



## Third Annual Venture Terms

# 2007 Venture Terms Survey Results

### Co-Hosted by:

Applied Materials, Annette Finsterbusch (CA)  
Bessemer Venture Partners, Scott Ring (NY)  
Charles River Ventures, Sarah Reed (MA)  
ComVentures, Rodi Guidero (CA)  
LLR Partners, Seth Lehr (PA)

### Hosted by:

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Where Ventures Meet Capital®

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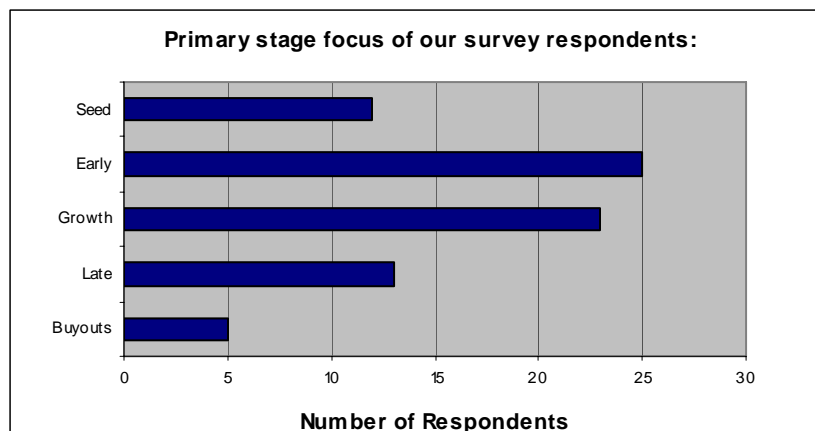
# Lowenstein Sandler Tech Group Third Annual Venture Terms Survey Results

Delivered: September 24, 2007

This summer, Lowenstein Sandler's Tech Group was pleased to co-host the 3rd Annual Venture Terms event at our offices in Midtown Manhattan. Once again senior investment professionals and the general counsel of venture and private equity funds across the country came together to have an in-depth discussion about the core business issues impeding the completion of investment transactions and exits. Of the 39 investors participating in the event, 14 came from New York, 7 from Boston, 5 from California, 3 from the Reston/DC area, and the rest from across the country. A dozen of the 45 event participants were general counsel and 27 were senior investment professionals at their funds, offering a mix of perspectives that are shared all too infrequently.

The data for the survey came from 36 respondents, 16 of whom are based in California, and 15 of whom are based on the East Coast (NY, MA, CT, NJ, PA, and the Reston/DC area). Three respondents are from funds with principal offices overseas (London, China and Mumbai), and one respondent is headquartered in the Midwest.

Our respondent funds were well seasoned -- 60% are more than 10 years old. The funds cover a broad cross section of industries, though we were weighted more heavily in tech than life sciences (12 of our respondents are life sciences investors). When we invited funds to participate, we tried to focus on venture (as opposed to control acquisition players) and to achieve a diversity of stage focus. As the chart to below indicates, we achieved the desired result:



The questions for our survey were developed based on the pre-event discussions among the co-hosts and event participants. While we greatly appreciate the efforts of the respondents, we want to acknowledge the tremendous efforts and support of our co-hosts, without whose insights, time and connections the event and this survey could not have happened.

Our 2007 co-hosts were:

- Annette Finsterbusch, Applied Materials (Santa Clara, California)
- Scott Ring, Bessemer Venture Partners (Larchmont, New York)
- Sarah Reed, Charles River Ventures (Waltham, Massachusetts)
- Rodi Guidero, ComVentures (Palo Alto, California)
- Seth Lehr, LLR Partners (Philadelphia, Pennsylvania)

If you would like to participate in one of our upcoming surveys, please email us at [tgevents@lowenstein.com](mailto:tgevents@lowenstein.com).

