Venture Capital Financing In The United States And Canada (Part 1)

Fredric Tannenbaum is a senior partner of Chicago-based Gould & Ratner and is recognized by the Illinois Venture Capital Association as a leading expert in private equity capital, and by a national bar association organization as a leading authority on mergers and acquisitions. He was selected an Illinois Super Lawyer and is a prolific writer on legal matters.

David Chaiton is a founding partner of Toronto, Canada-based Chaitons LLP, a law firm widely recognized as a boutique destination for the legal representation of both domestic and foreign financial institutions in financial matters, including venture capital, mezzanine, and senior lending challenges. A frequent speaker and published legal author, David is widely recognized as an expert in equipment finance, was honored as the 2002 Member of the Year by the Canadian Finance and Leasing Association, and currently serves on its board of directors.

Fredric Tannenbaum and David Chaiton

The differences are notable, but the needs are the same.

THE SIZE OF the venture capital industry in the United States is enormous. In 2005, there were 2,200 reported venture capital transactions at an estimate of close to $20 billion in volume. That number grew in 2006, increasing to an annualized rate of $22 billion of total venture capital transactions. Venture capital transactions, of course, do not include classic leveraged buyout ("LBO") transactions of public and private companies. Although venture capital is normally confined to the earlier stage of a company's development and in high growth industries such as biotech, Internet technology, and communications, LBO transactions are typically aimed at slower but more reliable growth businesses that can generate enough cash flow to service considerable debt. More than five times the level of equity capital has been raised for LBOs than venture capital. Some recently announced mega-transactions include the $31 billion takeover of HCA, one of the largest U.S. hospital chains, and the $25 billion takeover of Harrah's, one of the world's largest casino operators.

Venture capital in the United States, however, is more than just another source of capital. It constitutes an industry, a culture, and a mystique that is uniquely American. Venture capital epitomizes our distinct national spirit of optimism about the future, calculated risk-taking, and intrepid willingness to blaze new paths in new industries and new technologies in pursuit of breathtaking riches.

Many in the United States take for granted that the scope and reach of our venture capital industry extends to all modern mercantile economies. Further, we often summarily assume that the proportionate volume of venture capital transactions is equally pervasive throughout the developed world.

This article explores the validity of these premises. In Part 1, we will begin the discussion of the five major structural issues faced in virtually every venture capital transaction in the United States and analyze the extent to which venture capital transactions in Canada share or differ in approach. Part 2 will continue this discussion and briefly investigate the five underlying motivations of a venture capital investor in our respective countries and compare and contrast these fundamental precepts.

We hope that this thorough deconstruction of the significant structural and motivational underpinnings of this major source of finance will help facilitate cross-border investments, provide fertile ground for critical self-examination and improvement in each respective country as we each learn from the relative benefits of the other nation's approach, and offer insights to those seeking venture capital financing to appeal to the needs of their future partners.

THE CANADIAN LANDSCAPE • Canada has also seen exponential growth in the venture capital industry, driven in the main by historically low interest rates, over-liquidity in the financial markets and, on the institutional side, a race to maintain and increase return on equity ("ROE"). Private equity investors have become more common than ever before, at least in part due to the superior performance of the Canadian economy, which has produced year-after-year surpluses (the benefits of which, we might add, have not commensurately reduced the burden of taxation), unacceptably low returns on financial instruments, and large and small fortunes being made in the oil patch and related service industries. Centers of innovation have encouraged private investment as new ideas take shape and old ones find novel applications. The rise in venture capital financing as a means of generating return on investment ("ROI") at a level where risk and reward are better matched has led to a certain amount of "me too" activity north of the border in a search for lucrative investment opportunities. This influx of cash into the economy has palpably heightened competitive pressures here just as it has imported a business culture that is more homogeneous with that of the United States than in the past. Yet, differences abound.

