

Near-Term Prospects for Institutional and Government Investments in Venture Capital Funds

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In a recent survey of over 500 venture capitalists worldwide, the National Venture Capital Association and Deloitte LLP reported the widespread view, that in the next five years VC investment in the United States and Europe would decline significantly, while such investment in Brazil, China and India would continue to dramatically increase. Yet, the survey authors continue, "Despite the challenges, U.S. venture investors remain optimistic regarding the quality of the opportunities in the U.S., with most predicting a stable or improving environment for valuations and deal flow." This seems to contradict the survey conclusions. Is this optimism about the future of U.S. venture funds just "whistling past the graveyard," or is it justified?

The venture funds of other countries increasingly can avail themselves of their own governments' assistance. Recently, governments worldwide have rolled out extravagant funding measures to foster and prop up local venture capital funds in a variety of industries. Examples of recently unveiled large governmental funds to promote home-grown venture capital funds include Canada (Teralys), the U.K. (Innovation Incentive Fund), France (Strategic Investment Fund), Israel (Tender for Israeli Life Sciences Funds) and Russia (Rusnano). Similar governmental efforts have a checkered history; see Josh Lerner's 2009 book, "Boulevard of Broken Dreams." But at least these governments are trying to help. By contrast, the U.S. today seems intent on imposing a host of new regulatory and tax hurdles, which tend to decrease the attractiveness of venture capital

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funds to investors. As Mark Heesen, president of the NVCA put it recently, "The uncertainty and potential impact around many of the policies that have been discussed in Congress in recent months has contributed to an investment climate that is viewed as increasingly unfavorable by a majority of the venture capital industry. This course must change if we wish to remain competitive with other nations over the long term."

Although our government is not making life easier for the U.S. venture capital industry, help can come from unexpected quarters. Recently we were able to organize a pending investment of tens of millions of dollars in a North American venture fund client of ours, funded by an overseas governmental agency. Many countries still value investments in U.S. and Canadian VC funds as a useful bridge to the U.S. markets and U.S. deal flow, although clearly such deals are not easy to find. The private sector also is sending out positive signals. For example, earlier this year I moderated a panel of well-known major venture fund LP's whose outlook on the future of U.S. venture capital, as an asset class, was surprisingly and unabashedly bullish. Subsequent conversations with other LP's and investment bankers in the U.S. and Europe have provided confirmation of this perspective. Their consensus was that, despite dismal returns

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Amazing Clients[®]

Improving Human Health With Intelligent Vaccines



Jeff Baxter, President and CEO
of Variation Biotechnologies, Inc.

Until just a few years ago, Jeff Baxter was the managing partner of a successful venture capital firm. Previously, he had roles across Commercial Manufacturing and R&D at one of the world's largest pharmaceutical companies, GlaxoSmithKline.

Then the challenge of returning to a big operational role lured him to join Variation Biotechnologies in September of 2009.

The Company had been founded in 2001 in Ottawa. The three founders were leading scientists and researchers who had been investing their own money, pinching pennies and sleeping on sofas to survive, but they had seized upon a novel way of creating peptide antigens (proteins the body uses to fight infection) that could attack not only a targeted virus, but all of its likely mutant strains as well. The prognosis was exciting but it was still very uncertain. Their initial focus was HIV. Then in 2006, a \$35.7M Series A Financing was raised and the company transitioned from early stage research to product development.

"I had to take the job because the science was compelling, and the mission was not trivial," says Baxter, who is now the President and CEO of Variation Biotechnologies, Inc. ("VBI"). "This technology presents a huge opportunity to protect people from the flu and many other viral diseases, [and] it could potentially be the answer to all kinds of pandemic threats," he adds, noting

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Are Minimum Resale Price Plans Legal?

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Can a manufacturer prohibit retailers and distributors from discounting its goods? Before 2007, the answer was “no;” however, the law changed radically in 2007, when the U.S. Supreme Court overturned almost 100 years of precedent and ruled in *Leegin Creative Leather Products, Inc v. PSKS Inc.* that minimum resale price (MRP) plans are not automatically illegal under the antitrust laws. If a MRP plan promotes competition, the MRP plan can be legal.