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### **About the Tech Group at Lowenstein Sandler**

Lowenstein Sandler PC ([www.lowenstein.com](http://www.lowenstein.com)) is an East Coast-based law firm with more than 270 lawyers. Our Tech Group represents technology and science based businesses, their investors and the research institutions creating the intellectual property on which those businesses are founded. Because the Tech Group is the place *Where Ventures Meet Capital*® we do host events from time to time for members of the venture, private equity and angel investor community to meet with entrepreneurs. For more information about our Venture Terms event or other venture and private equity related events staged by the Tech Group at Lowenstein, please email us at [tgevents@lowenstein.com](mailto:tgevents@lowenstein.com) or contact one of the Tech Group partners listed below:

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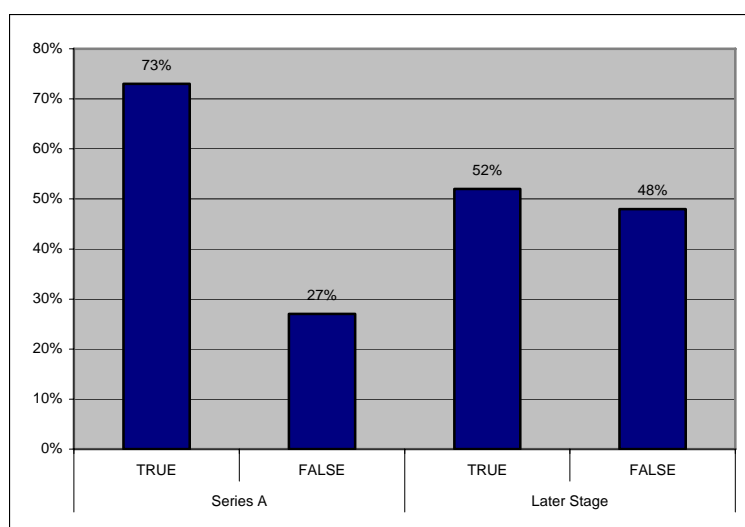
## Venture Investment Questions

Through the survey, we sought to answer some basic questions about the current state of the market, realizing that our data would be more impressionistic than based on a review of specific transaction documents -- in other words, the respondents answered based on their recollections of how their deals ended up and of the market more generally.

We believe that it is useful to cross reference our own data with that compiled by other sources. For one, we reviewed the Cooley Godward Kronish LLP Private Company Financing Report (CGK PCF) which was released in August 2007.<sup>1</sup> The CGK PCF Report is based on a review of deal documents in specific venture transactions covering a 6 rolling quarter time period and so we felt that it was a nice complement to the more anecdotal or impressionistic data set we gathered. We note that a specific closed deal may have 'market' and non-'market' terms, but we sought to determine what types of things our respondents would consider to be 'market' were they issuing a term sheet or advising a friend who was confronting her or his first venture term sheet. In other words, you might view our data set as being biased toward what the roughly 40 venture investors we surveyed thought were fair deal terms in the current market.

### Q: True or False: For Series A Deals: the "market" is that most or many deals get done at a liquidation preference equal to 1x + dividends and participation: For later stage deals, same question:

With 73% of respondents answering true to the first question, the market has clearly spoken in terms of a consensus on 1x+participation for early stage deals. This is consistent with the CGK PCF Report which found that 91% of all Series A deals and 85% of all Series B deals were done at a liquidation preference of 1x -- the CGK PCF Report tracked *participation*<sup>2</sup> separately. In terms of participation, the CGK Report found that 50% of Series



<sup>1</sup> The CGK PCF Report appears online at [http://www.cooley.com/files/tbl\\_s5SiteRepository/FileUpload21/1193/PCF2007Q1\\_color.pdf](http://www.cooley.com/files/tbl_s5SiteRepository/FileUpload21/1193/PCF2007Q1_color.pdf).

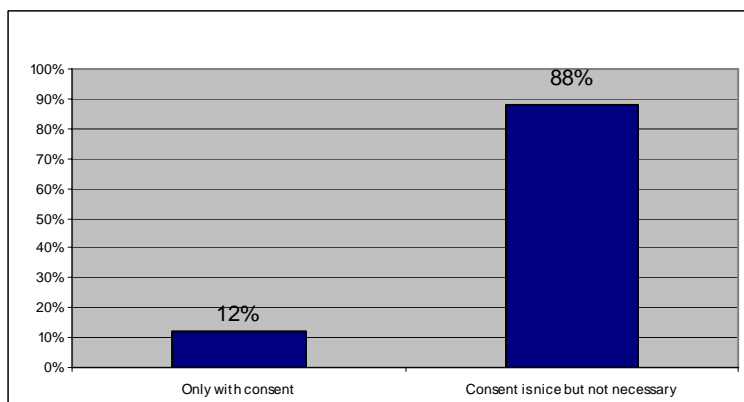
<sup>2</sup> "Participation" enables the holder of preferred stock to receive their preference amount (usually expressed as 1x or 2x, where "x" is the amount originally invested per share) and then to receive his or her pro rata share of the remaining deal proceeds after the liquidation preferences have been satisfied.

