2006 Venture Capital Report

WilmerHale

WILMER CUTLER PICKERING HALE AND DORR LLP ®

Table of Contents

2006 Review

2006 witnessed a continuation of two gradual but sustained trends that have characterized the venture capital market over the past several years: an increase in venture capital financing activity and an improvement in the markets for liquidity events.

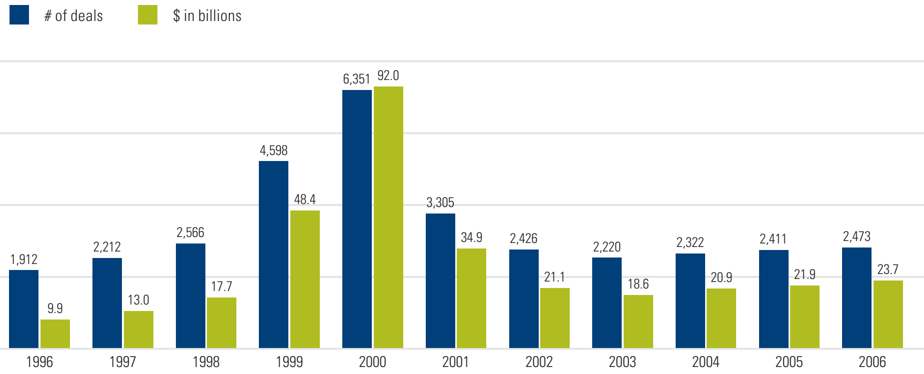
The number of reported venture capital financings increased modestly, from 2,411 in 2005 to 2,473 in 2006, while total proceeds climbed 8% to $23.7 billion in 2006 from $21.9 billion in 2005. Once all 2006 transactions have been reported, we expect that the improvement in 2006 will be even more evident. While 2006 marks the third straight year of increases in both the number of financings and the amount invested, the figures remain significantly lower than the corresponding amounts during the 1999–2001 Internet bubble.

The median size of venture capital financings in 2006 was $7.0 million, representing an increase from $6.5 million in 2005, and tying—with 2004—as the highest figure of any year other than 2000. The median financing size for life sciences companies ($7.9 million) was once again higher than for information technology companies ($7.0 million).

Valuations of venture-backed companies increased fairly dramatically from 2005 to 2006. The median pre-money valuation was $19.0 million in 2006, compared to $14.5 million in 2005—higher than any year other than 1999 and 2000. Pre-money valuations were up significantly for both life sciences companies (from $16.7 million in 2005 to $21.0 million in 2006) and IT companies (from $14.5 million in 2005 to $20.5 million in 2006). While life sciences company valuations in 2006 were once again higher than IT company valuations, 2006 marked the first year since 2001 that this gap was less than $2 million.

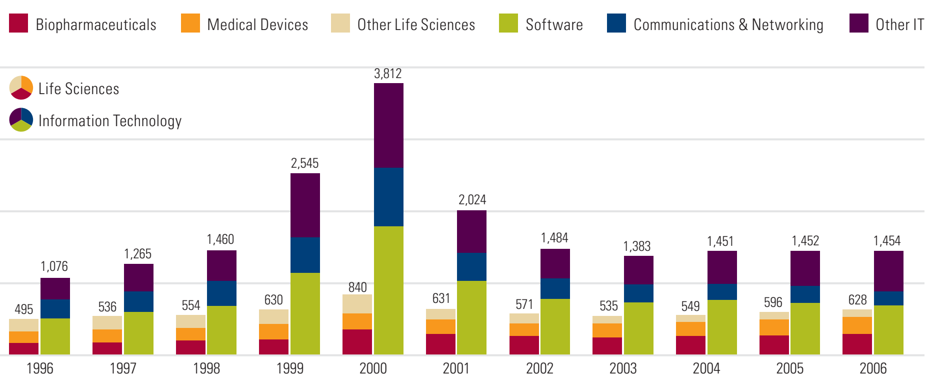
Seed and first-round venture capital financings represented 37% of the number of venture financings and 21% of the amount of venture money invested in 2006. These percentages have changed little over the past several years, as seed and first-round financings have constituted between 31% and 37% of the number of venture financings each year since 2001. The proportion of new investing activity during the last six years is significantly lower than not only the 1999–2000 level (54%) but also the 1996–1998 level (49%). This can be explained by more rigorous investment criteria following the burst of the Internet bubble and a longer average time from initial funding to a liquidity event, which increases the relative amount of money needed for investment in later-stage companies.

US Venture Capital Financings – 1996 to 2006



Source: Dow Jones VentureOne/Ernst & Young

US Venture Capital Financings by Industry – 1996 to 2006



Source: Dow Jones VentureOne/Ernst & Young

There was little change in 2006 in the breakdown of venture capital financings by industry sector. IT companies represented 59% of all venture capital financings in 2006, and life sciences companies accounted for 25%. IT company financings have represented between 54% and 63% of venture capital financings each year since 1996. Life sciences financings have represented between 22% and 26% of venture capital financings each year since 1996, other than during the 1999–2001 Internet bubble, when this figure dipped below 20%. The amount invested in life sciences companies as a percentage of total venture investments in 2006 (32%) was once again higher than the percentage of life sciences financings, due to the greater capital needs of life sciences companies.

The geographic breakdown for venture capital investing changed little in 2006, consistent with the last decade. California-based companies accounted for 44% of all venture financings in 2006, and have led the country in this regard each year since 1996 (the first year for which this data is available). Massachusetts, which has finished number two in this category each year since 1996, was home to 11% of the companies receiving venture capital investments in 2006. New York (6%), Texas (5%) and Pennsylvania (4%) held down the third, fourth and fifth positions.

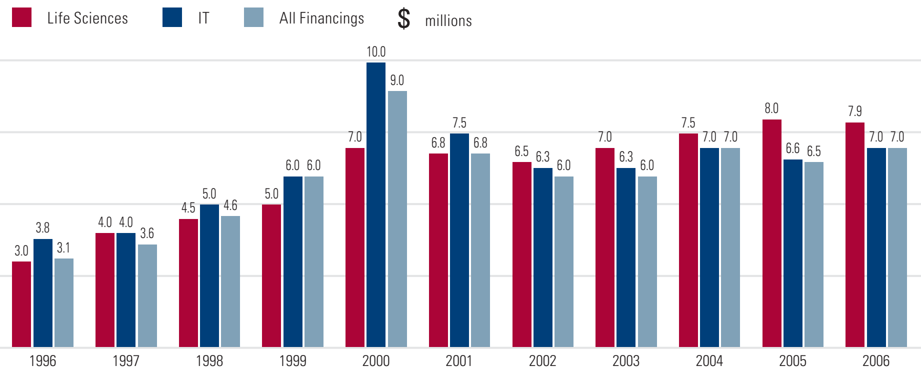
The IPO market for venture-backed companies was stronger in 2006 than it was in 2005. There were 56 IPOs by venture-backed companies in 2006, up from 42 in 2005 but down from 67 in 2004. The number of venture-backed IPOs in the last several years is significantly higher than the average number during 2001–2003 (22), but pales in comparison both to the average number during 1999–2000 (226) and 1996–1998 (135).

The increase in 2006 venture-backed IPOs was fueled by both IT companies and life sciences companies. IT companies accounted for 20 of the venture-backed IPOs in 2006 compared to 13 in 2005, while venture-backed life sciences companies accounted for 28 IPOs in 2006 and 21 in 2005.

The largest venture-backed IPO in 2006 was Vonage's $531.3 million offering—more than four times the size of the largest venture-backed IPO in 2005. Seven other venture-backed companies raised at least $100 million in their 2006 IPOs: CommVault ($161.1 million), DivX ($119.4 million), Isilon Systems ($108.6 million), Northstar Neuroscience ($106.5 million), Altus Pharmaceuticals ($105.0 million), IPG Photonics ($103.0 million) and ORBCOMM ($101.5 million).

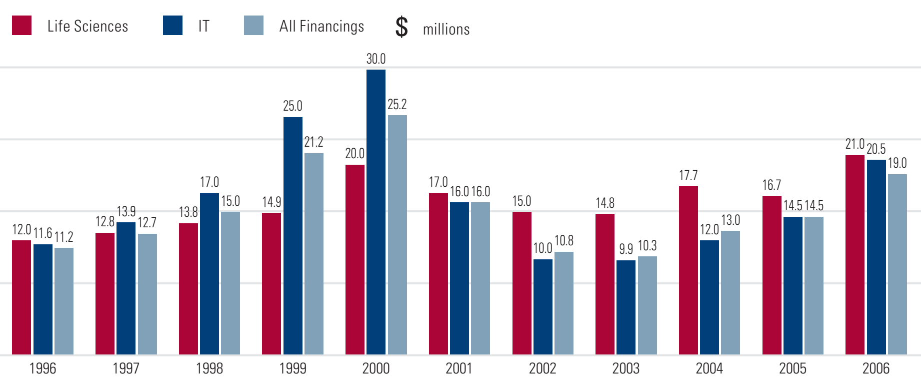
The median pre-IPO valuation of venture-backed IPO companies in 2006 was $202 million. This represents

Median Size of US Venture Capital Financings – 1996 to 2006



Source: Dow Jones VentureOne

Median Pre-Money Valuation in US Venture Capital Financings – 1996 to 2006



Source: Dow Jones VentureOne

a significant increase from 2005 ($166 million), but is below the valuations in the 2001–2004 period, when the "IPO bar" was raised so high that only the most successful companies were going public. Looking further back, the 2006 valuations are well below the lofty figures of 1999–2000, but greatly exceed the valuations in the 1996–1998 time period.

A comparison of the pre-IPO valuations to the median amount raised prior to IPO by venture-backed companies going public demonstrates that returns remain significantly lower than those achieved from 1997 through 2002. In 2006, the ratio of median pre-IPO valuation to median amount raised prior to IPO was 4.0 to 1. This ratio has remained between 3.0 to 1 and 4.0 to 1 for each year since 2003. In contrast, this ratio was 4.7 to 1 in 2002, 5.9 to 1 in 2001 and averaged 8.4 to 1 from 1997 through 2000. This starkly illustrates that not only have the number of IPO exits been significantly lower in the last several years than during the latter half of the 1990s, but also that those venture-backed companies that are going public—despite a recent increase in valuations—are producing considerably smaller returns on the venture capital money invested in them.

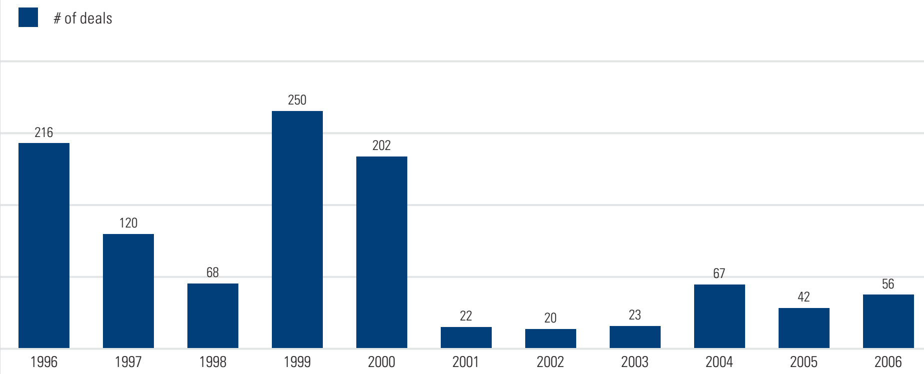
The M&A market for venture-backed companies also improved in 2006 compared to 2005. The number of reported acquisitions of venture-backed companies was 404 in 2006, essentially the same as the 407 reported in 2005 (although the data will show an increase in 2006 deals once all transactions are reported). Perhaps more significantly, the median acquisition price for venture-backed companies increased to $52 million in 2006. This represents the fourth consecutive annual increase in the median acquisition price for venture-backed companies, and is roughly two and one-half times the median acquisition price in 2002 ($19 million). The 2006 figure, however, falls considerably short of the $100.2 million median acquisition price in 2000.

The median acquisition price for venture-backed companies in 2006 got a boost from the increase in the number of very large sales. In 2006, a total of 23 venture-backed companies were acquired for at least $250 million, compared to 15 in the prior year. The largest deal of the year (Google's acquisition of YouTube for $1.65 billion) more than tripled the size of the largest deal of 2005 (Pfizer's acquisition of Angiosyn for $527 million).

The ratio of median acquisition price to median amount raised prior to acquisition portrays trends in the M&A market similar to those in the IPO market. At 2.3, this figure was the same in 2006 and 2005. For each year between 2000 and 2004, the ratio was between 1.2 to 1 and 2.0 to 1, whereas from 1996 to 2000 it was never lower than 4.5 and was as high as 9.6 in 2000. These figures illustrate that while the M&A market for venture-backed companies has improved gradually but steadily over the last five years, it is still producing far less attractive returns for venture capital investors than it did in the 1996–2000 time period.

