Legal Resource Guide For Entrepreneurs

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Guide to Starting a Corporation

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Our Offices

801 California Street
Mountain View, CA 94041
Tel: 650.988.8500

555 California Street, 12th floor
San Francisco, CA 94111
Tel: 415.875.2300

1191 Second Avenue, 10th floor
Seattle, WA 98101
Phone: 206.389.4510

950 W. Bannock Street, Suite 850
Boise, ID 83702
Tel: 208.331.0700

For more information about Fenwick & West LLP, please visit our Web site at: www.fenwick.com.

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Introduction

This guide describes certain basic considerations and costs involved in forming a Delaware or California corporation. Although Delaware and California law are emphasized, the legal concepts are much the same in other states. One important tip is that you should avoid making business decisions in a vacuum. Instead, consider how a decision may impact future alternatives. For example, an improperly priced sale of common stock to founders immediately followed by a sale of preferred stock may result in a significant tax liability to the founders. Another example is that converting a limited liability company into a corporation immediately before the business is acquired, rather than at an earlier time, may prevent the transaction from being tax-free.

This guide is only an overview, particularly as to tax issues and cannot substitute for a professional advisor's analysis and recommendations based on your individual fact situations when establishing your business.

A. Selecting the Form of Business Organization

No single factor is controlling in determining the form of business organization to select, but if the business is expected to expand rapidly, a corporation will usually be the best alternative because of the availability of employee incentive stock plans; ease of accommodating outside investment and greater long-term liquidity alternatives for shareholders. A corporation also minimizes potential personal liability if statutory formalities are followed. The characteristics of a corporation are described below, followed by an overview of other traditional forms of business organizations. Each of the following factors is described for comparison purposes: statutory formalities of creation, tax consequences, extent of personal liability of owners, ease of additional investment, liquidity, control and legal costs.

1. Corporation

A corporation is created by filing articles of incorporation with the Secretary of State in the state of incorporation. Corporate status is maintained by compliance with statutory formalities. A corporation is owned by its shareholders, governed by its Board of Directors who are elected by the shareholders and managed by its officers who are elected by the Board. A shareholder's involvement in managing a corporation is usually limited to voting on extraordinary matters. In both California and Delaware, a corporation may have only one shareholder and one director. A president/CEO, chief financial officer/treasurer and secretary are the officer positions generally filled in a startup and, in fact, are required under California law. All officer positions may be filled by one person.

The reasons for using a Delaware corporation at startup are the ease of filings with the Delaware Secretary of State in financings and other transactions, a slight prestige factor in being a Delaware corporation and avoiding substantial reincorporation expenses later, since many corporations which go public reincorporate in Delaware at the time of the IPO. Delaware corporate law benefits are of the most value to public companies. However, if the corporation's primary operations and at least 50% of its shareholders are located in California, many provisions of California corporate law may be applicable to a private Delaware corporation and such a company would pay franchise taxes in both California and Delaware. These considerations may result in such a business choosing to incorporate in California instead of Delaware. Another reason for keeping it simple and using a California corporation is the current non-existent IPO market which makes an acquisition a more likely exit for a start-up.

There is more flexibility under Delaware law as to the required number of Board members. When a California corporation has two shareholders, there must be at least two Board members. When there are three or more shareholders, there must be at least three persons on the Board. Under Delaware law, there may be one director without regard for the number of stockholders. Most Boards stay lean and mean in number as long as possible to facilitate decision-making. Since the Board is the governing body of the corporation, when there are multiple board members, a party owning the majority of the shares can still be outvoted on the Board on important matters such as sales of additional stock and the election of officers. Removing a director involves certain risks even when a founder has the votes to do so. Thus, a founder's careful selection of an initial Board is essential. You want board members whose judgment you trust (even if they disagree with you) and who can provide you with input you won't get from the management team.

A corporation is a separate entity for tax purposes. Income taxed at the corporate level is taxed again at the shareholder level if any distribution is made in the form of a dividend. The S Corporation election described below limits taxation to the shareholder level but subjects all earnings to taxation whether or not distributed. The current maximum federal corporate tax rate is 35%. The California corporate income tax rate is 8.84% and the Delaware corporate income tax rate is 8.7% but Delaware income tax does not apply if no business is done in Delaware and only the statutory office is there. There is also a Delaware franchise tax on authorized capital which can be minimized at the outset but increases as the corporation has more assets.

If the business fails, the losses of the initial investment of up to $1 million in the aggregate (at purchase price value) of common and preferred stock (so-called "Section 1244 stock") may be used under certain circumstances by shareholders to offset a corresponding amount of ordinary income in their federal income tax returns. An individual may deduct, as an ordinary loss, a loss on Section 1244 stock of up to $50,000 in any one year ($100,000 on a joint return).

If statutory formalities are followed, individual shareholders have personal liability only to the extent of their investment, i.e., what they paid for their shares. If the corporation is not properly organized and maintained, a court may "pierce the corporate veil" and impose liability on the shareholders. Both California and Delaware law permit corporations to limit the liability of their directors to shareholders under certain circumstances. The company can raise additional capital by the sale and issuance of more shares of stock, typically preferred stock when an angel or venture capitalist is investing. Though rare, the power of a court to look through the corporation for liability underscores the importance of following proper legal procedures in setting up and operating your business.

Filing fees, other costs and legal fees through the initial organizational stage usually total about $3,500 to $5,000, with a Delaware corporation being at the high end of the range.

2. Sole Proprietorship

The simplest form of business is the "sole proprietorship," when an individual operates a business on his own. The individual and the business are identical. No statutory filings are required if the sole proprietor uses his own name. If a different business name is used in California, a "fictitious business name" statement identifying the proprietor must be filed with the county clerk of the county where the principal place of business is located and published in the local legal newspaper. A sole proprietor has unlimited personal liability to creditors of his business and business income is taxed as his personal income. Because of the nature of this form of business, borrowing is the usual method of raising capital. The legal cost of forming a sole proprietorship is minimal.

3. General Partnership

When two or more individuals or entities operate a business together and share the profits, the enterprise is a "partnership." Partnerships are either general partnerships or limited partnerships (described below). Although partners should have written partnership agreements which define each party's rights and obligations, the law considers a venture of this type as a partnership whether or not there is a written agreement. No governmental filings are required for a general partnership. A partnership not documented by a written agreement is governed entirely by the versions of Uniform Partnership Act in effect in California and Delaware.

In the absence of an agreement to the contrary, each partner has an equal voting position in the management and control of the business. Each partner generally has unlimited liability for the debts of the partnership and is legally responsible for other partners' acts on behalf of the business, whether or not a partner knows about such acts.

The partnership is a conduit for tax purposes: profits (even if not distributed) and losses flow through to the partners as specified in the partnership agreement. There is no federal tax at the entity level. Some partnerships contemplate raising additional capital, but accommodating future investment is not as easy as in a corporation. The legal cost of establishing a partnership is minimal if no formal written agreement is prepared but not having a written agreement may cause disputes over the economic benefits, intellectual property and assets of the partnership. The cost of preparing such an agreement begins at about $2,000 and depends on the number of partners, sophistication of the deal and other factors.

4. Limited Partnership

This is a partnership consisting of one or more general partners and one or more limited partners which is established in accordance with the California and Delaware versions of the Uniform Limited Partnership Act. Like the corporation, this entity has no legal existence until such filing occurs. The limited partnership is useful when investors contribute money or property to the partnership but are not actively involved in its business. The parties who actively run the business are the "general partners," and the passive investors are the "limited partners." So long as the limited partnership is established and maintained according to statutory requirements, and a limited partner does not take part in the management of the business, a limited partner is liable only to the extent of his investment. Like a general partnership, however, the general partners are personally responsible for partnership obligations and for each other's acts on behalf of the partnership.

For tax purposes, both general partners and limited partners are generally treated alike. Income, gains and losses of the partnership "flow through" to them and affect their individual income taxes. A properly drafted limited partnership agreement apportions profits, losses and other tax benefits as the parties desire among the general partners and the limited partners, or even among various subclasses of partners subject to certain requirements imposed by U.S. tax law, i.e., the Internal Revenue Code (the "IRC").

5. Limited Liability Company

This form of business organization is available in Delaware and California as well as many other states. It is essentially a corporation which is taxed like a partnership but without many of the S Corporation restrictions identified below. An LLC has fewer statutory formalities than a corporation and is often used for a several person consulting firm or other small business. An LLC does not provide the full range of exit strategies or liquidity options as does a corporation. It is not possible to grant stock option incentives to LLC employees in the same manner as a corporation. Further, an acquisition of an LLC generally may not be done on a tax-free basis and the expenses of formation are higher than for forming a corporation.

B. S Corporations

A corporation may be an "S corporation" and not subject to federal corporate tax if its shareholders unanimously elect S status for the corporation on a timely basis. "S corporation" is a tax law label; it is not a special type of corporation under state corporate law. Like a partnership, an S corporation is merely a conduit for profits and losses. Income is passed through to the shareholders and is generally taxed only once. Corporate level tax can apply in some circumstances to an S corporation that previously had been a "C" corporation for income tax purposes. Losses are also passed through to offset each shareholder's income to the extent of his basis in his stock and any loans by the shareholder to the S corporation. The undistributed earnings retained in the corporation as working capital are taxed to a shareholder.

