



## Early Stage Financing Term Sheets

Prepared for Chinese Information & Networking Association (CINA)  
January 11, 2007

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# EARLY STAGE FINANCING TERM SHEETS

January 11, 2007

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Fred Greguras  
fgreguras@fenwick.com  
(650) 335-7241

Andrew Luh  
aluh@fenwick.com  
(650) 335-7964

Lily Toy  
ltoy@fenwick.com  
(650) 335-7687

## CHINESE INFORMATION AND NETWORKING ASSOCIATION WORKSHOP

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FENWICK & WEST LLP



# OVERVIEW

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- Assumes Caymans, BVI, US or other non-domestic China Corporation
- Seed Financing Terms
- Venture Capital Financing Terms
- Issues in China Venture Capital Deals

# EARLY STAGE FINANCINGS

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- Seed Financing
  - Friends, Family, Angels
  - Quick, Simple, Cheap
  - Sell common stock, preferred stock or convertible note
- Corporate Partner
  - Valuation
  - “Strings attached”
- Venture Capital
  - Market validation and economic scalability
- Role of a Term Sheet
  - Specification or blue print
  - Point discussions vs. entire term sheet

# SEED FINANCINGS: USE OF COMMON STOCK

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- Must value the company if stock is sold
- Pricing of common stock must be same for all sales at or about the same time. Cannot grant options to employees for \$0.01 and sell shares of common stock to seed investors for \$1.00 at the same time
- Selling common stock is not generally used because of the dilutive effect
  - Consider number of shares at \$0.01 per share needed to be sold to raise even \$100! (10,000 shares)
- Objective is to keep the common stock price low as long as possible to motivate employees and other service providers with stock options

# SEED FINANCINGS: USE OF PREFERRED STOCK

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- Requires a pre-money valuation for the company. Investors will buy a percentage of the company
- Series A round can be complicated and expensive even if raising a small amount of money. Cost may be disproportionate to amount raised
- No such thing as a “standard” Series A preferred stock
- Defer a preferred stock financing if possible when a small amount of money is being raised

## SEED FINANCINGS: USE OF CONVERTIBLE NOTES

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- Issue convertible notes for “next financing” preferred stock
- Defers valuation decision and keeps the financing simple and low cost
- Discount on conversion rate (or warrants) is often used as a “sweetener” for the investors to take the risk
- Sample term sheet for a convertible note financing



# SERIES A FINANCINGS PRE-MONEY VALUATIONS

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- \$4 – 7M approximate range
- Valuation and founder vesting are usually the key issues
- Pre-money valuation will likely be slightly greater than the amount invested
- Fully-diluted means (1) outstanding stock, plus (2) outstanding options, plus (3) option reserve, plus (4) any other outstanding equity
- Pre-money valuation includes fully-diluted

# START UP, INC. CAP TABLE AS OF JANUARY 11, 2007

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- Common Stock
  - Authorized: 10M shares
  - Outstanding: 4M owned by founders
  - Option Pool: 2M shares
    - 200K granted, none exercised
    - 1.8M available for grant
- No preferred stock authorized
- Ownership: founders own 100% on an outstanding share basis and 67% on a fully-diluted share basis
- Fully diluted:  $4M + 2M = 6M$
- Cap table should look conventional

# SERIES A FINANCINGS

## POST-FINANCING CAP TABLE

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- On a fully-diluted basis, resulting cap table may be:
  - 40-50% Preferred stock
  - 30-40% Founders common stock  
(with vesting restarts and other vesting pressure)
  - 20-25% Option pool – common  
stock (determined by bottoms up analysis)
  - means founders are outvoted  
on an outstanding share basis.  
Series A may own more than 50%  
on an outstanding share basis
- Term sheet is 40/40/20
- What happens if option pool size is increased?

# SERIES A FINANCINGS CONTROL

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- Control of company
  - Board of Directors: 1 vote per member
  - Preferred stock protective provisions
  - Common stock protections
- Board tends to be 5 persons
  - 2 represent preferred stock
  - 2 represent common stock
- Selection of 5th director is critical
  - Selected by other directors
  - Selected by outstanding shares
  - Industry expert, independent
- Scope of protective provisions

# SERIES A FINANCINGS TERM SHEETS

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- Sample term sheet
  - Non-binding
  - Period for acceptance
- Precedential impacts on future rounds
- No shop / exclusivity – item 16, page 8 (45 days)
- Pre-money valuation – item 1, page 1 (\$6M)
- Price per share – item 6, page 2 (\$1)
  - Impact of option pool – as pool size increases Series A price per share decreases
- Vesting – item 13, page 7. What about founders?
- Liquidation preference – applies in an acquisition – item 7, page 2 (participating/3x)
  - Initial
  - Non-participating
  - Participating (with and without cap)

## LIQUIDATION PREFERENCE EXAMPLE (I)

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- Startup, Inc. is acquired for \$40M
- Series A LP is for \$4M, participating, no cap    Series A owns 50% and common stock owns 50% of the outstanding shares
- Distribution:
  - 1) \$4M to Series A (initial)
  - 2) \$18M to Series A    \$18M to common stock
  - 3) Series A receives a total of \$22M. common stock gets \$18M

## LIQUIDATION PREFERENCE EXAMPLE (II)

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- Startup, Inc. is acquired for \$40M
- Series A LP is for \$4M, participating, 3X cap
- Series A owns 50% and common stock owns 50% of the outstanding shares
- Distribution:
  - 1) \$4M to Series A (initial); next \$18M to Series A, \$18M to common stock but Series A capped at 3X or \$12M
  - 2) Conversion to common stock scenario-50% is \$20M
  - 3) Series A will elect to convert so will receive \$20M as compared to \$22M in a no cap situation. Common stock gets \$20M.

# SERIES A FINANCINGS TERM SHEETS

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- Board composition – item 12, page 6
- Antidilution protection
  - Purpose is to adjust investors conversion price if stock is sold at a lower price
  - Conversion ratio increases - means investors will get more common stock upon conversion
  - Weighted average rather than full ratchet (more customary) – item 7, page 2 bottom
  - “Ratchet” conversion price reduced all the way to new sales price (less customary)
  - Exclusions



# ANTIDILUTION PROTECTION

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## ■ Weighted Average

- Difference in price (new sale vs. prior rounds)  
“weighted” by number of shares (new shares vs. prior shares)
- Broad Based Weighted Average (most favorable to company)
  - Includes outstanding shares, options, warrants, other rights
- Narrow Based
  - Includes outstanding shares only

## ANTIDILUTION EXAMPLES

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- 100 shares fully diluted
  - 40 Series A
  - 40 Founders
  - 20 Option pool
- Post Series A valuation of \$100.
- New purchase of 10 shares at \$0.50 per share.  
Total of \$5 paid.

