To our clients and friends:

Emerging Companies Update

A quarterly publication from Mintz Levin's Venture Capital and Emerging Companies Practice Group

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Emerging Companies Update

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Welcome to the first edition of Mintz Levin's *Emerging Companies Update*. The *Update* seeks to provide timely information on business and legal issues impacting the emerging business and venture capital communities.

Mintz Levin's reach is broad, with offices in major technology centers throughout the United States, London and Israel — and you will see a broad sweep of articles as well. In this issue, we cover the current state of venture capital funding, with an interview with leading venture capitalist Bob Davis of Highland Capital Partners. We also take a look at how technology companies can take advantage of three federal stimulus programs. We conclude with two articles on legal developments of interest to all technology companies.

We hope you enjoy the *Update*! Please let us know your thoughts on the *Update* together with ideas for future articles and interviews.

– Neil H. Aronson, Editor

In This Edition

The Current State of Venture Capital and an Outlook for Early Stage Companies

An Interview with Bob Davis of Highland Capital Partners

Interview by Neil H. Aronson

Bob Davis brings a unique perspective to the venture capital industry. Bob is a General Partner at Highland Capital Partners, where he focuses primarily on digital media and the Internet. Prior to joining Highland in 2001, he served as the Chief Executive Officer of Terra Lycos (TRLY), formed in October 2000 with the $5.5 billion acquisition of Lycos by Terra Networks of Spain. Previously, Bob was the Founder of Lycos, Inc. (LCOS) and served as its President and Chief Executive Officer since its inception in 1995, where he led Lycos from a start-up with $2 million in venture capital funding to become the most visited online destination in the world with over 100 million unique visitors. Under his leadership, Lycos jumped from the fastest IPO in Nasdaq history, a mere nine months from inception to offering, to a global media entity.

He currently represents Highland on the boards of Bullhorn, Going, Hangout Industries, NameMedia, Paragon Lake, Quattro Wireless and Turbine. Bob has previously served on the boards of a number of highly successful companies acquired by major industry leaders, including Fastclick (acquired by ValueClick), Quigo (acquired by AOL) and Navic (acquired by Microsoft).

Bob is the best-selling author of *Speed is Life: Street Smart Lessons from the Front Lines of Business*.

Q: What are your expectations for VC funding for the rest of 2009?

A: I think that it's a time of rare opportunity right now. If you look historically at venture investing, some of the best deals have happened in either recessionary or post-recessionary periods. You can look all the way back to the panic of 1873 when GE was founded, to HP which was founded during the Great Depression, to all the strong companies that were put together in the 1970s and then in the early 1980s, and all the way forward to after the 2001 bubble where we saw the development of the likes of Facebook. So I think we are in this time frame right now where the market has become less noisy and less crowded.

We have some really strong entrepreneurs that are looking to make a statement and looking to get something off the ground and have the opportunity of limited competition. In recent history, you could have 40 people doing something quite similar to it. Now, great ideas have a chance to really get some momentum before they get crowded in the marketplace. So for those who have the courage to go out and do something, it's a great time to start a company.

Q: Some people feel that this downturn has fundamentally changed the nature of venture capital investing — what do you think?

A: Well, I don't think it has changed it at all. I think it may have changed the venture capital market but I don't think it has changed the nature of venture investing because as an investor there are three fundamental things you look for: people, markets and products, in that order. Great people and great teams build great companies.

A great team can turn a mediocre idea into something spectacular but a spectacular idea with a mediocre team is destined to failure. That hasn't changed nor will that change.

Big markets — we have always looked for the next big thing and to try to invest in markets that we think could be explosive in their nature, that's still very much the case. If anything, in the last several years, a lot of venture money may have made that a little bit crowded. Today, for the reasons talked about in my first answer, that's less so.

Lastly, it's great products — there is no lack of innovation and I hear people often say, and I laugh at this, "are we innovated out or have we reached a saturation point for new ideas?" That, to me, is very myopic thinking — there's no time, past or future, where we will lack for progress, new ideas or new thinking, or new ways of doing things — it just won't happen. So I don't think it has changed the fundamentals of investing at all because that's what we look for.

Q: What should early stage companies do today that is different from the past in attracting venture capital?

A: Show a capital efficient model — and that's what we are really seeing quite a bit over the last few months. That is, businesses that have found a way to innovate without burning large sums of cash. And to the extent that you can assemble a good team of passionate and committed entrepreneurs without having to burn large amount of monies to prove milestones, I think it's a great first step.

Q: Is that an advantage for early stage companies during a recession — the cost of things are less?

A: No, I don't think so — on the margin maybe — but not in a meaningful way. I think what it does is says that an entrepreneur needs to get more disciplined in how they spend their cash and be more creative in terms of how they gain market share. I don't really think that costs are materially less.

Q: In the last couple of years Clean Tech has been a very hot area. Are there any new spaces that you expect to see blossom over the next couple of years?

A: Clean Tech has been a hot area and we have one of our partners looking at Clean Tech extensively right now. We have not been Clean Tech investors. I don't know if Clean Tech as a category has been wildly successful thus far because as much as I talk about capital efficient models, a lot of Clean Tech has been very capital intensive. It requires a lot of money to get things working so there's a lot of high spending on that.

One of the markets that I have seen that is destined to see big things is mobile. We really have this concept of mobile computing in a way that we only could have dreamed about 4 or 5 years ago and we all carry it in our pocket every day. People have talked about the $100 laptop but it exists — it's the $30 laptop that you buy at Best Buy, called your cell phone. The innovation and the rate of change and progress that we are seeing around it is mind boggling and right now it's a computer on every desktop — it's soon to be a computer in every pocket.

The breadth of applications and the breadth of opportunity, for that matter, the degree of change that we are all going to see in terms of how we operate from day to day is going to be very considerable. It will be a new payment mechanism. We will walk by a vending machine and swipe our cell phone and out will pop the Coca-Cola. It will also be a shopping comparison vehicle. We'll go into a given store, scan a bar code with our cell phone and it will tell us who else has that item and at what price and who has availability. Things that we just don't think about today will be there. Thus far, cell phone advertising is proving to be probably the most effective form of digital media out there in terms of customer response. I think mobile computing and data are the next big thing. Thus far, we have thought about it as a device to speak into and that's principally what we all use it for today. That is all about to change.

