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THE ENTREPRENEURS REPORT: Private Company Financing Trends

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Early-Stage Fundraising Advice for Tough Times

By Ken Elefant, General Partner, Opus Capital

Raising capital is never easy for a start-up company, especially now. Valuations, investments and exits have dropped off in recent quarters. Enterprise IT budgets are shrinking, and revenue models for many consumer businesses are still nascent. VCs are nervous, as are their investors.

But the average deal size of $7.7 million is still holding strong, and the dollars invested in certain sectors such as internet software have even increased. What's more, 23% of the venture capital invested in the most recent four quarters went to seed or early-stage deals--higher than in the previous two years (source: PricewaterhouseCoopers/NVCA MoneyTree report).

Bottom line: capital for company building is available, but exit opportunities in the near term are squeezed. But if you're starting a company now, your exit is most likely six to eight years away, when the market is expected to be more stable.

Some of the best companies were built in questionable economic climates. Riverbed Technology secured its Series A funding in December 2002, and had its initial public offering just four years later. In its first day of trading, Riverbed stock closed 57% higher than the opening price. Or take Virsa, a governance solutions provider that was acquired by SAP in 2006, only two years after receiving its first round of financing in a weak enterprise software market.

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Private Company D&O Insurance: Key Considerations

By Priya Cherian Huskins, Partner, Woodruff-Sawyer & Co.

Directors and officers of private companies potentially face unlimited personal liability if they are sued. As a result, when it is time for a start-up company to recruit serious talent to take the company to the next level, the purchase of director and officer liability insurance becomes a priority. In addition, venture capitalists often insist on having adequate D&O insurance in place before they finance the company and join the company's board of directors.

Unfortunately, although the cost of D&O insurance for most start-up private companies is about the same—roughly $5,000 to $10,000 for $1,000,000 to $2,000,000 of insurance per year—not all D&O policies are created equally. To avoid finding yourself insured by a D&O policy that does surprisingly little, consider the importance of:

(1) understanding the appropriate coverage limit to purchase;
(2) securing key policy terms and conditions; and
(3) using an insurance broker who specializes in D&O insurance.

Limits. Most early stage companies purchase $1,000,000 to $2,000,000 of D&O insurance, and most later stage private companies purchase $5,000,000 to $10,000,000 of D&O insurance. Some companies decide to select a certain amount in limits because that is what their venture capital backers have requested. Others purchase limits based on requests

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From the WSGR Database: Financing Trends

Segment Information

For the first time in this report, we are providing financing and valuation data on financing transactions segmented by industry, based on financing transactions where WSGR has assisted as counsel for either the issuer or the lead investor during the period from 2004 through March 2008. The purpose of this segment data is to attempt to show trend information by industry.

We have broken out segment information for eight industries and for all industries as a whole (including industry segments not included in the analysis). The identified industry segments are largely self-explanatory, but a few clarifications are in order. Biopharmaceuticals includes genomics, but excludes other life science companies. Medical Devices is treated as a separate segment. Electronics consists primarily of computer and disk drive companies and excludes consumer electronic and other electronics companies. Media consists solely of online content, search and social networking companies, and excludes media advertising, print, radio and television. Software includes only business application software.

Our analysis of industry information by segment is still in the early stages, which leads to a number of caveats concerning the utility of the data. First, the number of transactions included in most of the segments is relatively low—in the interest of emphasizing homogeneity of business models in the information broken down by segment, we included only those companies whose business models could be readily categorized in one of the eight identified segments. In respect of valuation information for Series B Preferred financing transactions, the data sets for companies in the Electronics and Energy Technology sectors were small and therefore excluded from the Series B Preferred analysis. As we continue our analysis of companies and transactions, we expect to increase the number of companies included within each segment and thereby the utility of the analysis.

For purposes of the charts on page 3, references to Series A Preferred financings include only institutional financing transactions, typically through venture capital funds. Angel rounds and bootstrapping transactions involving family members or friends were not included as part of this analysis.

Finally, because the data presented covers over four years of financing transactions, it may not capture some of the more recent trend information that, for example, may characterize the venture capital industry in the last six months.

In the charts that follow, we have parenthetically included for each segment the number of financing transactions used as the basis for the tabulated results.

The data in our reports is derived from financing transactions for the period from 2004 to the present in which WSGR 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.

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.

Series A Preferred Financings

Electronics and Biopharmaceuticals carried the highest pre-money valuations of the segments reported for companies engaged in Series A Preferred financings. Companies in the Biopharmaceutical segment have shown remarkable resilience in the face of volatile economic cycles that have impacted the technology sector as a whole, and the pre-money valuation data in our analysis would appear to confirm this.