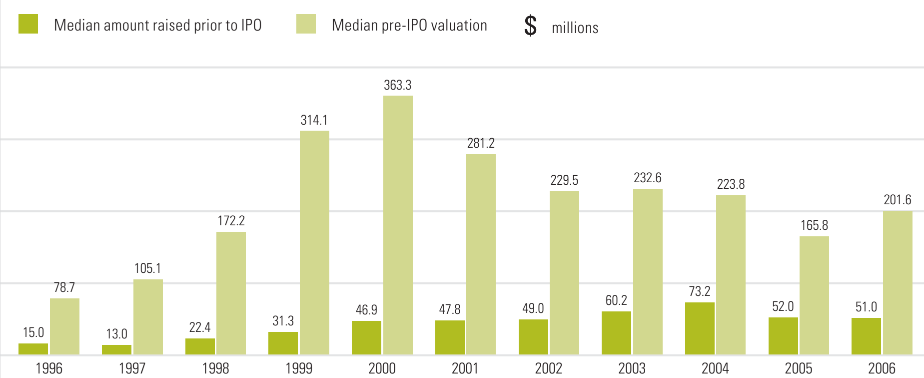
M&A transactions accounted for 88% of the liquidity events for venture-backed companies in 2006, with IPOs representing the other 12%. In every year since 2001, the ratio of M&A transactions to IPOs for venture-backed companies was at least 6.0 to 1. In contrast, over the five-year period from 1996–2001, the ratio of M&A transactions to IPOs for venture-backed companies was less than 2.0 to 1.

US Venture-Backed IPOs – 1996 to 2006



Source: Dow Jones VentureOne

Median Amount Raised Prior to IPO and Median Pre-IPO Valuation – 1996 to 2006



Source: Dow Jones VentureOne

2007 Outlook

In 2007, we expect to see greater levels of venture capital financing activity and a stronger market for liquidity events than in 2006, continuing the trends that have marked the last several years.

Specifically, we believe that the number of financings and the amount invested will increase in 2007, driven both by the abundant supply of venture money available for investment and the lure of improved exit valuations during the last several years. These same factors should also result in higher valuations in 2007, although we do not believe the rate of increase in recent years can be sustained.

Although it is difficult to assess annual trends in the amount of venture capital investment per company, we do not expect the amount invested per company to increase in 2007. On the one hand, the factors mentioned above that are leading to increased levels of investing activity should also contribute to an increased investment per company. On the other hand, it seems inevitable that the declining ratios of exit valuations to amount invested prior to exit will lead venture capital firms to limit the amount invested per company in order to achieve better returns on their investment.

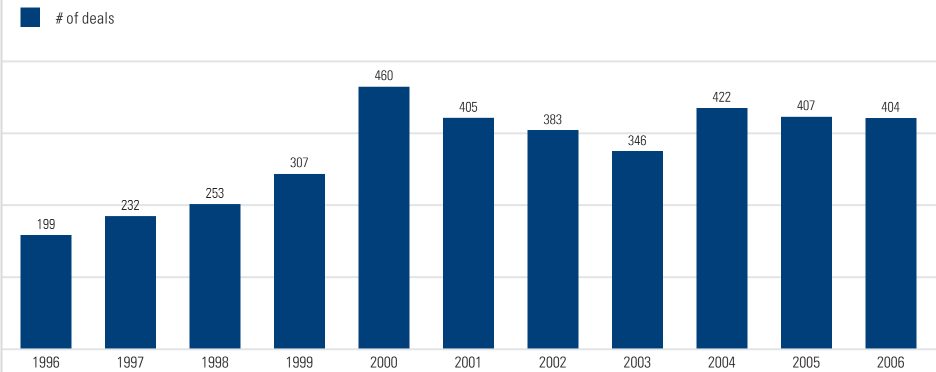
We expect to see a modest increase in the level of investments in IT companies as compared to life sciences companies in 2007, due to several factors. First, the exit markets for IT companies have generated more improvement in the last several years than the exit markets for life sciences companies. Second, any trend toward limiting the amount invested per company to help achieve better returns should result in some shift of investment dollars to IT companies, which typically require significantly less capital than life sciences companies. Third, we anticipate increased investments in companies developing "clean technology" and renewable sources of energy in 2007.

Globalization trends in venture investing should continue in 2007. Countries such as China and India, with enormous technology markets, have not historically been hotbeds of venture capital investment activity, but that is beginning to change as these markets become increasingly open to foreign investment. In addition, the vast amount of venture money available for investment and the competition for attractive deals is leading many venture capital firms to look for investments in other emerging markets, including Eastern Europe and other parts of Asia.

We expect to see another uptick in the number of venture-backed IPOs in 2007 for two reasons. First, the 2006 statistics indicate that the IPO market is becoming increasingly amenable to IT companies, which should lead to more IT company IPOs in 2007. Second, recent changes—including the SEC's decision in December 2006 to defer the time when newly public companies must first comply with the internal control management reports and independent audit rules, and the PCAOB's proposal of somewhat more lenient interpretive guidance for management and auditors on internal control audits—should make the regulatory environment for newly public companies less daunting. As early evidence of this anticipated trend, there were 26 venture-backed companies "in registration" with the SEC as of December 31, 2006, compared to 20 as of December 31, 2005, according to Dow Jones VentureOne.

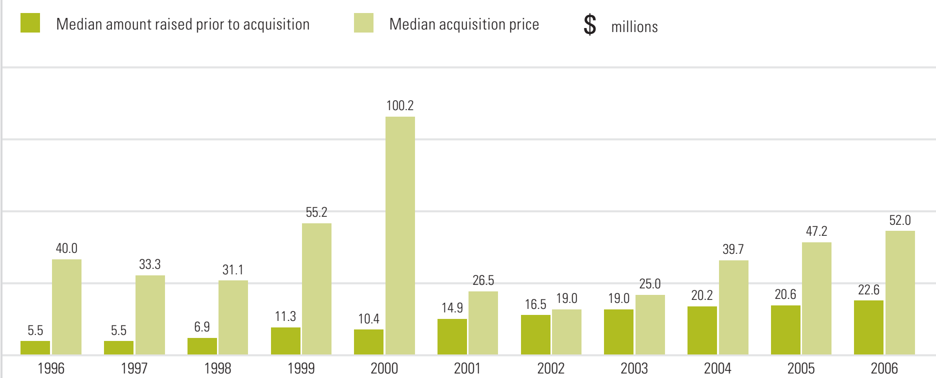
The M&A market should continue to be strong in 2007, and will undoubtedly continue to represent the significant majority of the exit events for venture-backed companies. There has been considerable speculation of late about buyout funds moving into the technology marketplace and helping to fuel a surge in both buyout activity and acquisition valuations for venture-backed companies. However, while buyout funds do appear to be increasingly interested in technology companies, most venture-backed companies are too small to elicit the interest of the typical buyout fund. Therefore, we believe the impact of buyout funds on the M&A market for venture-backed companies will not be significant in the near future. ■

Acquisitions of US Venture-Backed Companies – 1996 to 2006



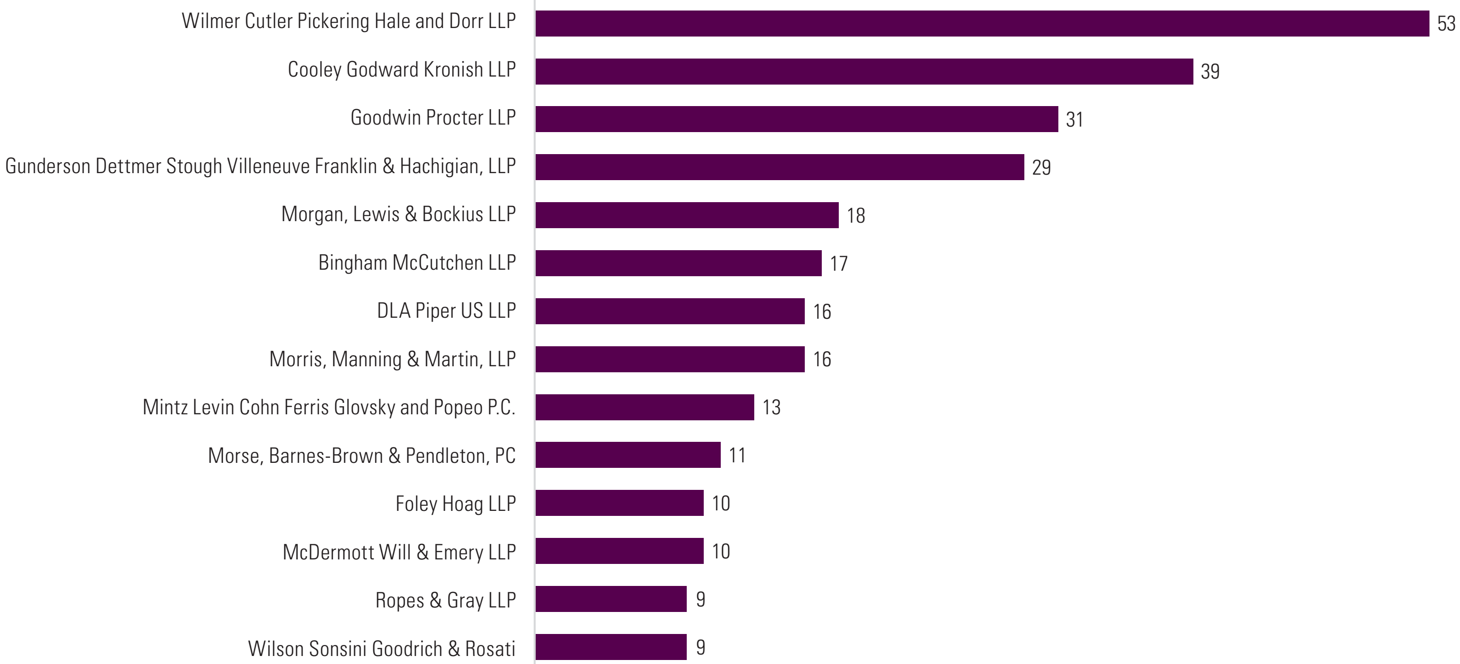
Source: Dow Jones VentureOne

Median Amount Raised Prior to Acquisition and Median Acquisition Price – 1996 to 2006



Source: Dow Jones VentureOne

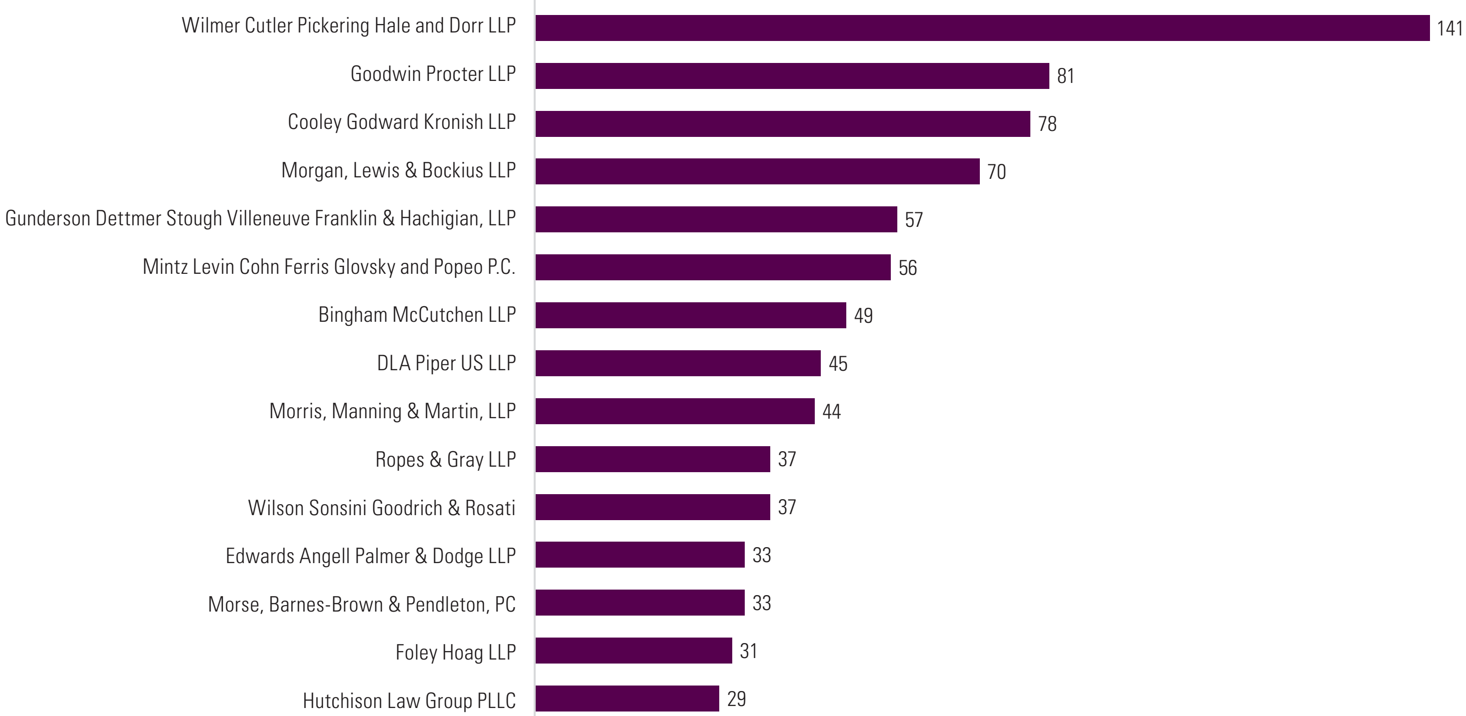
Counsel to Companies Receiving VC Financing in 2006 – Eastern US



The above chart is based on companies located east of the Mississippi River that completed a seed, first, second, later-stage or restart round of venture capital financing in 2006.