The Canadian banking industry is dominated by five large and profitable banks with little appetite for risk, particularly in the wake of forays into the U.S. markets that have not been consistently propitious (for example, investments in Enron, by no means a unique phenomenon) by Canadian financial institutions have opened eyes wide to U.S.-style litigation that has no analogue in Canada. Although most of the banks have created departments or divisions with a mandate to engage in venture capital transactions, the scale of their commitment pales in comparison to their heft, with perhaps the notable exception of Business Development Bank of Canada, which has demonstrated a greater interest in providing venture capital financing. Instead, other than funding a small number of third-party venture capital deals, the remaining Canadian banks prefer to invest on their own behalves in mature companies whose business comports with well-defined, aligned objectives. For example, Bank of Montreal's acquisition of Harris Bank and Toronto-Dominion Bank's recent foray into the northeast United States with Banknorth Group Inc. (now trading under the moniker TD Banknorth). In contrast, the proliferation of regional U.S. financial institutions, hedge funds, and privately backed investment managers, inspired by the American entrepreneurial spirit, has resulted in a readiness to engage in investment scenarios that would exceed the appetite of typical Canadian venture capitalists yet remain unattractive to Canadian financial institutions.

Adjusted for population, the venture capital and private equity industry in Canada has matured to a volume level approaching that of the United States. Much of this evolution has occurred over the past five years. But there are significant differences in deal size and structure that reflect clear differences in risk tolerance and governing law. The average Canadian transaction is in the vicinity of $3 million, contrasting with American deals that are typically closer to $10 million. In 2005, roughly twice as many companies attracted capital in Canada but only for a third of the amount invested in American companies.

Several reasons are offered for the disparity. The relative youthfulness of the Canadian industry is certainly a factor. There is also a dearth of Canadian funds able to target large transactions, and the absence of American-style leadership may also have contributed to more modest rates of return. A complicating factor is that too much capital is directed to early-stage investments, which, by definition, are proportionately riskier, often lead to early exits, and leave too little left over for expansion and later-stage development. In turn, there are fewer "home runs." As the industry matures, it is likely that larger funds, increased investment size, and improvement in the caliber of management teams will see enhanced results and gain greater investor satisfaction.

FIVE MAJOR STRUCTURAL COMPONENTS OF VENTURE CAPITAL FINANCING • Just as every person is composed of a myriad of bones, muscles, veins, and hundreds of other components, the organic structure of most venture capital transactions is quite complex and interwoven, with each feature interdependent on the other. For purposes of this article, we have identified five key components (in no particular order) of the structure of a venture capital deal and will briefly discuss their relevance and interrelationship.

1. LIQUIDATION PREFERENCES • In the United States, virtually all venture capital transactions are structured with liquidation preferences in favor of the investor. In other words, the investor will receive its investment back first, before any return to prior investors. For example, assume the target portfolio company is valued at $10 million before the investment and the venture capitalist invests $10 million for 50 percent of the equity. Then, unfortunately, the company is sold for only $10 million. The proceeds would all be distributed to the venture capitalist and the other owners would get nothing. That is a vast generalization and oversimplification, however, and many refinements abound.

Will Other Investors Share In The Distributions?

First, if there have been other rounds of venture capital financing, you will occasionally see the other venture capital investors in the prior rounds share in the distributions. Using the prior example, if there had been $10 million raised in the A round and then $10 million raised in the subsequent B round, and the hapless company were liquidated for $10 million, the B round investor would like to receive the entire $10 million. The A round investor, however, may have been able to negotiate pari passu treatment and therefore the $10 million would be distributed $5 million each to the A and B round investors.

Will The Investment Be Convertible To Common Equity?

A second significant consideration is whether the investment will participate or be directly convertible to common equity. The difference could be material and is often overlooked by less experienced founders. For example, assume the investor invests $10 million in the A round for 50 percent of the company on a fully diluted basis. This company is then ultimately liquidated for $40 million (much preferable to the prior examples). If the A round investment was a "participating preferred," then it would receive the first $10 million of proceeds. The remaining $30 million would be distributed on a 50-50 basis so that the investor would receive an additional $15 million and thereby receive a total of $25 million of the $40 million proceeds, which in this example equates to 60 percent of the total. Another way to look at the participating feature is to treat it like debt. You would always pay a lender back on liquidation before paying back equity owners. In contrast, if the A round equity were treated as "convertible preferred," then the investor would have the option to either receive its investment back (which it would only do if the sale price was less than $20 million) or convert to 50 percent of the common equity of the company. In this scenario, the investor would receive 50 percent of the $40 million liquidation price, which is $5 million less than the amount received in the case of a participating preferred investment.

Will The Preference Be Multiple?