The amount of cash raised by companies in both the Biopharmaceuticals and the Semiconductor segments reflects the capital intensive nature of these types of businesses. In light of this analysis, it is not surprising that Biopharmaceuticals experienced the most dilution associated with their fundraising activities within the VC community. The business model of a company in the Semiconductor space may typically require invested capital in the general range of $35 million to $60 million or more, and the data would seem to support this need even at the early stages of institutional financing.

In contrast, Media companies required the least amount of cash—many of these companies are "bootstrapped" by their founders to the point where they can show demonstrable user traction, and even revenue, before seeking institutional venture capital, with the result that less additional capital is required to further develop the business model. The amount of cash raised by companies in the Software segment also appears at the low end of the range of the reported segments.

Series B Preferred Financings

Much of the financing and valuation information shown for companies engaged in fundraising through the sale of their Series A Preferred

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From the WSGR Database: Financing Trends (continued from page 2)

Series A Preferred Financings
($ in millions)

Industry (# of Deals)	Amount Raised	Premoney Valuation
All Industries & Companies (474)	$ 5.0	$ 8.2
BioPharma (21)	$ 7.8	$ 8.6
Electronics (16)	$ 6.4	$ 12.1
Energy Technology (22)	$ 4.6	$ 7.6
Media (29)	$ 3.3	$ 7.1
Medical Devices (51)	$ 4.4	$ 5.5
Semiconductor (34)	$ 6.8	$ 7.6
Services (18)	$ 4.3	$ 5.2
Software (45)	$ 3.5	$ 6.2

Series B Preferred Financings
($ in millions)

Industry (# of Deals)	Amount Raised	Premoney Valuation
All Industries & Companies (331)	$ 11.1	$ 24.7
BioPharma (13)	$ 18.3	$ 21.8
Media (13)	$ 13.3	$ 25.2
Medical Devices (42)	$ 12.7	$ 22.5
Semiconductor (18)	$ 15.7	$ 28.1
Services (10)	$ 8.4	$ 19.8
Software (42)	$ 8.2	$ 18.7

continues in respect of companies completing Series B Preferred financing transactions.

Pre-money valuations for companies in the Software and Services segments are at the low end of the range of the segments reported. Services companies, absent distinguishing technology or other unique characteristics, have traditionally been valued lower than companies with a proprietary technology that is the foundation for leveraged product pricing.

Companies in the Biopharmaceuticals segment continue to require substantial amounts of capital, typically for research and product development and clinical trials, and sometimes to support collaborations with strategic partners. Similarly, Semiconductor companies if they are successful may typically require substantial amounts of capital to support marketing and business development activities at this stage.

Dilution

The table below shows dilution to founders' interests resulting from institutional financing transactions by segment at each round of financing involving the issuance of Series A and Series B Preferred. Dilution is cumulative by round of financing, e.g., a founder of a company in the Software segment that completes Series A and Series B Preferred financings may expect to be diluted by 66.7% (absent other stock adjustments). Not surprisingly, those segments with business models that are capital intensive show the most significant levels of dilution.

Industry	Dilution - Series A Financings	Dilution - Series B Financings
All Industries & Companies	37.9 %	31.0 %
BioPharma	47.6 %	45.7 %
Electronics	34.6 %	n/a*
Energy Technology	37.7 %	n/a*
Media	31.8 %	34.5 %
Medical Devices	44.0 %	36.1 %
Semiconductor	47.2 %	35.9 %
Services	44.9 %	29.8 %
Software	36.3 %	30.4 %

*Number of transactions too small to merit analysis.

Early-Stage Fundraising Advice for Tough Times *(continued from page 1)*

Without a doubt, entrepreneurs with passion, vision and a terrific concept should be starting companies, and shouldn't hesitate to seek out venture capitalists to fund their ideas. There's no reason not to.

Do, however, expect fundraising to be harder this year than it has been in recent years. While the capital is there, VCs are being more cautious. Nonetheless, enterprises still have key technology problems that they need help addressing, and consumers show no signs of slowing down use of the Internet and mobile devices.

A few things to keep in mind while fundraising: First, pursue venture firms that are lead investors and have a demonstrated interest in Seed and Series A investments—those with a portfolio to show for it. These are investors who will understand the challenges you face and be patient in helping you through them. With an average time-to-exit of 6.7 years (VentureSource), you want investors that will stick with you for the long haul.

When approaching VCs, you need all the outside support you can get. Work to get introduced through a business partner of your company—a law firm like Wilson Sonsini Goodrich & Rosati or a contact at another technology firm with whom you have a partnership. In addition to the benefit of an introduction, you're offering a prospective investor a built-in reference. In fact, have references prepared prior to any VC meetings—customers or business partners who can attest to the problem you're solving in the market.

Once your financing has been secured, start planning for the next round. Begin working immediately against the milestones that a follow-on investor will be looking for. These may include mediating the technology risks, ensuring successful, repeatable customer pilots and honing in on the right distribution model. Most important, focus on hitting real revenue targets that prove a scalable model.