A corporation must meet certain conditions in order to be an S corporation, including the following: (1) it must be a U.S. corporation, (2) it must have no more than 100 shareholders, (3) each shareholder must be an individual, certain trusts, certain charitable organizations, employee stock ownership plans or pension plans, (4) no shareholder may be a nonresident alien, and (5) it can have only one class of stock outstanding (as opposed to merely being authorized). As a result, S corporation status will be terminated when a corporation sells preferred stock or sells stock to a venture capital partnership, corporation or to an off-shore investor.

California and Delaware recognizes the S corporation for state tax purposes, which may result in additional tax savings. California, however, imposes a corporate level tax of 1.5% on the S corporation's income and nonresident shareholders must pay California tax on their share of the corporation's California income. In addition, only C corporations and noncorporate investors are eligible for the Qualified Small Business Corporation capital gains tax break. The benefit of this tax break is that if the stock is held for at least 5 years, 50% of any gain on the sale or exchange of stock may be excluded from gross income. This benefit may not be as important because of the reduction in the capital gains tax rate.

C. Choosing a Business Name

The name selected must not deceive or mislead the public or already be in use or reserved. "Inc.," "Corp." or "Corporation" need not be a part of the name in California but must be part of a Delaware corporate name. Name availability must be determined on a state-by-state basis through the Secretary of State. A corporate name isn't available for use in California merely because the business has been incorporated in Delaware. Several alternative names should be selected because so many businesses have already been formed. Corporate name reservation fees range from approximately $10-50 per state for a reservation period of 30-60 days. Exclusive state rights in a trade name can also be obtained indefinitely through the creation of a name-holding corporation, a corporation for which articles of incorporation are filed but no further organizational steps are taken.

D. Selecting the Location for the Business

This decision is driven by state tax considerations and operational need, for example, to be near customers or suppliers or in the center of a service territory. A privately-held corporation cannot avoid California taxes and may not be able to avoid the application of California corporate law if it is operating here and has most of its shareholders here. For example, Delaware law allows Board members to be elected for multiple year terms and on a staggered basis rather than on an annual basis. A privately held corporation, however, may be able to have the benefits of these Delaware laws or any other state's corporate law if it is actually operating in California and more than 50% of its shareholders are here.

E. Qualifying to do Business in Another State

A corporation may need to open a formal or informal office in another state at or near the time of founding. This requires a "mini" incorporation process in each such state. If a California business is incorporated in Delaware it must qualify to do business in California. The consequences of failing to do so range from fines to not being able to enforce contracts entered in that state. The cost of qualifying is approximately $1,000 per state. Some states, like Nevada, also charge a fee based on authorized stock, so the fee could be higher in such states.

F. Initial Capital Structure

1. Structure

The capital structure should be kept as simple as possible and be within a range of "normalcy" to a potential outside investor for credibility purposes. A common initial structure is to authorize 10 million shares of common stock and 4 million shares of preferred stock. Not all authorized shares of common stock are sold at the founding stage. After initial sales to founders, there are usually only about 3-5 million shares issued and outstanding and about 1-2 million shares reserved in the equity incentive plan. This is referred to as the "1X model" below.

While at the outset there may not seem to be any difference between owning 100 shares or 1 million shares, a founder should purchase all of the units of stock he desires at the time of founding. Thereafter, a founder will generally lose control over further issuances and stock splits, particularly once a venture capital financing occurs. In addition, the purchase price will usually increase.

The number of shares issued and reserved in the initial capital structure are driven by a desire to avoid a later reverse stock split at the time of an IPO because of excess dilution. The number of shares outstanding at the time of an IPO is driven by company valuation at IPO, the amount to be raised in the IPO and IPO price per share range (usually $10 to $15). The "pattern" for the business value at the time of the IPO can be reached by forward or reverse stock splits. For example, if a corporation has a market valuation at IPO time of $200 million, it would not be feasible for 40 million shares to be outstanding. A reverse stock split is needed. Reverse stock splits reduce the number of shares held. On the other hand, forward stock splits add shares to holdings. Neither changes the percentage ownership, but seeing the number of shares held decrease because of a reverse split is still hard on employee morale.

Because of the great demand for engineers during the Internet bubble, many corporations used a multiple of this 1X model in order to have more equity units available for employees. The immediate need for employees to increase the possibility of business success outweighed the potential consequence of a later reverse stock split. Currently, most startups use a 1X or 2X model to avoid excessive dilution.

2. Minimum Capital

Neither Delaware nor California law require a minimum amount of money to be invested in a corporation at the time of founding. The initial amount of capital, however, must be adequate to accomplish the purpose of the startup business in order for shareholders not to have personal liability. For example, a corporation which will serve only as a sales representative for products or a consulting operation requires less capital than a distributor or dealer who will stock an inventory of products. A dealership or distributorship will require less capital than a manufacturing operation.

3. Legal Consideration

A corporation must sell its shares for legal consideration, i.e., cash, property, past services or promissory notes under some circumstances. A founder who transfers technology or other property (but not services) to a corporation in exchange for stock does not recognize income at the time of the transfer (as a sale of such property) under IRC Section 351 if the parties acquiring shares at the same time for property (as opposed to services) own at least 80% of the shares of the corporation after the transfer. Because of this limitation, Section 351 is generally available at the time of founding but not later. Since a party who exchanges past or future services for stock must recognize income in the amount of the value of the stock in the tax year in which the stock is received, it is the prefered practice to issue the shares at a low valuation for cash or property.

4. Valuation

The per share value at the time of founding is determined by the cash purchases of stock and the number of shares issued. For example, if one founder buys stock in exchange for technology and the other founder buys a 50% interest for cash, the value of the technology and the fair market value per share is dictated by the cash purchase since its monetary value is certain. Sales of the same class of stock made at or about the same time must be at the same price or the party purchasing at the lower price may have to recognize income on the difference.

Thereafter, value is determined by sales between a willing seller and buyer or by the Board of Directors based on events and financial condition. Value must be established by the Board at the time of each sale of stock or grant of a stock option. Successful events cause value to increase. Such determinations are subjective and there is no single methodology for determining current fair market value. There are pitfalls of hedging on the timing of forming corporation to save on expenses. The longer the delay in incorporating, the more difficult it is to keep the founders price at a nominal level if a financing or other value event is imminent.

A general objective is to keep the value of common stock as low as possible as long as possible to provide greater stock incentives to attract and keep key employees. Tax and state corporate laws generally require option grants to be made at current fair market value. IRC Section 409A has increased the diligence needed in determining pricing for stock option grants.

5. Use of Debt

Loans may also be used to fund a corporation. For example, if a consulting business is initially capitalized with $20,000, half of it could be a loan and the remaining $10,000 used to purchase common stock. Using debt enables the corporation to deduct the interest payments on the debt, makes the repayment of the investment tax free and gives creditor status to the holder of the debt. If a corporation is too heavily capitalized with shareholder's loans, as opposed to equity (usually up to a 3-1 debt/equity ratio is acceptable), however, these loans may be treated as additional equity for tax and other purposes. Debts owed to shareholders may be treated as contributions to capital or a second class of shares and subordinated to debts of other creditors. Eligibility for S corporation status is lost if a loan is characterized as a second class of shares.

6. Vesting and Rights of First Refusal

Shares sold to founders are usually subject to vesting and rights of first refusal in order to keep founders on the corporate team and to maintain control over ownership of the corporation. Grants of options under an equity incentive plan also have such "stickiness" restrictions. Such safeguards are essential to securing a venture capital investment. By designing and implementing a reasonable vesting scheme themselves, founders may forestall an investor from doing so on the investor's terms. Vesting also assures investors that the founders and others are committed to the corporation and not just looking for a quick pay day. The corporation typically retains the option to repurchase unvested shares at the initial purchase price at the time of termination of a shareholder's employment. Vesting usually occurs over 4 years, i.e., if the employee remains employed by the corporation for the entire period, all shares become "vested" and the repurchase option ends. A common pattern is for 25% of the shares to vest after 12 months and the remainder to vest monthly over the next 36 months. Vesting is implemented by stock purchase agreements. An IRC Section 83(b) election must be filed with the Internal Revenue Service by a party buying unvested shares within 30 days of the date of purchase in order to prevent taxable income at the times such shares vest.

A right of first refusal is the corporation's option to repurchase shares when a third party makes an offer to purchase shares. This type of restriction can be used by itself or as a backup to the repurchase option to maintain control over stock ownership once vesting occurs. The corporation may repurchase the shares on the same terms as the offer by the third party. Rights of first refusal are implemented by stock purchase agreements, including under stock option plans, or in the corporation's bylaws. Rights of first refusal (but not rights of repurchase on termination of employment) terminate upon an IPO or acquisition.