Source: Dow Jones VentureOne

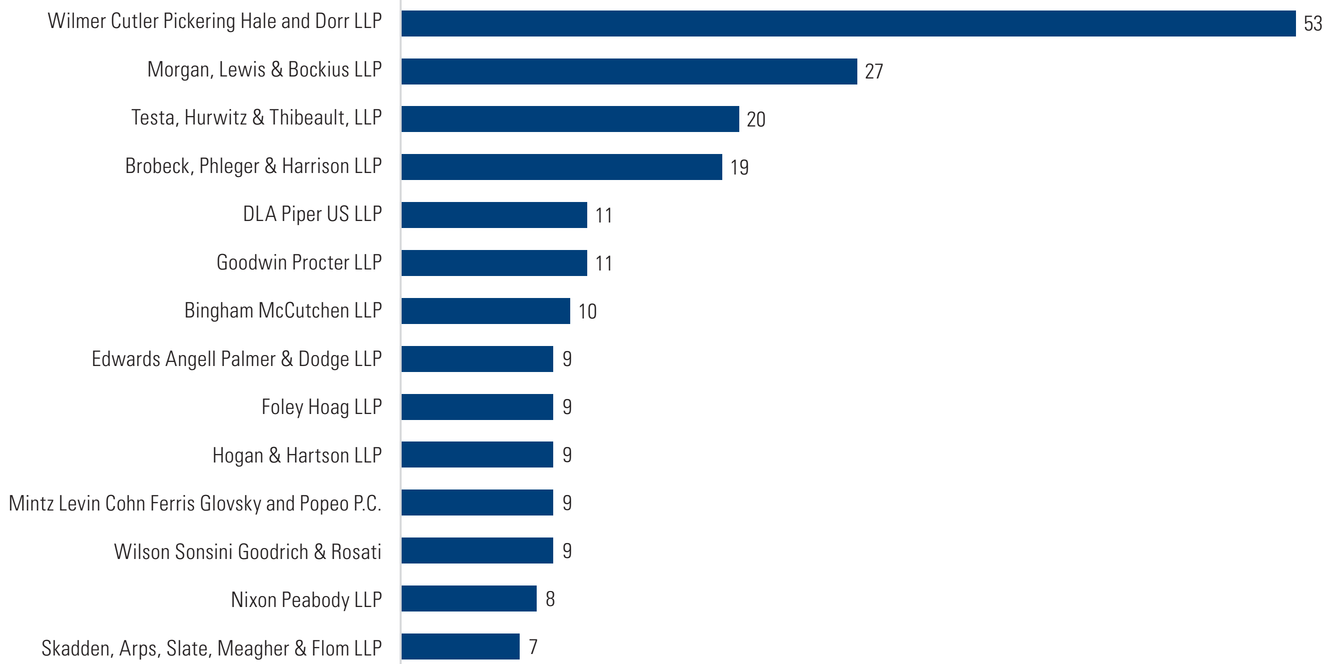
Counsel to VC-Backed Companies at Year-End 2006 – Eastern US



The above chart is based on VC-backed companies located east of the Mississippi River that were private and independent as of the end of 2006.

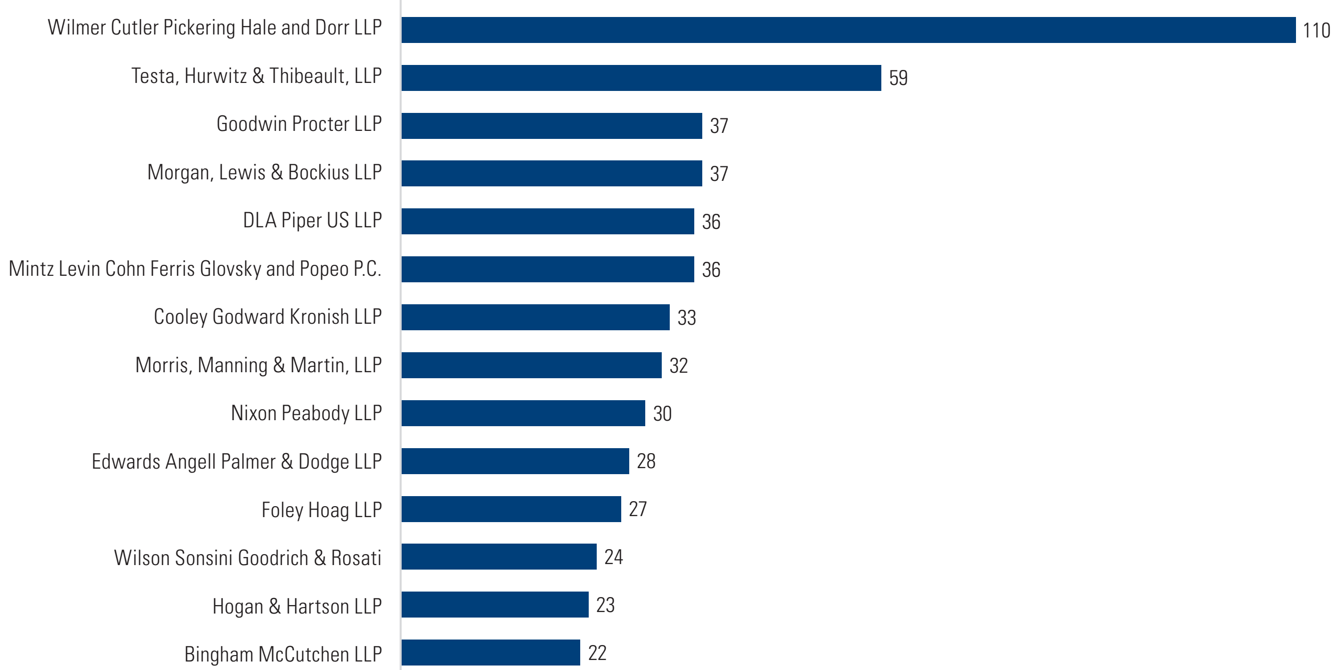
Source: Dow Jones VentureOne

Company Counsel in IPOs of Eastern US VC-Backed Companies – 1996 to 2006



The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureOne and SEC filings

Company Counsel in Sales of Eastern US VC-Backed Companies – 1996 to 2006



The above chart is based on VC-backed companies located east of the Mississippi River.
Source: Dow Jones VentureOne

California

California companies reported 1,084 financings in 2006—up slightly from 1,057 in 2005—while proceeds increased 10% from $10.30 billion to $11.28 billion. Final 2006 data—after all transactions have been reported—is likely to show further growth in both deal volume and proceeds.

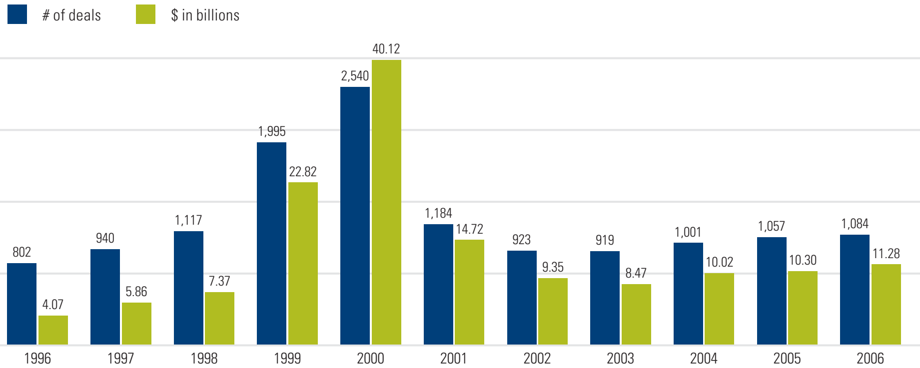
Roughly four times the size of the next largest venture capital market in the United States, California was responsible for 44% of all deals and 48% of all proceeds in the country in 2006. Although California's venture capital activity remains well below the peak year of 2000—when it produced a staggering 2,540 financings with $40.12 billion in proceeds—deal volume now exceeds pre-bubble levels by a modest amount while annual proceeds are substantially higher.

California's venture capital market spans all industry sectors, with particular strengths in technology, life sciences, consumer retail and media/entertainment. IT companies dominated the market again in 2006, accounting for 67% of all financings in the state, down slightly from 68% in 2005. Life sciences companies made up 20% of California's deals in 2006, compared to 21% the prior year.

California spawned 21 IPOs by venture-backed companies in 2006, up from 15 in 2005. The number of acquisitions of VC-backed companies increased from 138 in 2005 to 144 in 2006, and the state produced six of the 23 deals in the country over $250 million, including the largest sale of the year (YouTube's acquisition by Google for $1.65 billion).

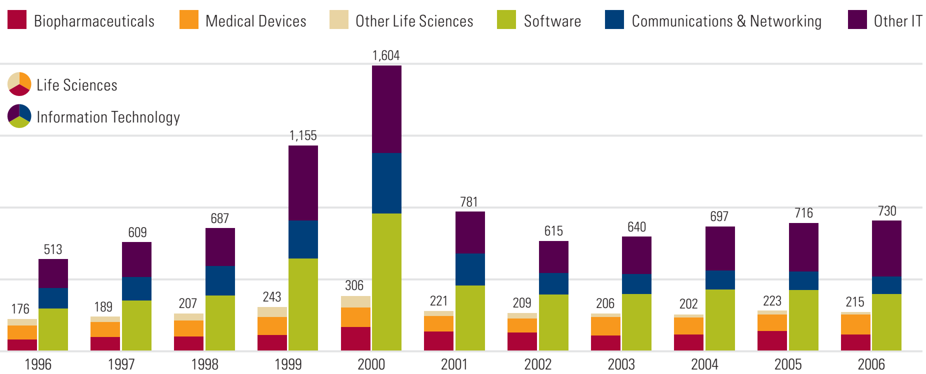
We expect California to maintain its venture capital leadership in 2007, especially in technology and life sciences. With California's heavy concentration of industry leaders, venture capitalists, scientific talent, entrepreneurs, service providers and other start-up infrastructure, conditions appear ripe for further growth. A significant part of that growth is likely to come from emerging sectors such as clean energy technology, wireless applications and services, and cross-border US/Asia deals.

California Venture Capital Financings – 1996 to 2006



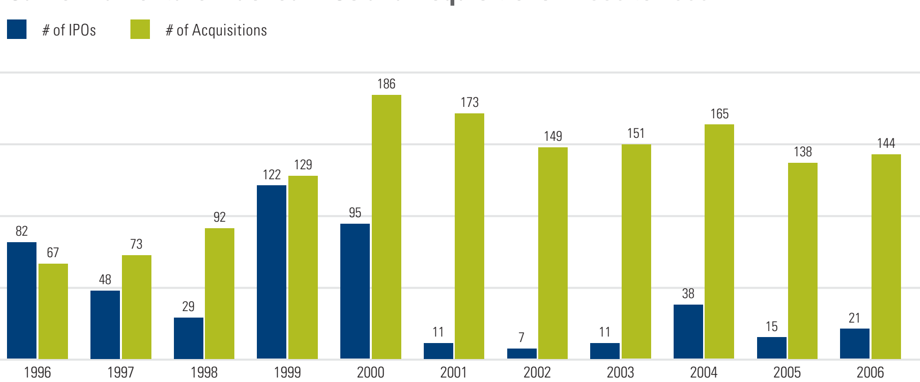
Source: Dow Jones VentureOne

California Venture Capital Financing by Industry – 1996 to 2006



Source: Dow Jones VentureOne

California Venture-Backed IPOs and Acquisitions – 1996 to 2006



Source: Dow Jones VentureOne

Mid-Atlantic

While the number of reported venture capital financings in the mid-Atlantic region of Virginia, Maryland, North Carolina, Delaware and the District of Columbia declined modestly, from 163 in 2005 to 154 in 2006, proceeds increased 17% from $1.35 billion to $1.58 billion. Once all 2006 transactions have been reported, we expect deal volume in the region will approach or exceed 2005's total.

With an average of 163 venture capital financings over the past five years, deal volume in the mid-Atlantic region now tops the levels seen in the pre-bubble years of 1996–1998 (an average of 149 deals per year), while average annual proceeds have increased even more (from $0.91 billion to $1.39 billion).

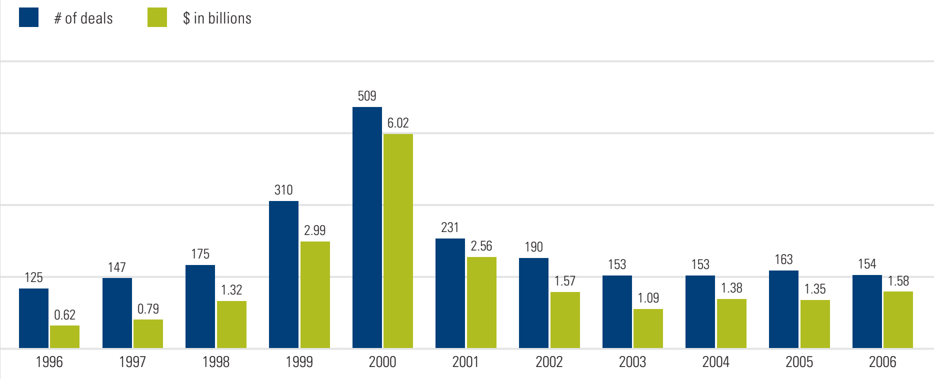
The percentage of all financings in the region completed by IT companies edged up from 56% in 2005 to 57% in 2006, while the portion attributable to life sciences companies increased from 31% to 34%—the largest percentage in at least a decade.

There were six IPOs by mid-Atlantic VC-backed companies in 2006—the largest number since 2000—compared to four in the prior year. Maryland led the region in IPOs in both years, with three in 2005 and four in 2006. Life sciences companies comprised five of the region's six IPOs, the largest of which came from Visicu ($96 million).