A third area of debate in structuring preferences in venture capital transactions is whether the preference will be multiple. Although this is purely an economic valuation concept and a function of the leverage of the parties, the issue is hotly contested. For example, you will sometimes see the venture capitalist insist on a three-times liquidation preference. In the example of a participating preferred with a $10 million investment for 50 percent of the fully diluted common and a liquidation of $40 million, the investor would then receive the first $30 million (i.e. three times its investment) and then 50 percent of the remaining $10 million. A compromise is sometimes reached to limit the venture capitalist to the greater of its multiple return or what it would receive if there was no participating feature and just a straight convertible preferred. In the prior example, the investor would have to choose between $30 million or 50 percent of $40 million and the choice is easy.

Additional Issues

Other areas frequently debated are whether the unpaid coupon on the preferred will also be credited to the investor on conversion to common or simply waived. Many founders and strong management teams will also try to insist that their common security will be reclassified as preferred so that their interests and the interests of the investor are perfectly aligned.

How It Works In Canada

Many of the foregoing features are also present in Canada. It is in the nature of venture capital investors to create structures limited only by ingenuity, risk aversion, and leverage.

To facilitate a comparative analysis, some attention must be devoted to local differences in nomenclature as well as investment objectives. Undoubtedly, in cross-border deals, in the absence of a common lexicon, these will bedevil the negotiation of priority and subordination agreements that capture differences in intent.

Convertible Debt Preferred Choice

Venture capital investors in Canada generally confine their interest to convertible debt, not usually acquiring equity as a principal objective. Primarily driven by this perspective, the goal is to acquire a level of ownership over time if the investment succeeds and participate, often disproportionately, in the increase in value. Negotiating and documenting these transactions is akin to "trap and release" fishing: the investor's main objective is to position itself for growth, exert sufficient control to enhance and contain the additional value, and in optimal conditions, subsequently realize its target profit by releasing that value in accordance with a carefully planned exit strategy. Venture capital investors in the United States more often than not seek to increase value by growing revenues through a strategy of acquisition and consolidation, not unlike buyout firms. Venture leasing, which is much more common in the United States than Canada, seeks a similar result but via a mechanism that achieves de facto control by de jure ownership of key assets.

There is little interest in first- and second-stage venture capital deals in the United States except when the business has attracted major corporate sponsorship, reflected in terms of actual investment or binding take or pay agreements that ensure adequate cash flow. Although third-stage venture capital deals (profitable companies requiring equity for expansion or movement into other markets) are more commonplace targets, pure-risk capital remains more elusive in the United States.

Mezzanine Financing

In the United States, mezzanine financiers frequently participate in debt and are often known as "second lien lenders." In Canada, mezzanine financing is the most common form of assistance to new or growing companies and usually takes the form of subordinated term debt with an equity kicker, often in the form of warrants. Save for the equity play, the business cultures of both countries regard mezzanine financing as secured, second-ranking debt, although in the United States it is not unusual for venture capital investors and hedge funds to insist on deeper subordination of the mezzanine piece to the point at which it may be regarded as pure equity.

In mezzanine transactions involving growing (as opposed to emerging) businesses, frequently the equity upside exceeds 15 percent in the form of company warrants. In the context of a liquidation event, such as a sale of the assets or shares, an initial public offering, material default, or on debt repayment, the pricing floor for the warrants is normally the greater of fair market value, the IPO price, and some multiple of earnings before interest, depreciation, taxation, and amortization ("EBIDTA") (which is the benchmark for return on equity). The holder's shares or warrants are almost always repurchased in priority to shares held by all other shareholders. Sometimes the issuer is granted the periodic right to repurchase some portion of the shares or warrants at an agreed premium, subject to the prior fulfillment of a variety of performance conditions.

The grant of a controlling interest is atypical in mezzanine transactions, but difficult priority issues arise when there are other investors also taking debt. This can result in a capital structure that creates a complicated payment waterfall to deal with the proceeds from the liquidation event. By implication, the treatment of proceeds, from a structural perspective, is achieved by different means in an asset rather than share transaction. In addition, one must not overlook the payment of a substantial application and commitment fee as an integral element of any "venture capital-like" transaction.