Q: What should an early stage company look for in picking the right venture capital firm?

A: I would say chemistry and commitment. You are establishing a long-term relationship with your investor that is more than just an exchange of equity for cash. You are bringing somebody together with you that will likely be a team member for many years. The time for forming a company to liquidity is 7 to 9 years. This is a long window and a long-term partnership you are beginning, and it's very important that the partner that you are selecting is one that you feel that you want to work with, you want to share with, you want to grow with, you want to develop with.

Commitment is equally important. A commitment relates to a number of things. Am I committed to the sector that your company is in? For instance, if you start an Internet company be sure to find a digital media investor — don't find a health care investor to help you with an Internet company and vice versa. Am I willing to work for you as an entrepreneur? Which means am I willing to put my rolodex, my connections, my past relationships, and my time on the table to help you to succeed and do I have a historic record of doing that? Basically I tell a CEO that the board member is just an extension of their employee base and they need to find someone who is willing to recognize that. Commitment and chemistry are the keys.

AUTHOR CONTACT NEIL H. ARONSON

Venture Capital Trends in 2009

by John P. Condon

Many venture capitalists have predicted that 2009 would be a difficult year for venture capital investment and fundraising. In November and December 2008, the National Venture Capital Association conducted a survey of more than 400 venture capitalists from throughout the United States to gather their forecasts for the venture capital industry in 2009. Respondents anticipated that “the coming year will be met with a slowdown in investing across most sectors and a continued weakened exit market… [but] predict a recovery in 2010 when the IPO market is expected to re-open and those companies and venture firms that weathered the storm will emerge strongly.”

Now that numbers are available for the first quarter of 2009, those predictions so far appear to be true. According to The MoneyTree™ Report for Q1 2009 by PricewaterhouseCoopers and the National Venture Capital Association, based on data from Thomson Reuters, venture capital investment in the first quarter was down 47 percent in dollars invested and 37 percent in the number of deals from the fourth quarter of 2008. Dollars invested fell from $5.7 billion to $3.0 billion and deals declined from 866 to 549, representing the lowest level of venture investment since 1997. According to the *Venture Capital Journal,* “The only good thing you can say about the first quarter is that it’s over.”

It appears that almost no industry escaped these declines. The Q1 2009 PwC/NVCA report shows first-quarter venture investment in software, life sciences, clean technology, and Internet companies all declined from the fourth quarter of 2008:

Industry	Dollars Invested	Number of Deals
Software	- 42%	- 34%
Life Sciences	- 40%	- 31%
Clean Technology	- 84%	- 51%
Internet	- 31%	- 32%

According to the Q1 2009 report, financial services was the only industry in which venture investment grew both in dollars invested (26 percent) and number of deals (21 percent).

The first quarter results represent a further decline in life science ven investment, but a reversal of the growth of clean technology venture investment in 2008. The PwC/NVCA report for Q4 2008 / Full-year 2008 shows dollars invested in life sciences fell by 15 percent to $8.0 billion in 2008, but the number of deals fell by only 3 percent to 853 deals in 2008. On the other hand, clean technology investment dollars grew by 54 percent and deal volume rose by 16 percent in 2008, with $4.1 billion invested in 277 deals.

According to the *Venture Capital Journal,* some venture firms are targeting companies that they believe are recession-proof. These include companies that help customers save money, provide customers with “need-to-have” rather than “nice-to-have” products, and afford customers with less expensive entertainment alternatives. Many venture capitalists, however, will not fund a company simply because it is well positioned in a down economy, but focus on businesses that will succeed in the long term. Indeed, many top-performing companies such as Google developed during difficult economic times.

The decline in venture investment during the first quarter touched companies at all development stages, according to the Q1 2009 PwC/NVCA report. Compared with the fourth quarter of 2008, venture investment in seed and early stage companies dropped by 45 percent in dollars and 40 percent in deals. In full-year 2008, however, investment in seed stage companies increased by 19 percent in dollars, but was invested in slightly fewer companies than in 2007, while early stage investment experienced little change in both dollars invested and the number of deals.

Venture investment in expansion stage companies during the first quarter fell 60 percent in dollars invested and 47 percent in deals, while later stage venture capital investment dropped 35 percent in dollars invested and 22 percent in deals. In all development stages, the average deal size also has fallen from the fourth quarter of 2008: from $5.1 million to $4.3 million for early stage deals, $7.5 million to $5.6 million for expansion stage deals, and $8.1 million to $6.7 million for later stage deals. The average deal for seed stage companies, however, increased from $3.4 million to $3.6 million. The *Venture Capital Journal* reports that venture firms are hesitant to add companies to their portfolios and instead are focused on retaining their cash for investment in their existing portfolio companies.

With respect to exit strategies, as the Q4 2008 PwC/NVCA report and a NVCA news release issued on April 1, 2009 show, IPOs and acquisitions of venture-backed companies declined substantially in 2008, and this trend continues in 2009. In particular, there were only six venture-backed IPOs in 2008 compared with 86 IPOs in 2007, reflecting the lowest level in 30 years. In the first quarter of 2009, there were no venture-backed IPOs and only 56 M&A exits, compared to five venture-backed IPOs and 106 M&A exits in the first quarter of 2008.

Many venture capitalists are also facing a difficult fundraising environment. According to a NVCA news release issued on April 13, 2009, only 40 venture capital funds raised money in the first quarter of 2009, compared with 47 funds in the fourth quarter of 2008, although dollar commitments rose by about 23%. NVCA President Mark Heesen believes that many venture firms have recently raised funds or are waiting for the market to improve, but that established venture firms continue to have access to capital.

Many of these first-quarter trends in venture capital investment in the United States are also reflected globally. In the first quarter of 2009, for example, the dollars invested by venture firms in Israeli high-tech companies declined 57 percent compared to the first quarter of 2008 and 33 percent compared to the fourth quarter of 2008, according to a report by the Israel Venture Capital Research Center. The average venture financing was $2.85 million, from $4.57 million in the first quarter of 2008 and $3.61 million in the fourth quarter of 2008.