# ANTIDILUTION EXAMPLES

## ■ Ratchet

- 40 Series A shares now convertible into 80 shares of common stock
- Result is Series A owns 57% of the company on an as converted and fully-diluted basis: 67% on an as converted basis

	<u>Shares</u>	<u>Percentage</u>
– Series A	80	57.1
– Founders	40	28.6
– Option pool	20	14.3
	140	100

## ■ Broad Weighted Average

- Total shares  $100 + 10 = 110$
- Post money plus amount paid for new shares = 105
- $110/105 = 1.05$
- 40 Series A shares now convertible into  $1.05 \times 40 = 42$  shares of Common Stock

## ■ Narrow Weighted Average (outstanding shares only)

- Total shares  $80 + 10 = 90$
- Post money + amount paid = 85
- $90/85 = 1.06$
- 40 Series A shares now convertible into  $1.06 \times 40 = 42.4$  shares of Common Stock

# DRAG-ALONG RIGHTS

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- Drag-along Rights – Item 17, page 8
  - Purpose is to provide investors with control over having liquidity through an M&A
  - Requires certain common stock holders to vote in favor of an acquisition
  - Board and preferred stock approve the transaction
  - Acquiror not affiliated with any major investor
  - Base valuation for the acquisition (no less than \$30M in the term sheet)

# SERIES A FINANCINGS TERM SHEETS

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- Investors right of first refusal on new issuances – item 10, page 5
  - Purpose is to provide investors the right to keep their ownership percentage in the company through additional investment
  - Exclusions
- Registration rights – item 9, page 4
  - Purpose is to provide liquidity in a public offering
  - Note “equivalent” language
  - Piggyback (also for founders) – item 9(8), page 5
  - Demand
  - S-3
  - Payment of expenses
  - Exclusions

# SERIES A FINANCINGS TERM SHEETS

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- Right of first refusal and co-sale on founder's stock – item 14, page 7
  - Purpose is to provide investor the right to purchase a founder's shares if the company doesn't purchase or sell shares on the same terms if the founder is permitted to sell
  - Carveouts: gifts to immediate family
  - Exclusions: minimal sales allowed (5-10%)

# PREFERRED STOCK PROTECTIVE PROVISIONS

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- Purpose is to require investor approval for certain actions – item 7(6), page 3 (13 actions)
  - Amend Articles/Bylaws
  - Create new series/Reclassify old series
  - Merger/Sale of Assets/Liquidation
  - Declare/Pay Dividend
  - Change Size of Board
  - Budget and spending
  - Others – avoid business micromanagement
- Series vs. Class Approval
  - Majority (or 2/3) of all Preferred Stock
  - Majority (or 2/3) of Series “X” Stock

# ISSUES IN CHINA VENTURE CAPITAL DEALS

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- Issues we sometimes see:
  - Investment may be made in installments based on milestones in larger deals
  - Deeper IP due diligence for technology critical businesses like chip sets
  - More personal accountability with founders' representations and warranties
  - More control over actions of the company with a greater number of protective provisions that require preferred stock approval such as budget approval, spending outside the budget, related party payments, drag-along right, etc.
  - More debt like such as mandatory cumulative dividends
  - Sometimes broad redemption provisions
  - Reincorporation in the Caymans



# SUMMARY

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- China venture capital deals usually have more control provisions of various types
- Larger financings are often made in installments based on milestones
- Founders are sometimes asked for representations and warranties to make them more personally accountable
- Deeper IP due diligence for some types of investment
- Investors often will require reincorporation in the Caymans if not already there

**THIS TERM SHEET SUMMARIZES THE PRINCIPAL TERMS OF THE PROPOSED FINANCING OF STARTUP, INC. (THE “COMPANY”). THIS TERM SHEET IS FOR DISCUSSION PURPOSES ONLY. THERE IS NO OBLIGATION ON THE PART OF ANY NEGOTIATING PARTY UNTIL A DEFINITIVE AGREEMENT IS SIGNED BY ALL PARTIES. THIS TERM SHEET DOES NOT CONSTITUTE EITHER AN OFFER TO SELL OR AN OFFER TO PURCHASE SECURITIES.**

**Non-Binding Term Sheet**

**January 11, 2007**

**Startup, Inc., a Cayman Islands company (the “Company”)  
Convertible Note Financing**

1. **Term of Loan** – 12 months
2. **Minimum Amount of Notes** – Up to \$350,000 in convertible notes which may be issued in multiple closings (the “Notes”). The Notes will be unsecured.
3. **Interest** – 8%/year, simple interest.
4. **Conversion Features** – Principal and interest due under the Notes automatically converts into preferred stock of the Company of the same series and with the same contract rights as is sold in the Company’s next equity financing in which the Company raises at least \$1,000,000 (including conversion of Notes) (a “**Qualified Financing**”); *provided* that, if a Qualified Financing does not close prior to the Note maturity date, then the Notes shall no longer convert but rather shall be due and payable. Lenders will receive preferred stock in the Qualified Financing as a result of automatic conversion on the same terms and conditions as other investors except as provided below under Discount.
5. **Prepayment** – Company may prepay the Note and accrued interest at any time prior to a Qualified Financing.
6. **Discount** – Each lender will receive a discount of 20% on the price per share of preferred stock in the Qualified Financing when a Note is converted into preferred stock.
7. **Acquisition** – In the event that the Company is acquired prior to the earlier of the conversion of the Notes in a Qualified Financing or the maturity date, then each noteholder shall be paid an amount equal to 1.5 the principal outstanding under each Note within 30 days after such acquisition.
8. **Subordination** – The Notes shall be subordinated to any Company borrowings from banks or other financial institutions.
9. **Securities** – Each lender must be an “accredited investor” or qualify under another securities law exemption.

**FOR EDUCATIONAL PURPOSES ONLY  
FRED GREGURAS  
FENWICK & WEST LLP  
fgreguras@fenwick.com**

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**MEMORANDUM OF TERMS FOR OFFERING  
OF SERIES A PREFERRED STOCK**

**January 11, 2007**

**VALID FOR ACCEPTANCE UNTIL 5:00 P.M. JANUARY 13, 2007 PST**

This memorandum summarizes the major terms of a private placement of Series A Preferred Stock of **Startup, Inc.** (the “**Company**”), an exempt company formed under the laws of the Cayman Islands. All dollar amounts are U.S. dollars.