G. Sales of Securities

Offers and sales of stock in a corporation, certain promissory notes and loans, certain partnership interests and other securities are subject to the requirements of the Securities Act of 1933, a federal law, and of state securities laws, so-called "Blue Sky" laws. While some state laws are preempted by federal securities laws in some cases, an offer or sale of securities in multiple states generally requires compliance with each state's law. The general rule under these laws is that full disclosure must be made to a prospective investor and that registration or qualification of the transaction with appropriate governmental authorities must occur prior to an offer or sale. An investor can demand its money back if securities laws are not followed. There are also severe civil and criminal penalties for material false statements and omissions made by a business or its promoters in offering or selling securities. Legal opinions regarding exemptions are not possible if securities are sold without regard for such laws. An opinion may be required in venture capital investments or an acquisition.

Exemptions from the registration and qualification requirements are usually available for offers and sales to founders, venture capitalists and foreign parties but offers and sales to other potential investors, even employees, are not legally possible without time consuming and expensive compliance with such laws. State laws have relatively simple exemptions for option grants and stock issuances under a formal equity incentive plan, which is why a plan should be the source of equity for employees and consultants.

The stock purchased in a sale exempt from federal registration and state qualification requirements will not be freely transferable. In addition to contractual restrictions, resales must satisfy federal and state law requirements. Shareholder liquidity occurs through Securities and Exchange Commission Rules 144 or 701, an IPO, other public offerings or other exempt sales.

2009 Update: Raising the Initial Funding for High Technology Companies in the San Francisco Bay Area

BY BLAKE STAFFORD

Fenwick
FENWICK & WEST LLP

Introduction

This is a brief summary of the process for raising initial funding in the Bay Area for high technology companies. We hope to help entrepreneurs seeking initial funding understand the alternatives, identify potential funding sources and, most importantly, understand the practical realities of raising initial funding in the Bay Area.

Although a number of business forms exist (*e.g.*, limited liability companies, limited partnerships, general partnerships, S-Corps), we assume that your high technology enterprise will be formed as a C-Corp. The C-Corp form is almost always selected for many good reasons. Nonetheless, under some particular circumstances, one of the other forms may be chosen. Again, the following discussion assumes that you will form a C-Corp.

Although we touch upon initial funding from the entrepreneur and "friends and family," the primary focus of the following discussion is how you can maximize your probability of obtaining initial funding from institutional angels and/or VCs. Both of these groups are sophisticated investors that insist upon thoroughly vetting your company. We want to prepare you to achieve success in this vetting process by getting the attention of institutional angels and VCs and by performing well when you are "on stage."

Seed Capital Financings

Seed capital is primarily available from the entrepreneur, "friends and family," an institutional angel investor and/or a prospective customer. Seed capital financing is needed to form the C-Corp, clear its name, create its by-laws and other corporate documents, create a stock option plan and complete other preliminary matters as well as to satisfy the validation requirements for a VC financing. "Friends and family" investors invest basically because they trust the entrepreneur, and thus the polished materials (discussed below) you will prepare to attempt to get the attention of institutional angels and VCs often are not required. "Friends and family" are the most likely source of seed financing for a first time entrepreneur. Many institutional angels approach these initial financings much like a VC and want the validation required by a VC. Major Bay Area angel groups include the Angels Forum, Band of Angels, Keiretsu Forum, Life Sciences Angels and Sandhill Angels.

Seed financing usually comes in the form of the purchase of common stock, preferred stock or notes convertible into common or preferred stock or a combination of a convertible note and selling common stock. Selling common stock by itself often is not useful for the seed financing because of the dilutive effect. Consider the number of shares at $0.01 per share needed to be sold to raise even $100. A low price of common stock, however, is useful to motivate employees and other service providers who will be granted attractively priced options or shares of common stock. Pricing of common stock must be same for all sales at or about the same time. Common stock is sold at the same price as options are granted when combined with the sale of a convertible note.

If preferred stock is used for the seed financing, the company must be valued. Preferred stock can be complicated and expensive to use even if raising a small amount of money. The cost of raising money should be proportionate to amount raised and it may not be if preferred stock is used at an early stage. By its nature, preferred stock provides its holders with protective voting rights including control over the next round of financing and in acquisitions.

Convertible notes for "next financing" preferred stock are often used for seed capital financings. This approach defers the valuation determination and keeps the financing simple and low cost. A discount on the conversion price in the "next financing" (or warrants) is often used as a "sweetener" for taking added risk.

First VC Round

VCs generally invest via the purchase of preferred stock that is convertible into common stock. On occasion they may purchase convertible notes. VCs will thoroughly vet your company scrutinizing the materials described below if you can get their attention.

Defining the Business and Communicating its Value

Preparing and refining an elevator pitch, executive summary and power point presentation for institutional angels and/or VCs to fully understand the business, its value proposition and the execution steps is a critical part of the initial fundraising process. The following materials should be prepared for communicating with prospective investors and others. They need to be clear, concise and persuasive **because if you are unable to create high quality versions of these materials, you almost certainly will be unable to attract the attention of institutional angels and VCs:**

- 30 second elevator pitch

  This is your "attract" mode for the purpose of persuading the target person to take the next step of asking questions

- 2 page executive summary which covers the following business points:

  The Problem and Solution

  What is the pain point and how are you solving it? The product must be "need to have, right now."

  Market Size

  How big is the market? Is it at least $1B?

  Sales Strategy and Channels

  How will you acquire customers?

  Intellectual Property Position

  Do you have protectible IP and how will you protect it? For example, have you filed provisional or full patent applications?

  Competition

  What is your "unfair" competitive advantage?

  Management Team

  Can the initial team execute at least through product development?

  Pro-Forma Financials for 3-5 years

  What initial valuation will the projected revenue numbers justify?

- 8-12 slide PowerPoint presentation

  The first bullet point of the first slide is the most important.

Be prepared to give the 30-second elevator pitch when meeting potential investors (or people who can introduce you to investors), potential customers or people who might join your team. Even your lawyer will want to hear it. Bay Area networking events provide access to potential investors, team members, customers and others who can help build a business. Make sure there is a clear "unfair" competitive advantage in the 30-second pitch — why is your company "special?" Being a cheaper alternative to a larger, better financed competitor is unlikely to be persuasive.

You will need validation of the technical feasibility of the product and its market need in order to get VC investment. This requires credible referenceable customers who will actively support the product in discussions with potential investors. You need one or more Fortune 100 type customers or a critical mass group of smaller customers. It is very difficult to raise venture capital without market validation. Validation is a "chicken and egg" problem in some spaces. In a chip business, for example, validation requires money while a software or Internet business may be able to reach validation with mostly "sweat" equity.

You will also need to demonstrate the market size is large enough (generally at least $1B) to provide investors with an acceptable ROI through an "exit event" (IPO or acquisition). Even if the product works and you have referenceable customers, most venture capitalists do not want to invest in a small business. This does not mean it isn't a good business, only that it has to be financed in another way.

Forming the Team

Your team can be assembled from friends and other business contacts and through meeting people at Bay Area networking events. In most cases, the technical founder must be from and have credibility in the business space of the company. The initial team needs to include someone who can credibly identify market requirements. Investors don't invest in technology; they invest in companies with a product that the market wants that generates scalable revenues. Defining and refining product requirements is a continuous task.

Meeting Angels and VCs

Many Bay Area marketing events provide an opportunity to meet institutional angels and venture capitalists and to learn their business segments of interest and investment criteria. There are usually a number of VCs at AAMA and TIE events and SVASE and other organizations offer small group meetings with VCs.

The best route to an institutional angel or a VC is through an introduction from someone they know such as a lawyer, accountant or another institutional angel or VC. Fenwick & West, for example, has a venture capital services group whose primary purpose is to introduce our clients to prospective investors. This approach usually results in the institutional angel or VC reading at least the pain point/

solution paragraph of the executive summary. The Silicon Valley Bank Venture Exchange program provides a good way to be introduced to potential investors.

In determining which institutional angels and VCs to try to meet, you should review a potential institutional angel's or VC's portfolio to make sure there is no competitive investment.

Company Presentation Events

There are several organizations in the Bay Area, which provide regularly scheduled (usually monthly) opportunities for entrepreneurs to present their companies to potential investors. These are so-called "amplification" events because an entrepreneur can reach more prospective investors with a single presentation. Each organization has a screening process and some charge entrepreneurs to present. Several of the organizations focus on a single business segment in each meeting since investors interested in the space will be more likely to attend if there will be a number of companies of interest presenting.

Use of Finders

You may be approached by a "finder" who offers to help you raise money through introductions to prospective investors. Do a reference check on the finder's track record. If the finder is asking for a "success fee" then the finder needs to be a registered broker dealer under federal and state securities laws. Institutional angels and VCs will not look kindly upon the use of a finder who has a claim to cash from the proceeds of the investment. Introductions to institutional angels and VCs can usually be arranged without the use of a finder.

Venture Lending

Once a first VC round has closed that includes material VC participation, it may be possible to obtain additional financing from institutions that specialize in venture lending to early stage companies, which may be pre-revenue. These financings help extend the companies cash. A critical factor in the decision of these lenders to enter into a financial arrangement is the quality of the VCs in the first VC round. Inevitably these lenders will receive an equity "kicker" usually in the form of company warrants. The lenders are banks (*e.g.*, Comerica Bank, Silicon Valley Bank, Bridge Bank) or funds (Western Technology, Lighthouse Capital, Gold Hill Capital, Pinnacle). The banks and funds tend to have somewhat different deal terms and deal size limitations.