The declines of the first quarter of 2009 that are reflected across industries and development stages and, in terms of exit opportunities and fundraising, reflect a challenging environment for venture firms and companies in need of venture financing.

AUTHOR CONTACT JOHN P. CONDON

Enforceability of Many Reseller Agreements in Question

by Claudia F. Torres

A recent high-profile decision by a California Superior Court involving Cisco Systems, Inc. places into question the enforceability of many provisions typically found in reseller agreements. As a result, companies should consult with their attorneys, particularly with regard to termination and limitation of liability provisions. Cisco elected to settle by paying the reseller $5.45 million instead of appealing a $6.4 million jury verdict. Whether similar verdicts in the future will be upheld by appellate courts and adopted by courts in other states remains to be seen.

In January 2008, Infra-Comm, a value-added reseller, sued Cisco over alleged breaches in its Indirect Channel Partner Agreement (ICPA) and deal registration program. The dispute centered around allegations by Infra-Comm that Cisco handed over to AT&T a deal with Irvine Company worth over $9 million that Infra-Comm had worked to develop over a five-year period and had registered with Cisco under its deal registration program. Cisco terminated its reseller agreement with Infra-Comm six months after Infra-Comm filed suit. Cisco contended that Infra-Comm was not qualified to provide the services required by Irvine Company and that it only acted with the best interest of the end-user customer in mind. The lawsuit was the first high-profile challenge of Cisco's reseller partner management practices.

Judge Rules Provisions of Cisco's Reseller Agreement Unconscionable

Superior Court Judge Gregory H. Lewis ruled three clauses in Cisco's ICPA unconscionable and therefore unenforceable because they were unfair to Infra-Comm. First, the court held that Infra-Comm was denied the ability to re-negotiate the contract during the renewal process because partners are only given the option to click a button on a website to renew the agreement. The issue for the court was whether Infra-Comm had the ability to negotiate the terms of the contract. Judge Lewis found that Infra-Comm met its initial burden that it had no ability to negotiate the terms, "[g]iven the 'click to accept' nature of the contract." In making its ruling, the court also considered the huge disparity in bargaining power and the lack of evidence from Cisco that it had ever negotiated any of its ICPA contracts with its thousands of resellers.

Second, the court found the ICPA's termination provision one-sided and unfair to Infra-Comm because Cisco had an absolute right to terminate for no reason with only one month's notice or without any notice at all at the beginning of each year. Cisco argued that Infra-Comm had the same rights to terminate the ICPA as Cisco. However, the issue for the court here was whether Cisco expected the reseller relationships to be long-term. Judge Lewis held that Infra-Comm showed that Cisco expected the reseller relationships to be long-term with returns expected for six years. Nevertheless, Cisco required its resellers to contract for only one year. Cisco also argued that the termination provision was necessary in order to avoid being forced into a long-term contract with anyone who clicks on its website. The court found Cisco's argument inapplicable to the facts of this case given that Infra-Comm had been a reseller to Cisco since 1999. Judge Lewis therefore ruled that the right to terminate without cause within 30 days is limited to new resellers and that the right to terminate with 30 days notice provision is limited to terminations for cause. Judge Lewis also considered as evidence of the huge disparity in bargaining power the fact that Infra-Comm lost 90 percent of its business and 10 registered deals totaling over $2 million as a result of Cisco's termination.

Third, the court held unconscionable the section of the ICPA limiting damages to what a reseller pays Cisco over the course of three months for services and products. While such damage limitations might be appropriate to a new reseller relationship, Judge Lewis held that they were not justified for a reseller relationship that had been in place since 1999. Cisco argued that the damages should be limited to an amount commensurate with the volume of business it did with Infra-Comm. However, Judge Lewis ruled that the court could not rewrite the contract.

Ultimately, the jury found Cisco guilty of violating the terms of the ICPA and its deal registration terms after only three hours of deliberations and awarded Infra-Comm $6.4 million in damages. On December 16, 2008, Cisco agreed to pay Infra-Comm $5.45 million as part of a settlement agreement and agreed not to appeal the decision.

Legal Precedent May Change the Vendor-Channel Partner Landscape

The unconscionability ruling is considered a general win for resellers and solutions providers who have in the past feared going up against large vendors in court to settle disputes. Channel partners may use this precedent to file their own lawsuits against large vendors. The ruling may also open the door for channel partners to negotiate term, termination, and damage limitations with vendors.

Leading research analysts in the area of indirect channel programs predict that the Infra-Comm ruling could have an enormous impact on how channel partner agreements are written moving forward. Industry experts expect that vendors will be forced to revise channel partner agreements to reflect more parity, but also expect vendors to scrutinize potential channel partners more closely.

Is Your Channel Partner Agreement Unconscionable? Avoiding Exposure to Similar Breaches of Contract Lawsuits

Vendors should act to review and amend their channel partner agreements to ensure they are not exposed to a similar breach of contract lawsuit.

- Determine whether existing language in channel partner agreements exposes the vendor to liability.

- Review and consider implementing other deal registration terms.

- Resist the temptation to pass deals from small to large channel partners.
- Work out a commission structure so that an unqualified small channel partner still gets credit for developing a customer even when the large channel partner gets the deal.

AUTHOR CONTACT CLAUDIA F. TORRES

Electronic Health Record Legislation Passed As Part of President's Stimulus Package Poses Opportunities and Challenges

by Neil H. Aronson, Claudia F. Torres, and Shawneequa Callier

On February 17, President Barack Obama signed into law an economic stimulus bill that includes provisions related to health care information technology ("Health IT") and reserves over $19 billion to support the adoption of Health IT. The legislation outlines several key provisions of President Obama's ambitious goal of the utilization of an electronic health record (EHR) for each person in the United States by the year 2014.