**Proposed Private Placement**

- 1. Pre-money Valuation:** \$6,000,000
- 2. Amount of Investment:** \$4,000,000
- 3. Investors:**
- 4. Type of Security:** Series A Preferred Stock
- 5. Number of Preferred Shares:** 4,000,000

The post-financing capitalization of the Company will be as follows on a fully-diluted basis:

	<b><u>Shares</u></b>	<b><u>%</u></b>
Founders (Common Stock)	4,000,000	40
Stock Option Pool (Common Stock)	2,000,000	20
Series A Investors	<u>4,000,000</u>	<u>40</u>
<b>Total:</b>	<b>10,000,000</b>	<b>100</b>

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FENWICK & WEST LLP  
fgreguras@fenwick.com**

6. **Price Per Preferred Share:** \$1.00
7. **Rights, Preferences, Privileges and Restrictions Of Series A Preferred Stock:**
- (1) Dividend Provisions: The holders of the Series A Preferred Stock will be entitled to receive noncumulative dividends in preference to Common Stock at the rate of 6% per annum when and if declared by the Company's Board of Directors (the "**Board**").
- (2) Liquidation Preference: In the event of any liquidation, dissolution or winding up of the Company, the holders of the Series A Preferred Stock will be entitled to receive in preference to the holders of Common Stock an amount equal to \$1.00 per share plus declared and unpaid dividends. After the full liquidation preference on all outstanding shares of Series A Preferred Stock has been paid, any remaining funds and assets of the Company legally available for distribution to stockholders will be distributed, pro rata among the holders of the Series A Preferred Stock and Common Stock on an as-converted basis until the holders of Series A Preferred Stock have received three times (3X) the original purchase price for the Series A Preferred Stock.
- A merger or reorganization or consolidation of the Company in which the Company's stockholders do not retain a majority of the voting power in the surviving entity, or a sale of all or substantially all the Company's assets, will each be deemed to be a liquidation, dissolution or winding up of the Company.
- (3) Conversion: The holders of the Series A Preferred Stock will have the right to convert the Series A Preferred Stock, at the option of the holder, at any time, into shares of Common Stock at the rate of 1:1, subject to weighted average antidilution protection and adjustment for stock split, combination, recapitalization and the like. There shall be no antidilution protection for the issuances excluded under Right of First Refusal below.
- (4) Automatic Conversion: The Series A Preferred Stock will be automatically converted into Common Stock, at the then applicable conversion rate, in the event of either (i) the closing of a bona fide underwritten public offering of shares of the Company with gross proceeds to the Company (prior to underwriter commissions and expenses) of not less than \$20 million (a "**Qualified IPO**") or (ii) the election of holders of a majority of the outstanding Series A Preferred

Stock.

(5) Voting Rights: The holder of each share of Series A Preferred Stock will have the right to that number of votes equal to the number of shares of Common Stock issuable upon conversion of such share of Series A Preferred Stock.

(6) Protective Provisions: Consent of the holders of at least a majority of the Series A Preferred Stock, voting as a class, will be required for: (i) any action which alters or changes the rights, preferences or privileges of the Series A Preferred Stock materially and adversely; (ii) any authorization of shares of any class of stock having preference over or being on a parity with the Series A Preferred Stock; (iii) any merger or reorganization or consolidation of the Company with or into one or more other corporations in which the Company's stockholders do not retain a majority of the voting power in the surviving entity, or sale of all or substantially all the Company's assets; (iv) the liquidation or dissolution of the Company; (v) the declaration or payment of any dividend on the Common Stock (other than a dividend payable solely in shares of Common Stock) or any series of the Preferred Stock; (vi) incurring any debt or financial obligation in excess of US\$250,000 in the aggregate unless incurred pursuant to the then current business plan approved by the Investors; (vii) extending or guaranteeing any debt or financial obligation; (viii) capital expenditure in excess of US\$50,000 unless such is incurred pursuant to the then current business plan approved by the Investors; (ix) transaction with a related party other than employment arrangements; (x) approval or amendment of annual business plans and budgets; (xi) appointment, termination, or change of terms of employment, including an increase of more than 10% in the total compensation in a twelve (12) month period of the ten (10) most highly compensated employees of the Company; (xii) material change in accounting methods or policies or change of auditors; and (xiii) change in the principal business activities of the Company.

## **8. Information Rights**

So long as an investor holds at least 500,000 shares of Series A Preferred Stock or Common Stock issued upon conversion of the Series A Preferred Stock ("Conversion Stock") (as adjusted for stock splits, stock combinations, etc.), the Company will furnish the investor with unaudited monthly financial statements plus annual budgets; provided, however, that the obligation of the Company to furnish monthly financial statements will terminate upon a public offering.

## 9. Registration Rights:

The following registration rights shall apply to an offering in the U.S., Hong Kong, AIM or elsewhere. References to U.S. offering provisions shall have the equivalent meaning in an offering in another jurisdiction. (1) Demand Rights: If, at any time after the fifth anniversary of the closing of this transaction (but not within six months of the effective date of a registration), investors holding at least 50% of the Registrable Securities (defined below) request that the Company file a registration statement for at least 10% of such shares (or any lesser number of shares if the anticipated aggregate offering price, net of underwriting discounts and commissions, would exceed \$15 million), the Company will use its best efforts to cause such shares to be registered. The Company will not be obligated to effect more than two registrations under this demand right provision; provided, that (a) the Company shall have the right, exercisable only one (1) time in any 12 month period, to delay a demand registration for a period not in excess of ninety (90) days if the Company certifies that it would be seriously detrimental to the Company's interests to effect such registration at that time and (b) the Company shall not be obligated to effect more than two registrations under this demand right provision. "Registrable Securities" will consist of shares of Common Stock issuable on conversion of the Preferred Stock.

(2) S-3 Demand Rights: Holders of Registrable Securities shall be entitled to registrations on Form S-3 (if available to the Company) unless: (i) the aggregate public offering price of all Registrable Securities to be sold in such registered offering is less than \$3,000,000; (ii) the Company certifies that it would be seriously detrimental to the Company's interest to effect such registration at that time, in which event the Company may defer the filing for up to ninety (90) days once during any 12 month period; or (iii) the Company has already effected two registrations on Form S-3 during the preceding 12 months.

(3) Company Registration: The holder of Registrable Securities will be entitled to "piggyback" registration rights on registrations of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered in view of market conditions; provided, however, that except in the Company's initial public offering, the Registrable Securities may not be cut back to less than twenty-five percent (25%) of the total number of shares included in the registration.

(4) Expenses: The registration expenses (exclusive of underwriting discounts and commissions) of the demand registrations and piggyback registrations will be borne by the Company, and all S-3 registration expenses and other expenses of registered offerings will be borne by the Company.

(5) Transfer of Rights: The registration rights may be transferred (i) to partners and affiliates, (ii) to a transferee who acquires at least 100,000 shares of Preferred or Conversion Stock and (iii) in cases where less than 100,000 shares of Preferred or Conversion Stock are held, to a single transferee if all share holdings are transferred.