Basic Legal Issues

Federal and state securities laws need to be complied with in selling securities to investors. Investors have, in effect, a money-back guarantee from the company and possibly its officers if you do not comply. Borrowing money from persons not in the business of making loans is a security under these laws. You should seek investment only from accredited investors or a tight circle of friends and family.

Due diligence by both professional angels and VCs includes a hard look at intellectual property ownership. An initial focus will be the relationship of the technical founders to their prior employers' technology. In California, even if the technical founder has not used any of his prior employer's resources, trade secrets or other property, the prior employer may have a claim to any inventions that relate to the prior employer's business or actual or demonstrably anticipated research or development under California Labor Code section 2870. There is much tension on this issue because entrepreneurs are reluctant to give up their jobs without funding. This means there may be a "hot" departure of the technical founder from the old employer and a "hot" start at the new company without any cooling off period or, even worse, an overlap of the technical founder working for both companies at the same time. Some entrepreneurs underestimate this risk since their perception is that many Bay Area companies have been started in the past by entrepreneurs who leave a company and start a company in the same space. Trying to delay a departure until funding is imminent is very risky and may in fact materially reduce the probability of funding. Investors will not want to buy into a lawsuit.

Another key due diligence item is rights to stock and other equity. The entrepreneur needs to have discipline in promising stock both to reduce claims to stock and to comply with securities laws. Adopting a proper stock option plan at the time of incorporation provides a securities law exemption for providing equity incentives to team members and others.

We hope this summary will help you understand the realities of raising initial financing in the Bay Area. Now go get your money!

If you have any questions about this memorandum, please contact Blake Stafford (bstafford@fenwick.com) of Fenwick & West LLP (telephone: 650.988.8500).

Key Service Agreement Issues: Service Providers Checklist

BY DAVID J. BARRY

FENWICK & WEST LLP

Outsourcing of technology-related services continues to grow. Many service engagements now include an offshore component. These overseas arrangements can reduce the cost of the business activity but they also present different issues for both parties, which need to be addressed in the agreement. Further, there is intense competition among service providers which leads to considerable pressure on pricing and on negotiating the other business and legal terms of the transaction. Many service providers may promise anything to get the deal. You need to try to avoid every deal being a "bet the company" deal. There will always be some risk-taking but the challenge is to balance risk allocation among the parties with the need to stand behind the quality of services. A provider's credibility and business acumen is visible in its agreements and negotiation positions. A welldrafted and negotiated agreement can lead to a stronger long-term business relationship.

This paper addresses the key agreement provisions from the service provider's vantage point and identifies the risks and consequences of such provisions. It highlights areas that a service provider should include in its standard agreements to speed up revenue generation and avoid problem situations.

1. Master Agreements. The best business practice is to use a master agreement so additional services or projects can be performed for the same customer simply by adding an agreed-upon statement of work which is signed by both parties. This will lower the cost and reduce the time to document additional deals with the same customer. Any changes in the allocation of risk for a specific project can be made in the applicable statement of work.

2. Revenue Recognition. Avoid broad customer remedies that postpone revenue recognition. For example, if the customer may receive a full refund upon a breach of a performance warranty at any time during the agreement, recognition of the revenue from the agreement may be delayed until the end of the agreement. Another example is a provision that provides a full refund if a software deliverable is not accepted by a customer even if interim deliverables have been accepted and payments made upon such deliveries.

3. Agreement Signing. Make sure the agreement or statement of work is signed by the customer before beginning work. While there are legal theories (quasi contract, quantum meruit) that may provide a means of recovery in the absence of a signed agreement, the best business practice is to have a signed agreement in place. Ignoring the temptation to begin work before an agreement is signed may be difficult but you will be at risk if you start work prematurely.

4. Customer Credit Risk. You may need to do fundamental financial due diligence on the credit risk of a potential customer. Some potential customers may represent they have funding when they do not. While you may need to take some credit risk, do so on an informed basis by having access to basic financial information (such as a D&B report, balance sheet or bank statement) to evaluate this risk.

5. Termination Rights; Payment. Relatedly, be sure the agreement can be terminated or at least work can be suspended within a reasonable time if the customer fails to pay you in accordance with the payment schedule. For example, if payment terms are net 30 days and there is a 30-day notice and cure period before termination is effective, you will have to continue work through at least a 60-day period before termination is effective. At a minimum, this means you have to keep working and have a high risk receivable for the 60-day period before termination can be effective. This period should be shortened to reduce your exposure. Sometimes a customer proposes a provision that provides there is no right to terminate if the payment obligation is disputed by the customer. Such a provision means you have no leverage to be paid and could be obligated to keep working indefinitely. To provide leverage to be paid, assignment of IP ownership to the customer should be conditioned on receiving full payment.

6. Operational Coverage. Ensure the agreement permits delivery of the services in the manner that you operate. For example, if an offshore subsidiary corporation will actually deliver all or part of the services to the customer, the agreement must permit subcontracts so delivery can be accomplished that way. Subsidiaries are separate legal entities and you must have a subcontract in place to cover their responsibilities. Confidentiality provisions are another example. They must permit disclosure of the customers' confidential information to the extent needed to protect all parties in the delivery cycle. The agreement would be breached if confidential information is released to a subcontractor when disclosure is permitted only between the parties to the agreement. Unless expressly allowed, only the parties and their employees (but not subcontractors or consultants) are covered.

7. Service Level/Performance Warranties. Define the level of service performance and schedule as clearly and realistically as possible. The performance level is sometimes referred to as an express performance warranty. Delivery metrics such as response time, service results, network or application downtime percentages, etc. should be defined as objectively as possible to reduce disputes over measurement. Exaggerated claims of performance will be quickly discovered and will destroy the ongoing relationship, so be realistic and precise. When using a master agreement, performance levels can be addressed in the applicable statement of work since requirements may vary by service engagement even for the same customer.

8. Implied Performance Warranties. Disclaim implied performance warranties of merchantability and fitness for a particular purpose to avoid the possibility that there are performance requirements beyond the express warranties. The Uniform Commercial Code ("UCC") is intended to apply to products but you should assume it will apply to a services agreement at least when software or other technology is being developed. For example: "EXCEPT AS OTHERWISE EXPRESSLY PROVIDED IN THIS AGREEMENT, SERVICE PROVIDER HEREBY DISCLAIMS ALLWARRANTIES, OF ANY KIND, EXPRESS OR IMPLIED INCLUDING, WITHOUT LIMITATION, ANY IMPLIED WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE." The capitalized wording should satisfy the conspicuousness requirement of the UCC.

9. Intellectual Property. Make sure you continue to own all pre-existing patents, copyrights, trade secrets and other intellectual property ("IP") before entering into the agreement and also, to the extent feasible, (1) any improvements or derivative works to such pre-existing IP and (2) other IP developed that may be repeatedly used in your business. In addition, to provide leverage to be paid, any assignment of IP ownership to the customer should be conditioned on being fully paid. Sometimes "joint ownership" with the customer without any duty of accounting to the other is an acceptable compromise at least as to the improvements to pre-existing IP. As a practical matter, there will be intense pressure from the customer to own IP. The best practice may be to allocate IP ownership in the applicable statement of work since it may vary by service engagement. The service provider will likely have to bear the risk of any claims of IP infringement or misappropriation in its deliverables.

Service businesses must not ignore their IP. Most service businesses have IP of some type. For example, IP includes the copyright and possible trade secrets in a database of domain knowledge in a technical support business and script in a call center business. It also includes the copyrights, possible trade secrets and patents in software routines that are incorporated into a software deliverable and software tools used in a network support business.

10. Damages Exclusions and Limitations. Economic exposure varies widely depending on the type of service. For example, the exposure from a tax return preparation service is considerably different from a call center business doing outbound sales calls. In all cases, exclude consequential, special, indirect and incidental type damages and, to the extent feasible, cap direct damages. Try to cap direct damages at the amounts paid in a payment period (month, quarter) rather than the total payments made under the agreement. Otherwise, the economic effect is that you have not been paid even for the good service you provided. Following are sample provisions: "In no event will either party be liable for any form of special, incidental, indirect or consequential damages of any kind, even if aware of the possibility of such damages. Service Provider's total liability under this Agreement will not exceed the amounts paid by customer during the three (3) months immediately preceding the date of the applicable claim." The UCC does not contain the conspicuousness requirement for these provisions.

11. Insurance Requirement. Comply with the workmen's compensation and liability insurance requirements of your customer. Work with an insurance broker who fully understands your business. Make sure your insurance covers all parties in the delivery process. For example, a special rider may be needed to cover the exposure of employees of a subsidiary corporation particularly if they are offshore. The named insured on a policy may not extend to these separate legal entities or the actions of their employees.