The number of acquisitions of venture-backed companies in the region fell from 32 to 26, with Virginia contributing 14 in 2005 and 15 in 2006, including the region's largest deal of the year (the $417 million sale of Mobile 365 to Sybase).

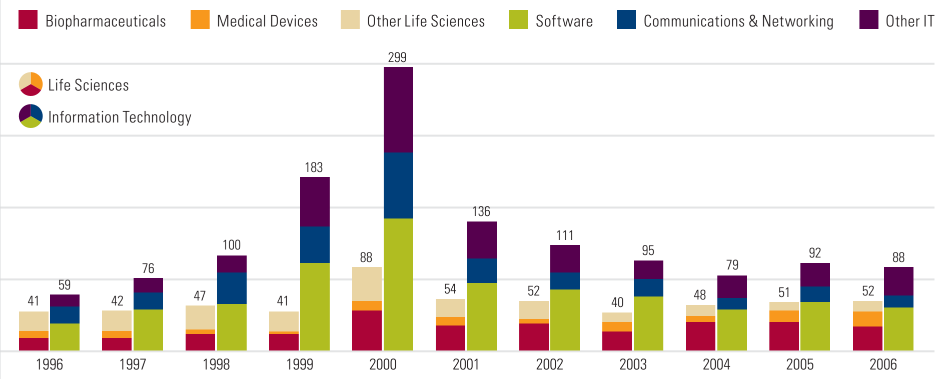
For 2007, we expect that the information technology, government-related IT services and defense industries will produce a steady stream of attractive emerging companies in the mid-Atlantic. We also anticipate that the region—particularly the Research Triangle area—will remain a leading center of life sciences–related investment.

Mid-Atlantic Venture Capital Financings – 1996 to 2006



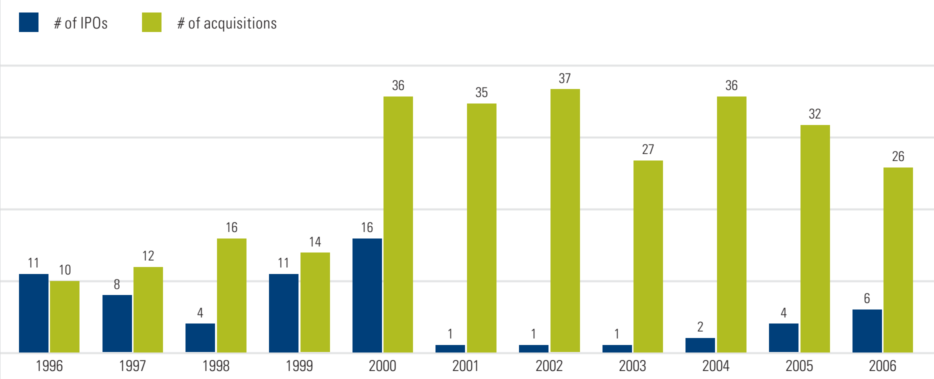
Source: Dow Jones VentureOne

Mid-Atlantic Venture Capital Financing by Industry – 1996 to 2006



Source: Dow Jones VentureOne

Mid-Atlantic Venture-Backed IPOs and Acquisitions – 1996 to 2006



Source: Dow Jones VentureOne

New England

New England companies reported 315 financings, with $3.09 billion in proceeds in 2006 compared to 319 deals and $3.02 billion in 2005. Once all 2006 transactions have been reported, we expect the number of 2006 deals to top the 2005 total and that financing proceeds will increase further.

While venture capital investment in the region remains well below the bubble years of 1999–2001, the average number of New England financings over the last five years (336 deals) closely parallels that of the 1996–1998 period (327 deals), and average annual proceeds have nearly doubled between these periods.

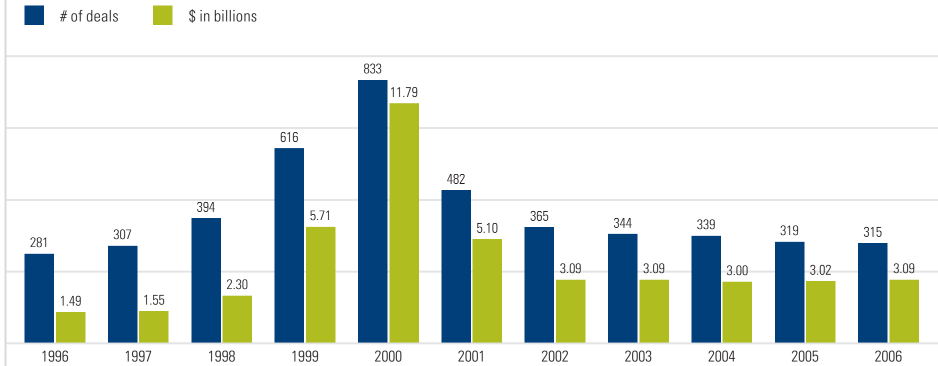
New England continues to be a leading center of activity for technology and life sciences companies, and is the only region to report increases in both IPOs and acquisitions of VC-backed companies in each of the past two years. In 2006, information technology companies accounted for 57% of the region's venture capital financings—down from 60% in 2005—while life sciences companies increased their market share from 27% to 30%.

The region produced nine venture-backed IPOs in 2006, compared to eight the year before—Massachusetts produced all the IPOs in 2005 and all but one in 2006. Six of the region's nine IPOs were by IT and life sciences companies.

Acquisitions of venture-backed companies in New England increased from 70 in 2005 to 73 in 2006—the largest annual figure in New England for at least a decade. The region also produced the largest cash acquisition of a private biotechnology company in history—the sale of GlycoFi to Merck for $400 million.

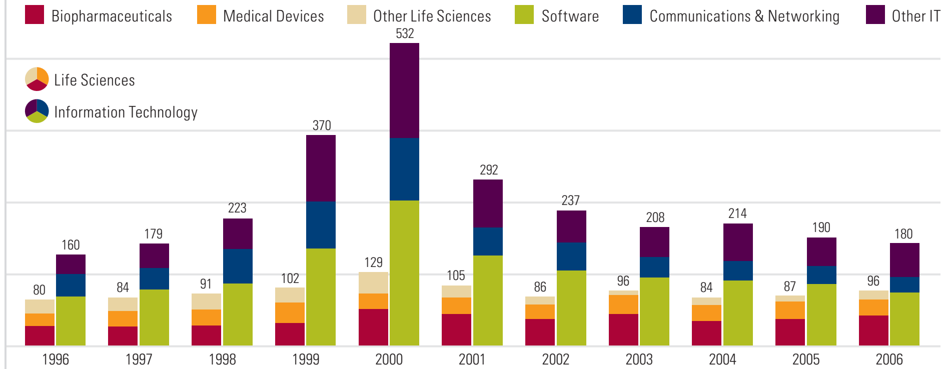
In 2007, we expect New England—and Massachusetts in particular—to remain one of the country's most appealing environments for emerging companies and a hub of venture capital activity.

New England Venture Capital Financings – 1996 to 2006



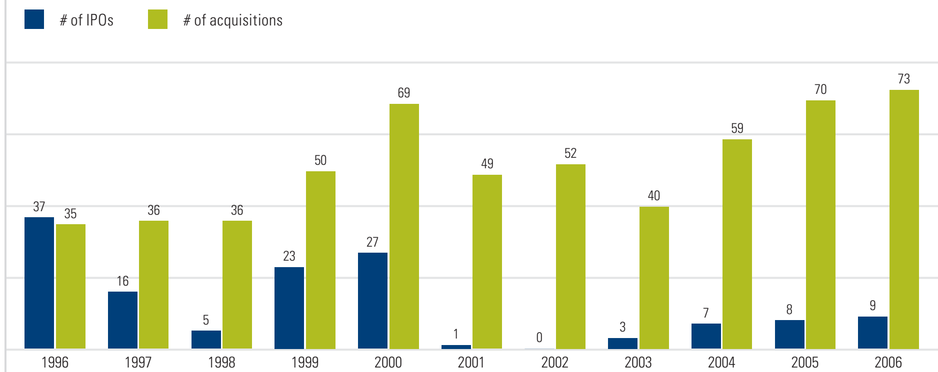
Source: Dow Jones VentureOne

New England Venture Capital Financing by Industry – 1996 to 2006



Source: Dow Jones VentureOne

New England Venture-Backed IPOs and Acquisitions – 1996 to 2006



Source: Dow Jones VentureOne

Tri-State

The number of reported venture capital financings in the tri-state region of New York, New Jersey and Pennsylvania surged 33%, from 227 in 2005 to 301 in 2006, and total proceeds climbed 14%, from $2.38 billion to $2.70 billion. We expect the region's gains will be even more pronounced once all 2006 transactions have been reported.

Venture capital activity in the region—averaging 214 deals with proceeds of $2.22 billion over the past five years—now significantly exceeds the pre-boom years of 1996–1998, which produced an annual average of 193 financings raising $1.27 billion. Year-over-year growth in 2006 was the greatest since the peak of the bubble, in 2000.

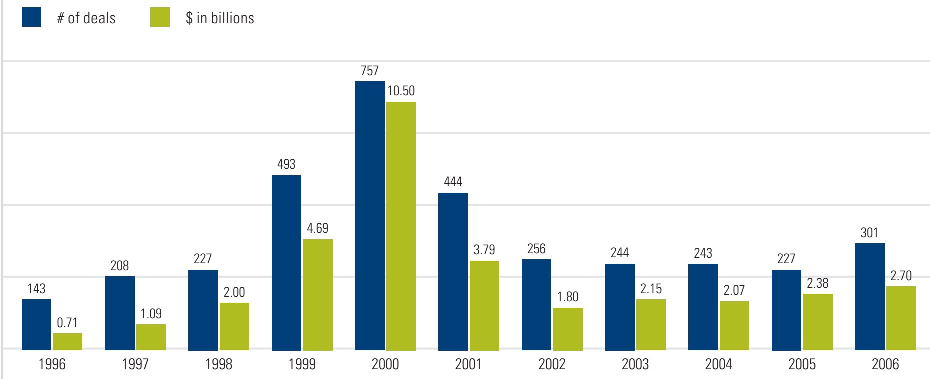
IT companies grabbed the largest share of the tri-state region's VC financing market, with 49% of all deals in 2006—up from 48% in 2005. Life sciences companies logged 30% of the region's financings, compared to 29% in the prior year.

The number of venture-backed IPOs in the region increased from five in 2005 to nine in 2006. New Jersey led the region with five IPOs in 2006, including the nation's largest VC-backed IPO of the year (Vonage's $531.3 million offering). After producing four of the region's five IPOs in 2005, New York generated only one IPO in 2006.

The number of acquisitions of venture-backed companies in the region decreased slightly from 51 in 2005 to 49 in 2006—still the second highest total in the past 10 years. The tri-state region accounted for three acquisitions of VC-backed companies for more than $250 million each—down from five in 2005, but exceeded only by California's six in 2006.

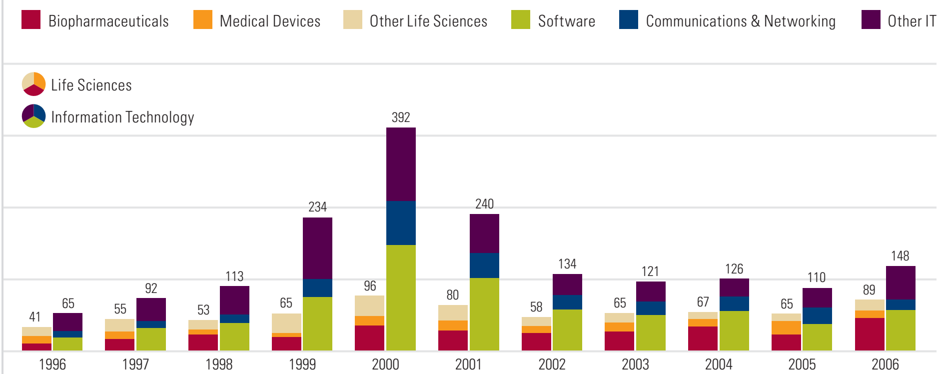
We believe that the tri-state region's strengths in the pharmaceuticals, life sciences, financial services and information technology sectors—combined with its large number of Fortune 500 companies—will provide a favorable environment for VC-backed start-up companies in 2007. ■

Tri-State Venture Capital Financings – 1996 to 2006



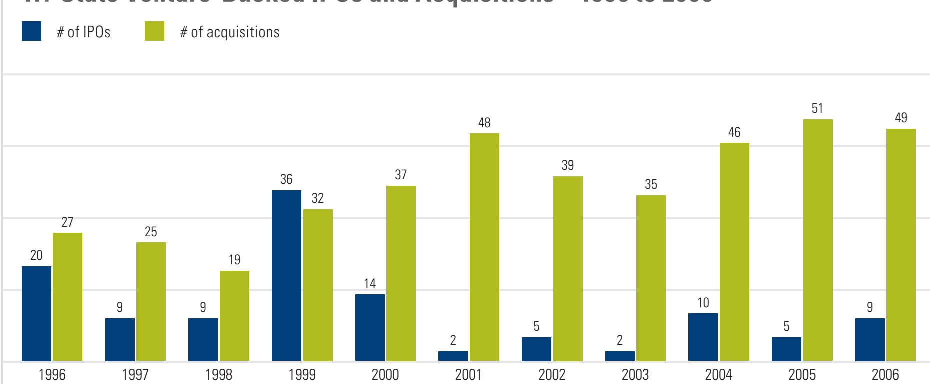
Source: Dow Jones VentureOne

Tri-State Venture Capital Financing by Industry – 1996 to 2006



Source: Dow Jones VentureOne

Tri-State Venture-Backed IPOs and Acquisitions – 1996 to 2006



Source: Dow Jones VentureOne

Counsel of Choice to Venture Capital–Backed Companies

SERVING INDUSTRY LEADERS IN TECHNOLOGY, LIFE SCIENCES, FINANCIAL SERVICES, COMMUNICATIONS AND BEYOND

Financings

XANTHUS PHARMACEUTICALS	zipcar	SiCortex	incipient	NanoNexus	TetraPhase Pharmaceuticals	Intercept pharmaceuticals	TransMedics	A123 SYSTEMS
$25,000,000	$25,000,000	$21,000,000	$24,000,000	$32,000,000	$25,000,000	$41,000,000	$29,750,000	$30,000,000
Second Round	*Late Stage*	*Second Round*	*Fourth Round*	*First Round*	*First Round*	*First Round*	*Third Round*	*Third Round*
November 2006	October 2006	September 2006	January 2006	May 2006	August 2006	May 2006	February 2006	January 2006