(6) Termination of Registration Rights: The registration rights shall terminate as to a holder if such holder can sell its shares under Rule 144 of the Securities Act of 1933, as amended.

(7) Market Standoff: Purchasers agree to 180-day lockup in connection with a Company IPO.

(8) Founders' Registration Rights: The Founders will have piggyback registration rights subordinate to those of the investors.

**10. Right of First Refusal  
For New Company  
Issuances:**

Each holder of more than 500,000 shares of Series A Preferred Stock (and/or Conversion Stock) (as adjusted for stock splits, stock combinations, etc.), shall have the right of first refusal to purchase up to its pro rata share (based on its percentage of the Company's outstanding shares of capital stock, calculated on an as-converted to Common Stock basis) of any equity securities offered by the Company ("New Securities") on the same price and terms and conditions as the Company offers such securities to other potential investors. "New Securities" shall not include (i) shares of Common Stock issued upon conversion of the Series A Preferred Stock; (ii) shares of Common Stock (and/or options or warrants therefore) that may be granted to employees, directors, contractors, consultants or advisors to the Company pursuant to incentive agreements, stock option plans, stock bonuses or awards, or incentive contracts, as approved by the Board; (iii) shares of Common Stock and/or Preferred Stock (and/or options or warrants therefore) that may be issued to strategic partners investing primarily in

connection with a commercial relationship with the Company, lenders, or lessors, in each case as approved by the Board, including a majority of the Preferred Stock Directors; and (iv) shares of Common Stock and/or Preferred Stock (and/or options or warrants therefore) that may be issued in connection with acquisitions by the Company of other entities or substantially all of their assets, in each case as approved by the Board. This right of first refusal will terminate immediately prior to the earlier of the closing of: (a) a Qualified IPO; (b) a merger or reorganization or consolidation of the Company with or into one or more other corporations in which the stockholders of the Company do not retain a majority of the voting power in the surviving entity), or (c) a sale of all or substantially all the Company's assets.

**11. Purchase Agreement:**

The Purchase Agreement will contain such other provisions as are reasonable, including representations and warranties of the Company and the Founders, conditions to closing, etc., including without limitation, delivery of a customary opinion letter by counsel for the Company.

**12. Board Composition:**

The Board will consist of 5 members.

So long as at least 50% of the shares of Series A Preferred Stock are outstanding (as adjusted for stock splits, stock combinations, etc.), the holders of Series A Preferred Stock will be entitled to elect two (2) members of the Board. So long as the holders of the Series A Preferred Stock are entitled, voting as a separate series, to elect directors, the holders of the Common Stock, voting together as a single class, will be entitled to elect two (2) members of the Board (initially the CEO and Founder One). Any directors not elected by the holders of a specified series or class of stock will be elected by the holders of the Common Stock and Preferred Stock, voting together as a single class.

The Company, the holders of Common Stock and the Series A Investors shall enter into a voting agreement which provides that: (i) Venture Capitalist One and Venture Capitalist Two each shall be entitled to designate one Series A director for so long as they hold a number of shares of capital stock of the Company equal to at least 50% of the shares of stock purchased in the Series A Financing (in each case as determined on an as-converted to Common Stock basis and adjusted for stock splits, stock combinations, etc.); (ii) the CEO and Founder shall hold the two Board seats to be filled by the vote of the Holders of Common Stock; and



(iii) \_\_\_\_\_ shall hold the Board seat to be filled by the vote of the holders of Common Stock and Preferred Stock, voting together as a single class. The initial directors upon the Closing of the Series A Financing will be \_\_\_\_\_ who will be chairman, two additional directors nominated by each of \_\_\_\_\_ and \_\_\_\_\_, and \_\_\_\_\_ and \_\_\_\_\_.

**13. Standard Vesting:**

Stock sold and options granted to employees will be subject to vesting over four years. 25% of the shares will vest at the end of the first year, with the balance to vest in equal monthly increments over the remaining three years; provided, however, that stock may be sold and options may be granted subject to a different vesting schedule if unanimously approved by the Board. The Company shall have a right to repurchase unvested shares upon termination of employment and a right of first refusal to purchase any shares of vested stock proposed to be transferred by an employee.

**14. Right of First Refusal and Co-Sale Agreement:**

Each holder of more than 500,000 shares of Series A Preferred Stock (and/or Conversion Stock) (as adjusted for stock splits, stock combinations, etc.) (a "**Rightholder**") shall have a right of first refusal on the sale of shares of Common Stock held by Founder One and Founder Two which are not purchased by the Company pursuant to its right of first refusal, calculated on a pro rata basis, based on such Rightholder's percentage of holdings of capital stock of the Company held by all Rightholders. In addition, each Rightholder shall have a right of co-sale in connection with sales by Founder One and Founder Two; calculated on a pro rata basis, based on the Rightholder's percentage of holdings of capital stock of the Company held all participating Rightholders. The foregoing rights shall terminate immediately prior to the earlier of the closing of: (i) a Qualified IPO; (ii) any merger or reorganization or consolidation of the Company with or into one or more other corporations in which the stockholders of the Company do not retain a majority of the voting power in the surviving entity), or (iii) a sale of all or substantially all the Company's assets.

**15. Closing:**

The closing of this transaction is expected to occur on or before February 15, 2007.

- 16. Exclusivity:** Company agrees to give the Investors forty five (45) days exclusivity (“**Exclusivity Period**”) starting from the signing date of this Term Sheet. During the Exclusivity Period, the Company and its shareholders, without the express written permission of the Investors, shall not engage in any discussions, negotiations or conclude any transaction with any third party with respect to an equity transaction or investment regarding the Company.
- 17. Drag Along Rights** The Series A will have a drag along right in an acquisition of the Company in which the Board of Directors has approved the transaction and the consideration to be paid for the Company exceeds \$30,000,000.
- 18. Investor’s Counsel Fees:** The Company will bear the expenses of one counsel to the investors in an amount not to exceed \$30,000.
- 19. Counsel to the Company:** Fred Greguras, Andrew Luh and Lily Toy  
Fenwick & West LLP  
801 California Street  
Mountain View, CA 94040  
(650) 988-8500

This Memorandum represents only the current thinking of the parties with respect to certain of the major issues relating to the proposed Series A financing. Therefore, except for item 16, it is understood and acknowledged that this Memorandum is not intended and will not be deemed to be a legally binding agreement among the parties for any purposes. All rights and obligations of the parties will be subject to negotiation and execution of definitive financing documents among the parties and completion of the other matters set forth above.



## Trends in Terms of Venture Financings in the San Francisco Bay Area

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Third Quarter 2006

# FENWICK & WEST LLP

## Trends in Terms of Venture Financings in the San Francisco Bay Area (Third Quarter 2006)

### Background

We analyzed the terms of venture financings for 120 technology companies headquartered in the San Francisco Bay Area that reported raising money in the third quarter of 2006.