12. Force Majeure. Use a force majeure provision, particularly for service offerings involving delivery over a network. For example, if you are using overseas affiliates to provide services and there is a disruption in service caused by an earthquake, the agreement should not be terminated. The agreement should provide an opportunity for recovery within a specified period. Termination may occur only if recovery doesn't occur within the period.

13. Governing Law. Choose a governing law to provide more certainty to the interpretation of the agreement and, to be sure it will apply, use the clause: "excluding that body of law known as conflicts of law", following the choice of law. For example: "This Agreement will be governed by the laws of California excluding that body of law known as conflicts of law." The chosen law must have a relationship to the parties or the transaction such as being the state of their principal office or incorporation.

14. Dispute Resolution. Adopt a dispute resolution procedure that elevates the resolution process in an orderly, timely way. The first step could be a discussion between CEOs and the next step, non-binding mediation. Use binding arbitration as the ultimate mechanism to resolve disputes in order to increase the chances of maintaining the relationship. To avoid frivolous claims by either party, designate the arbitration site to be the customer's business location when you request arbitration and your business location if the customer requests arbitration.

15. Entire Agreement. Include an entire agreement provision so that verbal agreements do not become part of the agreement and amendments may only be implemented in writing. The following provisions do so: "This Agreement and the exhibits hereto constitute the entire agreement and understanding of the parties with respect to the subject matter of this Agreement, and supersede all prior understandings and agreements, whether oral or written, between or among the parties hereto with respect to the specific subject matter hereof. This Agreement may be amended only in a writing signed by both parties."

A service provider's credibility and business acumen is visible in its agreements and negotiation positions. Because of the competitive environment there may be a great temptation to accept almost any terms or credit risk in order to get a deal. You need to make sure risk allocation is balanced. Securing a deal on any terms may mean you work for free.

A Patent Portfolio Development Strategy for Start-Up Companies

BY RAJIV P. PATEL

Successful high technology companies recognize that a comprehensive intellectual property portfolio can be of substantial value. One key component of the intellectual property portfolio is patents. A patent is a right granted by the government that allows a patent holder to exclude others from making, using, selling, offering to sell, or importing that which is claimed in the patent, for a limited period of time.

In view of this right many companies recognize that a well-crafted patent portfolio may be used for a variety of business objectives, such as bolstering market position, protecting research and development efforts, generating revenue, and encouraging favorable cross-licensing or settlement agreements. For companies that have developed original technology, a patent provides a barrier against a competitor's entry into valued technologies or markets. Thus, many start-up companies that have developed pioneering technology are eager to obtain patent protection. However, to develop an effective patent portfolio, a start-up company should first devise a patent portfolio strategy that is aligned with the company's business objectives.

A patent portfolio strategy may vary from company to company. Large companies that have significant financial resources often pursue a strategy of procuring and maintaining a large quantity of patents. These companies often use their patent portfolios for offensive purposes, *e.g.*, generating large licensing revenues for the company. For example, IBM generates close to $1 billion dollars a year from licensing its patent portfolio.

In contrast, for most start-up companies, developing and building a comprehensive patent portfolio can be prohibitively expensive. However, with an understanding of some basic principles of patent strategies and early planning, a start-up company can devise and execute a patent strategy to develop a cost-effective patent portfolio. For example, a start-up company can develop an effective patent portfolio by focusing on obtaining a few quality patents that cover key products and technologies, in alignment with their business objectives.

A patent strategy involves a development phase and a deployment phase. The development phase includes evaluation of patentable technologies and procurement of patents. A deployment phase includes the competitive analysis, licensing, and litigation of patents. For most start-ups the initial focus is on the development phase. Starting in the development phase, the patent strategy identifies the key business goals of the company. Clear business goals provide a long-term blueprint to guide the development of a valuable patent portfolio.

With the goals identified, the evaluation process begins by mining and analyzing intellectual assets within the company. In this process, a company organizes and evaluates all of its intellectual assets, such as its products, services, technologies, processes, and business practices. Organizing intellectual assets involves working with key company executives to ensure that the patent strategy closely links with the company's business objectives. Often, these individuals assist with developing a budget for the patent strategy, as well as making arrangements to get access to resources for executing the patent strategy.

Organizing intellectual assets also involves gathering key company documented materials. Examples of documented materials include business plans, company procedures and policies, investor presentations, marketing presentations and publications, product specifications, technical schematics, and software programs. It may also include contractual agreements such as employment agreements, license agreements, non-disclosure and confidentiality agreements, investor agreements, and consulting agreements. Such materials provide information used to determine ownership issues and the scope of patent or other intellectual property rights that are available for the company.

Organizing intellectual assets also includes identifying and interviewing all individuals who are involved with creating or managing the company's intellectual assets. These interviews uncover undocumented intellectual assets and may be used to evaluate patent and other intellectual property issues. For example, events and dates that may prevent patentability of some intellectual assets may be identified. Likewise, co-development efforts that may indicate joint ownership of intellectual assets may also be identified. Identifying such issues early on helps prevent wasteful expenditures and allows for effective management of potentially difficult situations.

After organizing information about the intellectual assets, each asset should be evaluated to determine how best to protect it. This evaluation includes determining whether the intellectual asset is best suited for patent protection or trade secret protection, whether it should be made available to the public domain, or whether further development is necessary. It also involves determining whether a patent will be of value when it issues, which is typically approximately 18 to 36 months after it is filed, and whether infringement of that patent would be too difficult to detect.

The evaluation phase may also provide an opportunity to determine whether obtaining protection in jurisdictions outside of the United States is prudent. International patent treaties signed by the U.S. and other countries or regions allow for deferring actual filing of patent applications outside the U.S. for up to one year after the filing of a U.S. application. Thus, planning at this early stage may include identifying potential countries or regions to file in and then begin financially preparing for the large costs associated with such filings.

The evaluation phase also provides an opportunity to determine whether a patentability or patent clearance study is necessary. Such studies are used to determine the scope of potentially available protection or whether products or processes that include or use an intellectual asset potentially infringe third-party rights. This evaluation may also involve identifying company strengths with regard to its patent portfolio as well as potential vulnerable areas where competitors and other industry players have already established patent protection.

While the evaluation phase is in progress, the company can move into the procurement phase. In the procurement phase of the patent strategy, a start-up company builds its patent portfolio to protect core technologies, processes, and business practices uncovered during the audit phase. Typically, a patent portfolio is built with a combination of crown-jewel patents, fence patents, and design-around patents.

Crown-jewel patents are often blocking patents. One or more of these patents is used to block competitors from entering a technology or product market covered by the patent. Fence patents are used to fence in, or surround, core patents, especially those of a competitor, with all conceivable improvements so the competitor has an incentive to cross-license its patents. Design-around patents are based on innovations created to avoid infringement of a third party patent and may themselves be patentable.

For most start-ups, costs for pursuing patent protection are a concern because financial resources are limited. Hence, most start-up companies begin the procurement phase by focusing on procuring one or more crown-jewel patents. To do this, the start-up company works with a patent attorney to review the key innovations of the company's product or services as identified during the evaluation phase. The patent attorney and start-up company consider the market for the innovation in relation to the time in which the patent would typically issue. This analysis helps identify the subject matter for the crown-jewel patents.

Once the subject matter is identified, in some instances a prior art search prior to filing provisional or utility patent applications may be conducted to determine what breadth of claim coverage potentially may be available. However, a company that considers such prior art searches should first consult with the patent attorney to understand the risks associated with them so that appropriate business decisions can be made.

Next, a strategic business decision is made as to whether to file a provisional patent application or a full utility, or non provisional, patent application for the identified subject matter. A provisional patent application is ideally a robust description of the innovation, but lacks the formalities of a full utility patent application.

The provisional application is not examined by the U.S. Patent and Trademark Office ("USPTO") and becomes abandoned 12 months after filing. Within the 12 months, an applicant may choose to file one or more utility applications based on the subject matter disclosed in the provisional application, and therefore, obtaining the benefit of the provisional application filing date. However, the later filed utility application must be fully supported by the disclosure of the provisional application in order to claim the benefit of its earlier filing date. Under U.S. patent law, this means the provisional application must satisfy the requirements of written description, enablement, and best mode, as is required for the utility application.

If the provisional application is filed with sufficient completeness to support the claims of subsequently filed utility applications, the provisional application provides a number of benefits. First, as previously discussed, one or more utility applications may claim the benefit of the provisional patent application filing date. The early filing date may not only protect the crown jewel subject matter, but may also protect some critical surrounding subject matter, hence increasing the overall value of the patent portfolio. Second, the provisional application provides an earlier effective prior art date against others who may be filing patent applications on similar inventions.

Third, provisional patent application filings costs are currently $80 to $160 versus $370 to $740 for a full utility application. Fourth, inventors often take it upon themselves to draft the core of a provisional application with the guidance of a patent attorney and request that the patent attorney spend time simply to review the application to advise on the legal requirements and potential pitfalls. This means that the attorney fees for a provisional patent application may be substantially less than attorney fees associated with preparing a full utility application.