Under the new law, the Secretary of Health and Human Services must invest in the infrastructure necessary to allow for and promote the electronic exchange and use of health information for each individual in the United States. The Office of the National Coordinator for Health Information Technology ("ONC"), established under President Bush for the purpose of coordinating federal Health IT policies and programs, is charged with developing a strategic plan setting forth the goals and strategies that will direct the investment. Specifically, the new law provides for investment in the architecture and integration of Health IT that will support the nationwide electronic exchange and use of health information in a secure, private, and accurate manner. The law also includes investment in training and publication of best practices to integrate Health IT and the promotion of the interoperability of clinical data. Dr. David Blumenthal, formerly director of the Institute for Health Policy at Massachusetts General Hospital and Samuel O. Thier Professor of Medicine at Harvard Medical School, has been appointed by President Obama to serve as the National Coordinator for Health Information Technology, within HHS.

The law is designed to provide needed stimulus to the Health IT sector. President Obama strongly believes that the legislation will allow the U.S. to improve the quality of health care while simultaneously driving down the cost of health care by both cutting administrative costs and by helping to prevent costly medical errors caused by incorrect or incomplete information. As health care costs continue to grow as a percentage of the U.S. GDP, the federal government and states could realize a significant return on investment through EHR adoption.

Starting in 2011, physicians utilizing EHRs and electronic prescribing systems will be eligible for certain reimbursement, estimated to be between $40,000 to $50,000 for physicians and millions of dollars for hospitals. However, the ultimate beneficiaries of these new systems will be insurers and payers and the federal government.

For IT providers, the EHR plan creates a “man to the Moon by the er decade” challenge and opportunity. The EHR initiative will require new technologies and service providers to implement and manage EHR systems. Virtually every sector of the IT world will be called upon to assist in this development effort, from servers to data storage to encryption and other security and privacy technologies. Similarly, the opportunity for new software applications for researchers mining this trove of data will be very significant and has the potential to revolutionize the field of medical research.

Benefits of Electronic Health Records

President Obama’s core reasons for promoting widespread adoption of EHRs are to improve the quality of health care and lower health care costs. EHRs permit multiple providers to access one medical record for one patient at the same time and allow for better coordination of the care delivered by multiple providers. Some have asserted that EHRs would also:

- reduce medical errors;
- prevent providers from repeating services unnecessarily; and
- improve the overall quality and efficiency of patient care.

In addition, patient claims data will be recorded in a compatible standardized electronic format that would increase billing accuracy and accessibility by patients. EHR adoption is also expected to encourage prevention of certain illnesses and provide meaningful clinical data to medical researchers. Ideally, EHRs will eventually have built-in intelligence capabilities that provide reminders and medical alerts, such as the recognition of abnormal test results or potential life-threatening drug interactions.

Despite the many benefits associated with EHRs, their widespread adoption will require providers to overcome significant challenges, including the interoperability of various EHR systems, the standardization of data, and the integration into EHRs of robust privacy and security safeguards to protect patients’ personal health information.

Privacy Issues

A patchwork of laws currently governs electronic health care information and some types of health care information are more vulnerable than others. The Health Insurance Portability and Accountability Act (HIPAA), for example, established rules governing the storage and transmittal of electronic health records with its passage in 1996. Yet, the HIPAA privacy rule covers only certain “covered entities,” such as providers, health plans, and health care clearinghouses. Private companies, such as Google Health, Microsoft HealthVault, and others are not covered by HIPAA. Patients and providers must determine which existing and proposed rules, if any, might apply to their health care information and decipher the types of protections available to them.

The stimulus package attempts to address the privacy concerns by requiring the creation of a new committee, the Health Information Technology Standards Committee (“HIT Standards Committee”), which would propose to the ONC standards, implementation specifications, and certification criteria for the electronic exchange and use of health information. A fundamental duty of the ONC is to ensure that each patient’s health information is secure and protected.

Further, the law includes privacy provisions designed to provide the following:

- greater protection against the sale and marketing of personal heath information;

- a federal, individual right to be notified of any security breach exposing personal identifiable information;
- easier access by patients to electronic copies of their records; and
- improved enforcement of health privacy rules.

At the same time, greater privacy protections could mean new burdens for providers. Notably, the law expands patients' rights to receive an accounting of disclosures of protected health information held by covered entities. Under HIPAA, patients do not have a right to an accounting of treatment-related disclosures. Yet, the law removes treatment and other disclosure exceptions related to EHRs, which will create a dramatically different disclosure burden on providers than that imposed by HIPAA.

Interoperability and Standardization

The widespread adoption of EHRs will also require the development of a nationwide health information technology infrastructure that enables the interoperability of systems so that data can flow between various health care providers, government agencies, and other data users. System designs must also meet regulatory requirements without hindering access by those with legitimate rights to the information. Several other issues relate to interoperability and must be addressed: the need for standardization of terminology, the development of EHR standards that enable the exchange of clinical content, and the adoption of and adherence to those EHR standards.

To promote the interoperability of systems and standardization of EHR standards, the law requires the Director for the National Institute for Standards and Technology in coordination with the HIT Standards Committee to establish infrastructure for the pilot testing of standards and implementation specifications. The development of the testing infrastructure may include a program to accredit independent, non-federal laboratories to perform testing. The stimulus package also provides for assistance to institutions of higher education, including non-profit entities, to establish Centers for Health Care Information Enterprise Integration. The mission of the centers would be to generate innovative approaches to health care information enterprise integration by conducting research in areas such as the development of software that improves interoperability and connectivity of health information systems.

Additional Challenges

Among the other barriers to the widespread adoption of EHRs are the challenges faced by health care professionals, including the general resistance to new technology and the need for training on EHR systems. A major concern for physicians is the capital investment required to acquire and implement EHR systems, as well as the continuing costs associated with their proper use and maintenance. The law has attempted to address some physician concerns by providing phased payment incentives to physicians that use certified EHR technology in a meaningful way starting in 2011.

A recent study printed in the *American Journal of Medicine* suggests that less than four percent of health care providers (excluding the Veterans' Administration) utilize comprehensive electronic health care records systems. Thus, compliance by all health care providers by 2014 will require a Herculean effort. Also, there are currently a number of patchwork systems in place, often used by a department of a health care institution, which may not be compatible with new systems. Several hospital IT directors have suggested that the cost of adopting EHRs will be massive, with federal stimulus funds only accounting for 30% or the total cost of adoption and integration. For many smaller medical practices, the costs of adopting EHRs may be prohibitive, requiring them to merge practices with larger medical groups.

