



# Evolving Market Terms for Venture Capital Investments

## Trade Association Updates Standards

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**O**n July 28, 2020, the National Venture Capital Association, the trade association for the venture capital community in the United States, published much-anticipated updates to its model legal documents, which are available for free download on the NVCA's website. These documents are widely used in the venture capital and angel investment communities and have become the industry standard for use by lawyers representing emerging growth companies and investors to effectively and efficiently document the terms of equity financings. This article summarizes the updates to the primary model legal documents, which include a Term Sheet, Certificate of Incorporation, Stock Purchase Agreement, Investors' Rights Agree-

ment, Voting Agreement, and Right of First Refusal and Co-Sale Agreement. The NVCA model documents assume the company is organized as a corporation, although they are adaptable for other applications.

### Term Sheet

The Term Sheet facilitates the discussion and agreement upon the key business and legal terms of the investment between the company raising capital and the lead investor for the round. While negotiating the Term Sheet, the company and the investor are able to focus on the primary economic and control issues involved in the proposed investment, facilitating a quick and cost-effective determination whether there is business agreement on the proposed terms. The Term Sheet,

among other things, sets forth the type of securities being purchased by the investor, the price per share (and the corresponding pre-money valuation of the company), and the control and economic rights and preferences of the securities being purchased (including dividend rights, rights upon liquidation, redemption rights, etc.). The NVCA Model Term Sheet was updated as follows:

- **Anti-Dilution.** While prior iterations of the Term Sheet included multiple alternative anti-dilution adjustments—a mechanism to adjust the rate at which the shares of preferred stock convert into common stock upon the occurrence of certain events, including to account for the dilutive effect of “down rounds” if the company issues shares at a lower price per share than the price paid by the investor—the Term Sheet now only includes a “broad-based weighted average” anti-dilution formula, which has been by far the most common formula used in venture financings.
- **Legal Fees.** A section in prior versions of the Term Sheet, with respect to the company’s obligation to pay the fees of investor’s counsel, is no longer a default binding provision and the obligation to pay the out-of-pocket fees of investor’s counsel is subject to the closing of the financing, and most frequently capped in dollar amount, reflecting current market practice.

### Certificate of Incorporation

The company’s Certificate of Incorporation (Charter) is a publicly filed document that authorizes different classes of capital stock of the company and sets forth the relative rights, preferences, and privileges of such classes of stock. The NVCA Model Charter was updated as follows:

- **Dividend Language.** The Charter now includes a provision for non-cumulative preferred dividends at a

specific rate (customarily 5%-8%) which are paid prior to and in preference to any other dividends. Note, however, that the fixed rate dividends are only payable when, as, and if declared by the Board of Directors and, as a practical matter, venture backed companies rarely declare dividends.

- **Protective Provisions.** The protective provisions—provisions requiring the company to obtain the consent of holders of a majority (or possibly higher percentage) of the preferred stock prior to taking certain enumerated actions—were updated to: (i) expand the protective provision for the creation, reclassification or increase of authorized shares of a series of capital stock; (ii) include a new protective provision for amendments of equity incentive plans and amendments to the terms of any equity awards granted pursuant to such equity incentive plans; and (iii) expand the protective provision for effecting a change to the authorized number of directors on the Board of Directors to include any changes to the voting power of each director.
- **Mandatory Conversion on Direct Listing.** The Charter now provides for mandatory conversion of the preferred stock to common stock in the event of a direct listing of the company’s common stock on a nationally recognized stock exchange, in addition to upon a Qualified IPO (as defined in the Charter) or upon the consent of holders of a majority (or possibly higher percentage) of the preferred stock.

### Stock Purchase Agreement

The Stock Purchase Agreement (SPA) is the document that sets forth the terms and conditions regarding the investor’s purchase of shares of the company’s preferred stock. The NVCA Model Stock Purchase Agreement was updated as follows:

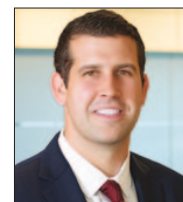
- **Removal of Founder Representations and Warranties.** While



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previous iterations of the model SPA included suggested language for representations and warranties to be made by the founders of the company, these representations and warranties have been removed in the updated SPA, requiring investors to rely upon the representations and warranties made by the company alone.

• **Representations and Warranties.**

The representations and warranties to be made by the company were updated as follows:

- The open source software representation was revised to narrow the representation and limit it to open source software licenses that would impose significant obligations on the company;
- The employee census representation, which required disclosure of compensation arrangements with each employee of the company, was deleted;
- The representation with respect to data privacy has been substantially revised to address updates to data privacy laws; and
- Two new sample representations have been added where any investors are non-U.S. persons concerning matters related to review of the proposed financing by the Committee on Foreign Investment of the United States, including changes in response to the Foreign Investment Risk Review Modernization Act, which expand the scope of CFIUS review of non-controlling investment in U.S. companies by foreign investors. Section 2.30 of the SPA now includes a representation by the company confirming that it does not currently conduct certain activities that may trigger CFIUS review, and Section 3.9 of the SPA now includes a representation by each investor that it is not a “foreign person” or “for-

foreign entity” as those terms are used in applicable CFIUS related regulations, and that the investor does not permit a “foreign person” to obtain CFIUS triggering rights by virtue of its investment.

• **Closing Conditions.**

- The SPA now includes a footnote in the closing condition requiring delivery of a legal opinion by the company’s counsel stating that parties may forego delivery of a legal opinion as a result of the expense and time associated with such legal opinion. Prior to these updates, the delivery of a legal opinion was the default position in the document (although in practice delivery of a legal opinion varied financing to financing, with earlier and smaller financings rarely requiring one).
- The requirement that the company satisfy preemptive rights with respect to the preferred stock issued to the investors has been removed as a closing condition as these rights can often be more efficiently satisfied or waived following the closing of the new investment.
- **Notice Provisions.** The SPA was updated to reflect the latest e-notice provisions of Delaware law and to provide permissibility of electronic notices subject to certain requirements and limitations as set forth therein.