Initial Public Offerings

media	Altus	LeMaitre Vascular	ACHILLION	VISICU	TARGACEPT	optos	acme packet
Initial Public Offering of Common Stock	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Common Stock*	*Initial Public Offering of Ordinary Shares*	*Initial Public Offering of Common Stock*
$380,525,000	$120,750,000	$38,500,000	$59,512,500	$110,400,000	$45,000,000	£50,000,000	$116,584,000
Counsel to Issuer	Counsel to Underwriters	Counsel to Underwriters	Counsel to Issuer	Counsel to Underwriters	Counsel to Underwriters	Counsel to Issuer	Counsel to Underwriters
June 2006	January 2006	October 2006	October 2006	April 2006	April 2006	February 2006	October 2006

M&A Transactions

GlycoFi	RELICORE	Infinity Pharmaceuticals	GeoTrust	domantis	I-Logix	BrassRing	IMlogic	SOFTRICITY
acquisition by	*acquisition by*	*acquisition of*	*acquisition by*	*acquisition by*	*acquisition by*	*acquisition by*	*acquisition by*	*acquisition by*
Merck	Symantec	Discovery Partners	VeriSign	GSK	Telelogic	Kenexa	Symantec	Microsoft
$400,000,000	$52,000,000	$162,500,000	$125,000,000	£230,000,000	$80,000,000	$115,000,000	$90,000,000	Undisclosed
June 2006	February 2006	September 2006	September 2006	January 2007	March 2006	November 2006	February 2006	July 2006

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2006 Review

In 2006, the European venture capital market produced the largest investment amount in four years and a significant improvement in liquidity events—particularly IPOs.

Venture capital financing proceeds in Europe increased for the third consecutive year, reaching €4.12 billion in 2006. The number of reported venture capital financings fell 27%, from 1,189 in 2005 to 868 in 2006, although we expect the final deal total for 2006 to narrow this gap once all transactions have been reported.

The median financing size in Europe increased again, to €2.2 million in 2006—the fifth consecutive annual increase and the highest level since at least 1999—despite an increase in early-stage rounds. Seed and first-round deals climbed from 35% of all rounds in 2005 to 43% in 2006—the highest level since 2001—while later-stage financings declined from 41% to 36%.

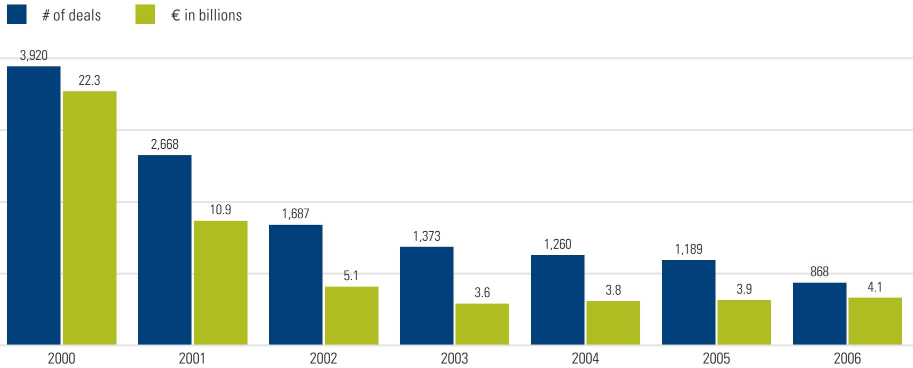
With a total of 210 deals, software companies again accounted for the largest sector of the European venture capital market in 2006, representing 24% of all financings, as compared to 29% in 2005. Financings by software companies produced €702 million in proceeds in 2006, compared to €808 million the year before.

Biopharmaceutical companies produced 137 financings in 2006, or 16% of all deals—down slightly from 17% in 2005. Total proceeds in this sector declined from €1.26 billion to €1.18 billion. Due to their comparatively larger average deal size, biopharmaceutical companies accounted for 29% of the total amount invested in 2006, down from 32% in 2005.

Rounding out the largest sectors in 2006 were information services, with 84 deals and €361 million in proceeds, and medical devices, with 79 deals and €240 million in proceeds.

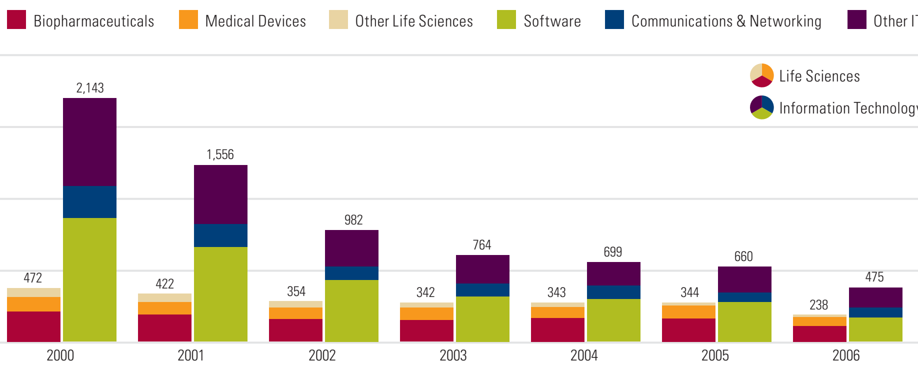
The United Kingdom remains the largest venture capital market in Europe, having produced 30% of all deals in 2006 (down from 31% in 2005), followed by France with 20% (up from 19%), Germany with 12% (unchanged) and Sweden with 9% (unchanged).

European Venture Capital Financings – 2000 to 2006



Source: Dow Jones VentureOne

European Venture Capital Financing by Industry – 2000 to 2006



Source: Dow Jones VentureOne

The IPO market for European venture-backed companies enjoyed its greatest deal volume since 2000. The number of IPOs jumped from 69 in 2005 to 91 in 2006—marking the highest yearly total since 2000 and surpassing the total number of IPOs for the period of 2001–2004. The year ended on a high note, with 33 IPOs in the fourth quarter, compared to 29 in the fourth quarter of 2005. For the second consecutive year, the number of IPOs by European VC-backed companies exceeded the number of IPOs by US VC-backed companies.

In contrast to the strong deal flow, total IPO gross proceeds edged down from €2.16 billion in 2005 to €1.75 billion in 2006. As a result, median IPO proceeds declined from €15.2 million to €13.1 million, though median pre-IPO valuations climbed for the fourth consecutive year, reaching €41.5 million in 2006.

The largest and most highly valued IPO of the year was by Russian television networks operator CTC Media, whose $380.5 million IPO resulted in a post-IPO valuation of $2.3 billion.

The continued increase in pre-IPO valuations reflects, in part, a more mature base of IPO companies. The median time from initial equity funding to IPO was 5.9 years in 2006, up from 5.5 years in 2005, but less than the

6.2 years median time for US VC-backed companies completing IPOs in 2006. And European VC-backed companies are getting to market on less than before: the median amount invested prior to IPO declined to €7.1 million in 2006—the third consecutive annual decline—compared to €10.3 million in 2005.

Technology sectors again dominated the European VC-backed company IPO market in 2006, with information technology companies producing 38 IPOs and life sciences companies contributing 30. With 32 IPOs, Germany was the largest source, followed by France with 17, Sweden with nine and the United Kingdom—the leader in 2005—with only eight, as UK companies opted for more M&A exits than IPOs.

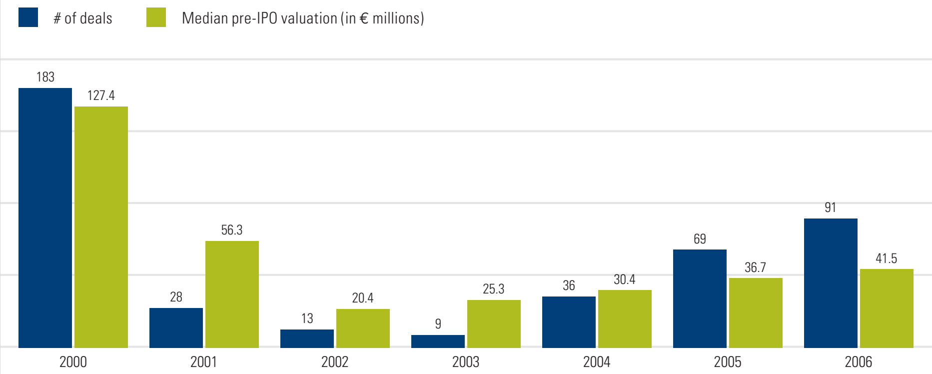
Despite the strong IPO results of 2006, the lack of a European public market where high-growth companies can raise substantial sums of money and provide sufficient liquidity to investors remains a concern for European VC-backed companies seeking exits—the largest IPO of the year was conducted on Nasdaq.

The number of reported acquisitions of European venture-backed companies declined from 206 in 2005 to 187 in 2006. However, the reported 2006 figure already exceeds the number of acquisitions in every other year since 2000, and we expect the total number of acquisitions in 2006 to approach or exceed that of 2005 once all transactions have been reported.

Two-thirds of the year's reported deals (125) were for information technology companies—the most since at least 2000. In a reversal of the geographical source of IPOs in 2006, UK-based companies accounted for 49 deals, followed by France with 31 and Germany with 28.

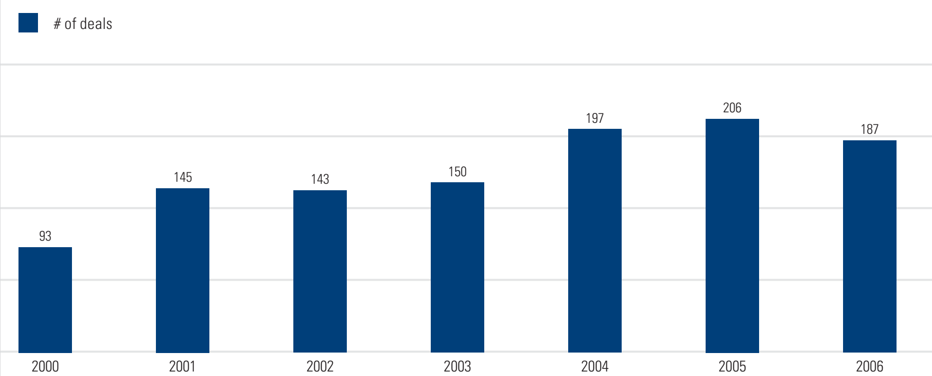
The median acquisition price reached €18.7 million in 2006, and the median amount raised prior to acquisition was €5 million. Technology companies fetched even higher prices—a median of €19.6 million—while the median amount invested in them prior to acquisition inched up from €4.7 million in 2005 to €5.1 million in 2006. The higher acquisition prices probably reflect the greater maturity of the acquired companies, whose median time from initial equity funding to acquisition increased one year from 2005 to reach nearly six years in 2006—matching the median time for acquired VC-backed companies in the United States.