Convertible Preferred Shares

Convertible preferred shares also figure prominently in Canadian transactions because of several advantages they offer, including preferential repayment on liquidation or sale and flexibility in structuring share conditions and shaping dividend participation. (Note that these rights are limited by statutory provisions in most Canadian jurisdictions so as to preclude the American practice of issuing "blank check" preferreds.) Nevertheless, preferred shares remain an important force in Canadian venture capital financing, giving considerable flexibility to investors, which includes priority distributions of capital, rights similar to common shareholders to participate in the excess assets on liquidation, and accrued but unpaid dividends, limited in most cases to some multiple of invested capital. However, although preferred shareholders may be accorded one or multiple votes for each share held, it is unusual for the holders of convertible debt to vote as commons, control issues being left to the unanimous shareholder agreement. In addition, there are a number of statutory instances in which major changes are contemplated and in which normally non-voting shareholders have the right to vote.

Canadian Usury Law

One of the biggest differences between the U.S. and Canadian environments in relation to venture capital financing—particularly in situations involving some component of debt with an opportunity for conversion, royalty participation, or some other "upside"—is brought into focus by section 347 of the Criminal Code, the so-called "usury law." In Canada, criminal law is within federal jurisdiction and, therefore, applies across the country without provincial variation. Section 347 finds its roots in the prevention of loan sharking and crimes of economic opportunism but by its wording may render criminal that which originates as a purely commercial transaction priced against risk. Although prosecutions for violating this provision of the Criminal Code are rare and require the prior consent of the Attorney General, its breach is frequently raised as a defense to claims, which, if successful, would have the effect of exceeding the criminal rate of interest. Furthermore, as the section states and as it has been interpreted, the amount of any required fees (including legal fees of the lender/investor), bonuses, royalties, penalties, or other collateral benefits are included, along with the stipulated rate of interest, in determining whether the transaction is in violation.

They are comparatively rare, but there have been cases that have considered the effect of convertible debt on the overall rate of return in a transaction, and found that the statute has been breached. In these instances, the plaintiff's recovery has typically been reduced to a point below the threshold rather than eliminated in its entirety. Many have called for the repeal of section 347 because of its negative effect on commercial practice, particularly with short-term lending and venture capital financing, in which some profit participation by the lender is easily justified. As the law presently stands, however, it would be a difficult matter indeed to secure a compliance opinion from competent counsel in these circumstances.

2. DILUTION PROTECTION • In the United States, a difficult issue in a venture capital financing transaction is how to protect the interests of the venture capital investor if additional rounds of financing are required. Venture capital investors typically demand protection against "dilutive" financings. Because any sale of additional ownership interests to a new investor group reduces the existing investors' claims to the Company's assets and income stream, the broadest concept of dilution would render every financing dilutive. There are two types of anti-dilution protection: pre-emptive rights to subscribe to purchase shares in new offerings and anti-dilution protection in "down rounds."

Pre-emptive Rights

Pre-emptive rights afford the venture capital investor the right to subscribe to its pro rata share of the next round to maintain its pro rata ownership interest in the company. Although this is straightforward, two issues typically arise.

First, should the venture capital investor have this right in perpetuity (or at least until the IPO)? Many would say yes, because the company is not harmed by allowing the venture capital investor to maintain its position. Companies often desire to dilute the input of the venture capital investor and therefore ask that if it ever chooses not to participate in exercising its pre-emptive right, then those rights are forfeited not just for that round, but for all future rounds.

A second consideration is the exceptions in which pre-emptive rights are not applicable. These typically include the conversion of the preferred into common, a certain set-aside for an option pool for management, and sometimes "strategic alliances" and similar items. The venture capital investor needs to be careful in clearly delineating this often undefined phrase or at least have the alliances be approved by the Board.

The other type of anti-dilution mechanism is to adjust the venture conversion ratio if the price per share of the stock issued in any subsequent round of financing is less than the price per share that the venture capital investor paid for its stock (even if it is a different class of security). There are two basic types of anti-dilution protection.

Full-Ratchet Method

The full-ratchet method is the harshest and most punitive form of venture capital protection against a down round. The full-ratchet method reduces the venture capital investor's conversion price of its preferred stock from the purchase price paid by the venture capital investor to the purchase price paid by the new purchaser (or, if the venture capital investor has already converted its preferred, or has purchased common, the venture capital investor will be issued additional shares of common at that lower price).

For example, if the venture capital investor purchased 1 million shares of convertible preferred stock at $1 per share, and new capital is raised at 50 cents per share, then the venture capital investor's conversion price will be reduced to 50 cents, and the venture capital investor thus will be entitled to convert its preferred stock into 2 million shares instead of 1 million shares. This method has extremely harsh consequences for the founders and existing shareholders because their shares are diluted not only by the down round but also by the change in the venture capital investor's conversion price. This dilution of the founders' interest is heightened especially if the amount raised in the down round was an insignificant amount of money.