There's no doubt it's a tough time to be starting a business. But if you focus on the long-term, and on building a successful, sustainable company, capital is readily available for you, both now, and when you're ready for an exit.

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Private Company D&O Insurance *(continued from page 1)*

from their boards of directors, and often as an inducement to help solidify a highly-sought after board candidate's decision to join the board. To get a handle on how much insurance to purchase and to avoid purchasing too much insurance, it is helpful to first understand the types of suits that are covered by D&O insurance, and then consult with your outside counsel to understand the expected cost associated with defending and settling each type of suit.

Broadly, there are two types of plaintiffs that can proceed against directors and officers: the government and private party plaintiffs. Although it is highly unusual for a governmental agency to pursue private company directors and officers, it does happen. One example is when the government investigates and perhaps prosecutes directors and officers for securities fraud in the context of a private placement offering to raise capital. Experienced outside litigation counsel will be able to provide guidance on what it would cost to defend against this type of suit, and the expected defense cost should be included in the D&O insurance limits calculation. Because the government will not allow a director or officer to use insurance proceeds to settle a dispute, the company purchasing insurance should not include the potential cost of the settlement itself when calculating appropriate D&O insurance limits.

By contrast, insurance proceeds can be used both to pay for defense costs and to settle the claim when directors and officers are sued by private party plaintiffs, such as a company's shareholders, employees or competitors. For example, private plaintiffs might sue the directors and officers of a company for breaching their fiduciary duties in the context of a dilutive financing that washes out earlier investors or the sale of a company for a price that the plaintiffs believe to be inadequate. Experienced outside litigation counsel will again be able to provide guidance on what it would cost to defend as well as settle this type of suit (as opposed to allowing it to proceed to trial). The settlements of this type of suit are generally small relative to comparable suits brought against public company directors and officers, but they are never insignificant for the directors and officers who potentially face personal liability.

Employees are a notable source of claims against directors, officers and the private companies they serve—approximately one-third of all such claims. These suits concern employment-related matters. Private company D&O insurance policies can be expanded to respond to these employee claims. If a company elects to expand coverage in this way, it should consider raising the total amount of insurance limits it is purchasing to accommodate the employment practice claims that may be brought against the policy. In the alternative, these employee claims can be addressed through a separate Employment Practices Liability insurance policy with its own separate insurance limit. For an

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Private Company D&O Insurance *(continued from page 4)*

early-stage company that has less than 30 employees, the cost of a stand-alone EPL policy is about $5,000 to $10,000 for $1,000,000 to $2,000,000 of insurance per year. Compared to having two stand-alone polices with separate limits, combining the EPL policy and the D&O policy into a single policy with a shared limit is one way a company can reduce its premium.

Key Terms & Conditions. D&O insurance policies are highly negotiated risk transfer contracts; there can be enormous differences in the quality of insurance policies, even when issued by the same insurance carrier. Counterintuitively, a better negotiated, broader private company D&O policy is generally not more expensive than a poorly negotiated one when negotiated by a skilled broker.

A D&O insurance contract is normally divided into three separate insuring agreements known as Side A, Side B, and Side C. From an individual director's or officer's perspective, the most important insuring agreement is the one that agrees to indemnify directors and officers when the company cannot, such as when the company is insolvent. Referred to as Side A of a D&O insurance policy, this part of the contract provides first dollar (no deductible) insurance coverage and should be obtained in a manner that makes it difficult if not impossible for an insurance carrier to deny payment later. Specifically, a private company should obtain Side A on a "non-rescindable" basis, meaning that the insurance carrier cannot revoke the insurance contract for any reason.

From the company's perspective, an important function of a D&O insurance contract is to reimburse the company for its obligation to indemnify its directors and officers. Referred to as Side B, this part of the insurance contract is most likely to respond when a company's directors and officers are sued. The vast majority of claims in the United States that are brought against directors and officers are indemnifiable by the corporation so long as the company is solvent. Lastly, Side C of the insurance contract pays for the company's own defense and settlement when it is named in a covered suit. Side B and Side C are together referred to as "Balance Sheet Protection" and are normally subject to a deductible, also known in this context as a "self-insured retention."

Among the most important terms that a skilled insurance broker will negotiate when brokering the D&O insurance policy is "full severability." This means that in the context of a claim, the intentional bad acts of one insured director or officer cannot cause an innocent director or officer to lose the benefit of this insurance coverage. Without this clarifying language, innocent directors and officers can find themselves without insurance coverage as a result of another officer or director having been a bad actor.

Private, high-growth companies whose business plan includes routinely raising capital should pay special attention to whether the D&O insurance contract covers this activity. Some highly reputable insurance carriers routinely place caps on the amount of money that can be raised before the activity is excluded from insurance coverage. Other insurance carriers go so far as to exclude this activity altogether, unless it is negotiated back into the D&O insurance policy contract.