European Venture-Backed IPOs – 2000 to 2006



Source: Dow Jones VentureOne

Acquisitions of European Venture-Backed Companies – 2000 to 2006



Source: Dow Jones VentureOne

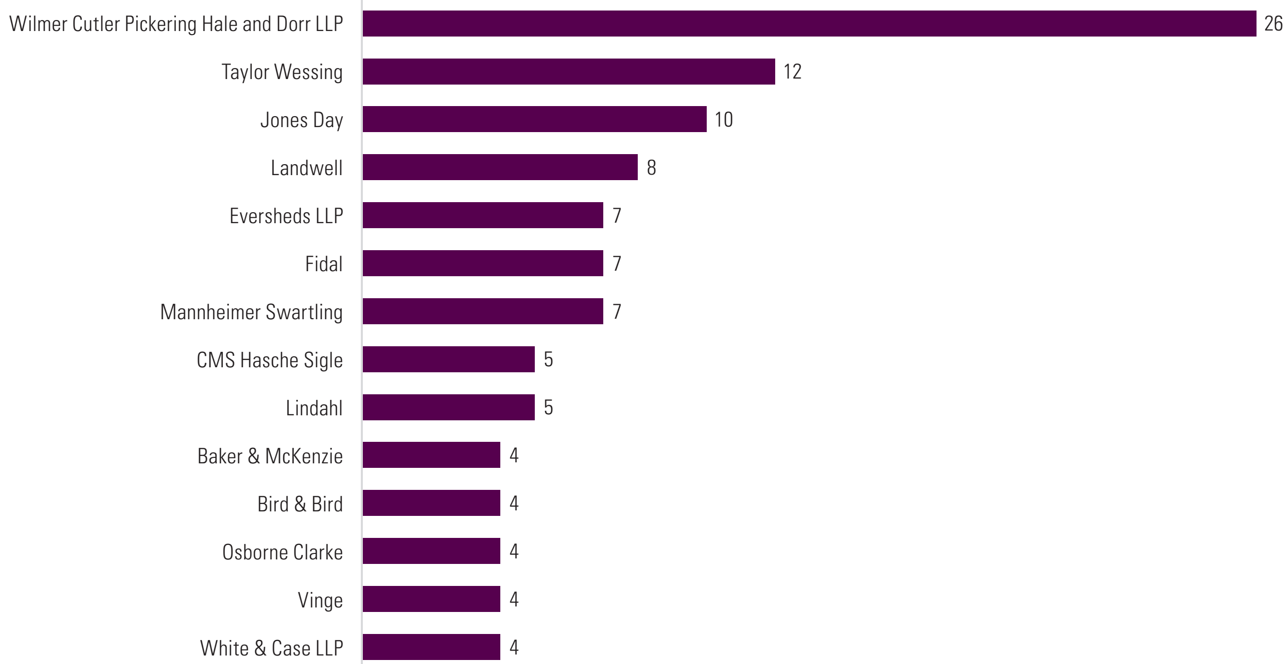
The two largest European VC-backed company acquisitions announced in 2006 were the £312 million sale of Cramer Systems to Amdocs, and the £230 million sale of Domantis to GSK—one of the largest cash purchases of a private biotech company in history.

2007 Outlook

For 2007, we expect European venture capital investment to remain steady or increase modestly. We also anticipate the median financing size of VC deals in Europe will continue to increase as improved liquidity conditions enable more larger, later-stage rounds—particularly deals led by private equity firms—to be completed.

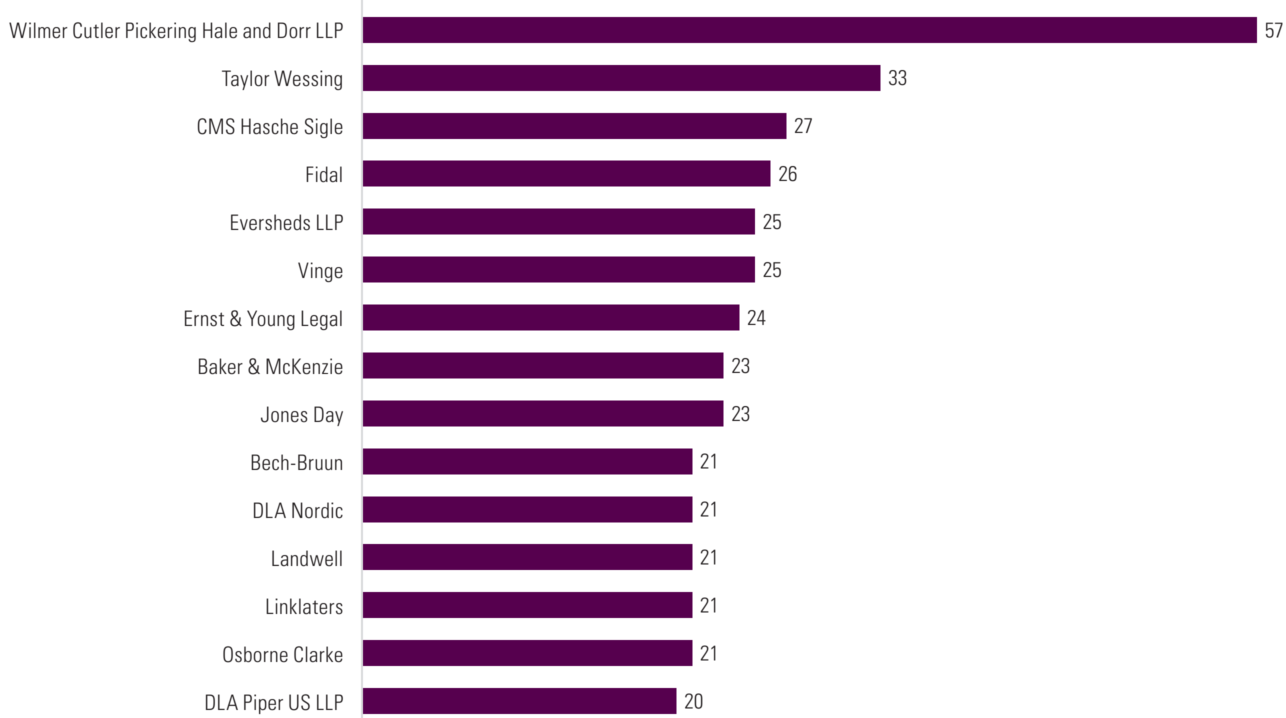
On the heels of the best year for liquidity events by European VC-backed companies since 2000, conditions appear conducive to continued strength in the IPO and M&A markets. In particular, the success of the CTC Media IPO may herald an increasing receptiveness to European VC-backed technology companies in the public markets, and the large Cramer Systems and Domantis acquisitions suggest strong demand for strategically important tech companies. ■

Counsel to Companies Receiving VC Financing in 2006 – Europe



The above chart is based on European companies that completed a seed, first, second, later-stage or restart round of venture capital financing in 2006.
Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2006 – Europe



The above chart is based on European VC-backed companies that were private and independent as of the end of 2006.
Source: Dow Jones VentureOne

Fundraising Activity

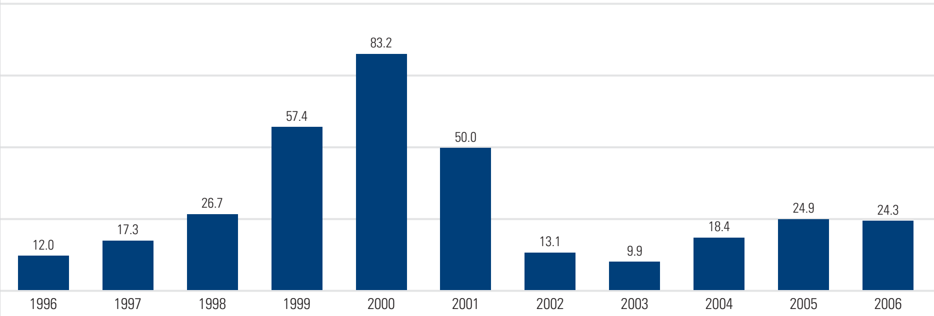
US venture fund formation activity continued at a brisk pace for most of 2006 before slowing in the fourth quarter to finish the year with total committed capital of $24.3 billion. Although down slightly from the $24.9 billion raised in 2005, we expect the 2006 total to top 2005 once all fundraising transactions have been reported.

Fund sizes in 2006 were moderate for the most part, as general partners continued to hedge their bets on investment pace. The market welcomed many established firms, as well as a number of first- and second-time funds.

We expect that the fund formation market will remain robust in 2007. Many funds are currently in the market and planning closings in the first half of the year, and institutional investors continue to have a healthy appetite for private equity. We anticipate that fund sizes will remain moderate, to provide flexibility to fund management.

Commitments to US Venture Capital Funds – 1996 to 2006

$ billions



Source: Dow Jones VentureOne

The Fundraising Process

During 2007, we expect many first- and second-time funds to enter the market. The following suggestions are for funds seeking to raise capital in the coming months:

- **DO** ***Start Early.*** Funds seeking to raise money in 2007 should have begun their marketing process in 2006, in order to lay the groundwork, contact existing relationships and establish new ones.
- **DO** ***Get Your Story Straight.*** The message should always be consistent—whether in a flipbook, private placement memorandum or in oral presentations.
- **DO** ***Pre-Sell Terms.*** Take the opportunity during meetings with prospective investors to introduce the deal terms and provide the supporting rationale. Seek to avoid surprises on the material terms—the first time investors focus on the carry and fee structure should not be when they review the private placement memorandum or lawyer's comment memo.
- **DO** ***Your Homework on Prospective Investors.*** Each investor will have its own diligence process, internal committee approvals and investment timeline. Be sensitive to that process and adjust your plans accordingly. Researching prospective investors can make your marketing process more efficient and, in the end, more successful. Determine an investor's history of investing in private equity funds or, in particular, funds similar to yours (which might show its knowledge of the asset class and understanding of the market). Find out if the investor has a stable base of managers or whether you are likely to run the risk of having a new manager monitoring the investment in your fund each year.
- **DO** ***Keep and Maintain an Investor Database, and Do Maintain Detailed Notes of Each Investor Meeting.*** Work to establish and maintain a database of prospective investors. When you meet with an investor, be diligent about feeding the database with notes from the meeting—topics discussed, questions raised or specific concerns conveyed by the investor. The database will prove invaluable when strategizing for follow-up meetings or when raising future funds.
- **DO** ***Comply with Applicable Law.*** Many legal issues need to be considered and discussed with counsel, including disclosure issues under state and federal securities laws and rules relating to presentation and attribution of track records.
- **DO** ***Be Patient.*** It generally takes multiple meetings to get a commitment from an investor.
- **DON'T** ***Oversell.*** Be positive about your firm, but do not oversell the opportunity. Investors will scrutinize your firm as part of their diligence process and reach their own conclusions.
- **DON'T** ***Over-Promise to Investors.*** In the marketing phase, you are pre-selling terms, but not negotiating. Use this time to listen to investor concerns, but seek to avoid making promises to investors. The time to negotiate is in the closing phase where you will need to consider the requests of a large number of investors and make choices as to which investor concerns will be accommodated.
- **DON'T** ***Use PowerPoint Presentations at LP Meetings.*** Try to make investor meetings as relaxed and conversational as possible. Use a flipbook to keep the investor's attention—PowerPoint presentations with dimmed lights can cause minds to wander and fingers to reach for BlackBerrys, and may discourage questions or meaningful interactive discussions with the investor.

The fundraising process can be long and arduous, and each fund sponsor faces challenges that are unique to its firm. With a little luck, and a lot of hard work and process management, the outcome can be very rewarding. ■

Why Are These Plans Needed?

The uneven economy and choppy capital markets of recent years have created a difficult environment for venture capital–backed companies. Many of these companies are finding that it takes longer than initially planned to generate revenue traction or to attain cash flow breakeven. It is therefore not uncommon for venture-backed companies to have to raise more venture capital funding than originally anticipated, resulting in large liquidation preferences. Moreover, if these companies must raise funds at a time when their business is not clicking on all cylinders, the result is often a "down round" (a financing at a lower price than the previous financing round), which not only adds to the total liquidation preference, but also significantly dilutes the equity holdings of the management team.

One approach to address this situation, which has gained popularity in recent years, is a so-called "management carve-out plan." Such a plan provides that, upon an acquisition of the company, instead of allocating the purchase price among company stockholders strictly in the manner provided for in the corporate charter (which might result in little or none of the proceeds being allocated to common stockholders and optionholders), a portion of the acquisition price is paid directly to plan participants, with the balance allocated in the manner provided for in the charter.

Basic Terms

A company that wishes to implement a management carve-out plan must address a number of often-complicated issues.

The first set of issues relates to participation in the plan:

- Who will be the participants—all employees, or only management?
- Are the selection of participants and the allocations of economic interests in the plan made at the time the plan is implemented or at the time the company is sold? The former approach should be a more effective retention and recruiting tool since employees can be assured of some type of payoff upon a sale of the company, while the latter approach provides more flexibility to the board of directors to reward those employees who contribute the most to the company through the time of sale.
- Do plan participants' interests vest over time?
- If participants in the plan are designated at the time of implementation, do they lose their participation rights if they leave the company prior to a sale? If so, what happens to the forfeited interests—do they automatically accrue pro rata to the benefit of the other participants, or is the total payoff to plan participants reduced to that extent?

The second group of issues involves the determination of the amount to be paid to plan participants:

- Is it a fixed amount or a percentage of the sale price?
- If it is a percentage of the sale price, does it accrue from the first dollar or apply only above a minimum sale price (to avoid rewarding employees for a sale at an unattractive price) and/or below a maximum sale price (because at a higher sale price the employee's equity interest becomes valuable again and the carve-out plan is not necessary)?
- Is the payment under the plan made in cash or in the form of the consideration (e.g., stock) paid by the acquiring company?
- Is the amount payable to participants reduced by the value received for their common stock and/or stock options in the acquisition of the company?

Possible Structures

Described below are four common structures for a management carve-out plan, along with the principal advantages and disadvantages of each one.

Alternative One

Under this approach, the company establishes a cash bonus plan or enters into an agreement with individual employees that provides for a cash payment to participating employees upon an acquisition of the company.

Primary advantages:

- It is simple to implement—stockholder approval is typically not required, and no new securities are issued.
- Participation in the plan can be limited to specific persons (such as key employees) and subject to certain conditions (such as remaining employed through the closing of the sale).
- It does not require any payments by plan participants.

Primary disadvantages:

- In effect, it forces the acquiring company to pay a portion of the acquisition price in cash (by funding the payments under the plan), even if the acquiring company wishes to use stock for the acquisition.
- The payments to plan participants are taxable as ordinary income rather than as capital gains.

Alternative Two

The second alternative involves the establishment of a plan providing for the payment of a portion of the acquisition price to plan participants,

	Alternative One	Alternative Two	Alternative Three	Alternative Four
Ease of implementation	Simple	Complicated (charter amendment often required)	Complicated (charter amendment often required)	Very complicated
Plan participation	Flexible	Flexible	Inflexible	Flexible
Payments by participants	No	No	No	Yes
Acquiring company forced to pay some cash	Yes	No	No	No
Tax-deferred treatment possible	No	No	Yes	Yes
Capital gains possible	No	No	Yes	Yes

in the form of the consideration paid by the acquiring company.