Another barrier to successful deployment of EHRs is the need for a flexible information infrastructure that will address both financial and medical needs. In the April 2009 edition of the *New England Journal of Medicine,* Drs. Kenneth Mandl and Isaac Kohane argue that "flexibility is critical" to the new EHR system "since the system will have to function under new policies and in the service of new health care delivery mechanisms, and it will need to incorporate emerging information technologies on an ongoing basis." Unlike the perceived need to "fix" the Y2K inadequacy in computing systems, only a very small percentage of doctors have adopted EHRs and there is no common system in place from which IT directors can build. Thus, most practices and institutions are being advised to wait until further standards are promulgated before jumping on to the EHR train now. Whether a fully functional EHR system which will meet basic requirements, as well as the flexibility requirements suggested by Drs. Mandl and Kohane, will be fully available and operational by 2014 remains to be seen. At this time, the two major hurdles to adoption remain: the cost to adopt and maintain an EHR system and the need for these systems to provide health care providers with the ability to seamlessly exchange patient information while maintaining heightened privacy requirements.

While the challenges for the EHR initiative may be significant, the initiative offers a tremendous opportunity for the Health IT industry.

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Highlights of the Stimulus Package for the Energy and Clean Technology Sector

by Richard A. Kanoff and Scott C. White

On February 17, 2009, President Obama signed into law the American Recovery and Investment Act of 2009 (the "Act"), an unprecedented economic stimulus package totaling over $787 billion in spending and tax incentives. The Act emphasizes energy related investments and technologies with renewable energy, smart grid, energy efficiency, and electric-vehicle provisions accounting for well over $60 billion of the total. On Friday, February 20, 2009 at 12:00 pm, Mintz Levin and ML Strategies hosted a webinar to provide more information (learn more).

The Act provides significant funding for loan guarantees and grants for the deployment of renewable energy and smart grid technologies. The loan guarantees are expected to support over $60 billion in new loans, while the grants are designed to award companies 50% of the cost of demonstrating smart grid projects.

In addition to these spending provisions, the Act relies heavily on tax incentives. As noted in detail below, the Act extends the availability of the production tax credit, significantly expands the energy investment tax credit (including possibly receiving its value up-front as a grant), and adds a new investment tax credit for advanced energy manufacturing.

The Act further provides for over $10 billion of research and development grants in the areas of renewable energy, smart grid, and energy efficiency technologies. It also provides for direct government spending and grants totaling over $18 billion related to energy efficiency programs and alternative fuel and electric-vehicle technologies.

The following is a summary of the key provisions of the Act regarding renewable energy and smart grid projects, energy efficiency programs and alternative fuel and electric-vehicle technologies.

Loan Guarantees and Grants for Renewable Energy and Smart Grid Projects

Renewable Energy and Electric Transmission Loan Guarantee Program

The Act authorizes $6 billion for the cost of guaranteeing loans under the existing Innovative Technology Loan Guarantee Program to support projects that commence construction before September 30, 2011 in the categories of renewable energy systems, electric power transmission systems, and biofuels. Examples of projects for which the program has solicited proposals in the past include battery manufacturing facilities, bio-oil derived fuel projects, smart grid technologies, geothermal advanced exploration and drilling technologies, combined heat and power fuel cells for buildings, solar technology manufacturing facilities, and advanced wind power plants. These new loan guarantees are expected to support more than $60 billion in loans providing much-needed capital for these types of projects.

Smart Grid Demonstration Projects

The Act authorizes the Department of Energy (DOE) to award grants for up to 50% of the cost of certain smart grid demonstration projects. Smart grid technologies enable utilities and their customers to track and manage the flow of energy more effectively, reduce expensive peak-power usage, prevent blackouts and integrate renewable energy and storage into the grid. Notably, to encourage innovation and greater interoperability among smart grid components, the grants are conditioned upon the projects utilizing open internet-based protocols and standards and providing all information requested by DOE, such information to become available through a DOE-established clearinghouse. Examples of qualifying smart grid demonstration projects include:

- manufacturers designing and installing internal devices that allow appliances to engage in smart grid functions;
- utilities purchasing and installing transmission and distribution equipment fitted with monitoring and communications devices to enable smart grid functions;
- utilities, distributors and consumers purchasing and installing smart meters that allow consumers to see and respond to real-time pricing information through in-home displays, smart thermostats and appliances; and
- purchasing software that enables devices or computers to engage in smart grid functions. In making the grants, DOE is to seek to reward innovation and early adoption, rather than deployment of proven and commercially viable technologies.

Tax Incentives for Renewable Energy Projects

Extension of Renewable Energy Production Tax Credit

The Act extends the production tax credit an additional three years for facilities producing electricity from wind, biomass, geothermal and certain other renewable energy sources. The production tax credit is earned basis of the number of kilowatt-hours of electricity produced by the facility and is paid out over a period of ten years. The current credit rate is 2.1 cents per kilowatt-hour for wind, closed-loop biomass, geothermal, and solar and 1 cent per kilowatt-hour for open-loop biomass, municipal sold-waste, and qualified hydropower.

Prior to the Act, wind facilities were required to be placed in service on or before December 31, 2009 in order to qualify for the production tax credit, and the cutoff date for the other facilities was December 31, 2010. With the three-year extension under the Act, wind facilities placed in service on or before December 31, 2012 will now qualify for the production tax credit, as will biomass, geothermal, municipal solid-waste, and qualified hydropower facilities placed in service on or before December 31, 2013.

Expansion of Investment Tax Credit

Under the Act, those firms qualifying for the production tax credit will now have the option to take the investment tax credit instead. The investment tax credit is a one-time, up-front tax credit equal to 30% of the cost of the facility. The Act permits firms that place qualified facilities in service to irrevocably elect to take the 30% investment tax credit in the year the facility is placed in service, instead of the production tax credit, which is taken for ten years. A firm that elects to take the investment tax credit is prohibited from later filing an amended return to revoke the election.

Prior to the Act, the investment tax credit was primarily available and used for solar equipment; the Act now expands the availability of the investment tax credit to include wind facilities placed in service between January 1, 2009 and December 31, 2012 and biomass, geothermal, municipal solid-waste, and qualified hydropower facilities placed in service between January 1, 2009 and December 31, 2013.