Using a Specialist. D&O insurance should be purchased through an insurance broker who specializes in D&O insurance. Both the background legal landscape against which these policies are written as well as the available policy terms are constantly evolving. A D&O insurance specialist will be able to guide a company toward insurance carriers that are able to provide the most comprehensive coverage at competitive prices. Moreover, even beyond placing a solid contract, there is the issue of actually getting a claim paid under a D&O insurance policy. Claims management for D&O insurance claims is a specialty in and of itself. The key to a good D&O insurance outcome—i.e., getting a claim ultimately paid—is placing the D&O insurance policy through an experienced broker who also has significant D&O claims management experience.

Of all the mistakes that a company can make when placing D&O insurance, the worst mistake from a risk management perspective is relying on an insurance broker who does not specialize in D&O insurance. The unfortunate, yet all too predictable, result is that when a claim against directors and officers is made, the claim turns out not to be covered by the D&O insurance. Private, high-growth companies are well advised to work with an insurance broker that frequently works with similar companies and has the ability to look around the corner when it comes to avoiding or mitigating risks on behalf of the client.

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Who Leaked Our Financing Information? The Perils of Form D

By Herb Fockler, Partner (Palo Alto Office)

You've just closed your Series A round and finally have the money to build your business. But you still need some stealth time before your competitors find out what you're doing or that you have received funding from Really Impressive Venture Partners. Suddenly, however, an article appears on the Internet announcing the deal, the amount you raised and the names of your investors. Your cover is blown. How did this happen? Who leaked?

Since the 1980s, the most common securities law exemption for VC financings – Regulation D – has required both public and private companies to file a Form D notice with the Securities and Exchange Commission, disclosing, among other things, the fact that they have raised money, how much they have raised, the names of their stockholders who hold more than 10% of any class of stock and even a brief description of their business. (Note that the required disclosure does not extend to the price of the financing or any investors who do not hold 10%.) In the early days of paper filings, no one other than the company's lawyer seemed to notice or care much. More recently, however, news services have made a practice of monitoring Form D filings and publishing their contents, generally over the Internet with immediate and widespread public dissemination. Stealth mode is gone. And this situation is likely to get worse once the SEC requires that Form Ds be filed electronically (effective March 16, 2009). After that, the filings will be available easily and immediately online to everyone directly from the SEC.

How do you avoid this forced and sometimes unwanted publicity? Some companies are choosing not to file Form Ds in connection with their VC financings, and thus keep their financing information out of the public eye. Similarly, a number of leading VC firms have requested that the companies they invest in, whether or not in stealth mode, not file Form Ds for their investments, in order to maintain the confidentiality of the VC firms' investment portfolios. Companies should note, however, that while the failure to file a simple form with the SEC may appear to be a mere administrative defect, it can have significant consequences, including the inability to use the Regulation D exemption in the future and possibly giving investors in the financing a right to put their securities back to the company.

Under federal securities laws, every issuance of securities in the US must be registered with the Securities Exchange Commission or else qualify for an exemption. The exemption most commonly relied upon in VC financings is Regulation D under the Securities Act of 1933, specifically Rule 506 of that regulation. Rule 506 permits companies to sell securities to an unlimited number of "accredited investors" (generally entities with more than $5 million in assets and individuals with more than $1 million in net worth or $200,000 in annual income), plus up to 35 non-accredited investors. Rule 506 is a "safe harbor," meaning that it has clear, objective requirements that, if met, assure you the availability of the exemption. One of these requirements is the filing of a Form D with the SEC within 15 days after first stock sale in a financing. So what happens if you intentionally do not file?

The SEC has stated in commentary on Regulation D that the failure to file a Form D does not cause the loss of the Rule 506 exemption. Nonetheless, many attorneys see a large difference between inadvertently failing to file and overtly choosing not to do so. In other places, Regulation D excuses "insignificant deviations" from meeting its requirements, but a "good faith and reasonable attempt" to comply must still be made. Choosing not to file, in full knowledge of the law, certainly isn't a good faith and reasonable attempt to comply. In addition, the SEC has the explicit power to deny use of Regulation D for future financings by a company that fails to file a Form D. Thus, intentionally failing to file the Form D may lead to loss of the Regulation D exemption, if not for the current financing, then at least as to future financings.

What are the consequences of not having the Regulation D safe harbor? Why care about qualifying for Regulation D at all? In the absence of Regulation D, companies generally rely upon the general exemption contained in Section 4(2) of the Securities Act, which exempts issuances "not involving any public offering." The apparent broad coverage of Section 4(2) sounds great, but is actually its weakness. Determining whether an issuance does not involve "any public offering" is very much a facts-and-circumstances test, and the SEC has expressly declined to lay down clear objective guidance as to how to apply that test (other than complying with Regulation D). Even more problematic is that the U.S. Supreme Court has interpreted the Section 4(2) exemption only once, going so far as to indicate that an offering to one or two persons can be considered a public offering if they need the protection of the securities laws. That's about as far from an objective standard as you can get, and enough to make company counsel pause before giving the customary legal opinions regarding securities law compliance in a financing.