Founders should strenuously resist the full-ratchet method (or any variation of it). It implies that the founders are guaranteeing that the venture capital investor's stock will never go down in price and that the founders are to blame for any such decline. This logic may be appropriate in the rare case in which the venture capital investor does not participate at all in decision-making or on the Board. In most cases, however, the venture capital investor is active and also has the ability to veto the transactions, causing significant price declines. Compromises include adopting the full-ratchet method for the first 12 months and then use a fairer method thereafter, only employing the full-ratchet method if the amount raised exceeds a specified level (to avoid the absurd result of lowering the venture capital investor's price when only $1000 was raised in the down round), or using the full-ratchet method only if new financing is needed resulting from a breach of representations and warranties or covenants of the Company.

Weighted-Average Method

A fairer approach to protect the venture capital investor against dilution is the weighted-average method. This method also reduces the investor's conversion price to a lower number, but that lower number depends on the number and price of new shares issued in the subsequent offering. For example, assume that a Company had 200,000 issued and outstanding shares (including the investor's 100,000 shares of convertible preferred) before the new offering, and the investor's initial conversion price was \$2 per share. If the Company issued 100,000 additional shares to a new investor at 10 cents per share raising \$10,000 in new funds, the investor's conversion price would be reduced from \$2 per share to \$1.34 per share determined as follows:

New conversion price = $((X + Y)/(X + Z)) \times$ Old Conversion Price

In this formula:

- "X" equals the number of issued and outstanding shares before the new financing (i.e., 200,000);
- "Y" equals the number of shares that the new financing would have purchased using the original higher conversion price (i.e., \$10,000 would have purchased 500 shares at the original per share price of \$2 per share); and
- "Z" equals the number of shares actually issued as a result of the new financing (i.e., 100,000).

This formula should apply if only subsequent rounds of financing are at lower prices, thus locking in their low price per share. Complications arise with warrants and options, as well as with subsequent rounds of financing with prices between the original and new price, or with options taken into account in computing "X," but then not exercised. Careful drafting should also exclude from "X" shares issued for employee options, upon conversion, and due to a merger or a strategic alliance.

Some founders detest the apparent unfairness of the venture capital investor receiving the downside adjustment of its conversion price with no risk or obligation to participate in the subsequent round. The founder with significant bargaining power may require the venture capital investor, therefore, to exercise its pre-emptive rights to avail itself of the dilution protection. Some "pay-or-play" provisions actually require the venture capital investor to convert its preferred shares to common at the higher original price if it refuses to participate in a new round of financing.

Canadian Approaches

Canadian methods of dealing with dilution lie along a continuum and depend upon a plethora of circumstances that affect the negotiation equation. It is important to note, however, that there are significant regulatory barriers to punitive anti-dilution provisions affecting public companies, such as the requirement for shareholder approval, that may not be required in the United States.

Dilution In Value v. Dilution In Ownership

In Canada, all of the above features are also present, although frequently the anti-dilutive provisions distinguish between dilution in value and dilution in ownership depending upon the importance which the investor attaches to each. To some, a small piece of a bigger pie may be quite satisfactory and agreeable if the event is likely to secure that result. Equivalency in terms of shareholdings and value are usually not controversial unless corresponding changes in voting control produce untoward consequences given the investor's objectives in a particular transaction. This is infrequently the case because voting rights and board representation are normally addressed in a unanimous shareholder agreement, which has precedence over voting rights associated with share ownership.

Make-Whole For Below-Market Rounds

If the amount paid for the new round is less than fair market value, however, some form of gross-up or make-whole provision is appropriate. Thus, the weighted-average method is often adopted, or more accurately, procedures aimed at producing a similar result are included, particularly when the playing field is relatively level, to soften or eliminate dilution in value, although, as in the United States, complications do arise if there are options, warrants, certain forms of pre-emptive rights, and/or employee stock option plans. Often, the mezzanine financier will negotiate a put arrangement, triggered upon the occurrence of specified events, by which its minimum financial objectives are achieved to blunt the effect of any new round of financing. A similar conclusion to the investment position may occur on the exercise of rights under which the new investor is required to purchase the existing investor's holdings on the same terms and conditions as are offered to the other shareholders. In contrast, a put is usually to the corporation and takes place at a price determined by reference to some function of EBIDTA.