### Overview

The results of the 3Qo6 survey showed a continuation of the strong positive trend in venture valuations. The highlights of the quarter were as follows:

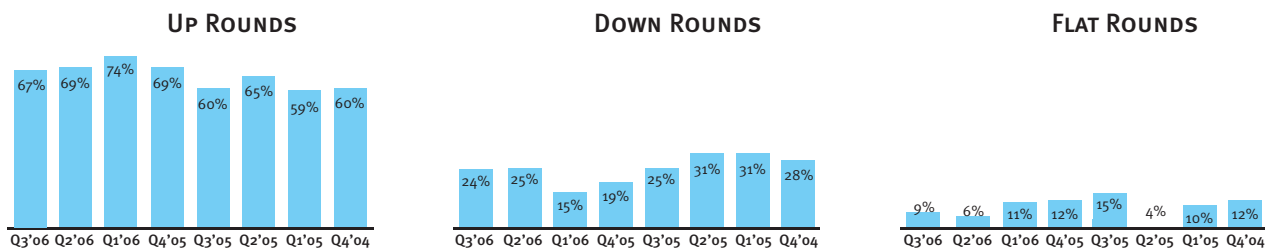
- Up rounds exceeded down rounds in 3Qo6 for the eleventh quarter in a row (67% up vs. 24% down, with 9% flat).
- The Fenwick & West Venture Capital Barometer™ showed a 49% average price increase for Silicon Valley companies receiving venture capital in 3Qo6 compared to such companies' previous financing round.

Other U.S. venture industry related results for the quarter included the following:

- The amount invested by venture capitalists in the U.S. in 3Qo6 was approximately \$6.4 billion, effectively flat with \$6.8B in 2Qo6 and \$6.3B in 1Qo6. If current trends continue 2006 is on track to be the best year for U.S. venture investing since 2001.<sup>1</sup>
- Acquisitions of venture backed companies in the U.S. in 3Qo6 was approximately \$6.8 billion in 97 transactions. This is a decline from the two most recent quarters, but overall 2006 is on track to slightly exceed 2005 and to be the best acquisitions year since 2000.<sup>1</sup>
- There were 8 IPOs of venture backed companies in the U.S. in 3Qo6, a decline from 16 in 2Qo6 and 13 in 1Qo6.
- Nasdaq was up 4% in 3Qo6 and is up approximately 6% in 4Qo6 to date.

### Price Change

The direction of price changes for companies receiving financing this quarter, compared to their previous round, were as follows:



The percentage of down rounds by series were as follows:

Series	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
B	13%	16%	12%	10%	16%	12%	19%	24%
C	24%	32%	12%	5%	35%	32%	36%	25%
D	38%	14%	27%	46%	33%	37%	30%	28%
E and higher	33%	57%	12%	35%	23%	60%	62%	42%

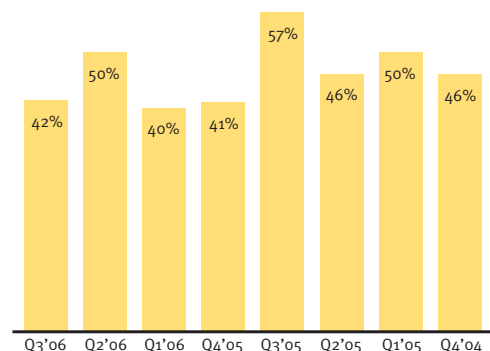
**The Fenwick & West Venture Capital Barometer™ (Magnitude of Price Change)**—Set forth below is (i) for up rounds, the average per share percentage increase over the previous round, (ii) for down rounds, the average per share percentage decrease over the previous round, and (iii) the overall average per share percentage change from the previous round for all rounds taken together. Such information is broken down by series for Q3'06 and is provided on an aggregate basis for comparison purposes for the prior five quarters. In calculating the “net result” for all rounds, “flat rounds” are included. For purposes of these calculations, all financings are considered equal, and accordingly we have not weighted the results for the amount raised in a financing.

Q3'06 Percent Change	Series B	Series C	Series D	Series E and higher	Combined total for all Series for Q3'06	Combined total for all Series for Q2'06	Combined total for all Series for Q1'06	Combined total for all Series for Q4'05	Combined total for all Series for Q3'05	Combined total for all Series for Q2'05
<b>Up rounds</b>	+86%	+76%	+78%	+174%	+86%	+69%	+95%	+81%	+88%	+83%
<b>Down rounds</b>	-44%	-34%	-30%	-27%	-35%	-57%	-49%	-56%	-60%	-43%
<b>Net result</b>	+62%	+41%	+29%	+78%	+49%	+34%	+64%	+45%	+38%	+41%

**Financing Round**—The financings broke down according to the following rounds:

Series	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
<b>A</b>	23%	14%	11%	22%	18%	15%	24%	18%
<b>B</b>	31%	34%	40%	35%	31%	26%	29%	24%
<b>C</b>	24%	28%	17%	17%	23%	27%	16%	28%
<b>D</b>	17%	16%	15%	11%	15%	21%	22%	18%
<b>E and higher</b>	5%	8%	17%	15%	13%	11%	9%	12%

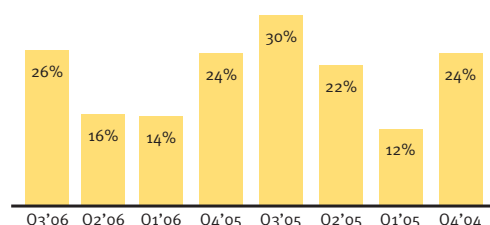
**Liquidation Preference**—Senior liquidation preferences were used in the following percentages of financings:



The percentage of senior liquidation preference by series was as follows:

Series	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
<b>B</b>	30%	35%	29%	22%	42%	25%	38%	32%
<b>C</b>	41%	76%	47%	40%	48%	40%	57%	39%
<b>D</b>	57%	36%	60%	69%	87%	68%	55%	72%
<b>E and higher</b>	67%	57%	41%	65%	77%	70%	62%	50%

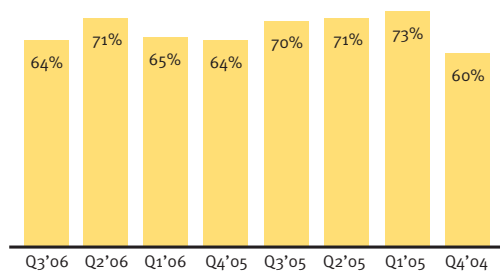
**Multiple Liquidation Preferences**—The percentage of senior liquidation preferences that were multiple preferences were as follows:



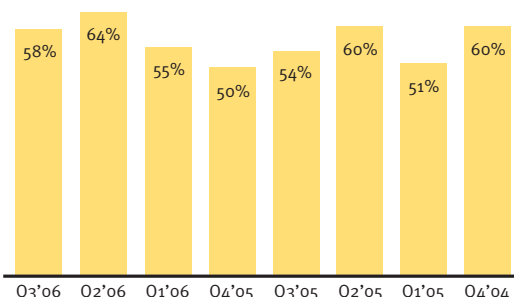
Of the senior liquidation preferences, the ranges of the multiples broke down as follows:

Range of	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
<b>&gt;1x- 2x</b>	90%	83%	80%	67%	93%	88%	100%	89%
<b>&gt;2x – 3x</b>	10%	0%	20%	33%	7%	0%	0%	0%
<b>&gt; 3x</b>	0%	17%	0%	0%	0%	12%	0%	11%

**Participation in Liquidation** – The percentages of financings that provided for participation were as follows:



Of the financings that had participation, the percentages that were not capped were as follows:



**Cumulative Dividends** – Cumulative dividends were provided for in the following percentages of financings:

Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
7%	8%	3%	4%	3%	4%	9%	9%

**Antidilution Provisions** – The uses of antidilution provisions in the financings were as follows:

Type of Provision	Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
Ratchet	4%	2%	4%	9%	7%	8%	9%	9%
Weighted Average	95%	97%	92%	85%	92%	88%	87%	85%
None	1%	1%	4%	6%	1%	4%	4%	6%

**Pay-to-Play Provisions** – The use of pay-to-play provisions in the financings was as follows:

**Percentages of financings having pay-to-play provisions.**

Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
10%	16%	11%	16%	8%	16%	17%	12%

**Redemption** – The percentages of financings providing for mandatory redemption or redemption at the option of the venture capitalist were as follows:

Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
29%	33%	27%	31%	32%	29%	30%	28%

**Corporate Reorganizations** – The percentages of post-Series A financings involving a corporate reorganization were as follows:

Q3'06	Q2'06	Q1'06	Q4'05	Q3'05	Q2'05	Q1'05	Q4'04
5%	12%	9%	11%	17%	15%	13%	8%

For additional information about this report please contact Barry Kramer at 650-335-7278; [bkramer@fenwick.com](mailto:bkramer@fenwick.com) or Michael Patrick at 650-335-7273; [mpatrick@fenwick.com](mailto:mpatrick@fenwick.com) at Fenwick & West. To be placed on an email list for future editions of this survey please go to [www.fenwick.com/vctrends.htm](http://www.fenwick.com/vctrends.htm).

The contents of this report are not intended, and should not be considered, as legal advice or opinion.

<sup>1</sup> Information in this paragraph obtained from Dow Jones VentureSource.

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# **THE CURRENT VENTURE FINANCING ENVIRONMENT**

## **3Q 2006 BAY AREA VENTURE CAPITAL TERMS SURVEY**

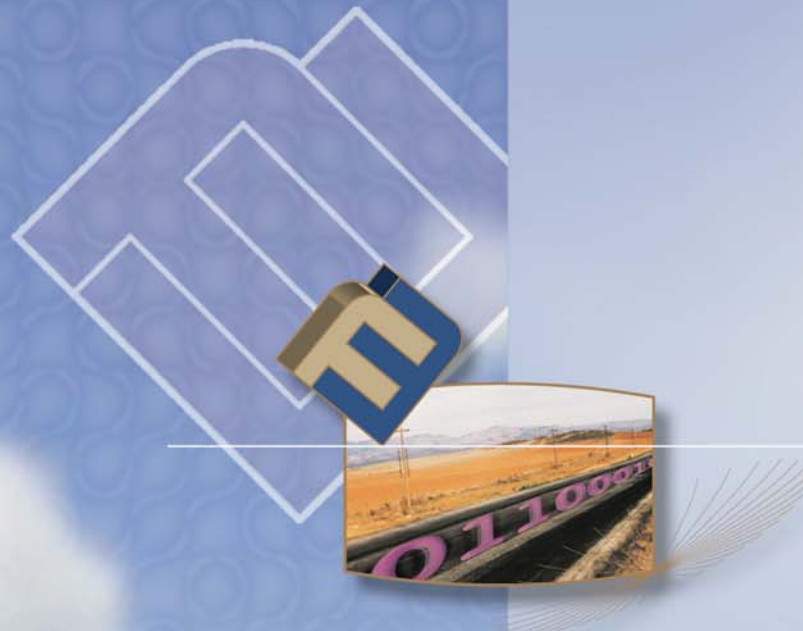
### **SERIES A AND B ROUND OBSERVATIONS**

**Fred Greguras**

**Fenwick & West LLP**

**[fgreguras@fenwick.com](mailto:fgreguras@fenwick.com)**

**650.335.7241**



**FENWICK & WEST LLP**

**November 20, 2006**

# 3Q 2006 Bay Area Venture Capital Legal Terms Survey Results



- 120 Bay Area technology financings in 3Q 2006 compared to 90 in 2Q 2006.
- Series A financings were 23% of Bay Area financings in 3Q 2006 (27 financings) compared to 14% in 2Q 2006 (13 financings).
- Continuing large numbers of Series B Rounds (37 in Q3 and 31 in Q2) and national statistics on early stage financings indicate many Series A financings are not reported.
- More up rounds (67%) than down rounds (24%) in Q3 2006 as compared to 69% and 25% in 2Q 2006. Eleventh straight quarter of more up rounds than down rounds.
- Series B up rounds were 78% in 3Q 2006 compared to 84% in 2Q 2006.



# 3Q 2006 Bay Area Venture Capital Legal Terms Survey Results



- Series B down rounds were 14% in 3Q 2006 compared to 16% in 2Q 2006.
- Life sciences (biotech and medical devices) and software received the most investment at the national level. The number of software investments is declining.\*
- Financings that had participating liquidation preferences (LPs) in 3Q 2006 were 64% compared to 62% in 2Q 2006. Participating LP was uncapped in 58% of 3Q 2006 financings compared to 38% in 2Q 2006.
- Some form of weighted average antidilution protection was used in about 95% of 3Q 2006 financings compared to 97% in 2Q 2006.