Even if no opinion is required of company counsel, the issuer itself cannot be certain that it has a valid securities law exemption for the financing, given the facts-and-circumstances nature of Section 4(2). Some

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Who Leaked Our Financing Information? The Perils of Form D *(continued from page 6)*

financings are fairly safe, such as when the investors are a small number of well-known VC firms. But many financings are problematic, such as when friends, family and/or angels invest (or have previously provided bridge funding that is now converting to equity in the financing). It is possible that a court, with the benefit of hindsight after the company has proven to be a bad investment (otherwise, why would you be in court?), could find that one of these unsophisticated investors really needed the benefit of the securities laws. The danger of uncertainty here is exacerbated by the fact that it is the company that bears the burden of overcoming the uncertainty and proving that the exemption has been met.

Putting aside the uncertainty issue, relying upon Section 4(2) raises other problems. Regulation D focuses on actual purchases and purchasers; Section 4(2) requires also looking at offers and offerees, even if they do not end up purchasing in the financing. One illegal offer or one unqualified offeree may blow the exemption for the whole deal. Similarly, the company must count not just purchasers but also offerees when it is proving to a court that the offering is not so broad that it constitutes a "public" offering. Regulation D also does not require that any particular information be provide to purchasers, so long as they are all accredited investors. For Section 4(2), on the other hand, courts have stated that every purchaser and offeree must be provided with information equivalent to that contained in an IPO prospectus. Thus, proving to a court that sufficient disclosure has been provided under a financing covered by Section 4(2) may be substantially harder than under a Regulation D financing.

The consequences of issuing stock without a valid exemption under the securities laws are substantial. Putting aside possible fines and other penalties for the individuals involved, the principal penalty for the company is rescission of the stock sale, thus enabling a disgruntled investor – and all other investors — to get his money back. Obviously, this can be a serious blow to a struggling company trying to hold things together in tough times. Even if the company no longer exists, the disgruntled investor may be able to recover the investment from the officers and directors involved. Moreover, the possibility that a legal rescission right may exist in favor of a company's stockholders could necessitate disclosure and/or reserves in the company's financial statements.

Thus, the decision not to file a Form D in many cases is not one to be taken lightly. Companies and VC firms that confront this situation need to evaluate whether the benefits of stealth outweigh the potential legal consequences that may result.

Anti-Dilution Protection: What You Need to Know

By Mark Baudler, Partner (Palo Alto Office)

In the context of a venture financing, anti-dilution protection refers to protection from dilution when shares of stock are sold at a price per share less than the price paid by earlier investors. This is known as price-based anti-dilution protection.

Preferred stock is normally convertible at the option of the holder at any time into common stock, and typically is automatically converted upon the occurrence of a qualified initial public offering or upon the vote of a specified percentage of the preferred stock (or a series of preferred stock). The initial conversion ratio on issuance of the preferred stock is almost always 1:1, that is, one share of common stock for each converted share of preferred stock. Price-based anti-dilution adjustments involve increasing the number of shares of common stock into which each share of preferred stock is convertible. The primary difference between the various anti-dilution formulas described below is the magnitude of the adjustment under different circumstances.

An anti-dilution adjustment will affect the voting rights of the company's stockholders because the preferred stockholder is almost always entitled to vote on an as-converted to common-stock basis.

"Weighted Average" Anti-Dilution Protection. The most common anti-dilution protection in venture capital preferred stock financings is called "weighted average" anti-dilution protection. This formula adjusts the rate at which preferred stock converts into common stock based upon (i) the amount of money previously raised by the company and the price per share at which it was raised and (ii) the amount of money being raised by the company in the subsequent dilutive financing and the price per share at which such new money is being raised.

This weighted average price is then divided into the original purchase price in order to determine the number of shares of common stock into which each share of preferred stock is then convertible. Thus, the reduced conversion price for the preferred stock resulting from a dilutive financing will result in an increased conversion rate for the preferred stock when converting to common stock.

If new stock is issued at a price per share lower than the conversion price then in effect for a particular series of preferred stock, the conversion price of such series will be reduced to a price determined by multiplying the conversion price by the following fraction:

$$\frac{\text{[Common Outstanding pre-deal] + [Common issuable for amount raised at old conversion price]}}{\text{[Common Outstanding pre-deal] + [Common issued in deal]}}$$

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Anti-Dilution Protection *(continued from page 7)*

There are two primary variations of the weighted average formula depending on what constitutes "Common Outstanding" in the above formula—"broad-based weighted average" and "narrow-based weighted average."