Primary advantages:

- Participation in the plan can be limited to specific persons (such as key employees) and subject to certain conditions (such as remaining employed through the closing of the sale).
- It does not require any payments by plan participants.
- It does not force the acquiring company to pay a portion of the acquisition price in cash.

Primary disadvantages:

- This approach is not as simple to implement as alternative one. For example, it typically requires a charter amendment to provide that payments under the plan are not in contravention of the preferred stock liquidation preferences.
- The payments to plan participants are taxable at the time of receipt, even in a tax-free acquisition and even if the payments are in the form of stock that cannot be immediately sold.
- The payments under the plan are taxed as ordinary income rather than as capital gains.

Alternative Three

The third alternative includes an amendment to the terms of the company's charter to provide that a percentage of the proceeds of an acquisition of the company (e.g., 10%) is paid to the holders of common stock (and, possibly, optionholders) on a *pari passu* basis with the payments to the holders of preferred stock in respect of their liquidation preferences.

Primary advantages:

- It does not require any additional payments by plan participants (i.e., holders of common stock and options).
- It does not force the acquiring company to pay a portion of the acquisition price in cash.
- If the acquisition is structured as tax free, the plan participants will share in that benefit.
- In a taxable acquisition, the payments to plan participants would typically be treated as capital gains (rather than ordinary income) if the common stock has been held for more than one year.

Primary disadvantages:

- Payments are shared on a pro rata basis by all holders (including non-employees) of common stock and options and cannot be directed solely or disproportionately to contributing employees.
- Implementing this approach requires an amendment to the company's charter.

Alternative Four

Alternative four involves the creation and issuance of a new class of equity—frequently called senior common stock—the terms of which provide for the payment of a certain portion of the proceeds of an acquisition of the company to the holders of that class of stock.

Primary advantages:

- Participation in the plan can be limited to specific persons (such as key employees) and subject to certain conditions (such as remaining employed through the closing of the sale).
- It does not force the acquiring company to pay a portion of the acquisition price in cash.
- If the acquisition is structured as tax free, the plan participants will share in that benefit.
- In a taxable acquisition, the payments to plan participants would typically be treated as capital gains (rather than ordinary income) if the new stock has been held for more than one year.

Primary disadvantages:

- It is exceedingly complex to structure and implement.
- Because the issuance of new stock is involved, plan participants must either pay for this stock (either initially, if issued as restricted stock, or at the time of exercise, if granted in the form of options), or incur taxable income upon receiving the stock if it is issued without consideration. Moreover, because the terms of this class of stock include a liquidation preference that effectively guarantees some payment upon an acquisition of the company, the fair market value of this stock (which would either be paid by plan participants or recognized as taxable income) cannot be set as low as the fair market value of ordinary common stock.

It is impossible to state in the abstract which plan structure is preferable, as the facts and circumstances of each company will vary. However, a company contemplating a management carve-out plan should carefully consider each of the four approaches to determine which is best suited for its particular needs.

Other Issues

Depending on how it is structured, a management carve-out plan can raise a number of other legal and tax issues, such as:

- Whether the implementation of the plan is a taxable event to plan participants; and whether the plan raises issues under Section 280G (parachute payment provisions), Section 409A (deferred compensation provisions), or the ERISA provisions of the Internal Revenue Code
- Whether the implementation of the plan is consistent with the fiduciary duties of the board of directors
- What consents or waivers are required to implement the plan, such as stockholder approval of a charter amendment, the waiver of anti-dilution provisions and the waiver of preemptive rights

Conclusion

Management carve-out plans can be complicated to implement because they often involve difficult choices with respect to the terms and structure of the plan and challenging legal issues. However, when properly structured and implemented, a management carve-out plan can go a long way toward addressing a fundamental problem many venture-backed companies face. ■

Based on hundreds of venture capital financing transactions we handled from 2002 to 2006 for companies and venture capitalists in the United States and Europe, we have compiled the following deal data:

Deals with Multiple Liquidation Preferences		2002	2002 Range	2003	2003 Range	2004	2004 Range	2005	2005 Range	2006	2006 Range
A "multiple liquidation preference" is a provision that provides that the holders of preferred stock are entitled to receive more than 1x their money back before the proceeds of the liquidation or sale are distributed to holders of common stock.	Series A	38%	1x – 2x	0%	N/A	22%	1.25x – 5x	3%	1.5x	5%	2x
	Post–Series A	25%	1.5x – 3x	24%	1.5x – 5x	11%	1.5x – 3x	10%	1.5x – 2x	9%	1.25x – 3x

Deals with Participating Preferred		2002	2002 Range	2003	2003 Range	2004	2004 Range	2005	2005 Range	2006	2006 Range
"Participating preferred" stock entitles the holder not only to receive its stated liquidation preference, but also to receive a pro rata share (assuming conversion of the preferred stock into common stock) of any remaining proceeds available for distribution to holders of common stock.			if capped		if capped		if capped		if capped		if capped
	Series A	56%	1.5x – 2x	61%	2x – 4x	56%	2x – 5x	58%	2x – 5x	59%	2x – 5x
	Post–Series A	64%	2x – 5.5x	76%	2x – 5x	54%	1.75x – 5x	71%	2x – 5x	62%	2x – 5x

Deals with an Accruing Dividend		2002	2003	2004	2005	2006
"Accruing dividends" are generally payable upon liquidation or redemption of the preferred stock. Because the sale of the company is generally deemed to be a "liquidation," the accrued dividend effectively increases the liquidation preference of the preferred stock.	Series A	81%	30%	47%	78%	53%
	Post–Series A	44%	52%	48%	87%	55%

Anti-Dilution Provisions		2002	2003	2004	2005	2006
A "full ratchet" anti-dilution formula is more favorable to the investors because it provides that the conversion price of the preferred stock will be reduced to the price paid in the dilutive issuance, regardless of how many shares are involved in the dilutive issuance. In contrast, a "weighted average" anti-dilution formula takes into account the dilutive impact of the dilutive issuance based upon factors such as the number of shares and the price involved in the dilutive issuance and the number of shares outstanding before and after the dilutive issuance.	Series A					
	Full Ratchet	28%	3%	3%	0%	7%
	Weighted Average	72%	97%	97%	100%	93%
	Post–Series A					
	Full Ratchet	24%	30%	7%	16%	7%
	Weighted Average	76%	70%	93%	84%	93%

Deals with Pay-to-Play Provisions		2002	2003	2004	2005	2006
"Pay-to-play" provisions provide an incentive to investors to invest in future down rounds of financing. Investors that do not purchase their full pro rata share in a future down round lose certain rights (e.g., their anti-dilution rights are taken away or their shares of preferred stock may be converted into common stock).	Total	23%	31%	26%	25%	22%
	% of Total That Convert to Common Stock	30%	50%	67%	55%	65%
	% of Total That Convert to Shadow Preferred Stock	70%	50%	33%	45%	35%

We reviewed all merger transactions involving venture-backed targets signed or consummated in 2004, 2005 and 2006 (as reported by Dow Jones VentureOne)—a total of 54 transactions in 2004, 39 transactions in 2005 and 53 transactions in 2006—where the merger documentation was publicly available and the deal value was $25 million or more. Of the 2004 merger transactions, 23 (or 43%) were for cash, 22 (or 41%) were for stock and nine (or 17%) were for a mixture of cash and stock. Of the 2005 transactions, 27 (or 69%) were for cash, four (or 10%) were for stock and eight (or 21%) were for a mixture of cash and stock. Of the 2006 transactions, 36 (or 68%) were for cash, four (or 8%) were for stock and 13 (or 24%) were for a mixture of cash and stock.

Based on this review, we have compiled the following deal data:

Deals with Earn-Out	**2004**	**2005**	**2006**
With Earn-Out	24%	15%	17%
Without Earn-Out	76%	85%	83%
Deals with Indemnification	**2004**	**2005**	**2006**
With Indemnification			
By Target's Shareholders	89%	100%	94%
By Buyer[1]	37%	46%	38%
Survival of Representations and Warranties	**2004**	**2005**	**2006**
Shortest	6 Months	9 Months	12 Months
Longest	36 Months	24 Months	36 Months
Most Frequent	12 Months	12 Months	12 Months
Caps on Indemnification Obligations	**2004**	**2005**	**2006**
With Cap	85%	100%	100%
Limited to Escrow	72%	79%	84%
Limited to Purchase Price	7%	5%	2%
Exceptions to Limits[3]	74%	73%	84%
Without Cap	15%	0%	0%
Escrows	**2004**	**2005**	**2006**
With Escrow	83%	97%	94%
% of Deal Value			
Lowest	4%	2%	3%
Highest	23%	20%	20%
Most Frequent	10%–20%	10%	10%
Length of Time			
Shortest	6 Months	6 Months	12 Months
Longest	36 Months	24 Months	36 Months
Most Frequent	12 Months	12 Months	12 Months
Exclusive Remedy	64%	84%	89%
Exceptions to Escrow Limit Where Escrow Was Exclusive Remedy[4]	72%	66%	86%
Baskets for Indemnification	**2004**	**2005**	**2006**
Deductible	39%	38%	48%
Threshold	51%	62%	52%
MAE Closing Condition	**2004**	**2005**	**2006**
Condition in Favor of Buyer	81%	82%	98%
Condition in Favor of Target[5]	30%	13%	23%
Exceptions to MAE	**2004**	**2005**	**2006**
With Exception[6]	78%	79%	85%

[1] *The buyer provided indemnification in 48% of the 2004 transactions, 25% of the 2005 transactions and 41% of the 2006 transactions where buyer stock was used as consideration. In 65% of the 2004 transactions,17% of the 2005 transactions and 35% of the 2006 transactions where the buyer provided indemnification, buyer stock was used as consideration.*

[2] *Measured for representations and warranties generally; specified representations and warranties may survive longer.*

[3] *Generally, exceptions were for fraud and willful misrepresentations.*

[4] *Generally, exceptions were for fraud and criminal activity.*

[5] *In 50% of these transactions in 2004, in 80% of these transactions in 2005 and in 83% of these transactions in 2006, buyer stock was used as consideration.*

[6] *Generally, exceptions were for general economic and industry conditions.*

Most executives at venture-backed companies expect that an acquisition of their company will result in a payday that compensates them for their long hours and hard work in building the business, as well as the typically lower salary and bonus inherent in being employed by a start-up. What they do not expect, however, is to pay a penalty tax as a result of receiving that compensation.

Under Sections 280G and 4999 of the Internal Revenue Code, referred to as the "golden parachute" rules, certain cash and non-cash payments that are customarily made in connection with a change-in-control transaction (including bonuses, severance and accelerated vesting) can result in the imposition of a 20% penalty tax on the executives, as well as a loss of the compensation deduction for the company.

The golden parachute rules will not apply—meaning that no penalty tax will be payable and no deduction loss will occur—if the stockholders of the acquired company approve the payments in the prescribed manner. Because of the draconian effect of the Section 280G penalty tax on executives and the company itself, such stockholder votes have become standard practice in acquisitions of venture-backed companies.

Nevertheless, the stockholder vote requirements are complex and replete with nuances, and strict compliance with the Section 280G regulations is a must. Below is a brief summary of the golden parachute provisions, followed by a summary of the requirements for the stockholder approval exception and the process for obtaining such approval.

Overview

Under Section 280G, compensation paid by the company undergoing the change-in-control transaction (Target) or by the acquiror (Buyer) is generally characterized as a parachute payment if it:

- is paid to an officer, significant stockholder or highly compensated individual of the Target (disqualified individuals),
- is contingent on a change in control of the Target, and
- together with all similar payments, equals or exceeds three times the individual's average annual compensation paid by the Target for the five most recent taxable years (such average is referred to as the "base amount").

The types of compensation that are treated as "contingent on the change in control" include not only actual cash payments made in connection with the transaction, but also the value of accelerated vesting of restricted stock and options. Payments made pursuant to certain agreements, including stock options and other equity grants, entered into between a disqualified individual and the Target within the one-year period prior to the change-in-control transaction are also presumed to be contingent on the transaction. Moreover, certain payments are presumed to be contingent on the change in control even if the payments are conditioned on the occurrence of another, subsequent event. For example, any payments made as a result of a voluntary or involuntary termination of a disqualified individual's employment are presumed to be contingent on the change in control. As a result, severance and noncompete payments, and the value of "double trigger" vesting of restricted stock and options, are all presumed to be contingent on the change in control.

If the golden parachute rules apply, the total amount of parachute payments over the disqualified individual's base amount (excess parachute payments) is subject to the 20% penalty tax and is nondeductible by the Target.

In the chart to the left, the Target would also lose a tax deduction for the $350,000.

Sample Calculation of 280G Penalty Tax

Assumptions:

- Change in control date July 1, 2007.
- CEO, a disqualified individual, received an average bonus of $20,000 per year from 2002 through 2006 and an average salary of $130,000 during that period, for a base amount of $150,000.
- CEO is entitled to receive a total of $500,000 of payments that are contingent on the change in control, including the value of acceleration of equity awards, bonuses and severance payments.
- Change-in-control payments have not been approved by the Target stockholders.