\*Source: Dow Jones VentureOne

# Series A Financing Observations

## Pre-Money Valuations



- **\$4M – 7M Range**
- **Pre-money valuation tends to be slightly higher than the amount to be invested which means investors own about 40-45% on a fully-diluted basis**
- **Resulting fully-diluted cap table may be:**
  - **40-45% Preferred Stock**
  - **25-40% Founders (with vesting pressure)**
  - **20-30% Plan**
- **Size of plan is a key deal point**
- **Funding must stretch until the validation/inflection point for securing Series B funding**
- **Pressure to get more done with less money**

# Series A Financing Observations

## Board Size and Composition



- **Control issue**
- **Tends to be 5 persons if there are two investors:**
  - 2 P/S
  - 2 C/S
- **Selection of fifth director is critical**
  - selected by other directors
  - selected by outstanding shares
  - Industry rep, outsider
- **Fifth director often not seated until Series B financing**

# Series A Financing Observations

## Other Provisions



### ■ Liquidation Preferences

- initial 1X:
  - 3Q 2006: 25 of 27 were 1X
  - 2Q 2006: All 13 were 1X
- more participating:
  - 3Q 2006: 16 of 27 were participating of which 13 of the 16 were uncapped
  - 2Q 2006: 8 of 13 were participating of which 5 of the 8 were uncapped

### ■ Antidilution

- weighted average:
  - 3Q 2006: 26 of 27 were weighted average
  - 2Q 2006: All 13 were weighted average

### ■ Protective Provisions – standard and comprehensive

- Place of incorporation: 3Q 2006: 20 of 27 Series A were Delaware; remainder were California; 2Q 2006: 11 of 13 Series A were Delaware corporations

## Series B Financing Observations

- Series B valuations and round amounts are increasing because of greater demand for B deals
- Exit valuation ranges may not support higher valuations. Pressure to get more done with less money
- Larger round amounts and number of new investors are creating a larger Board in some cases
- Venture debt “growth lines” are more readily available immediately after closing of Series A and Series B rounds because of the number of competitors in the venture lending market



# Series B Financing Observations

## Other Provisions



### ■ Liquidation preference of 1X, most were participating

- 3Q 2006: 32 of 37 initial LP were 1X; 25 of 37 were participating (11 of 25 uncapped); 11 of 37 were senior; remainder pari passu
- 2Q 2006: 30 of 31 initial LP were 1X; 25 of 31 were participating (13 of 25 uncapped); 11 of 31 were senior; remainder pari passu

### ■ Weighted average antidilution

- 3Q 2006: 35 of 37 were weighted average
- 2Q 2006: All 31 were weighted average

# IPO and M&A Exits



- 3Q 2006 IPOs continued at a very weak pace, 8 venture-backed IPOs (\$623M raised), as compared to 16 in the 2Q 2006 (\$956M raised)\*
- Threat of an IPO is usually not a credible alternative to M&A
- 3Q 2006 M&A exits (97) for venture-backed companies were lower in number than 2Q 2006 (111) and with a lower average valuation as compared to the 2Q 2006, about \$70M as compared to \$75M\*
- Overall, 2006 M&A activity should exceed 2005 activity and be the best since 2000\*
- More global acquirers are in the hunt for acquisitions
- The AIM stock market in the UK is being considered by more U.S. companies for an IPO

\* Source: Dow Jones VentureOne



# Conclusions

- More Series A deals are in stealth mode and not reported
- Investors ownership percentage (on a fully-diluted basis) in Series A financings is decreasing; vesting and size of option pool are other key deal points
- Series B valuations and round amounts are increasing because of greater demand for Series B deals
- M&A is the highly probable exit; IPO exits are unlikely to increase at least in the U.S.
- IPOs on AIM are being considered by more companies
- Venture debt should be considered immediately after round closing to raise more cash to extend a company's runway







Fred M. Greguras

Of Counsel

Corporate and Technology  
Transactions Practice Groups

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Phone: 650.335.7241

Fax: 650.938.5200

E-mail: [fgreguras@fenwick.com](mailto:fgreguras@fenwick.com)

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Emphasis:

Startups and Venture Capital  
Financings

Licensing

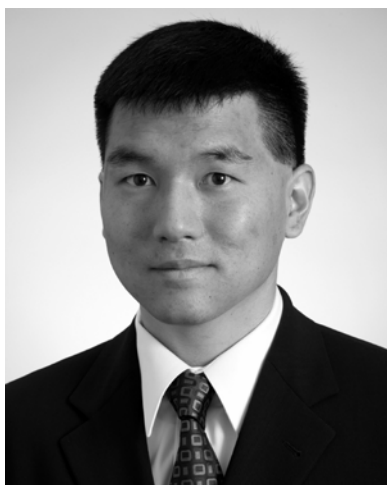
Intellectual Property Protection

Fred M. Greguras is of counsel in the corporate and technology transactions groups at Fenwick & West LLP, a law firm specializing in high technology matters. He practices out of the firm's Mountain View, California, office. Mr. Greguras focuses on strategic legal issues for software, semiconductor-related and life sciences companies. His practice includes start-up issues and financings in both domestic and international transactions. He has represented a wide range of companies in financing, M&A, licensing and other commercial transactions, from privately held start-ups to publicly traded companies. Mr. Greguras has also been a venture capitalist and a general counsel and CFO for a startup. Some of the clients he has represented are:

- BioMarker Pharmaceuticals, Inc.
- Excite@Home
- Exodus Communications, Inc.
- Kintana, Inc.
- Speedera Networks, Inc.

Mr. Greguras has authored many articles on start-up, financing, outsourcing, Internet and international legal issues, which are available at [www.fenwick.com](http://www.fenwick.com).

He received a Bachelor of Arts in mathematics from University of Omaha in 1966, a Masters of Science in mathematics and computer science in 1968, and his J.D. in 1975 from the University of Nebraska. Mr. Greguras is a member of the State Bar of California.



Andrew Luh

Partner

Corporate Group

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Phone: 650.335.7964

Fax: 650.938.5200

E-mail: [aluh@fenwick.com](mailto:aluh@fenwick.com)

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Emphasis:

Mergers and Acquisitions

Venture Capital Financings

Securities Law Compliance

Andrew Luh is a partner in the Corporate Group at the law firm of Fenwick & West LLP. Mr. Luh practices out of the firm's Mountain View, California, office. His practice focuses on general corporate representation of high technology clients and transactional representation on mergers and acquisitions, venture capital financings, securities offerings and related matters. Among the clients he has represented are:

- Cisco Systems, Inc.
- Dell Inc.
- Exodus Communications, Inc.
- Silicon Image, Inc.
- Sun Microsystems, Inc.
- Symantec Corporation

Mr. Luh received his undergraduate education at the University of Virginia, where he graduated ranked first in his class with a B.A. in economics in 1993 and was elected to Phi Beta Kappa. He attended law school at Stanford University, where he graduated with distinction with a J.D. in 1996 and was elected to the *Order of the Coif*.



Lily M. Toy

Associate

Corporate Group

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Phone: 650.335.7687

Fax: 650.938.5200

E-mail: [ltoy@fenwick.com](mailto:ltoy@fenwick.com)

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Emphasis:

Securities Offerings

Mergers & Acquisitions

Venture Capital Financings

Lily Toy is an associate in the Corporate Group of Fenwick & West LLP, a law firm specializing in technology and life sciences matters. Fenwick & West is headquartered in Mountain View, California, with an office in San Francisco.