The calculation of "Common Outstanding" in the broad-based formula is defined to include all shares of common stock and preferred stock (on an as-converted-to-common basis) outstanding, common issuable upon exercise of outstanding options (and, potentially, common reserved for future issuance under the company's stock plans) and any other outstanding securities, such as warrants and convertible notes. Broad-based weighted average anti-dilution is the most common form of anti-dilution protection for venture capital preferred stock financings.

What makes a price-based anti-dilution provision broad-based versus narrow-based is the definition of "common outstanding" in the formula above. A narrow-based provision, in contrast to the broad-based formula, will include only currently outstanding securities, or a subset of the outstanding securities (such as just the then outstanding preferred stock).

The effect of reducing the shares included in the narrow-based formula increases the magnitude of the anti-dilution adjustment given to holders of preferred stock as compared to the broad-based formula. Consequently, the narrower-based formula provides a greater number of additional shares of common stock to be issued to the holders of preferred stock upon conversion than the broad-based formula. The extent of the difference depends upon the size and relative pricing of the dilutive financing as well as the number of shares of preferred stock and common stock outstanding.

Full Ratchet Anti-Dilution Protection. Full-ratchet anti-dilution protection is conceptually much simpler than the weighted average approach, and its effect on the company is considerably more severe in the event of a dilutive financing. Under the full ratchet formula, the conversion price of the preferred stock outstanding prior to such financing is reduced (i.e., "ratchets down") to a price equal to the price per share paid in the dilutive financing.

For example, if the outstanding preferred stock was previously sold at a price of $2.00 per share, and the new preferred stock in the dilutive financing is sold at a price of $0.50 per share, the effective conversion price of the previously outstanding preferred stock would be reduced to $0.50 per share with the result that each share of such preferred stock previously convertible into one share of common stock would now be convertible into four shares of common stock (i.e., $2.00 ÷ $0.50).

Under a full-ratchet formula, this same result is obtained whether the company raises $10,000 at a price of $0.50 per share or $10,000,000 at a price of $0.50 per share. In contrast, the amount of money raised in the dilutive financing is an important factor in determining the new conversion price in the weighted average formula.

In part because of the severe dilutive effects of full-ratchet anti-dilution protection, this type of provision is relatively uncommon, absent unusual circumstances. These unusual circumstances can include financings that re-capitalize the company. In addition, it is not unusual for the ratchet-based anti-dilution provision to expire after a certain time (e.g., six months after the initial closing of a financing) and for the preferred stock with the ratchet-based anti-dilution protection to thereafter have a weighted average anti-dilution protection.

Share issuances that are carved out from price-based anti-dilution protection

A company will want to ensure that certain types of stock issuances (e.g., share issuances not related to private equity financing transactions) do not trigger anti-dilution protection.

Carve-outs to anti-dilution protection are subject to negotiations between the company and investors and may include: (i) shares issued upon conversion of the preferred stock; (ii) shares or options, warrants or other rights issued to employees, consultants or directors in accordance with plans, agreements or similar; (iii) shares issued upon exercise of options, warrants or convertible securities existing on the closing of the financing; (iv) shares issued as a dividend or distribution on preferred stock or for which adjustment is otherwise made pursuant to the certificate of incorporation (e.g., stock splits); (v) shares issued in connection with a public offering; (vi) shares issued or issuable pursuant to an acquisition of another corporation or a joint venture agreement approved by the board; (vii) shares issued or issuable to banks, equipment lessors or other financial institutions pursuant to debt financing or commercial transactions approved by the board; (viii) shares issued or issuable in connection with any settlement approved by the board; (ix) shares issued or issuable in connection with sponsored research, collaboration, technology license, development, OEM, marketing or other similar arrangements or strategic partnerships approved by the board; (x) shares issued to suppliers of goods or services in connection with the provision of goods or services pursuant to transactions approved by the board; or (xi) shares that are otherwise excluded by consent of holders of a specified percentage of the preferred stock. The company and the investors will negotiate the scope of the carve-outs and potentially the number of shares in any given carve-out. In order for some of the carve-outs to apply, the investors may require that the issuance of stock be unanimously approved by the board or approved by the directors designated by the preferred stock.

Additional considerations

Deals Without Price-Based Anti-Dilution Protection. Occasionally (although rarely), price-based anti-dilution protection may be absent in a venture capital preferred stock financing, most likely in the first institutional round of financing. This is usually as a result of early-stage

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Anti-Dilution Protection

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investors seeking to avoid the precedent of price-based anti-dilution protection that is likely to be replicated in later rounds of financings. In many cases anti-dilution provisions potentially can hurt early-round investors more than later round investors. For example, if the Series A preferred stock price is $1.00, the Series B preferred stock price is $2.00, and the Series C preferred stock price is $1.50, then the Series B preferred stock's anti-dilution protection comes at the expense of the Series A (as well as the common stock).