Base Amount (average compensation for five years prior to year of change in control)	$150,000 = ($150,000*5)/5
Three Times Base Amount (total payments that can be made without imposition of 280G penalty tax)	$450,000 = $150,000*3
Total Change in Control Payments	$500,000
Excess Parachute Payments (amount by which total payments exceed one times base amount)	$350,000 = $500,000-$150,000
Excise Tax (imposed on excess parachute payments)	$70,000 = $350,000*0.20

Stockholder Approval Exception: The Requirements

The adverse tax consequences under the golden parachute rules can be avoided if:

- no shares of the Target are readily tradeable,
- the Target stockholder vote to approve the payments is separate from the vote to approve the change in control,
- the payments are approved by a vote of the holders of more than 75% of the voting power of all outstanding stock of the Target, excluding shares held by disqualified individuals and related persons,
- there is adequate disclosure of all material facts relating to the payments to all Target stockholders entitled to vote, and
- the vote determines the right of the disqualified individuals to receive or retain the payments.

Each requirement is explained more thoroughly below, along with some common traps for the unwary:

No Readily Tradeable Stock. The stockholder approval process is only available to a Target if no shares of the company's stock are readily tradeable. Significantly, a Target is deemed to have readily tradeable stock if an entity whose interests are readily tradeable holds stock in the Target, and such Target stock constitutes one-third or more of the gross assets of the entity stockholder. In addition, there is a per se rule that no member of an affiliated group is eligible for the stockholder approval exception if stock of any other member of that affiliated group is readily tradeable.

Separate Vote. The Target stockholder vote will not be effective if approval of the change-in-control transaction is contingent, or otherwise conditioned, on the approval of the parachute payments by the stockholders. As such, while the transaction documents can require as a condition to closing that the Target stockholders undertake the Section 280G vote, the documents cannot require that the stockholders **approve** the payments.

75% Approval. While the Target's normal voting rules must be followed for the Section 280G vote to be effective, the following limitations apply:

- target stock held by disqualified individuals whose payments are being submitted for stockholder approval (affected disqualified individuals), and stock held by certain related persons, is not treated as outstanding for purposes of determining whether the more-than-75% vote has been obtained,
- a vote by any stockholder that is not an individual (an entity stockholder) generally must be made by the person authorized by the entity to approve the payment(s), but that person cannot be an affected disqualified individual (or a related person), and
- if a substantial portion (one-third or more) of an entity stockholder's assets consists of Target stock, then approval of the payments generally must be made by a separate vote of the persons who hold more than 75% of the voting power of the entity stockholder.

Disclosure. To be considered adequate, the disclosure must be full and truthful regarding the material facts and must include such additional information as is necessary to ensure that it is not materially misleading to Target stockholders at the time the disclosure is made. This means that the amount and terms of all payments being approved, as well as any other payments that are being made but not being submitted for stockholder approval, must be disclosed. Furthermore, this disclosure must be made to all Target stockholders entitled to vote, and not just those stockholders whose vote will provide the required 75% approval. Please note that this disclosure requirement exists independently of any disclosure requirements under applicable securities laws, and will apply even in a transaction for which little or no disclosure about the parachute payments would be required under the securities laws.

Forfeit Payments if Stockholder Approval Not Obtained. In order for the vote to be effective, each affected disqualified individual must agree, if stockholder approval is not obtained, to forfeit his or her right to receive or retain any and all payments for which approval is being sought. A disqualified individual does not have to agree to forfeit, nor must stockholders approve, the portion of aggregate parachute payments that is up to three times that disqualified individual's base amount, provided that disclosure of all payments being made to such individual is supplied to stockholders.

Stockholder Approval Exception: The Process

In light of the complexity of satisfying the requirements of the stockholder approval exception, when a change in control becomes likely, a Target should immediately begin to analyze the potential exposure under the golden parachute rules. In general, the following steps should be taken:

Collect Data. The Target should identify the disqualified individuals and, for each disqualified individual, collect historic compensation information and gather the documents and information relating to all payments to such persons that are contingent upon the change in control.

Perform Section 280G Calculation. Using the formulas and rules in the Section 280G regulations, the Target and its advisors should calculate, for each disqualified individual, the base amount and the total value of all payments that are contingent on the change in control.

Determine Whether Stockholder Vote Exception Is Available. The Target, together with its advisors, should determine whether the stockholder vote process is available in light of the applicable requirements.

Prepare Forfeiture Agreements. Provided that the stockholder vote is available, all affected disqualified individuals must sign an agreement (prior to requesting such vote) pursuant to which they will forfeit the right to receive the amount of contingent payments that exceeds three times their base amount if stockholder approval is not obtained.

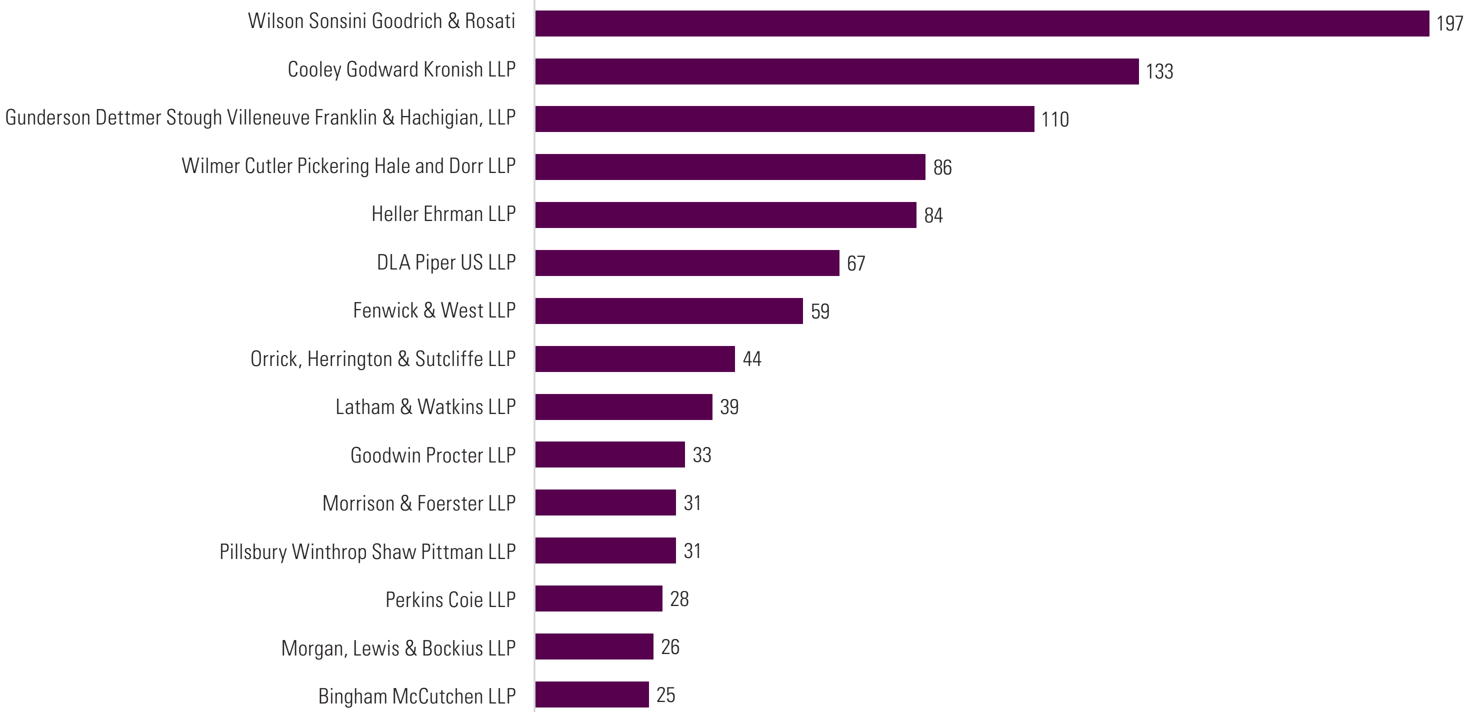
Prepare Disclosure Statement. The stockholder disclosure statement should be sent to all Target stockholders eligible to vote and generally should include (1) complete disclosure of the contingent payments to be made to the affected disqualified individuals; (2) a voting form to record the stockholder's vote on the contingent payments separately from the vote on the acquisition transaction; and (3) an entity stockholder questionnaire to confirm that the vote of such entity complies with the requirements described above.

Review Stockholder Responses. After receiving stockholder responses, the Target and its advisors must review the stockholder votes and entity questionnaires to determine if the stockholder approval exception requirements have been satisfied.

Conclusion

For venture-backed companies, the ability to seek stockholder approval to protect their executives from the Section 280G penalty tax, and the company from a deduction loss, is potentially very valuable. However, satisfaction of the applicable rules can be burdensome and requires significant planning. Companies seeking to implement a stockholder vote are well advised to begin analyzing the effect of the golden parachute rules as soon as a change-in-control transaction appears on the horizon. ■

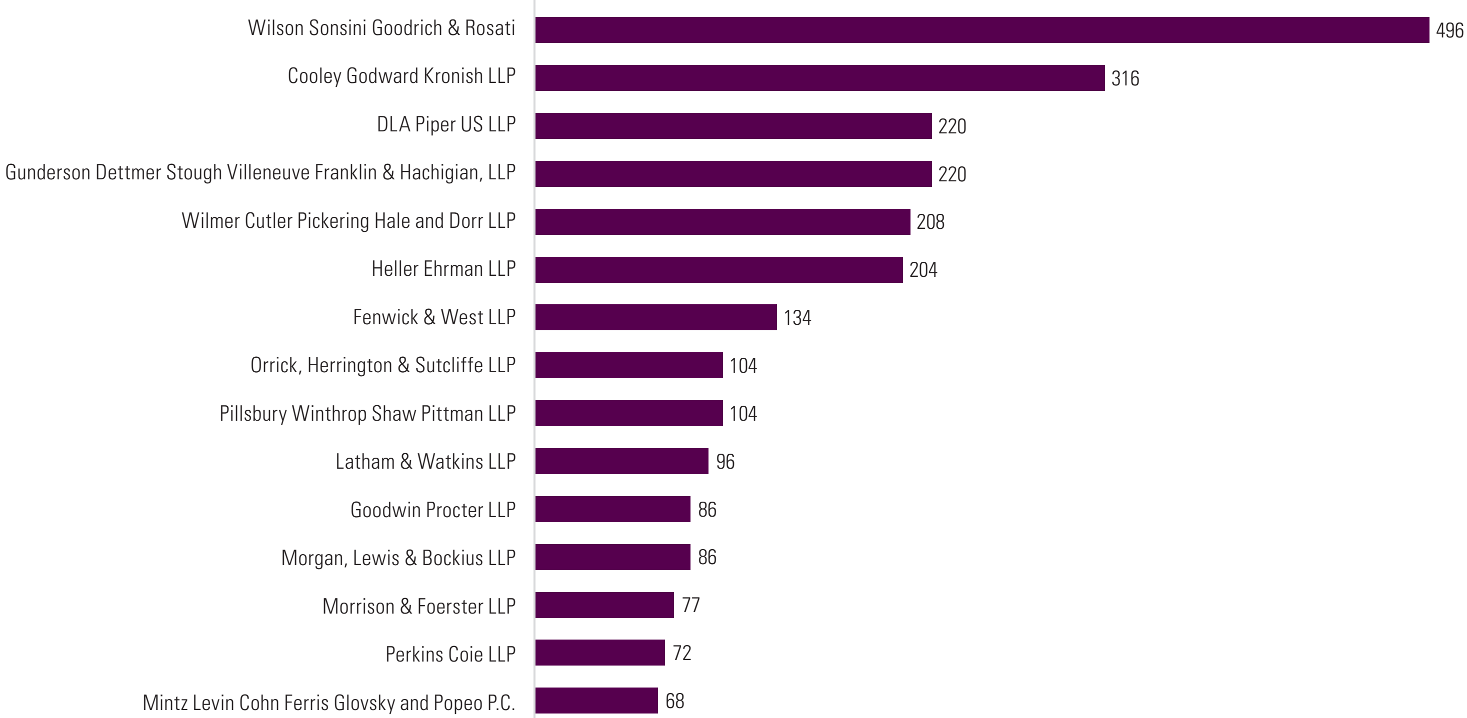
Counsel to Companies Receiving VC Financing in 2006 – Worldwide



The above chart is based on all companies contained in the VentureSource database (covering the United States, Europe and Israel) that completed a seed, first, second, later-stage or restart round of venture capital financing in 2006.

Source: Dow Jones VentureOne

Counsel to VC-Backed Companies at Year-End 2006 – Worldwide



The above chart is based on all VC-backed companies contained in the VentureSource database (covering the United States, Europe and Israel) that were private and independent as of the end of 2006.

Source: Dow Jones VentureOne

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For summaries and analysis of compensation data collected from hundreds of executives and private companies located throughout the country, see the *2006 Compensation and Entrepreneurship Report in Information Technology* and the *2006 Compensation and Entrepreneurship Report in Life Sciences* at www.wilmerhale.com/compreports.

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Data Sources

All data in this report was compiled from the VentureSource database from Dow Jones VentureOne, except as otherwise described.

Special note on data: *All venture capital financing and M&A data discussed in this report is based on currently available information. Due to delayed reporting of some transactions, the 2006 data that is presently available is likely to be adjusted upward over time as additional deals are reported. Based on historical experience, the adjustments in US data are likely to be in the range of 5–10% in the first year following the initial release of data and in smaller amounts in succeeding years, and the adjustments in European data are likely to be more pronounced.*

Prior results do not guarantee a similar outcome.

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