Ms. Toy received her J.D. from Cornell Law School in 2004. During law school, Ms. Toy was a judicial extern for the Honorable Alan Jaroslovsky of the United States Bankruptcy Court. She received her B.A. with honors in Economics and Legal Studies from the University of California, Berkeley in 2001.

Prior to joining Fenwick & West, Ms. Toy was a corporate associate with the Menlo Park office of Shearman & Sterling LLP.

Ms. Toy is a member of the State Bar of California. She is fluent in Chinese (Mandarin and Cantonese).

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**FENWICK & WEST LLP**

SILICON VALLEY ► SAN FRANCISCO



## Fenwick & West Firm Overview

FENWICK & WEST LLP PROVIDES COMPREHENSIVE LEGAL SERVICES TO HIGH TECHNOLOGY AND LIFE SCIENCES COMPANIES OF NATIONAL AND INTERNATIONAL PROMINENCE. MORE THAN 250 ATTORNEYS OFFER CORPORATE, INTELLECTUAL PROPERTY, LITIGATION AND TAX SERVICES FROM OUR OFFICES IN MOUNTAIN VIEW AND SAN FRANCISCO, CALIFORNIA.

### Corporate Group

We service high technology and life sciences companies, from early start-ups to mature public companies.

*Start-Up Companies.* We have represented hundreds of growth-oriented companies from inception through maturity. Our attorneys understand what it takes to start with only an idea, build a team, found a company, raise venture capital funding and grow a business. We have represented many of the nation's leading venture capital firms and do multiple deals each year with companies financed by these market leaders.

*Mergers and Acquisitions.* We are ranked by *MergerMarket* as one of the top five most active legal advisor in the U.S. for technology sector M&A. We understand the problems that arise in technology company acquisitions and focus our efforts on issues that are of the most value to the client. Our expertise spans the entire spectrum of high technology, from life sciences to semiconductors, and our lawyers are equally adept at small private company transactions and multi-billion dollar public transactions. Of particular importance to our high technology client base is the extraordinary acumen of our due diligence mergers and acquisitions teams in locating and documenting intellectual property holdings of buyers and sellers. For clients involved in larger deals, our antitrust lawyers are experienced in working with the Department of Justice and Federal Trade Commission in the pre-merger clearance process. We understand the many issues that can mean the difference between a successful transaction and a broken promise.

*Public Offerings and Securities Law Compliance.* Our extensive representation of emerging companies has given us substantial depth of experience in public offerings. In recent years, we have represented companies or investment banks in more than 100 initial public offerings, which, combined, have raised over \$7 billion dollars. We have helped our clients raise billions more in follow-on debt and equity offerings. Our counseling practice for technology companies regarding ongoing public securities law issues includes extensive Sarbanes-Oxley compliance and board or audit committee counseling.

*Strategic Alliances.* For many high technology companies, the path to financing and commercialization begins with their first collaboration or joint venture with an industry partner. These agreements can often make or break a young technology company. We help clients think through the business, intellectual property, tax and other legal issues that arise in their corporate partnering transactions and joint ventures.

*Executive Compensation.* As an integral part of the corporate practice, we counsel clients on a wide range of employee benefits and compensation matters. We assist companies in establishing and administering employee benefit arrangements. Our lawyers help define and structure stock or other equity plans and arrangements, as well as tax qualified and fringe benefit plans, that meet the companies' needs and comply with ever-changing regulatory requirements. In the context of public offerings and acquisitions, our attorneys handle the issues that regularly arise with equity plans or other employment benefit arrangements.

**Intellectual Property Group**

We deliver comprehensive, integrated advice regarding all aspects of intellectual property protection and exploitation. Fenwick & West has been consistently ranked as one of the top five West Coast firms in intellectual property litigation and protection for the past 10 years by Euromoney's *Managing Intellectual Property* publication. From providing sophisticated legal defense in precedent-setting lawsuits, to crafting unique license arrangements and implementing penetrating intellectual property audits, our intellectual property attorneys have pioneered and remain at the forefront of legal innovation. We are continually in sync with our clients' technological advances in order to protect their positions in this fiercely competitive marketplace.

The Intellectual Property Group is comprised of approximately 80 lawyers and other professionals. A significant number of the lawyers in the group and other practice groups in the Firm have technical degrees, including advanced degrees, and substantial industry work experience. More than 35 attorneys are licensed to practice before the U.S. Patent and Trademark Office. Our lawyers' technical skills and industry experience help us render sophisticated advice with respect to novel technologies and related intellectual property rights issues. Attorneys in the group have lectured and published widely on emerging issues raised by the development, application and commercialization of technology.

**Litigation Group**

Litigation is an unfortunate fact of life in business today. Our Litigation Group has the range of experience and critical mass to protect our clients' interests in virtually any type of dispute, large or small. We are experienced in all methods of alternative dispute resolution and find creative ways to resolve cases short of trial. However, we are trial lawyers first and foremost; and the presence of our lawyers in a case signals to the other side that we are ready and willing to try the case aggressively and well, a message that itself often leads to a satisfactory settlement. While we have extensive litigation experience in

a wide range of industries, we have exceptional depth and breadth in the areas of the law critical to our high technology clients. Those clients are leaders in such sectors as software and programming; Internet and entertainment; computer hardware; semiconductors and life sciences. We are regularly involved in significant cases involving intellectual property (patents, copyright, trademarks and trade secrets), employment disputes, corporate governance, securities, antitrust and general commercial litigation. In addition to civil litigation, our attorneys are experienced in representing clients in civil and criminal government investigations. Using a network of experienced local counsel, we routinely represent clients in cases throughout the United States. To support our lawyers, we have created a first-class litigation infrastructure of experienced legal assistants and computerized litigation support systems capable of handling everything from relatively small and simple cases to the largest and most complex "bet-the-company" mega-cases.

**Tax Group**

Fenwick & West has one of the nation's leading domestic and international tax practices. The Tax Group's unusually exciting and sophisticated practice stems from a client base that is represented in every geographic region of the United States, as well as a number of foreign countries, and has included approximately 100 Fortune 500 companies, 38 of which are in the Fortune 100. In recent surveys of 1,500 companies published in *International Tax Review*, Fenwick & West was selected as one of only seven First Tier tax advisors in the United States.

**Fenwick & West Offices**

801 California Street	555 California Street
Mountain View, CA 94041	San Francisco, CA 94104
Tel: 650.988.8500	Tel: 415.875.2300

[www.fenwick.com](http://www.fenwick.com)