A deals had no participation whatsoever, 25% had capped participation and 25% had uncapped participation. The CGK PCF Report also notes, however, that participation and multiple preferences were more common in East Coast deals (our data set had a roughly even mix of East Coast and West Coast respondents while the CGK PCF Report appears to be biased toward West Coast deals).

There are several different explanations for the almost even split between true and false responses to the question concerning later stage deals. When we read the narrative responses, however, it became clear that for those who answered false, the commentary typically focused on eliminating or capping the participation feature. Our data suggests that as the stage grows later, the likelihood of capping or eliminating participation increases. Interestingly, the CGK PCF Report found that participating preferred increased rather than decreased in later stage deals. While at first blush, this appears to be at odds with our findings, we believe that the basis for the apparent contradiction lies in semantics: while our question spoke of Series A as opposed to late stage, the CGK PCF Report analyzed deals by "series" without regard to whether they were early or late stage or restarts. In other words, in the CGK PCF Report, a company that has not done well with fatigued incumbent investors infusing additional capital would be a Series D round, while a high flying late stage company that has never taken institutional capital could indeed be classified as an A round.

**Q: If pay-to-play has already been built into a deal, are you willing to impose the agreed-upon penalties on non-participating funds/strategics/angels or are you only imposing the penalties if the non-participants consent to the application of the penalties?**

In the last 18 months or so, we have seen (and our pre-event calls referenced) that VCs were unwilling to trigger pay to play<sup>3</sup> provisions because the VCs did not want to incur the reputational harm and ill-will engendered by cramming a co-investor or because they feared the threat of litigation. While our survey results indicate that the overwhelming majority of respondents were willing to cram non-participating co-investors, the discussion at our event itself suggested a very different outcome and

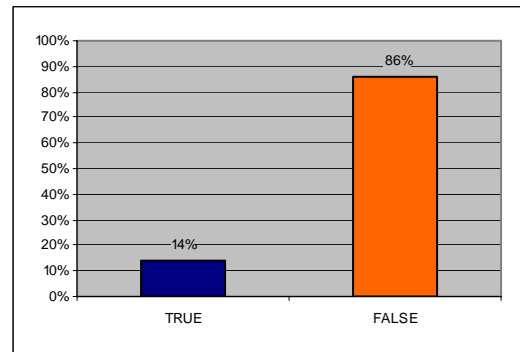


<sup>3</sup> Pay-to-play provisions attempt to cure "free rider" problems by penalizing those investors who do not participate in subsequent financings, especially subsequent rounds done at a valuation below or flat with that of the prior round. When investors invoke pay-to-play, the non-participating stockholders lose rights by swapping their preferred for a weaker preferred or even for common stock. These provisions grew increasingly common following the nuclear winter of 2001 through 2004 when it became more difficult to complete inside-led rounds.

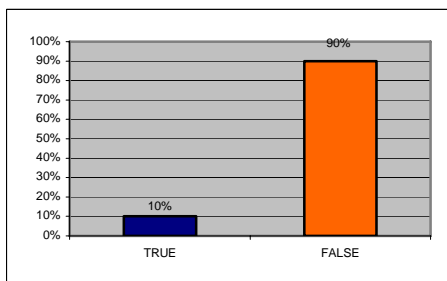
causes us to wonder whether there was some bravado influencing the way in which people answered an anonymous survey; or perhaps it was wishful thinking.

**Q: True or False: It doesn't hurt the reputation of a fund to walk away from a signed term sheet because people understand that the nature of the market dictates that we cannot complete diligence until a few weeks after signing the term sheet:**

Opinions at our meeting were quite virulent on this subject. It quickly became clear that reputation continues to play a powerful role in this market in which repeat players meet each other and frequently make decisions about syndication based on relationships. Perhaps some of the strong emotion here is fueled by an increase in the number of venture rounds involving an investment banker-led auction and the frustration investors have felt when they have spent time and effort on a losing bid only to later learn that the winning bidder walked away from the signed term sheet. The implication is that the spurned bidder would feel that its bid could have been higher too if it had either intended to lower the share price post-term sheet or if it had not done the necessary work to put in a good faith bid it could stand behind. We note that entrepreneurs may be less aware than VCs regarding which funds actually walk away from signed term sheets on a repeat basis. Entrepreneurs may also be more forgiving of a fund's reputation for having done this in other deals. On the other hand, VCs with whom we work suggest that "hanging around the hoop" can prove to be a good strategy if a company rebuffs a VC suitor because it will enable the fund to step into a largely negotiated deal (at a more appropriate valuation) when the first fund's term sheet that was too good to be true, turns out to be just that.