It is not unusual to find "pay-to-play" provisions under which the investors who opt out of down round financings may find their investment more subject to dilution than would otherwise be the case.

3. GOVERNANCE • Management of the day-to-day operations of the Company, as well as decisions on fundamental issues, present a frequent source of tension between venture capital investors and founders. Control issues vary dramatically based on the size and stage of each investment.

Board Control

More and more venture capital investors are demanding control of the Boards even at early stages. They feel their investment is just too risky to abrogate ultimate control. Founders and earlier investors will obviously resist this and try to remain in control as long as possible. Depending on the size and stage of investment, as well as the relative leverage of the parties, you will occasionally see the Board comprised of five persons, with one selected by the venture capital investor, two by management, and one mutually agreed upon by management and the venture capital investor, with the fifth director being specified as an industry expert or an otherwise experienced person.

Although a venture capital investor may own a minority of the fully diluted shares of the Company (i.e. after conversion of all convertible debt and preferred and options), it will nonetheless typically demand a far disproportionate influence, as discussed below.

Voting Power

The venture capital investor's block of stock will usually possess the power to appoint at least one member to the Board. In addition, the venture capital investor's director or block of stock usually has the right to wield negative control in many major matters. For example, notwithstanding the fact that the venture capital investor may have a minority of the seats on the Board, major corporate actions such as the issuance of additional securities, sale or merger, or even hiring or firing of key personnel may require the venture capital investor's director's assent. The scope of these rights is heavily negotiated. The parties will also negotiate the duration of the venture capital investor's director's right. It may terminate after the next round of significant financing, the passage of time, or the reduction of the venture capital investor's ownership below a certain threshold. Venture capital investors would be better advised to exercise this voting power right by virtue of their share holdings, not by virtue of their board representation. Although the law of most states will impose fiduciary duties on the venture capital investor acting in its own capacity as a director and thereby creating considerable conflicts of interest, most state laws impose no such duties on venture capital investors asserting their rights as shareholders.

Canadian Approach

In Canada, some proportion of the directors (it varies with the statute that governs the particular corporation) must be Canadian residents, as is the case in certain regulated industries. As in the United States, the right to elect a specified number of directors is a hotly contested issue, but it is worth noting that nominee directors are subject to the same fiduciary and other obligations that affect directors generally.

Board Committees

The venture capital investor may require the Company's Board to establish specific subcommittees for particular tasks and thereby enable the venture capital investor director to participate in greater degree in a more focused environment. These committees frequently address audit, compensation, and sometimes technology matters. Venture capital investors will insist that their representative sit on each of the main committees.

Information Or Observer Rights

Even if a representative of the venture capital investor no longer serves on the Board of the Company, the venture capital investor will often seek to gain access to information to which other shareholders may not be entitled. The venture capital investor may seek to observe or attend board meetings and be furnished the package of information provided to Board members. The venture capital investor may also obtain the right to receive periodic financial reports and reports of the Company's activities.

Canadian Arrangement

In Canada, all of the above-mentioned features are also present and the usual split is two investor nominees, two management nominees, and one director from the industry. In most cases, however, controls are implemented by using a unanimous shareholder agreement that spells out in considerable detail the rights and obligations of the parties and that, in most provinces, has the effect of devolving to the shareholders themselves the duties and obligations of directors, including those of a fiduciary nature. Thus, as in the United States, it may not be possible to avoid conflicts of interest and other difficulties associated with directorship when the venture capital investor exercises control by virtue of its shareholdings. However, Canadian law recognizes the concept of "de facto" directorship in circumstances in which the degree of control over the affairs of the corporation is at a level that is the equivalent of a director. Basically, if a person looks like a director and acts like a director, under Canadian law, he or she is a director for all practical purposes. To this end, so-called "observers" who have access to internal information and may speak at meetings of the board may find that their influence over decision-making invites not only the perception that they are acting as directors but the juridical result of becoming de facto directors.

On the other hand, in the case of mezzanine financing, the doctrine of equitable subordination is not recognized in Canada, so Canadians enjoy a significant advantage over mezzanine lenders in the United States who exercise significant control over the corporation's affairs, particularly in matters of insolvency.

Part 2 of this article, which will appear in the April issue, will discuss exit strategies, pursuit of new opportunities, and the key needs of venture capital investors.