How can a policy that prohibits discounted sales promote competition? Manufacturers argue that the MRP policy enables them to offer better service to consumers, as opposed to the minimal service offered by discounters who take a “free ride” on the brand’s reputation. For example, a consumer can learn about the benefits of a product from a retailer that invests in showrooms, offers product demonstrations and hires knowledgeable employees. In contrast, the discounter offers little, if any, of these extras. Manufacturers fear that the consumer will learn about the product from the authorized retailer, and then will buy from the discounter. This can cause high-service retailers to go out of business. MRP plans, therefore, give consumers more options so they can choose between low-price low-service brands, high-price high-service brands, and those that fall in between.

The new rule announced by *Leegin* is that a plan can be lawful if its pro-competitive benefits outweigh the anti-competitive harms. This means that manufacturers must carefully analyze their market to determine the lawfulness of a proposed MRP plan. They should consult with their attorneys before undertaking any MRP plan.

It is not always just manufacturers that drive the creation of a MRP plan. In fact, a manufacturer may not oppose discounting of its product by retailers, as long as the manufacturer receives its full wholesale price. The greater concern is when the MRP plan results from retailer pressure. Dominant retailers may oppose price competition from discount or internet retailers and can compel a manufacturer to institute a MRP plan. This pressure may be deemed anti-competitive and will not be protected by the *Leegin* decision.

After *Leegin*, some manufactures began to ban discounted sales by eBay, Amazon and others. Discounters complained that *Leegin* was hurting their businesses. Consequently, there was sentiment to change the *Leegin* decision. Several bills were introduced in Congress to restore the illegality of MRP plans. Action on those bills is pending.

Some state governments have also been active in their opposition to *Leegin*. Each state has its own antitrust laws. California and New York announced that their state antitrust laws would not be bound by the *Leegin* decision and filed suit against manufacturers who had imposed MRP restrictions. Other states probably will follow the examples of New York and California.

Manufacturers who are considering MRP plans should consider several factors, including:

1. Does the MRP plan encourage customer service and competition?
2. Does the manufacturer have a substantial share of the market?
3. Is the impetus for the MRP plan coming from retailers?
4. What is the antitrust rule in their state regarding MRP plans?

Manufacturers should analyze the market and obtain careful legal advice before considering a MRP plan. ☰

Poor, Poor Pitiful Estate Tax: It’s the most misunderstood tax around

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When Texas pipeline billionaire Dan Duncan died in March of this year, and again when George Steinbrenner died, much was made of the fact that the heirs of both men might inherit their riches free of the federal estate tax, because a one-year repeal is currently in effect. Here, paraphrased, are some of the many different responses which followed: “Hooray! The government should not get one cent of their hard-earned money;” “They paid tax on the money once: the death tax is a double tax!” “The government established the free society which allowed them to earn their money and should be allowed to tax it;” and “The idea of vast inherited wealth is intrinsically in conflict with the ideals of a democratic society.”

Clearly the estate tax strikes deep emotional and philosophical chords in our citizenry, but what is it, exactly? And what will it mean if it comes back in 2011, as it most probably will? There is much misinformation circulated about this tax. Herewith, an attempt to clear the air as Congress prepares to “fix” the estate tax problem.

First, the event taxed is the *transfer* of wealth. The tax is paid by the executor, from the assets of the estate, and its burden falls on the beneficiaries, not those who may have earned the money. It is computed on the fair market value of the decedent’s taxable estate on the date of death, or if lower, the value six months later.

The “taxable” estate is the gross estate after deducting property passing to a spouse or to charity, and debts and expenses. In 2009, estates valued up to \$3,500,000 *after* these deductions enjoyed an exemption from the tax. That meant that with properly drawn wills, a married couple could pass twice that amount—\$7,000,000—to their children, estate tax-free. It is fair to say then, that the tax

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Amazing Clients[®]

Improving Human Health With Intelligent Vaccines Variation Biotechnologies, Inc.

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that more than 33,000 people died last year in North America from pandemic flu alone.

Thanks to the injection of venture capital funds that VBI received in 2006, the company now has successfully developed and tested three next-generation technologies on animal subjects with promising results, and it is ready to move forward with clinical testing of drugs related to those technologies.

