merely meant to serve as a convenient handle? Will the name make a clear impression? Will it be easy to pronounce and spell? What is the company's long-term marketing strategy? Will the name allow the company to grow and its product lines to expand? Is it prone to (good or bad) manipulation? Founders also should understand that, legally speaking, some company names are stronger than others. Made-up names (e.g., Exxon or Google) or those that have no literal connection to the company (e.g., Apple for a computer company) are well positioned to establish strong intellectual property rights. Names that require a slight leap of logic or suggest a company's products or services (e.g., Titanium for a travel-bag company, connoting strength and durability) are protectable trademarks and often strike the right balance between developing strong brands and educating the public about the company. On the other hand, names that merely describe what a company does (e.g., Online Advertising, Inc., for a company that sells Internet ads) tend not to be initially protectable.

Founders often gravitate toward descriptive names because they want the public to immediately understand the company's business. However, choosing a descriptive name can hurt a company's long-term bottom line. For example, it might be impossible to stop competitors from using the identical name. As a result, it might require the company to spend more money on marketing to differentiate its descriptive name from a crowded field. Also, there could be additional expenses caused by the increased burden of "policing" other businesses eager to use similar names.

Founders should consider their company names as carefully as they select key hires and develop core technology. A company's name makes a critical first impression.

Legal and Business Issues

Founders should understand that there are a host of legal and business issues as part of the company naming process.

As an initial step, a new company must determine whether its name is available under state laws relating to entity names. In the case of a corporation or limited partnership, this involves checking with the office of the Secretary of State in the state where the company is formed and where it must qualify to do business (usually where it has offices, resident employees, or a sales force).

The state office checks its records to ensure that there is no other corporation or limited partnership with an identical or closely similar name; if one is found, the new name generally is not permitted. This happens even if the two companies operate in vastly different lines of commerce; the sheer similarity of the name bars the second name. (On some occasions, however, consent of the earlier company or a relatively minor alteration of the name, such as "Ultigra, Inc." to "Ultigra Software, Inc.," might increase the chances that the state will allow the new name.)

Another set of legal issues concerns trademark law. The Secretary of State's approval of a business name does not grant trademark rights or authorize a company to use the name in commercial activities. (Nor does registration of a corresponding Internet domain name result in any significant legal rights.) Even if a company incorporates under a name, its use of the name to brand products or services might create liability for trademark infringement or dilution. The penalties can be severe, including an injunction, disgorgement of profits, monetary damages, and more.

Trademark infringement occurs when a person or company uses a name or mark in a way that causes a likelihood of confusion with another person or company offering similar products or services. Thus, "McCoffee" may infringe upon the marks of McDonald's Corporation by leading the public to believe that "McCoffee" is a product or an affiliated company of McDonald's. A company also may be liable for trademark dilution by using the famous mark of another company even if there is no competitive overlap or likelihood of confusion. For example, the name "Pentium Petroleum Corporation" may well dilute the PENTIUM trademark of Intel Corporation.

Therefore, it is vital to assess the potential trademark law risks of a name before adopting it as a company name.

It is important to realize that even if a new company still has a low public profile, does not yet have products on the market, or does not operate a website, it is not immunized from legal challenges over use of its name. On occasion, companies have been sued for allegedly causing confusion through their financing activities or for use of a pre-release code name for a new product.

In a rush to get started, some companies devise names in a hurry and do not clear them for trademark purposes. Often, they consider the name a place holder until a later time when they can invest the money and effort to create a new name. Unfortunately, this strategy is risky. First, there is a chance of liability. Second, management may "fall in love" with the place-holder name and become unwilling to give it up. Third, the company may develop goodwill under the place-holder name that would be lost upon a name change. Fourth, the company may incur significant legal and administrative costs when it changes its name.

Importance of Trademark Searches

Prior to deciding on a name, founders should conduct an initial trademark investigation on their own. At the very least, they should poke around online for third-party names that would pose obvious problems. Internet search engines and the U. S. Patent and Trademark Office online database are useful tools for identifying companies that already may be using similar names. In addition, the availability of a corresponding domain name often is critical, so domain names also should be checked.

If the founders' initial diligence does not uncover any major risks, they should ask counsel to check the availability of the name with the appropriate Secretary of State; if the name is available, it should be reserved pending full trademark clearance. Checking the availability and reserving the name cost only nominal fees.

Once a company is comfortable with the level of risk of its chosen name, it is important to find ways to protect the name as a trademark.

