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Exchangeable Share Structure Allows U.S. Venture Capital Investors to Look to Canada

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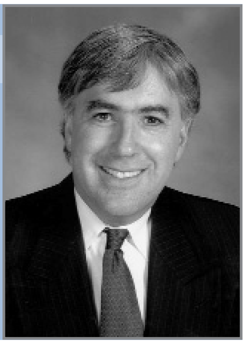

U.S. Venture Capital investors (VCs) are now looking more and more to Canada for good deal flow. Investors from the U.S. are becoming more knowledgeable about investment opportunities north of the border and how best to structure transactions to address cross border tax and corporate issues. VCs from the U.S. are seeing Canada as a logical extension of their U.S. activities. This is especially true for Boston-based VCs who find it easier to monitor investments in Ontario and Quebec than in the western U.S. due to the proximities of time and distance.

Canada also offers lower valuations than comparable companies in the U.S. The cost of doing business is also significantly less, which results in a lower annual cash burn rate by Canadian companies. Also attractive are the tax incentives offered by the federal and provincial governments. Most important, however, is the advanced technology that some of the Canadian companies offer.

Canadian VCs, which tend to invest in earlier-stage companies than U.S. VCs, are now actively seeking U.S. VCs to assist them in taking their companies beyond the stages of research and development and initial commercialization. Typically, U.S. VCs look to invest in companies where the technology has been proven and commercialization has commenced. Ideally, the company will even have some revenue. In addition to investing money in a company, VCs also aim to provide their expertise and contacts. They seek to utilize their network to assist in commercializing the product in the U.S. The VC will also provide valuable assistance in finding strategic partners and future co-investors.

A structure which has been widely utilized when US VCs invest in Canadian companies involves the use of Exchangeable Shares. This structure involves setting up a U.S. corporation, typically a Delaware corporation, into which the U.S. investors will make their investment. U.S. investors, particularly VCs, are more comfortable utilizing the well developed Delaware corporate structure in which they can receive Preferred Stock with rights and preferences substantially similar to those they would receive in a typical investment in a U.S.-based company. In this structure, the Canadian corporate structure is maintained and Canadian investors who might also participate in a round of financing will continue to invest in the Canadian entity.

The structure also involves agreements which are put in place at the time of the investment which provide for the Canadian investors to exchange their securities in the Canadian entity for like securities in the U.S. entity upon an exit event. This will allow, for example, the sale of the U.S. company or the public offering of securities of the U.S. company to occur with all shareholders of the Canadian company then holding their interest in the U.S. entity and the assets and operations of the Canadian company coming under the U.S. company. The primary objective of this structure is to allow the U.S. investors to obtain favorable tax treatment on their investment upon an exit, while attempting to preserve the Canadian structure, which may include preserving significant research and development credits and grants in Canada. The charter documents of the U.S. entity are also drafted to include these exchangeable shares.

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There are certain variations of the structure to take into account Canadian and U.S. tax considerations as well as corporate governance and intellectual property considerations; however the overall structure is generally as described above. The key to making these cross border investments work is creating an efficient process where the transactions costs and process do not overly burden the transaction. Many VCs that have successfully completed investments in Canada have found ways to streamline the process and feel that the structural issues and costs associated with the Exchangeable Shares structure do not outweigh the favorable investment opportunities.

One of the successes of the Burns & Levinson U.S./Canada Venture Capital Pipeline is Simpler Network Inc., a leading Montreal based telecommunications equipment manufacturer. Simpler initially closed a $15.5 million financing co-led by Highland Capital Partners and Kodiak Venture Partners. The round also included their Canadian investors. Less than a year after closing the $15.5 million round, Simpler completed a $25 million funding with their current investors. The company has gone from 15 employees to over 100 employees with most of them based in Montreal. The structure in both transactions involved the use of Exchangeable Shares in which the research and development remains in Montreal while certain of the executive and sales functions are in the U.S.

Projections indicate that investments by U.S. VCs north of the border will continue to increase in the next few years and that the use of the Exchangeable Share structure will continue to be the dominant way in which such transactions are structured.

Many Boston-based VCs have attended a series of Burns & Levinson U.S./Canadian Venture Capital Pipeline events which link Canadian companies seeking financing with U.S. VCs. Executive summaries of the companies are disseminated to the firm's VC network, which results in one-on-one meetings between the U.S. VCs and the Canadian companies held at the firm's offices. Time is also spent at these events helping the companies and the VCs understand the operations in Canada and discussing structures including Exchangeable Shares which include U.S. entities and operations as part of the structure. For information on the next Pipeline event, please contact Leonard M. Gold at 617-345-3831.

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