Milestone-Based Anti-Dilution Protection. Occasionally, venture capital preferred stock financings include provisions that tie anti-dilution calculations to agreed-upon milestones (e.g., revenue, product development or other operational targets). Under this type of anti-dilution protection, there is a conversion price adjustment in the event that the company does not meet the specified milestones. Usually this type of anti-dilution protection is negotiated as an attempt to bridge valuation differences between the company and its venture capital investors.

Other non-priced based anti-dilution concepts

Structural Anti-Dilution Protection. Structural anti-dilution protection is an adjustment of the conversion price of the preferred stock into common stock upon the occurrence of any forward or reverse splits of common stock, stock dividends and other distributions, reorganizations, reclassifications or similar events affecting the common stock. These provisions are always part of venture capital preferred stock financings.

Absolute Anti-Dilution Protection. Occasionally, absolute anti-dilution protection is requested by investors (or executives) against any dilution arising as a result of the subsequent sale of stock. This form of protection guarantees a specified level of ownership of the company. However, these provisions are generally rare and almost always problematic and may impair the company's ability to raise financing.

Conclusion

Price-based anti-dilution protection is commonly part of venture capital preferred stock financings. The anti-dilution rights are one of the features that distinguish preferred stock from common stock rights. Although broad-based weighted average anti-dilution provisions are by far the most common form of anti-dilution protection for venture capital preferred stock financings, the specific terms of the anti-dilution provisions (including the type of price-based anti-dilution protection and the scope of the carve-outs) are subject to negotiation between the company and the investors and often depend on the facts and circumstances of the financing.

Vesting of Founders' Stock: Beyond the Basics

By Doug Collom, Partner (Palo Alto Office)

One of the most fundamental elements in the issuance of founders' stock in a startup company is vesting. Vesting is virtually universal as a convention, and is highly effective as a retention tool in connection with the grant of stock to founders and employees. Because common stock is a vital component of the compensation package for managers and employees, vesting is also the means by which the company conserves its equity for purposes of hiring new employees and retaining continuing employees.

In a normal vesting arrangement, shares issued to an employee are subject to a repurchase right in favor of the company that typically lapses in a linear manner over a period of time, subject to the continued service of the employee. If the employee's relationship with the company terminates for any reason, shares that have not vested may be repurchased by the company at their original purchase price. Thus, using a typical example, a founder may receive 1,000,000 shares of common stock in a startup company, priced at $0.001 per share. Under the contractual stock purchase terms, these shares are subject to monthly vesting in equal amounts over a period of 48 months. In this example, if the founder's employment relationship with the company is terminated at the end of three years (i.e., 36 months, or 3/4ths of the vesting period), the company as a matter of contract would have the right to repurchase from the terminated founder a total of 250,000 shares, representing the unvested portion of the total grant, by paying the sum of $250—even though the stock at that point in time may in fact be worth considerably more.

So much for the basics. What are some of the more important elements of vesting that a founder might need to understand in establishing the organizational structure of the company at its inception?

The Vesting Period. The predominant time period used by startup companies in establishing a vesting program, for founder- and non-founder employees alike, is four years. Although some venture firms require a five-year period for founders and employees of their portfolio companies, this is unusual and the convention in Silicon Valley and other technology-intensive areas continues to be the four-year vesting period. The vesting time period is highly relevant to the employee, since only vested shares end up in the employee's hands following a termination of employment. It is equally relevant to the company's venture investors—when shares have vested in the hands of founders or employees in

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Vesting of Founders' Stock: Beyond the Basics

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accordance with the vesting period, this usually signals the need to provide a round of replenishment stock grants with new vesting schedules, which may dilute the ownership interest of the venture investors in the company.

Credit for Vesting. It is almost invariably the case that when a founder has successfully attracted the attention of a venture investor, a discussion ensues about the vesting of the founder's stock. Even in the instance where there is no disagreement on vesting philosophy, the founder may focus on how much "credit" the founder should receive in a time-based vesting arrangement for the time spent by the founder prior to the investor's investment, or for the founder's contribution to the startup in the form of technology, customer relationships, expertise, and the like. Some investors take the view that no credit should be given—the time-based vesting clock begins only at the time of the investment, thus subjecting the founder to a full four-year service requirement (in the case of a four-year vesting arrangement). Other investors will acknowledge the time and/or value already contributed by the founder, and offer "credit" for vesting, usually in a range of somewhere between 25 and 50% of the founder's stock (i.e., the founder may immediately take claim to the "credited" portion of the stock as fully vested, and the remainder of the stock will be unvested and subject to the agreed upon vesting arrangement). This question of vesting "credit" is a matter of negotiation between the founder and the investor at the time of the investment.