Founders also should have counsel perform a trademark availability search. Counsel typically runs an initial trademark scan to quickly eliminate names that have obvious problems and, if clear, orders an in-depth trademark search from an outside search company. The in-depth search examines federal and state trademark registers and a large number of sources of unofficial information about company and product names in relevant fields, such as newspapers, magazines, trade journals, business records, and domain-name registries. Counsel analyzes the report carefully for potential conflicts and confers with the founders about the availability of the name.

Once a company is comfortable with the level of risk of its chosen name, it is important to find ways to protect the name as a trademark. If the name will be used on products or in connection with the advertising or promotion of services, it often is a good idea to file an application for federal registration of the name based on the company's intent to use the trademark. This will help establish enforceable rights to the name and, equally important, give early notice to others who might otherwise overlook the company's name when doing trademark searches to develop their own names.

By taking important steps to best assess the availability and strength of its name, a new company can proceed more confidently, branding its products and services with assurance, and focusing its energy on developing its business.

FYI . . .

According to a statistic published in a 2007 Global Insight Report and reported by the National Venture Capital Association on July 1, 2008, companies that were once venture-backed but are now public account for 10.3 million jobs and 18% of U.S. GDP.

Events

California Clean Tech Open

In August, Wilson Sonsini Goodrich & Rosati hosted a series of meetings and a special reception featuring representatives from the U.S. Department of Energy (DOE), which announced a $100,000 contribution to the California Clean Tech Open (CCTO). Co-founded by Wilson Sonsini Goodrich & Rosati partner Marc Gottschalk, the CCTO is an annual competition for start-up clean technology companies. More than 250 individuals attended, including Alexander (Andy) Karsner, the Assistant Secretary of the U.S. Department of Energy; David Rodgers, the Deputy Assistant Secretary for Energy Efficiency; directors from five national laboratory sponsors of the event; and CCTO mentors and participants.

In making its contribution, the Department of Energy joined the five national laboratories—Lawrence Berkeley National Laboratory of California, Oak Ridge National Laboratory of Tennessee, Argonne National Laboratory of Illinois, National Renewable Energy Laboratory of Colorado, and Pacific Northwest National Laboratory of Washington State—to encourage the development of net-zero-energy commercial buildings (buildings that supply their own energy by combining energy-efficient designs with their own power from renewable sources). The first act of their collaboration is to sponsor the CCTO's Green Building Prize for 2008, the recipient of which will be announced on November 6.

Phoenix 2008: The Medical Device and Diagnostic Conference for CEOs

October 2-5, 2008
The Phoenician
Scottsdale, Arizona

Phoenix 2008 will mark the 15th annual conference for chief executive officers and senior leadership of medical device and diagnostic companies. The event will provide an opportunity for top-level executives from large healthcare and small venture-backed companies to discuss strategic alliances, financing, and other industry issues.

For more information, please visit www.wsgr.com/news/phoenix, or contact Tni Newhoff at tnewhoff@wsgr.com.

Algae Biomass Summit

October 23-24, 2008
Bell Harbor Conference
Seattle, Washington

The Algae Biomass Summit will survey the emerging industry exploring the use of algae as a feedstock for biofuels and other sustainable commodities. Participants will hear from entrepreneurs, investors, technologists, producers, scientists, and policymakers on issues of critical importance to this emerging industry including the commercial viability of algae production, current government and private initiatives, evolving technologies, processing concepts, and venture and project finance.

For more information, please visit www.algalbiomass.org/events/index.html, or contact Nancy Farestveit at nfarestveit@wsgr.com.

The Life Sciences Report

Wilson Sonsini Goodrich & Rosati soon will issue the Fall 2008 edition of *The Life Sciences Report*, a newsletter providing an in-depth look at regulatory, intellectual property, and corporate securities issues facing life sciences companies today. Articles in the upcoming issue include:

- IRC 409A and SFAS 123R – What Should Companies Be Aware Of?
- Small Business Federal Funding Update
- Federal Circuit Denies Regulatory Safe Harbor Defense to Manufacturer of Research Tools
- PhRMA Marketing Code Revisions Significantly Affect Drug and Device Marketing in California and Nevada
- From the Ivory Tower to the Consumer Market: Key Terms in Licensing Technology from Universities

For more information regarding this report, or to be added to the mailing list, please contact Marketing at marketing@wsgr.com.

FYI . . .

Wilson Sonsini Goodrich & Rosati ranked first among U.S. law firms for the total number of issuer-side venture financings in the first half of 2008 according to Dow Jones VentureSource.

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