The three revolutionary technologies are:

- Variosite™ Technology, which uses bio-informatics and computer modeling to detect the genetically determined structure of a virus and predict its likely mutations, enabling the creation of peptide antigen “cocktails” that can stimulate immune responses for both targeted viruses and all of their likely mutations;
- Thermostable Vaccine Technology, which facilitates the creation of stable vaccines that can be shipped and delivered without need for refrigeration or immediate use, maintaining their stability for more than three months at up to 40 degrees Celsius (104 degrees Fahrenheit); and
- Oral Vaccine Formulation Technology, which enables the formulation of new antigens or the reformulation of existing vaccines for oral delivery, using gel caps or enteric-coated tablets instead of lyophilized products that must be injected with needles by over-stretched health-care workers.

“Our predictive modeling, oral formulation and thermo-stability technologies have displayed huge potential [and] could change the way medicine is delivered,” Baxter exclaims.

In fact, VBI is working on partnership agreements now involving both the United States and Canadian governments, which are expected to fund Phase One (human subject) clinical trials for flu vaccines.

“We are leading the effort to develop a ‘universal’ flu vaccine that can fight multiple strains of flu,” Baxter says. He suggests that people might effectively immunize themselves against flu with just one treatment every five to 10 years, because known antigen strains tend to be predictable within those periods.

Potentially, a vaccine based on predictive modeling will not just save time and money, it will save lives. Vaccines that need to be customized and targeted to just one strain can take months to develop, as evidenced by last year’s H1N1 vaccine, and a pandemic killer could mutate from an existing strain with little or no time for traditional vaccine development. Because 36,000 people a year die from all kinds of influenza in the U.S. alone, the development of a “universal” vaccine could be a major life-saver.

Baxter says that the thermo-stability technology is incredibly valuable as well. “Putting an end to the necessity of cold-chain distribution is incredibly important, especially in developing countries,” he asserts, noting that extreme heat or cold can kill the effectiveness of current vaccines, which must be stored at precise temperatures (between 36 and 46 degrees) and used quickly.



JEFF
BAXTER

President and CEO of Variation
Biotechnologies, Inc.

He points for example, to one recent incident involving hundreds of Chinese children who died from Hepatitis A after receiving vaccinations that had been accidentally frozen, and notes that VBI is also developing a stable Hepatitis A vaccine.

The ability to formulate oral vaccines is critical too, says Baxter, because there are real fears about needles in many countries, and there are grave concerns about contaminated needle-sticks among health care workers. Furthermore, the potential for patients to receive over-the-counter tablets instead of getting injected by nurses, could help relieve labor pressures in the health care sector.

Baxter notes that VBI is already working with the Walter Reed Institute on an oral vaccine to fight Shigella, a common and debilitating stomach virus in many parts of the world that often afflicts soldiers overseas.

He believes that VBI will succeed in its mission of improving human health with intelligent vaccines, not just because the science is right, but because the company has a board of directors and an advisory group that are fully invested and compose “the strongest boards in the vaccine field.”

The former president of Abbott Company, the founder of Immunex, the former chairman and CEO of Cubist Pharmaceuticals and a former senior executive at Merck & Co. all sit on the board, while the Director of the NIH Vaccine Institute and a doctor who has developed many modern vaccines are all key advisers.

Baxter credits his legal advisers for playing a key role as well, “Burns & Levinson has acted as company counsel since day one, and they have the full confidence of our investors.” Noting that VBI has U.S. and Canadian operations, he adds that “our law firm is the perfect fit for us because of their presence in both countries. Partner Len Gold is particularly effective at working with the Canadian and U.S. governments, and he has helped us to connect with government policy-makers, and to secure grants and tax credits for the company,” says Baxter, adding that the firm also handles day to day issues involving employment, tax, and corporate matters as well. “We put it all in their hands,” Baxter says. ■■■

- John O. Cunningham, freelance writer/editor

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Poor, Poor Pitiful Estate Tax: It's the most misunderstood tax around

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only affects those who enjoy "wealth" in the common sense of the term.

Moreover, as of 2009, if the gross estate did not exceed the exemption, the executor did not have to file a return at all. In 2007, only about 1.5% of all U.S. estates (which in that year were subject to a much lower \$2,000,000 exemption) had to file the return, and less than half of those returns showed a tax due after deductions.