Time-Based or Performance-Based? Most vesting arrangements for early stage startup companies are based on vesting periods oriented around the passage of time. This structure is simple to administer by the company, and is readily understood by employees. Implicit in the time-based vesting arrangement is the understanding that if the founder's or employee's relationship with the company should terminate for any reason (e.g., death, disability, poor performance, etc.), the vesting of the stock immediately stops.

With the advent of Financial Accounting Standard 123R in January 2006, the accounting penalties that companies used to face in granting stock with performance-based vesting have largely disappeared. As a result, many public corporations and some private companies use stock grants that vest, subject to the continued service of the employee, upon the achievement of identified performance milestones (e.g., first commercial release of a product, achievement of a specified revenue level, etc.). In the private company sector, the use of performance-based vesting arrangements requires careful planning. In large part this seems to be due to the highly changeable nature of the startup company business plan—a performance milestone that may make sense in June 2008 may be completely irrelevant six months later, or the likely timeframe in which the milestone was supposed to occur has changed, or the priority assigned to achieving the milestone has changed in the face of overtaking business objectives. Any of these circumstances would frustrate the purpose of the performance-based arrangement. In addition, the use of performance-based vesting arrangements may have unfavorable tax consequences to the employee, particularly in the circumstance where the stock price continues to increase over the vesting period. As a result, performance-based vesting arrangements are not commonly used in private early stage companies.

No-Fault Vesting. The conventional time-based vesting arrangement is typically set up as a "no-fault" arrangement; that is, vesting of the employee's stock stops immediately upon the termination of the employment relationship, without regard to the circumstances of the termination.

Many founders at least ask to themselves the question upon the issuance of founders' stock in connection with the formation of the company—why should this be the case? After all, the founder may have spent long evenings and weekends over the last several years refining the scope and vision of the business plan, developing the technology, personally bootstrapping the outlay of capital costs, establishing the customer and support contacts—effectively putting together all the mission-critical elements of a promising startup company. Why should the founder accept a no-fault vesting arrangement that potentially could strip the founder of unvested stock if for any reason the investors on the board of directors decide that the founder is no longer useful to the company?

Founders who take this view might seek protection in their employment arrangements with the company. Even in the "at will" employment relationships that are the convention for startup companies with all founders and employees, the founder may seek severance payment, acceleration of vesting or other separation benefits in the instance where the founder is terminated without cause, or voluntarily resigns for "good reason" (which might include a reduction in title or responsibilities or compensation, or relocation to a different office, etc.).

However, before broaching this matter with the venture investor, it is important for the founder to understand the investor's perspective. No-fault vesting, combined with the usual "at will" employment agreement, is fundamental to what the investor sees as a level playing field. The investor is putting up equity financing and has no guarantees that the business plan will succeed or that the founders will be up to the task of executing the plan. If a founder or the company underperforms, or if the investor and the founder fail to agree on the fundamental growth path of the company, the investor cannot withdraw the investment. Therefore,

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the investor has no recourse but to come up with a solution to set the company back on track—usually hiring a new manager or managers to carry on. The investor believes that providing the founder with protective separation arrangements that require accelerated vesting in circumstances where things don't work out unfairly tilts the playing field in favor of the founder. And this protective arrangement is at the expense of not just the investor but the company as a whole—stock that, but for the accelerated vesting, would otherwise be unvested and repurchased by the company for use in hiring a replacement manager, is now held irrecoverably by the terminated founder and has no further incentive value to new or continuing employees of the company.

The question as to whether a founder should be entitled to something more than the usual no-fault vesting arrangement is usually addressed, if at all, in the term sheet investment conditions that are offered by the interested venture investor. In most instances, founders understand that investors are planning for success when they make an investment and are betting on the founders as much as they are betting on the business plan. As a result, the no-fault vesting arrangement continues as an industry convention for founders and employees alike in venture-backed startup companies.

As commonplace as vesting arrangements are, it is nevertheless important for founders to understand vesting conventions and the competing philosophies behind them. The implementation of vesting arrangements in many ways goes directly to the nature of the personal relationships and chemistry that build between founders and venture investors. These arrangements also directly impact the wealth objectives of founders, the hiring and retention objectives of the company, and the dilution concerns of venture investors. As a result, founders need to approach vesting arrangements thoughtfully with all of these considerations in mind.

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.

For more information about our Entrepreneurs College and other programs, please contact Tni Newhoff (tnewhoff@wsgr.com).

Remaining Spring 2008 Sessions

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***
Michael O'Donnell*, Presenter*
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.

The Life Sciences Report

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

- Relationships between Medical Device Companies and Physicians Subject to Increased Government Scrutiny
- Laws of Nature and the Business of Biotechnology
- The Role of Equity in Corporate Partner Transactions

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

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.

Please contact Danielle Gowdy for more information (dgowdy@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.

Please contact Nancy Farestveit for more information (nfarestveit@wsgr.com).

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