**Q: True or False: We require fund employees to resign from a portfolio company's board of directors upon an IPO:**



Despite the increase in venture-backed IPOs in the past few quarters, it is difficult for us to tell whether the responses to this question were based on (a) too small a data set of portfolio companies going public with the respondent fund on the board, or (b) funds taking a less conservative approach now that they have lived with Sarbanes-Oxley for a few years. Nonetheless, this was a topic on people's minds before and at the event and the survey results surprised a number of the event participants.

## M&A Questions

The participants in our event were not only keenly interested in the way in which M&A in our industry occurs but acknowledged that even among technology M&A transactions, there are very different approaches and issues inherent in selling a venture-backed technology company. Our participants wanted to understand that specific niche of the market. We formulated a number of questions based on their input.

In reviewing our impressionistic data, we also wanted to reference two recent surveys that looked at closing documents in private company M&A deals. While these surveys are not a direct fit with our target response group, there are a number of similarities in outcomes.

The first is a report compiled by a working group of the American Bar Association's Section of Business Law (the ABA Report).<sup>4</sup> The report covers M&A deals completed in 2006 involving private targets. For their study, the ABA working group reviewed publicly-filed M&A documents involving a public buyer and private seller, excluding reverse mergers and sales out of bankruptcy, among other deals the committee deemed to be outliers. The report ended up with a sample size of 143 deals, with heavy weighting toward smaller deals -- roughly 63% of their transactions ranged from \$25MM to \$100MM, while only 11.2% exceeded \$301MM and none exceeded \$500MM. Tech deals comprised only 25.9% of all deals and only 34.3% of all deals involved targets which had significant backing from financial sponsors. These parameters mean that the ABA Report is a barometer of a broader market than that which most of our respondents inhabit.

The second report is a little less on-point because the data covers a much longer time-frame (77 deals closed between January 1, 2002 and June 30, 2006), and on whole, the deals are much larger (the 2003 through 2006 deals ranged from a low of \$125MM to a high of \$4.2BN), with only four deals in 2006. This report, the Kaye Scholer LBO Legal Issues Survey (KS LBO Survey)<sup>5</sup> was released in February 2007 and also asked more technical legal questions, which limits the overlap in questions. Nonetheless, it is useful to look at the data from this report as well.

### **Q: For portfolio company sales, what is "market" for these terms:**

Our pre-event discussions this year, as in each of the last two years, confirmed that participants wanted to know where the market was on indemnification in the sale of venture backed companies. One of the ways in which venture-backed businesses in an industry differ from other companies in the same industry is the ability of the

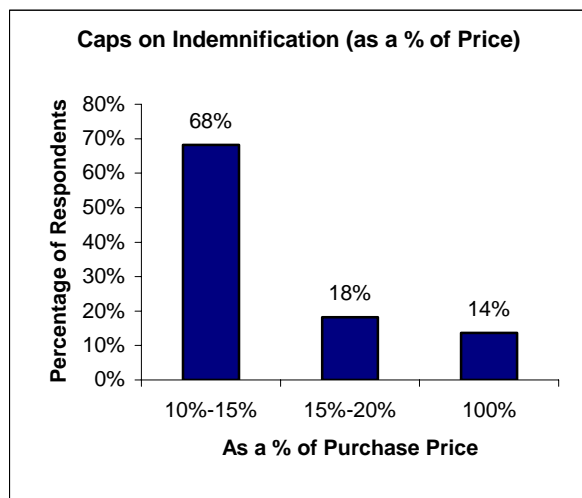
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<sup>4</sup> The 2007 Private Target Deal Points Study (posted 8/10/07) appears online at <http://www.abanet.org/dch/committee.cfm?com=CL560003> but can only be viewed by committee members who have a password. This study may also be available soon on the members-only portion of the NVCA website.