The investment tax credit continues to be available for investments in solar, small wind (utilizing wind turbines of 100 kilowatts or less of rated capacity), and fuel cell equipment at a 30% rate, as well as for investments in microturbine, geothermal heat pump, and combined heat and power equipment at a 10% rate. Such equipment must be placed in service prior to January 1, 2017 to qualify for the credit. The investment tax credit for small wind investments has historically been capped at $4,000 per year; however, the Act repeals this cap.

Election of Renewable Energy Investment Grants

The Act further provides that firms may elect to receive direct grants in lieu of the production tax credit and investment tax credit, which will benefit firms that may not have otherwise had sufficient tax liabilities to take advantage of the credits.

In general, the amount of the grant is 30% of the cost of the facilities or equipment otherwise eligible for the production tax credit and investment tax credit. Eligible investments include wind, biomass, geothermal, municipal solid-waste, qualified hydropower facilities, as well as solar and fuel cell equipment. Investments in microturbine, geothermal heat pump, and combined heat and power equipment are entitled to grants in the amount of 10% of the cost of the equipment. To qualify, firms must place in service or begin construction of such facilities or equipment during 2009 or 2010; for those beginning construction, the property must be placed in service before the applicable date that eligibility for the investment tax credit expires.

These grants will generally mimic the operation of the investment tax credit; for example, the grants are not reported in taxable income. For purposes of future depreciation and amortization, the tax basis of the property is reduced by 50% of the grant (a 15% reduction in basis on a 30% grant). In addition, some or all of each grant is subject to recapture if the property is disposed of or otherwise ceases to be eligible energy property within five years.

Repeal of Subsidized Energy Financing Limitations

Firms receiving any subsidized energy financing or proceeds from private activity bonds have been required to reduce the basis of the property by the amount of the financing. The Act removes this limitation.

Advanced Energy Manufacturing Tax Credit

The Act establishes a 30% tax credit for investment in projects that reequip, expand, or establish manufacturing facilities that produce:

- equipment designed to be used in the generation of energy from renewable resources;
- fuel cells, microturbines, or energy storage systems for use with electric or hybrid-electric motor vehicles;
- electric grids to support the transmission of intermittent sources of renewable energy, including storage of such energy;
- equipment designed to capture and sequester carbon dioxide emissions;
- equipment designed to refine or blend renewable fuels (but not fossil fuels) or to produce energy conservation technologies (including smart grid technologies);
- plug-in electric vehicles or any component designed specifically for use in such vehicles;
- advanced equipment designed to reduce greenhouse gas emissions; and
- other equipment having the greatest potential for technological innovation and commercial deployment, as determined by the Secretary of the Treasury in consultation with the Secretary of Energy.

The Act authorizes $2.3 billion for these manufacturing credits to be allocated by the Treasury in a competitive bidding process. Applications must be received within two years from the date the Treasury begins accepting applications, and each applicant will have one year from the date the application is accepted to provide the Treasury with evidence that the requirements for certification have been met. An applicant receiving certification will then have three years to place the project in service.

New Clean Renewable Energy Bonds Issued by Government and Non-Profit Entities

The Act authorizes the issuance of up to an additional $1.6 billion of new clean renewable energy bonds (“New CREBs”) by municipal entities, electric cooperatives, public utilities, and certain not-for-profit entities. These bonds are issued for projects that generate electricity from clean and/or renewable sources. In lieu of interest payments by the issuer, the holder receives a quarterly tax credit at a rate that is set by the Treasury. Repayment is made in equal, annual payments. The proceeds from the issuance of these New CREBs must be used within three years of the date of issuance.

Repeal of Personal Tax Credit Caps

The Act removes existing personal tax credit caps on solar electric, geothermal, wind, and fuel cell purchases.

Research and Development Grants

Electricity Delivery and Energy Reliability

The Act authorizes an additional $4.5 billion for the Electricity Delivery and Reliability program to support, among other things, research and development of technologies that modernize the nation's electricity delivery systems. Such technologies include distributed energy (*i.e.*, small-scale and modular devices designed to provide electricity to locations close to consumers); energy storage to help balance electricity output with demand (important to the integration of wind and solar which produce electricity inconsistently); and other smart grid technologies.

Energy Efficiency and Renewable Energy

The Act authorizes $2.5 billion for the. Energy Efficiency and Renewable Energy program to be used for applied research, development, demonstration and deployment activities in energy efficiency and renewable energy. This amount includes $800 million for projects related to biomass, $400 million for geothermal projects, and $50 million to improve the efficiency of information and communications technology.

Fossil Energy Research and Development

The Act authorizes an additional $3.4 billion in funding for the Fossil Energy Research and Development program. The funding breaks down as follows: $1.0 billion for fossil energy research and development programs; $800 million for the Clean Coal Power Initiative Round III Funding Opportunity Announcement; $1.52 billion for a range of industrial carbon capture and energy efficiency improvement projects; $50 million for site characterization activities in geologic formations; $20 million for geologic carbon sequestration training and research grants; and $10 million for program direction funding.

Energy Efficiency Programs and Building Improvements

Energy Efficiency Programs

The Act authorizes an additional $3.2 billion for the Energy Efficiency and Conservation Block Grant program (EECBG) to fund state and local governments in developing and implementing energy efficiency and conservation strategies. The EECBG will help state and local governments finance energy audits and consulting services, development and installation of onsite renewable energy power generation facilities, and the implementation of energy distribution and landfill gas technologies. In addition to the portion of the EECBG funds allocated to the states, the Act authorizes $3.1 billion for the State Energy Program, which will assist states in addressing their energy priorities and adopting emerging renewable energy and energy efficiency technologies. The Act also increases the national limitation on the issuance by state and local governments of conservation bonds from $800 million to $3.2 billion. These bonds are for green-community programs and include the financing of loans to individual homeowners to retrofit existing houses with energy conservation products. The Act further authorizes $300 million for the Energy Efficiency Appliance Rebate program and the Energy Star program to encourage consumer purchases of energy-efficient appliances.