**Investors’ Rights Agreement**

The Investors’ Rights Agreement is the document pursuant to which the company grants investors (sometimes limited to certain “Major Investors” holding a negotiated minimum amount of stock of the company) certain rights, including information rights, rights to participate in future financings, and registration rights. The NVCA Model IRA was revised as follows:

- **Treatment of “Competitors”.** The revised IRA notes that the use of the defined term “Competitor” in the document applies only to rights to future stock issuances. Other mentions of “competitors” in the context of transfer restrictions and information rights are not defined, allowing the company more flexibility to determine what constitutes a “competitor” in such instances.
- **Underwriting Requirements.** Section 2.3 provides sample language that would exempt stockholders from the need to make representations in an underwriting agreement with respect to the registration of the company’s securities in a public offering (except with respect to their ownership of shares of the company) and further limits the stockholders’ liability with respect thereto.
- **Lock-Up Restrictions.** The “market stand-off” restrictions in Section 2.11 (commonly referred to as a lock-up provision) have been revised to reflect changes in regulatory framework, including a new exception for the establishment of a 10b5-1 trading plan (a plan that allows certain insiders of the company to sell shares of capital stock in predetermined amounts and at predetermined times to comply with insider trading laws).
- **Restrictions on Transfer.** Section 2.12 includes new language that would provide that shares transferred pursuant to an effective registration statement or, following an Initial Public Offering, pursuant to Rule 144, would no longer be bound by the terms of the IRA.
- **Information Rights.** Section 3.1 now requires the company to deliver financial statements after each fiscal quarter of the company, not just the first three fiscal quarters.
- **Extension of Information Rights for Transactions Involving New Private Company Securities.**

Section 3.4 clarifies that information rights shall continue in any successor company that is not subject to periodic reporting requirements of the Securities Exchange Act of 1934.

- **Waiver of Statutory Stockholder Rights.** Newly added Section 3.7 provides a sample provision for the waiver of all Delaware statutory rights to information regarding the company under Section 220 of the Delaware General Corporation Law.
- **Termination of Information Rights and Rights to Future Stock Issuances.** The revised IRA removes prior language that would terminate the investors' information rights and preemptive rights when the company first becomes subject to the periodic reporting requirements of the Securities Exchange Act of 1934, although underwriters in an IPO frequently seek such post-IPO termination of rights.
- **CFIUS Considerations.** The revised IRA includes multiple changes with respect to CFIUS, including:
  - The right to require the company to register shares provided in Section 2.1(a) has been revised to exclude any stockholder that is a "foreign person" from triggering the demand right;
  - Inclusion of a covenant that the company will not provide an investor that is a "foreign person" with access to any "material non-public technical information" as that term is used in applicable CFIUS related regulations;
  - Inclusion of a limitation on the rights to future stock issuances that no "foreign person" investor shall use the preemptive rights to acquire unsubscribed shares in a future offering to purchase more than 9.9% of the company's voting securities; and
  - Inclusion of a new covenant preventing the company from provid-

ing certain rights to "foreign persons" in order to comply with CFIUS.

- **Company Covenants.** The revised IRA includes drafting clarifications, modifications, and slight expansions to many of the sample company covenants in Section 5. Some noteworthy changes include:
  - Suggested language for extending D&O insurance to investors entitled to designate directors;
  - Suggestion for Preferred Director approval of vesting acceleration provisions with respect to any equity award grants;
  - Significant expansion of the company's obligations to provide a certification to investors that the company is a "Qualified Small Business" and that the shares of preferred stock issued to the investors will be "Qualified Small Business Stock"; and
  - New covenants related to the foreign corrupt practices act, cybersecurity, and real property holding corporations.

#### Voting Agreement

The Voting Agreement sets forth the agreement and understanding of the stockholders with respect to how shares of capital stock held by them will be voted in connection with the election of the board of directors, a sale of the company, and certain other matters. The NVCA Model Voting Agreement was updated as follows:

- **Board Composition.** The Voting Agreement has been updated to delete the covenant with respect to maintaining the size of the board, and a footnote was added to highlight that board size may be addressed in the Charter or the bylaws.
- **Drag Along.** The Voting Agreement adds a condition to the drag-along—

a provision that provides that all stockholders must vote their shares in favor of a sale of the company that is approved by the Board of Directors and certain predetermined groups of selling stockholders—that the stockholders are not required to grant releases in connection with such sale of the company other than a customary release of claims arising solely in their capacity as a stockholder.

#### Right of First Refusal and Co-Sale Agreement

The NVCA Model Right of First Refusal and Co-Sale Agreement, which provides for restrictions on transfer of shares of capital stock held by certain "key holders," such as founders of the company, was revised to update the lock-up provisions to allow establishment by the restricted holders (generally founders and senior company management) of a 10b5-1 trading plan during the lock-up period as long as the plan does not permit transfers of shares during that lock-up period.

#### Conclusion

The updates to the model legal documents reflect the evolving norms in the venture capital industry and updates to state and federal laws applicable to venture-backed companies in the United States. The updated model legal documents continue to establish a framework for effective and efficient negotiations between startup companies and venture capital investors, establish market terms, and further the NVCA's goal to provide a comprehensive set of internally consistent financing documents to reduce transaction costs and time in negotiating and closing a venture capital or angel investment financing. ☞