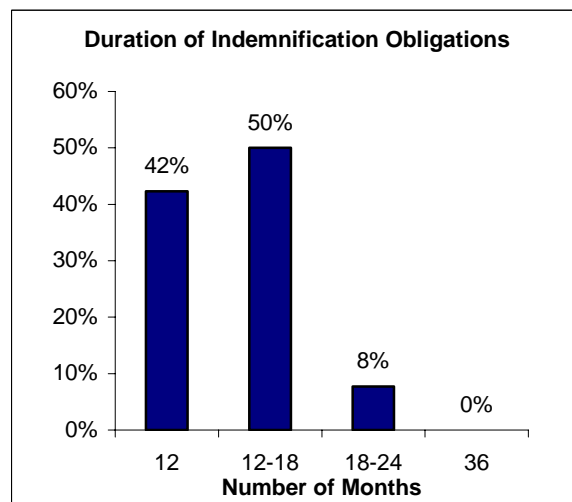
<sup>5</sup> The KS LBO Survey appears online at [http://www.kayescholer.com/web.nsf/0/8826731B9C982AC1852572B500693D19/\\$file/WhatsMarket.pdf?openelement](http://www.kayescholer.com/web.nsf/0/8826731B9C982AC1852572B500693D19/$file/WhatsMarket.pdf?openelement).

stockholders to provide indemnity. The nature of LP investments into venture funds makes it extremely difficult to provide indemnification beyond the amount escrowed to secure against breaches.

**Caps on indemnification (% of price):**



**Duration of indemnification obligations:**



## Caps & Baskets

These questions generated a clear consensus which both the ABA Report and the KS LBO Survey further support.

In the KS LBO Survey, the average cap on indemnification was only 14.4% of the purchase price, while the average "basket"<sup>6</sup> was 0.6% of the purchase price for deals under \$250MM and 0.7% of the purchase price for all deals covered by the survey. The ABA Report was generally consistent with the KS LBO Survey (28% of the deals in the ABA Report had a basket of between 0.5% and 1.0% and 62% of the deals had a basket of 0.5% or less). As a negotiating strategy, we have seen people use to good effect a strategy of offering the other party the opportunity to choose for itself between a high tipping point or a slightly lower deductible.

We found it noteworthy that when one reviews the ABA Report's findings against their 2004 version of the same report, the baskets as a percentage of total purchase price are in fact declining, which is not great news for sellers. That said, the shifts in absolute dollars are not huge, indicating that there is some stability around the consensus view of an appropriate basket in private company M&A deals.<sup>7</sup>

<sup>6</sup> A "basket" is the threshold amount which damages must equal or exceed in order for the buyer to recover against the seller. Some baskets are "tipping points" (meaning that once the basket is reached, the buyer can recover from the first dollar of damage it suffered) and others are "deductibles" (meaning that the buyer can only recover the damages in excess of the threshold). Of the deals surveyed in the ABA Report, 54% used the basket as a deductible, while 36% used the basket as a tipping point.

<sup>7</sup> More specifically, in the 2004 version of the ABA Report, 49% (as compared to 28% in 2006) of the baskets were between 0.5% and 1% of the purchase price and 40% (as compared to 62% in 2006) were at 0.5% or less. While the ABA Report and the KS LBO Survey did not mention this, we note that baskets are often expressed as round numbers (i.e., \$200,000) rather than as a specific mathematical percentage of the purchase price (though they are certainly very often related to the purchase price) and so the shifts from above 0.5% to below 0.5% may also have to do with the way the numbers round. Accordingly, we take

## Duration

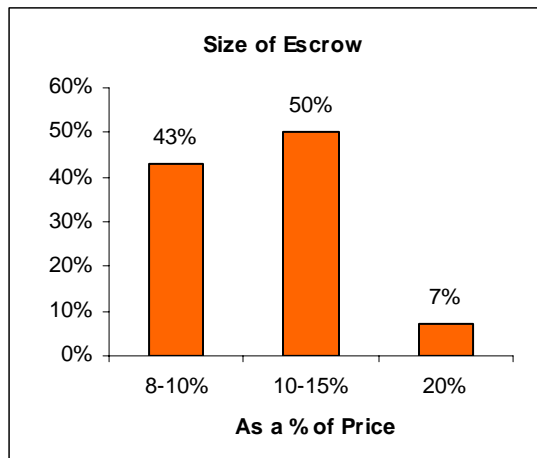
The survival period for reps and warranties is the period during which a claim can be asserted for breach of a given representation or warranty. We did not phrase this as a multiple choice question so the consensus was achieved without coaching. That said, the numbers have some softness to them as the people who answered "12" months may not be in a real disagreement with those who answered "12 to 18 months. "

Note that in the KS LBO Survey 14.7% of the deals had representations which did not survive the Closing ("as is" deals), while 64% had reps surviving from 6 through 18 months post-closing. This tracks the ABA Report, which noted that 69% of the deals they reviewed contained 12 to 18 month survival while 16% contained 24 month survival. Only 5% of the deals surveyed in the ABA Report contained survival in excess of 24 months. These are the other numbers from the KS LBO Survey: 12% had reps surviving from 18 through 24 months (as compared to 8% in our survey) and 1.3% had unlimited survival.