The gross estate is the value of every economic interest owned by an individual. Taxpayers will go to great lengths to disguise wealth by changing its form in order to avoid the tax. The tax code catches most interests, but one can still avoid the tax by giving up the legal ability to control or enjoy certain aspects of the property. Trusts, partnerships and other entities are often used to achieve these ends. Granted, when property does not escape taxation, the rate is high, 45%. However, even at that rate (which has dropped from 55%), the tax has not really cut into the amounts owned by the very wealthiest individuals and families. After 93 years of continuous estate taxation, the wealthiest 1% own about 34% of U.S. total wealth, a percentage that has been rising. So it is fairly difficult to make the case that the tax is significantly redistributionist.

Is it a double tax? Well, partially. To the extent that a person's wealth at death consists of accumulated after-tax income, this is true. But insofar as wealth is growth on assets such as real estate and stocks, which have been acquired and held for investment, the gain has often not been subject to tax before death. Further, under the capital gains tax regime in effect before the estate tax was repealed, heirs were not *ever* subject to gains tax on the growth before death. So the estate tax was the government's only crack at taxing such gain. By the way, such is not the case under the 2010 repeal, which, if it were extended by Congress, would replace lost estate tax revenue by taxing the capital gains on inherited assets sold by the heirs in some estates.

Does the tax force the sale of small businesses, as is often claimed? In many cases, the government will lend the estate the money to pay the tax at highly advantageous rates for terms of up to 15 years. When one looks behind the stories of heirs who were "forced" to sell the family business, one rarely finds that the estate tax was the sole, or even primary, cause. On the other hand, it is true that estates consisting primarily of large holdings of real estate may be at risk, and persons with such estates should plan their transfers accordingly. Business owners should plan well in advance as well, so as not to leave their heirs scrambling for liquidity.

Finally, as with all taxes, citizens are well within their rights to avoid, if not evade, the estate tax. Families affected by the tax are usually those with means to understand and avoid it. Massachusetts and Rhode Island did not repeal their state estate taxes, and the federal estate tax will probably be resurrected, or maybe even made retroactive to 2010. Sophisticated legal counsel is the best choice when evaluating the options available to avoid or minimize estate taxes. You can't take it with you, so fair tax or "heir tax," it is a tax to think about and plan for now. ❧

Near-Term Prospects for Institutional and Government Investments in Venture Capital Funds

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from the venture capital industry in the past decade, the future is bright for venture funds as an asset class. In fact, they made a telling comparison to the fund environment 10 years ago. In contrast to those heady days, today valuations are down, deal pipelines are full, and amateur hour in the VC business finally is over. Thanks to those factors, they predicted that the coming decade will bring historically superlative returns for U.S. venture capital as an asset class.

Of course that was in February, prior to Washington's intensified efforts to "reform" the financial landscape. The uncertainty caused by new legislation and regulation has taken its toll. Furthermore, even if the tide of private sector venture funding is rising, this time it will *not* lift all boats. In fact, the LP's on my panel flatly predicted that over half of currently existing U.S. venture capital funds will end after their current fund is concluded. Limited partners are more restrictive today about which funds they invest into, and the conditions they impose on those funds (as is seen by the influential ILPA pronouncements of late 2009). Consequently, we are seeing a Darwinian survival of the fittest for many individual U.S. venture funds; while at the same time, paradoxically, a resurgent outlook for U.S. venture capital as an asset class.

One side effect of this environment is that many hard-pressed VC funds favor later-stage investments, hoping to hit the proverbial "home run" in the few remaining years left to their funds. The stronger funds, the survivors, are becoming more selective about their investments, stingier on valuations, tougher on terms, and more careful about due diligence. Faced with this reality, entrepreneurs should take aggressive advantage of whatever resources are available, including lawyers, accountants and other friendly advocates who possibly can provide an edge. In addition, they should explore alternative sources of funding, such as angels, strategic investors, private placements and other creative financing solutions. Ironically, however, new Federal legislation also complicates angel investing and private placements somewhat, just when entrepreneurs most urgently need their support.

To prevail in this challenging environment, one must leave no stone unturned, use all the resources at one's command, and remain flexible, creative and patient. Despite the tight funding environment, the best teams still will prevail and thrive. ❧

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