Fifth, the provisional patent application precludes loss of patent rights resulting from activity and public disclosures related to the target inventions. For example, almost every country except the U.S. has an absolute novelty requirement with regard to patent rights. That is, in these countries, any public disclosure of the target invention prior to filing a patent application results in a loss of patent rights. For many start-ups this can be somewhat disconcerting. On the one hand, the start-up may want to preserve the right to pursue patent protection outside of the U.S. On the other hand, immediate business opportunities and time demands often conflict with the timely preparation and filing of a utility patent application. However, through international treaties, most countries will recognize a filing date of a provisional application filed in the U.S. Thus, the applicant may be able to file for a provisional application and convert it to a utility application that can be filed in the U.S. and other treaty countries within 12 months.

Although the provisional application provides a cost-effective tool for creating a patent portfolio, filing a provisional application does not end the portfolio development process. Once the provisional application is filed, and when finances and time permit, the company should be diligent in filing utility applications that may claim the benefit of the provisional application filing date. This is true for a number of reasons.

First, the provisional application is not examined and will go abandoned 12 months after it is filed. Therefore, the filing of the provisional application provides no more than a filing date placeholder for the subject matter it discloses. Second, the utility application costs more than the provisional applications to prepare and file. Thus, a company must adequately budget and plan for this expense. Third, as time passes the time available for patent matters may become more difficult in view of product cycles, marketing launches, and sales events. Hence, budgeting time for planning and reviewing filings of subsequent utility applications based on a provisional application becomes important. Fourth, products and technologies continually evolve and change, often soon after the filing of a provisional application. Therefore, a company must continually revisit their patent portfolio and strategy to reassess whether the provisional application can provide sufficient protection in view of further development.

Over time, companies that value their intellectual assets set aside time, money and resources to further enhance their patent portfolio. To do this a company may move to the deployment phase. In the deployment phase, the company begins the competitive analysis process to study industry trends and technology directions, especially those of present and potential competitors. The company may also evaluate patent portfolios of competitors and other industry players.

Also in the deployment phase, the company may incorporate the licensing process. Here, the company determines whether to license or acquire patents from others, particularly where the patent portfolio is lacking protection and is vulnerable to a third-party patent portfolio. Alternatively, in the licensing process the company determines whether to license or cross-license its patent portfolio to third parties. The deployment phase may also include the litigation process. Here, the company determines whether to assert patents in a lawsuit against third party infringers.

In summary, for most start-up companies, devising a patent portfolio development strategy early on can be a wise investment to help the company develop and build a strong foundational asset on which to grow. This investment will likely reward the company with positive returns for years to come.

Rajiv Patel (*rpatel@fenwick.com*) is a partner in the intellectual property group of Fenwick & West LLP. His practice includes helping companies develop, manage, and deploy patent portfolios. He is registered to practice before the U.S. Patent and Trademark Office. Fenwick & West LLP has offices in Mountain View and San Francisco, California.

It is on the web at *www.fenwick.com*.

2008 Update to Guide to Establishing a Subsidiary in China

BY JIE CHEN AND JIANWEI ZHANG

Fenwick
FENWICK & WEST LLP

As China's strength in the global economy continues to grow, businesses need to consider the prospect of establishing operations within its borders. In order to successfully transact business in China or with Chinese enterprises, foreign investors, including financial investors and entrepreneurs, should consider setting up a subsidiary in China. This article provides general information on establishing a subsidiary by foreign investors, to help provide guidance and demystify the process.

Purpose of Establishing a Subsidiary in China

Establishing a subsidiary in China should be considered by those who have long-term business objectives in China. Although foreign companies can enter into some commercial contracts with a Chinese entity or individual, such as sales contracts, license agreements, and distribution agreements, they cannot do business directly in China without an approved business license. Doing business in China through a subsidiary is at least advantageous—and sometimes a necessity—in overcoming certain legal and business restrictions on foreign companies.

Some foreign companies may already have a resident representative office in China. Such representative offices function as internal liaisons for their parent company. However, they may not do business in China directly. Because resident representatives are not recognized as independent legal persons under Chinese law, they may not assume independent civil liabilities to a third party, which prevents significant commercial activities such as signing commercial contracts with a third party. Nor may they directly hire local Chinese employees. There are limited exceptions, however, such as a lease contract for office space.

Companies that desire to invest directly in China, hire local employees, conduct research and development, manufacture products, and market their products or services directly to the Chinese market, should consider establishing a subsidiary in China.

Forms of Subsidiaries

"Subsidiaries in China" as used herein means entities where at least one of the shareholders is a foreign entity or individual ("foreign investor") incorporated or with citizenship outside of China (for the purpose of this article only, excluding Hong Kong, Macao and Taiwan). Such a subsidiary is often called "Foreign Invested Enterprise" (FIE) in China. Until the effectiveness of the *Notice of the Relevant Issues on Strengthening the Approval, Registration, Foreign Exchange Control and Taxation Administration of Foreign-funded Enterprises* ("Notice") jointly released by the Ministry of Foreign Trade and Economic Cooperation, the State Taxation Administration, the State Administration for Industry and Commerce and the State Administration of Foreign Exchange (SAFE) as of January 1, 2003, the percentage of equity shares held by foreign investors in an FIE must be no less than 25%.[1]

If all shareholders of a company are Chinese registered companies or Chinese citizens, the company should be a domestic company, not an FIE. Although FIEs and domestic companies are both governed by the *Company Law of the People's Republic of China* ("Company Law"), FIEs are also governed by specific FIE-related laws that subject them to additional or different rules and regulations in many respects.

In some business industries restricted to foreign investors, such as telecommunication services and online content providers, even if an FIE is allowed it is restricted by such thresholds as maximum equity ownership of foreign investors (which means that the foreign investor(s) must joint venture with a Chinese partner), additional requirements on the qualification of its investors, and/or a lengthy approval process for its establishment. Under these circumstances, it is not unusual for a foreign investor to have affiliated Chinese persons or entities establish a pure domestic company, instead of an FIE or simultaneously with an FIE in an allowed or encouraged industry. This structure enables contractual arrangements to be set up between the foreign investor, its non-restricted FIE in China and

[1] Even after the effectiveness of the above Notice, an enterprise whose foreign investor(s) holds less than 25% is hard to approve. Even if approved or allowed by some specific regulations, generally, it is not qualified to enjoy the preferential treatment as granted to FIEs having more than 25% shares held by foreign investor(s).

the domestic company. Such arrangements with affiliated domestic companies can provide flexibility that may help foreign investors reach their business objectives more quickly and efficiently. See the article 2008 Update to Investment and Operation in Restricted Industries in China at http://www.fenwick.com/publications/6.3.0.asp for additional information if your company operates within a restricted industry.

There are four possible incorporation forms that are allowed for FIEs:

1. Wholly foreign-owned enterprise (WFOE);

2. Sino-foreign equity joint venture (EJV);

3. Sino-foreign contractual joint ventures (CJV)[2]; and

4. Sino-foreign joint stock limited company.

The first three enterprises are called limited liabilities companies in China (except for a CJV in the form of non-legal person). Liabilities of shareholders in joint stock limited companies are also limited by their subscribed shares, however, joint stock limited companies are not as commonly used by foreign investors as the first three for the following reasons: an FIE joint stock limited company must be approved by the Ministry of Commerce at the central government level. The approval time is significantly longer and a higher minimum investment amount is required. Further, the promoters' shares in a joint stock limited company may not be transferred until one year after its establishment. Therefore, unless the Chinese subsidiary itself intends to directly go public in the near future, most foreign investors will select a WFOE, CJV or EJV rather than a joint stock limited company.

Foreign investors should consider their own business model and circumstances to decide between a WFOE and a JV, unless the industry the FIE is in restricts it from being a WFOE. Currently, if they operate in an industry that permits WFOEs, more foreign investors are choosing WFOEs. If a foreign investor has to rely heavily on local support, such as land, factories, equipment, or access to local sales and market channels, the JV structure may also be considered if the foreign investor's Chinese partner can assist the JV with these items. Nonetheless, since many foreign investors are now more familiar with China's markets and business environment, a WFOE is acceptable for foreign investors if they can find local support on their own by hiring capable local employees. Additionally, many Chinese governmental authorities are becoming more accustomed to direct communication with foreign investors. For these reasons, a WFOE is not necessarily disadvantageous for FIEs that rely heavily on local resources and channels. In addition, the parent company of a WFOE generally has more flexibility in controlling the management and intellectual property (IP) issues of an FIE, making contractual arrangements with an FIE and exiting from an FIE.

Instead of setting up a new FIE at the outset, the foreign investor could also set up a subsidiary by acquiring an existing FIE or a domestic company and the acquired enterprise would become a WFOE or JV.

Who Sets Up a Subsidiary and Where to Locate It

From the perspective of Chinese law, in general, the foreign investor's country of origin does not impact the approval procedure or treatment of its FIE in China. No matter where the foreign investor is incorporated—in the Cayman Islands or in the U.S.—the FIE follows the same approval procedures and regulations and receives the same treatment .[3] Foreign investors from special regions such as Hong Kong, Taiwan, and Macao are also treated as foreign investors for the purpose of FIEs. Of course, different countries will have different tax implications for foreign investors, based on whether there is a bilateral taxation agreement between China and the investor's country. Also, the investor should consider its future plan to exit from the FIE, as well as tax planning from the perspective of other applicable jurisdictions, when deciding who is to set up the subsidiary and where it is to be located.