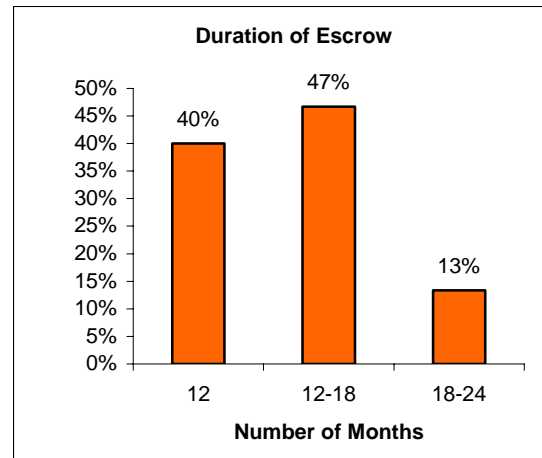
There are also carve outs for specific types of claims. Carve outs mean that a seller's indemnification obligations for certain types of claims will last longer than the general obligations. This was one area in which, as we expected, our venture survey did not mesh with the KS LBO Survey or the ABA Report. This difference makes sense because, by and large, the companies our respondents back are dependent upon their intellectual property while those covered in the other two studies are generally not. Accordingly, 34% of our respondents indicated that when selling their portfolio companies, indemnification for intellectual property representations was not limited by the cap that applied to other types of claims. In the ABA Report, 13 different types of carve outs appeared in at least 10% of the deals surveyed; intellectual property was not among those. The most commonly occurring exceptions in the ABA Report were fraud (64%), Capitalization (46%), Due Authority (43% -- up from 11% in the 2004 version of the ABA Report), and Taxes (40%). Note that, the ABA Report found that intellectual property reps survived longer than the other representations in only 10% of the deals surveyed (down from 13% in the 2004 version of the Report).

## ESCROW

### Size of Escrow:



### Duration of Escrow:



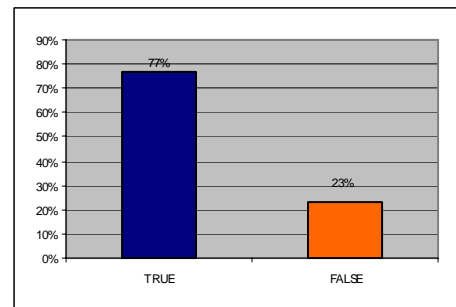
### Size & Duration of Escrow

The size of the escrow (or the amount held back to give the buyer security for claims of breach against the sellers) seems to fall into a very narrow range of between 8% to 20% of the total price (with 93% of our respondents going even narrower to 8% to 15%). Similarly, in the ABA Report, the vast majority of the deals with escrows ranged from 3% to 15% of the deal price (83% of all deals surveyed). Within that range, 15% of the deals had an escrow of 10% of the purchase price while 16% were between 10% and 15% of the purchase price. Only 8% of the deals surveyed in the ABA Report included an escrow that was lower than 3% of the purchase price. While the size of the escrow will clearly vary depending on what the seller discloses (and the buyer finds) during diligence, the market for venture-backed companies and for other smaller privately held firms seems to have arrived at consensus on a 10% escrow, give or take 5%.

Escrow duration appears to be fairly stable in the 12 to 18 month range. We did not measure whether there are interim releases to the sellers from the escrow at, for instance, the 6 or 9 month mark.