Building Improvements

The Act authorizes:

- $5 billion for the Weatherization Assistance Program, which enables low- to moderate-income families to permanently reduce their energy bills by making their homes more energy efficient;

- $4.5 billion to build and upgrade federal buildings to be "high-performance green buildings";
- $510 million to rehabilitate and improve the efficiency of housing units maintained by Native American housing programs; and
- $250 million to increase the energy efficiency of low-income housing supported by the Department of Housing and Urban Development.
- The Act also increases existing personal tax credits for energy-efficient home improvements from 10% to 30%, removes tax credit caps on certain purchases and extends the credits through 2010.

Alternative Fuel and Electric-Vehicle Technologies

Alternative-Energy Refueling Infrastructure

The Act increases the tax credit for qualified alternative-energy refueling properties placed in service during 2009 and 2010 from 30% to 50%, except in the case of hydrogen refueling property, which remains at 30%.The maximum credit is increased from $30,000 to $50,000, except in the case of hydrogen refueling property, which is increased to $200,000. This primarily benefits investments in clean-fuel stations dispensing ethanol (at least 85%), natural gas, compressed natural gas, liquefied natural gas, liquefied petroleum gas, hydrogen, or biodiesel.

Fuel Efficient Vehicles

The Act authorizes $300 million for the Alternative Fueled Vehicles Pilot Grant Program and $300 million for the acquisition of high-fuel-efficiency vehicles for the federal fleet, including plug-in hybrid vehicles if they are commercially available before September 30, 2010.

Advanced Battery Manufacturing Grant Program

The Act authorizes $2 billion in grants to support the manufacturing of advanced batteries and components. These grants are available to manufacturers to fund facilities that produce vehicle batteries and other advanced battery systems in the United States, including advanced lithium ion batteries and hybrid electric systems. Grants are also available to firms for manufacturing components and designing software for advanced battery systems.

Conclusion

The Act presents a significant opportunity for companies and investors in the energy space to obtain federal support and incentives that encourage development of energy technologies and facilities. In particular, the provisions of the Act are clearly designed to incentivize the rapid expansion of renewables and innovative technologies through an unprecedented infusion of grants, tax credits, and bonds.

Mintz Levin and ML Strategies can provide additional information regarding the Act and guidance regarding taking full advantage of the tax incentives and grants available to companies, investors, research institutions, and government and not-for-profit entities.

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Broadband Stimulus Funding Presents Opportunities and Risks

by Neil H. Aronson and Howard J. Symons

A small but highly touted part of the $787 billion American Recovery and Reinvestment Act (Act) is the set-aside of $7.2 billion for broadband grant and loan programs. $4.35 billion of these funds will be distributed through the Broadband Technology Opportunities Program (BTOP), run by the National Telecommunications & Information Administration (NTIA) of the Commerce Department. BTOP grants will be made available to fund “broadband“ in “unserved“ and “underserved“ areas, and to assist in promoting adoption of broadband services by populations where penetration remains low. BTOP grant recipients must also comply with “nondiscrimination“ and “interconnection“ obligations.

Another $2.5 billion will be administered by the Rural Utilities Service (RUS) of the Agriculture Department, for grants, loans, and loan guarantees to help foster broadband deployment in rural areas. Similar to the BTOP “nondiscrimination“ requirement, RUS must give priority to project applications for broadband systems that will deliver end users “a choice of more than one service provider.“

Funds allocated for broadband activities will be funded in three tranches beginning in the October-December 2009 timeframe, through March 2010. The legislation requires that all funds be distributed by September 30, 2010, and all funded projects must be completed within two years. NTIA has launched its BTOP website to provide the public a window into how the Government intends to invest its money - http://www.ntia.doc.gov/broadbandgrants. USDA has launched a similar site at http://www.usda.gov/rus/telecom/index.htm.

As is the case with much of the stimulus bill, a huge amount of work remains to be done to define key terms of the legislation. The agencies will also need to determine whether to use these programs as a basis for addressing the ongoing controversy within the industry regarding net neutrality. In that regard, the Act specifies only that, at a minimum, the “nondiscrimination“ requirement include adherence to the FCC’s Internet Policy Statement, which declares that consumers are “entitled to the lawful Internet content of their choice“ and their choice of legal devices and applications, and are entitled to expect competition among network, application, service, and content providers. NTIA could go beyond the Policy Statement and impose a general “nondiscrimination“ requirement, as net neutrality advocates have urged. The FCC’s effort to enforce the Policy Statement against Comcast is pending in the courts, but it appears likely that those obtaining BTOP funding will have to abide by the Policy Statement (and any additional requirements adopted by NTIA), while providers not receiving BTOP funding will not.

With key terms left undefined by Congress — such as “broadband,” “unserved area,” “underserved area,” and “non-discrimination” — which projects will be funded remains unclear until NTIA and RUS fill in the blanks. NTIA will also need to address the tension between the Act’s overall goal of financing “shovel ready” projects — that is, projects which can be started immediately — with the specific statutory requirement that BTOP applications demonstrate that the proposed project would not have been implemented during the grant period without grant assistance. NTIA and USDA have announced their intention to adopt final rules for the programs by mid- to late-June.

The Act also specifies additional criteria that NTIA must consider in awarding

BTOP grants: whether an application will increase the affordability of, and subscribership to, service to the greatest population of users in an ar whether the application will enhance service for health care delivery, education, or children to the greatest population of users in an area; and whether it will not result in unjust enrichment as a result of support from another federal program in the area. The Act also directs the agencies to consider other important factors, such as whether the applicant is a socially and economically disadvantaged small business concern and whether the application will provide the greatest broadband speed possible to the greatest population of users in an area. The Act also establishes criteria for the RUS broadband program, including use of funds for rural areas without sufficient access to high speed broadband service to facilitate rural economic development, as determined by the Secretary of Agriculture, with priority for awarding such funds given to project applications for broadband systems that will deliver end users a choice of more than one service provider — particularly for projects that provide service to the highest proportion of rural residents who do not have access to broadband service.