A qualified employee pool is one of the main factors for deciding where to locate a subsidiary. A location with universities and colleges nearby helps to provide qualified R&D staff for high-tech subsidiaries. It is not surprising that many high-tech companies are located in Beijing and Shanghai, the two biggest cities in China. Cities in many other developed regions such as Jiangsu, Zhejiang, Sichuan and Guangdong Provinces also provide large quantities of high-tech personnel. Investors of a manufacturing subsidiary would likewise want to establish plants and distribution facilities in areas where the available labor pool can support manufacturing work.

[2] There are some differences between EJV and CJV, both of which require the foreign investor to partner with a local Chinese partner to organize the company together. EJV shareholders' obligations and rights should be assigned pursuant to their equity percentage, while shareholders to a CJV are allowed to organize the company in a more flexible way.

[3] Except for that qualified investors of Hong Kong and Macao can enjoy special treatments in relevant industry in accordance with the *Mainland and Hong Kong Closer Economic Partnership Arrangement* and the *Mainland and Macao Closer Economic Partnership Arrangement*.

A good relationship ("Guanxi") with local Chinese government departments and enterprises is also crucial. Many investors will seek a location where they can have frequent and close contacts with local governments and local businesses. Or they may prefer to select a location where they can engage capable managerial personnel with established local relationships. A good Guanxi, which today emphasizes communications rather than deals under the table, generally helps the subsidiary start its business more quickly and smoothly.

Many cities and regions have established industrial and high-tech parks to attract investors to invest within the park by providing various benefits. Tax benefits, basically those on income tax and taxes on importation, depend on the nature of the park and its FIEs. Except for some local taxes and charges, major FIE taxes are generally regulated at the national level. Investors should make sure that the park they select is officially recognized by the state. As for which city to choose, FIEs need to consider many other important factors, such as available employee pools, local support, Guanxi, transportation and infrastructure.

Under current Chinese laws, if the ultimate investor is a Chinese resident, who invests in China though a foreign special purpose venture (SPV) in which he/she has interest ("return investment"), the situation shall be quite different and the procedures shall be more complicated. Firstly, such a Chinese resident shall apply for registration of oversea investment with competent foreign exchange authorities before he/she carries out the oversea investment; secondly, if such a Chinese resident injects the assets or equity interest of a domestic entity held by himself/herself into the SPV or the SPV seeks an equity financing after the capital injection, he/she shall apply for an amended registration with competent foreign exchange authorities; and thirdly, if the SPV acquires the domestic affiliate companies of such a Chinese resident, the approval from the Ministry of Commerce shall be obtained. In addition, if the SPV has not completed the oversea investment registration mentioned above, or even such registration has been completed but the SPV has been consistently operated for less than 3 years, such a SPV can not apply for the registration with competent foreign exchange authorities for establishing a subsidiary or acquiring a domestic company in China in accordance with a circular released by the General Affairs Department of State Administration of Foreign Exchange on May 29, 2007.

The Incorporation Process and Approximate Cost

FIEs must be approved by the Ministry of Commerce or its equivalent authorities at the provincial level or municipality level (collectively, "approval authorities"). The ability of a local approval authority to approve an FIE depends on the amount of total investment and nature of the industry in which the FIE desires to engage. Because approval by the central approval authority generally takes much longer, many investors prefer to have the subsidiary approved by the local approval authority. Currently most FIEs may be approved by local approval authorities. If all the required documents are completed and are submitted directly to the local approval authority, many FIEs not subject to specific legal restrictions can be approved and registered within one month.

Once approved, an FIE must register with the State Administration for Industry and Commerce or its counterparts at the provincial or city level (collectively, "registration authority"). The registration authority issues the FIE its business license, at which time the FIE is considered legally established and incorporated.

Chinese law divides industries into four categories for foreign investment: 1) encouraged; 2) allowed; 3) restricted; and 4) prohibited. In the post-WTO age, China is less restrictive on the number of industries that may receive foreign investment.

The costs for establishing an FIE are mainly the registration fee, announcement fee and registered capital. The registration fee and announcement fee are collected by the registration authority based on the amount of registered capital. These two fees generally will be around US$1,000 to US$3,000. For FIEs with greater investment, the fees can be more, but are still generally less than US$8,000. Chinese law requires shareholders to put real money (cash or in kind) into the enterprise. All shareholders of an FIE must subscribe the registered capital to the invested company according to their respective ownership percentage, which must be paid fully by them within a specified time period after the FIE is set up, as described in the incorporation documents. In accordance with the Company Law, the first contribution to registered capital must be no less than 20% of the registered capital and the statutory minimum registered capital,[4] and the rest registered capital must be fully subscribed within 2 years after the issuance of the business license.[5]

[4] Based on the Company Law, for a liability limited company, the minimum registered capital is RMB 30,000; for a joint stock limited company, such minimum is RMB 5,000,000. In addition, relevant government authorities may impose a higher threshold for registered capital for a company engaging in a specific business.

[5] The remainder of the investment company's registered capital can be injected within 5 years after the issuance of the business license.

In practice, local governments and relevant authorities in charge may have different policies on the minimum registered capital and subscription period of FIEs, so the investors should confirm these points with local authorities in advance. Nevertheless, since the registered capital is paid within the time schedule described in the incorporation documents, it still provides some flexibility for investors to contribute capital at their own pace.

Hiring Local Service Providers

There are some authorized agencies that specifically help foreign investors set up FIEs. They can prepare the incorporation documents and communicate with the approval and registration authorities. With their help, the incorporation process can be accelerated. However, since many local governments are very willing to attract foreign investment, the approval of a typical FIE is quite routine. Many investors find that they can handle the approval process without agency assistance.

Lawyers may also help their client to secure approval and registration from governmental authorities. Sometimes lawyers work with authorized agencies, which can be more cost efficient for the client: the agency facilitates routine work with the authorities, while the lawyer ensures all the legal documents and approval procedures are properly done.

For financial reasons, many start-ups prefer to deal with all aspects of the FIE establishment without legal assistance. However, hiring a lawyer or a service agency is not necessarily costly and obtaining a Chinese lawyer's advice on the most advantageous legal structure can facilitate future negotiations and funding—especially if the investors intend to make special contractual arrangements for the FIE or have specific requirements on the FIE.

Controlling a Subsidiary

Unlike a general domestic limited liability company, whose highest power authority is the shareholders' meeting, an FIE's highest power authority is the board of directors, which decides all material matters of the JV. This was the case until 2006, when several approval authorities and registration authorities started requiring foreign invested limited stock companies and WFOEs that may only have one shareholder, to have a shareholders meeting according to the Company Law. The directors are appointed by the shareholders or elected at a shareholders' meeting. Depending on the situation, how to regulate and balance power between the board of directors and management can be flexibly arranged in the incorporation documents. WFOEs have more flexibility in setting up and regulating the allocation of power and the management team.

In addition to control by the board of directors, some arrangements between the parent and its subsidiary can also be established to control the subsidiary. It is not unusual for the parent company to own the critical IP and license it to the subsidiary. Another common arrangement is that products of the subsidiary may only be marketed, distributed and sold through the parent company. In other cases, the investor controls the operation of the subsidiary, to some extent, under covenants in a loan agreement.

Operational Implications

Each enterprise in China, including a domestic company or FIE, must conduct its business within the business scope specified on its business license. Generally, domestic enterprises are approved for a much broader business scope than FIEs. Domestic enterprises may be granted carte blanche "to conduct any business as allowed by law, except those required to be specially permitted by law must be conducted only upon obtaining the special permit." Currently, this kind of catch-all business scope may not be granted to FIEs, which are required to be set up for a specific business. Since each industry is categorized as encouraged, allowed, restricted or prohibited for foreign investment, each FIE is expected to do some specific business. For example, an FIE approved to manufacture semiconductor products generally would not be granted a business scope to produce chemical products; a non-retail or wholesale FIE should not sell a third party's products (since a retail or wholesale FIE is subject to specific legal requirements), although the FIE could sell products it "manufactures" itself. Under some circumstances, it may be unclear at what point the FIE is operating beyond its approved business scope. The registration authority has the flexibility to determine whether the business conducted by the FIE is beyond the approved business scope, which sometimes makes implementation ambiguous.

In addition, some business activities, even within the business scope, still may only be conducted upon the grant of a special permit. For example, a basic telecommunication business or value-added telecommunication business can only be conducted under a permit issued by the Ministry of Information Technology (MII) or its local offices.

During its daily operation, an FIE can transact business with other domestic or foreign entities or individuals, including signing commercial contracts, licensing, borrowing loans from banks and engaging a distributor, as long as these transactions are in compliance with Chinese law. An FIE, as a limited liability company, is an independent legal person and independently assumes the liabilities to any third party with which it made a deal. An FIE's liability to a third party is limited to its assets. Shareholders' liabilities are limited by their contribution to the FIE. Generally speaking, shareholders are not liable to third parties with which an FIE transacts, except that they must pay fully the registered capital subscribed to the FIE.