### Q: True or False: In most of my M&A exits, the escrow is the sole source of recovery:

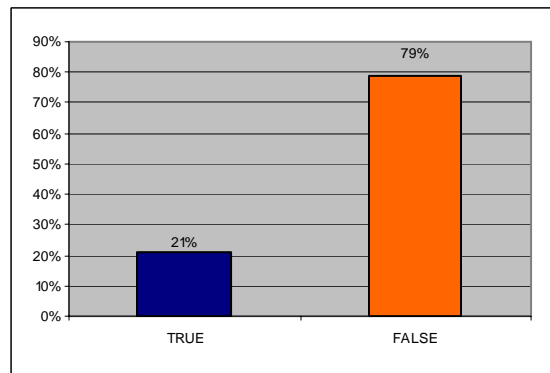
Because venture and private equity funds are not in a position to return to a buyer sale proceeds distributed to the funds' limited partners, the issue of whether the escrow is the sole source of recovery in M&A deals is a very hot topic. While 77% of our respondents indicated that the escrow was indeed the sole source in their M&A exits, this is not surprisingly an area in which our survey differs from the ABA Report. Of course, the ABA



Report covers many deals involving a target which does not have any financial sponsor, so sole source is less of an issue. With that as context, the ABA Report found that the escrow was the sole remedy in only 32% of the deals. When you add in the possibility of the escrow and an offset against earnout dollars as the sole sources of recovery for a buyer, the number only increases to 36% of all deals. Note that 13% of the deals in the ABA Report did not have any escrow.

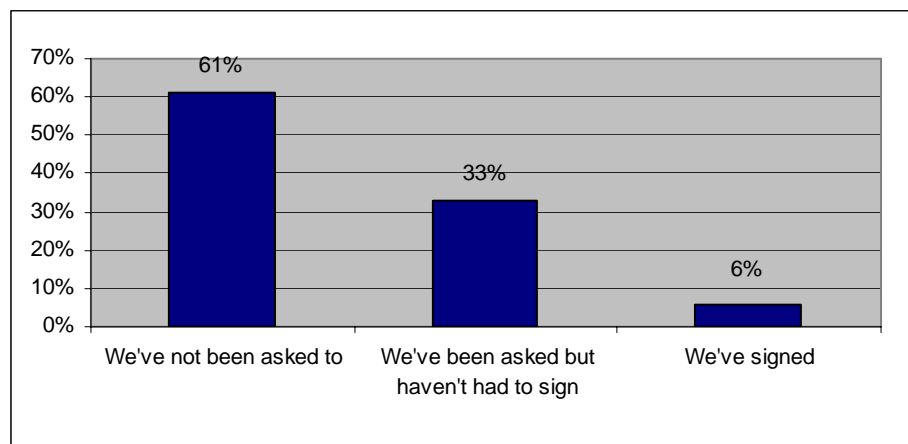
**Q: True or False: I'm seeing escrow claims more frequently today than in the past:**

Over the last several years, we have consistently heard complaints from our venture and private equity clients about the extent to which buyers will make claims at the end of an escrow period even though the claims are based on 'areas of concern' rather than either actual damages or live legal proceedings. These assertions are often enough money to be meaningful but not enough to yield a good return on investment should the fund decide to take the buyer to court.



We too have seen these kinds of claims in escrows. Consequently, we were not surprised when pre-event, our venture and private equity clients asked about this issue of the 'escrow shakedown.' The numbers here raise an interesting and unanswered question -- is the absence of an increase indicative of the venture community merely getting used to a high frequency of shakedowns or has there been an actual decrease or leveling off?

**Q: The following is a true statement regarding my fund signing a non-compete in connection with the sale of a portfolio company:**



In the last year or so, we have heard more about buyers asking funds to sign non-competes in connection with a sale of a portfolio company. When you combine the respondents who said that they have not been asked to sign with those who were asked and ended up not having to do so, the numbers make clear that the ask itself is off-market. One respondent (within the 6% of "we've signed") notes that funds may be willing to sign non-competes that bind only the fund and not any partners or portfolio companies of the fund -- in other words, signing a document saying that the fund itself won't compete in the, for instance, selling semiconductors (this is akin to giving snow in winter).

## Conclusion

The participants in our survey and event were very generous in sharing their insights, questions and strategies for overcoming the toughest business issues which confront venture investors in completing investments and exits. Because many of our participants were bi-coastal, it becomes increasingly difficult to discern West Coast terms from East Coast (is the general counsel of a fund with an equal number of partners in Silicon Valley and on the East Coast an East Coast person?). The market itself continues to be characterized by competitive transactions with undisclosed terms and a trend toward agented deals, resulting in more competition and higher valuations for the best deals. When you add to that what we see as the de-centralization of venture -- the increasing number of deals being done outside of Silicon Valley -- funds will need to share data with one another to equip themselves with knowledge of where the market is now or soon will be. We are privileged to have served as a conduit for this information.

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