Once NTIA and the RUS create a system for distributing stimulus grants, they will consult with the various states to identify areas where the states believe assistance is most necessary. NTIA and RUS retain the final say over where the money goes, however. Applications for funding could come in the form of wired or wireless projects that connect end users to the Internet, or “middle mile“ projects that connect local networks to the Internet backbone. Still other projects will offer assistance to households that have yet to connect to the Internet, and to community colleges, libraries, and other “public community centers” that can serve as broadband hubs in a community. Vendors, ISPs, non-profits and others will submit grant proposals and the Washington, D.C., entities will broker the final arrangements for funding approved proposals.

To try to prevent fraud and abuse, the law also mandates a “fully searchable database, accessible on the Internet at no cost to the public, that contains at least a list of each entity that has applied for a grant, a description of each application, the status of each application, the name of each entity receiving funds made available, the purpose for which the entity is receiving such funds, each quarterly report submitted by the entity, and such other information sufficient to allow the public to understand and monitor grants awarded under the program.” The Act and the Office of Management and Budget (OMB) also prescribe additional audit and “transparency” requirements for awarding and tracking the use of all stimulus funding, including broadband funds.

One fact is clear: much like some elements of TARP funding, there is no such thing as a free lunch when it comes to BTOP and RUS broadband funds. The opportunities created by these programs will become clearer in the next few weeks. Stay tuned.

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Salary Deferral Arrangements May Be Void under Massachusetts Wage Act, Even for Top Executives

by Thomas M. Greene, Adelita C. Press, and Joel M. Nolan

Wage Act

Recently, in *Stanton v. Lighthouse Financial Services, Inc.*, the U.S. Court for the District of Massachusetts held that a salary deferral arrangement in an employment contract was void under the Massachusetts Wage Act ("Wage Act" or the "Act"). This decision is an important reminder that the Wage Act sweeps broadly, and that deferred salary provisions are problematic for several reasons.

In *Stanton*, the plaintiff, John Stanton, was the company's co-founder and its President. The company was a start-up that provided payment processing services and did not have sufficient cash flow to pay wages on a current basis. Faced with this reality, Stanton and the company's CEO entered into employment agreements, which provided that salary may be deferred at the election of the board of directors for the first year of employment, but must be paid before the distribution of any profits of the corporation. These agreements were mutually negotiated with the help of corporate counsel. The company continued to struggle financially. In fact, the CEO withdrew money from his 401(k) account to pay for basic operating expenses of the company.[1] Just over 14 months after entering an employment agreement, Stanton left the company without having received the majority of his salary.

Stanton sued the company and the CEO individually for various claims. One of the claims was for violation of the Wage Act, which provides that employers must pay wages to an employee within six or seven days following the end of the pay period in which the wages were earned.[2] The Act allows an aggrieved employee to recover treble damages, attorney fees, and costs. In *Stanton*, the parties disagreed as to whether the President of the company could bring a claim under the Wage Act. The company argued that he was not an employee because he could be sued as an employer under the Act.[3] The Court reasoned that a person can be both an employer and an employee for purposes of the Wage Act. Here, the President was subordinate to the board of directors, at least in terms of receiving his pay, and as such he was an employee and could bring a claim under the Wage Act. Further, the President's salary constituted wages under the Act because the deferral arrangement did not make his pay contingent on any individual performance criteria and was a deferral of base wages, not of a bonus. As such, the President could sue the company and the CEO under the Act for unpaid wages. Indeed, *Stanton* reveals that the Wage Act reaches even the highest-ranking employees in an organization, not just rank-and-file employees who lack bargaining power.

The *Stanton* case also makes clear that salary deferral arrangements may result in liability under the Wage Act. The Wage Act itself specifies that no person can exempt themselves from the Act by special contract. Here, the Court examined an arrangement to defer all base compensation at the discretion of the board of directors, and found that such a provision runs afoul of the Act's special contract prohibition. While some forms of deferred compensation are permissible, arrangements that defer base salary at the employer's discretion are very likely unlawful. Indeed, there is a tension between deferred compensation arrangements entered into by employees for their benefit and those that leave wage deferral decisions in the employer's hands.

IRC Section 409A

Deferred salary arrangements may also trigger unexpected tax implications under Section 409A of the Internal Revenue Code of 1986, as amended ("409A"). If salary is earned by an employee in one year but may not be received by the employee until a later year, such deferred salary is very likely deferred compensation subject to 409A. Among other requirements, any deferred compensation subject to 409A must comply with certain requirements related to the timing of the deferral election and payme example, as a general rule, an election to defer salary must be in place by December 31 of the year before the salary is earned, and the arrangement must specify when payment will be made in accordance with 409A. In any case, an open-ended discretionary option to defer salary is not permissible under 409A. Failure to comply with such requirements with respect to the deferred salary could require the employee to currently include such salary in income, even if the employee has not yet received it. In addition, a 20% excise tax would be imposed on the deferred salary and there may be interest penalties if income is not timely recognized. Employers should pay close attention to the personal income tax implications of deferred compensation arrangements because affected employees would likely look to employers to make them whole.

Conclusion

As *Stanton* indicates, malformed deferred compensation arrangements can create significant employer liability under the Wage Act. They also can result in personal income tax exposure under 409A. Start-up organizations are particularly at risk for Wage Act violations because executive pay is often deferred until the company is financially stable. In these situations, careful drafting of the deferral arrangement can make all the difference.

Action Items for Employers:

Employers should:

- Work with experienced counsel to develop plans that comply with the law while also reflecting the realities of the workplace.
- Review existing compensation arrangements to be sure they comply with the Wage Act and 409A.
- Contact a Mintz Levin Employment, Labor and Benefits attorney with any questions, and look for further information from us regarding developments in this area of law.

Endnotes

[1] Although not the focus of this advisory, withdrawing funds from a 401(k) account to pay for business expenses raises prohibited transaction and plan qualification issues under the Employee Retirement Income Security Act of 1974 and Internal Revenue Code of 1986.

[2] The number of days within which an employer must pay wages after a pay period depends on the number of days an employee works during a work week. Pay periods may be weekly, bi-weekly, or in some cases semi-monthly or monthly.

[3] The company also argued that startup co-venturers should be treated like co-operative associations, which are exempt from the Act. The Court did not find the two types of organizations sufficiently analogous to extend the Act's exemption to startup co-venturers.

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