Intellectual Property

Intellectual property can be protected administratively and judicially in China. The relevant administrative governmental authority could impose an administrative penalty for infringement within its authority, while the holder of intellectual property rights can also claim its rights before the court in China. China is a member of the major IP international conventions, including Berne Convention (for copyright protection), Universal Copyright Convention, Paris Convention (for patent protection), Patent Cooperation Treaty and Madrid Protocol (for trademark protection). Trade secrets are protected mainly by the Unfair Competition Law, Contract Law and Labor Contract Law. Confidentiality agreements and non-competition agreements can also be valid and enforceable in China. IP rights can even be the equity investment in an FIE, but the percentage of cash should not be less than 30% of the registered capital of a limited liability company.

With respect to the judicial enforcement of infringement of intellectual property rights, courts may issue injunctive orders, require infringers to pay monetary damages and make public apologies. Although monetary damages may include reasonable expenses, actual damages and sometimes constructive damages, generally speaking, the monetary damages confirmed by courts are not big enough to frighten off infringers. Nonetheless, the trend now is toward bigger damage awards. Further, for their serious infringement of intellectual property rights, infringers may be jailed subject to the Criminal Law which now is enforced more strictly.

Foreign Exchange

China does not allow foreign currency to be freely circulated within its borders. Except for the allowed maximum amount for foreign exchange reserved in its bank account, an FIE's revenue in foreign exchange must be converted into RMB (Renminbi, Chinese lawful currency). On the other hand, lawful payments made outside of China are allowed to be converted into foreign currency. Banks authorized to conduct relevant foreign exchange business will examine the required documents for each remittance. Shareholders' dividends, license fees, and purchase prices for imported equipment and materials may be remitted out of China if the completed documents and verifications are submitted to the bank, and the proper withholding taxes have been deducted. Under some circumstances, an approval from the SAFE or its local offices may be required.

Employment and Stock Options

An FIEs' employment matters are subject to the Labor Contract Law and related regulations. Social insurance benefits such as medical insurance, pension, unemployment insurance, and housing funds are legally required. Employers can require non-disclosure agreements, non-competition agreements and intellectual property ownership assignment agreements, as long as the provisions in such agreements are in compliance with the relevant laws and regulations.

The granting of stock options is also more acceptable for Chinese employees nowadays. However, there is no fixed method for employees to exercise their stock options.[6] In practice, some Chinese employees will exercise the option with funds (or funds of their family members or relatives) deposited outside of China. Since most Chinese employees do not have bank accounts outside China, they may arrange a cashless exercise with the employer. See the article 2008 Update to Overview of Share Incentive Schemes in China at http://www.fenwick.com/publications/6.3.0.asp for additional information.

Exits and Liquidity

A foreign investor may exit from its subsidiary by selling their shares in the FIE or transferring their shares in the parent company. A transfer of shares in an FIE must be approved by the original approval authority, although this kind of approval generally is routine. If the share transfer is made from all foreign investors to a Chinese investor, who then converts the FIE into a domestic company, the later-formed domestic company must satisfy the requirements for establishing a domestic company under Company Law, rather than under FIE law.

In some cases, when an acquirer chooses to purchase the assets and business of an FIE, such an FIE may be requested to enter into liquidation and dissolution. After the liquidated FIE pays off its salaries, taxes and debts owed to third parties, in that order, the remaining assets may be distributed to the shareholders according to their equity percentage. This kind of acquisition will help the

[6] Except for the stock options granted by a listed company. The China Securities Regulatory Commission released the Measures for the Administration of Equity Incentive Plans of Listed Companies (Provisional) on December 31, 2005 to regulate the implementation of share incentive schemes of companies listed on domestic stock exchanges. To guide the implementation of share incentive schemes of state-controlled listed companies, the China State-Owned Assets Supervision and Administration Commission and the Ministry of Finance jointly released the Provisional Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Domestic) and the Provisional Measures for Implementing Equity Incentive Plans by State Holding Listed Companies (Overseas) respectively in 2006.

acquirer avoid assuming the seller's liabilities to third parties. Subject to the approval of the original approval authority, investors may wind up an FIE after completing the liquidation and dissolution procedure and foreign investors may transfer the remaining assets distributed to them outside China.

Investors may also have the parent company, or its subsidiary, registered in a foreign country and taken public, so their shares can be sold on the open market. In addition, as a result of the completion of the reform of the A Share Market, the formulation of the A Share Market of full circulation of the stocks, which means the shares held by promoters also can be tradable on stock exchanges, has made the listing of FIEs on domestic exchanges as a considerable choice of exit strategy for foreign investors.

New Significant Developments in 2007

Many important Chinese laws were released or amended in 2007. Several have affected or will affect FIEs' business and operations significantly. Below is an overview of some of the most important laws with relation to FIEs.

The *Enterprise Income Tax Law of the People's Republic of China* ("New Income Tax Law") was issued on March 16, 2007 and will be effective as of January 1, 2008. Upon effectiveness, the New Income Tax Law will repeal the *Enterprise Income Tax Law of the People's Republic of China for Foreign Investment Enterprises and Foreign Enterprises*, under which FIEs have been granted specific income tax advantages such as a lower tax rate and tax remission. As a result, FIEs shall no longer be eligible for any income tax advantage compared with domestic enterprises, and shall be subject to the uniform income tax rate of 25%, which shall directly increase the FIEs operating cost and lower their competitive advantage. The *Implementing Ordinance of Enterprise Income Tax Law of the People's Republic of China* was release by the State Council on November 28, 2007, which will also come into effect as of January 1, 2008.

The *Labor Contract Law of the People's Republic of China* ("Labor Contract Law") was issued on June 29, 2007 and will be effective from January 1, 2008. As compared with the original *Labor Law of the People's Republic of China*, the Labor Contract Law further enhances protection for the employees and emphasizes the responsibilities of employers. With the approach of the effectiveness of the Labor Contract Law, all Chinese employers, both domestic companies and FIEs, have to consider the impact of this law seriously. Recently, a few enterprises even have taken actions, such as mass layoffs, to avoid the potential huge increase of the cost of human resources after the effectiveness of the Labor Contract Law. Most enterprises, however, prefer a wait-and-see strategy as the detailed implementing provisions of the Labor Contract Law are still being created.

As indicated above, to govern foreign investment, Chinese authorities divide investment industries into 4 categories for foreign investors: 1) encouraged, 2) allowed, 3) restricted, and 4) prohibited, based on the nature of the industry and other factors. *Catalogue for Guidance of Foreign Investment Industries* ("Catalogue") is one of the most important laws detailing each different category. The National Development and Reform Commission and Ministry of Commerce jointly released the new Catalogue on October 31, 2007 to replace the old one issued in 2004. The new Catalogue consists of 478 clauses including 351 groups of encouraged, 87 groups of restricted and 40 groups of prohibited. Each category has a few changes compared with that of old Catalogue released in 2004. The new Catalogue became effective on December 1, 2007, and foreign investors considering investing in China must comply with the new Catalogue.

Conclusion

Companies accustomed to business in the United States will find the Chinese legal system and its operational environment are quite different. Investors and entrepreneurs who seek to establish a subsidiary in China should consider their market needs and the long-term strategy of the subsidiary. Subject to the approval of the original approval authority, investors may wind up an FIE after completing the liquidation and dissolution procedure and foreign investors may transfer the remaining assets distributed to them outside China.

A well-designed subsidiary in China, together with other carefully designed arrangements, can prevent unnecessary economic costs and eliminate surprises when the subsidiary seeks future funding. Armed with a thorough understanding of the business constraints—as well as the opportunities—in China, investors can make business decisions that will help them successfully establish, operate, and exit from their subsidiaries.

Jie Chen is a visiting lawyer in the Corporate Group of Fenwick & West. Ms. Chen is a partner at Jun He Law Offices in Beijing, China, where she has represented multinational companies, high-tech companies, investment banks and Chinese state-owned enterprises. She may be reached at 650.335.7147 or jchen@fenwick.com.

Jianwei Zhang is a visiting lawyer in the Corporate Group of Fenwick & West. Mr. Zhang is an associate at Jun He Law Offices in Shenzhen, China. He may be reached at 650.335.7871 or jzhang@fenwick.com.

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Firm Overview

FENWICK & WEST LLP PROVIDES COMPREHENSIVE LEGAL SERVICES TO TECHNOLOGY AND LIFE SCIENCES COMPANIES OF NATIONAL AND INTERNATIONAL PROMINENCE. APPROXIMATELY 300 ATTORNEYS OFFER CORPORATE, INTELLECTUAL PROPERTY, LITIGATION AND TAX SERVICES.

Corporate Group

We service innovative 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 advisors 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 $7.5 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 technology and life sciences 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
Mountain View, CA 94041
Tel: 650.988.8500

555 California Street, 12th Floor
San Francisco, CA 94104
Tel: 415.875.2300

1191 Second Avenue, 10th Floor
Seattle, WA 98101
Tel: 206.389.4510

950 W. Bannock Street, Suite 850
Boise, ID 83702
Tel: 208.331.0700

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