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CLIENT ALERT

Venture Capital Financing Update: National Venture Capital Association Releases Updates to Model Legal Documents

August 10, 2020

On July 28, 2020, the National Venture Capital Association (**NVCA**) released updates to its model legal documents for use in VC financing transactions (the **NVCA Agreements**). The NVCA Agreements have become the industry standard equity financing documents for Series A financings and beyond, and are used by startups, VC investors and lawyers in Silicon Valley and elsewhere. Prior to this round of updates, the NVCA Agreements were last updated in October 2019 and January 2018.

Updates were made to the following NVCA Agreements: (1) Term Sheet, (2) Certificate of Incorporation (**Charter**), (3) Stock Purchase Agreement (**SPA**), (4) Investors' Rights Agreement (**IRA**), (5) Voting Agreement (**VA**), (6) Right of First Refusal and Co-Sale Agreement, (7) Management Rights Letter (**MRL**), (8) Indemnification Agreement and (9) Model Limited Partnership Agreement (**LPA**) Insert Language Regarding CFIUS. One impetus for the updates appears to be the finalization of the regulations implementing the Foreign Investment Risk Review Modernization Act of 2018 (**FIRRMA**) relating to the Committee on Foreign Investment in the United States (**CFIUS**). However, there are also significant changes unrelated to CFIUS. This alert summarizes some of the material changes to the NVCA Agreements.

Generally Applicable Changes

Many of the changes to NVCA Agreements flow across various agreements. We highlight those points at the outset:

CFIUS

By way of background, FIRRMA was signed into law on August 13, 2018, and made significant changes to the rules applicable to national security reviews of foreign investment in U.S. businesses by CFIUS, which is an inter-agency committee chaired by the Department of Treasury. While historically, CFIUS has had authority to review transactions that could result in "control" of a U.S. business by a foreign person, FIRRMA expands CFIUS's authority to include non-controlling investments in certain U.S. businesses (where the U.S. business is engaged in certain activities related to "critical infrastructure" and/or "critical technology," or maintains and collects certain sensitive data, referred to as a "**TID U.S. Business**"). In addition, while notification of a proposed transaction to CFIUS generally is voluntary (though with the specter that CFIUS could unilaterally initiate a review and – even post-closing – recommend the President unwind a transaction if it identified a national security concern), FIRRMA introduced for the first time a requirement for mandatory pre-closing filings under certain circumstances, with the authority to impose penalties up to the value of the transaction for failure to submit a mandatory filing. Also relevant to the changes to the NVCA Agreements, FIRRMA provided clarification with respect to investments by investment funds, and laid out the criteria for when foreign limited partners in such U.S. funds would not cause the fund to be considered foreign, though this carve-out is relatively narrow and certain funds – particularly smaller funds or special purpose – may not meet the criteria.

The 2020 NVCA Agreement updates have added to the SPA a company representation as to whether it is engaged in a TID U.S. Business. The purpose of this representation is to elicit disclosure and determine whether a CFIUS filing is mandatory, which

makes sense given the recent finalization of the new CFIUS rules under FIRRMA. A representation by the investor that such investor is not a foreign person has also been added to the list of investor reps. This representation likely would suffice as an alternative to the company representation discussed above for purposes of determining whether a CFIUS filing is needed.

To the extent that the company is engaged in a TID U.S. Business, the form IRA now includes a number of covenants designed to elicit compliance with FIRRMA, including restrictions on demand registration rights, restrictions on access to information, restrictions on pre-emptive rights, restrictions on observer rights, and limitations on voting rights. Corresponding revisions have been made to the MRL as well.

The update to NVCA Agreements includes additional language to be included in LPAs to allow venture funds to assess CFIUS considerations. The inserts generally require the limited partners to (a) provide notice to the general partner within 15 days of the date upon which any foreign government holds a substantial interest in it or its limited partner affiliates during the term of the LPA and (b) cooperate with any requests for information regarding “foreign person” ownership holdings.

The complexity overall of FIRRMA and the NVCA Agreement provisions relating to CFIUS matters means that foreign investors potentially investing in, and companies engaged in, a TID U.S. Business, need to carefully consider CFIUS issues with counsel at the outset of a transaction and then as their businesses mature.

Governance Provisions

The 2020 changes to the NVCA Agreements impact both stockholder and board protective provisions:

Stockholder Protective Provisions. The stockholder protective provisions (found in the model NVCA Charter) were updated to include the approval requirements from the holders of preferred stock for:

- Issuances, sales and distributions of crypto-currencies and digital/blockchain assets, unless approved by the issuer’s board, including investor directors;
- The adoption of, or any amendment to, equity compensation plans, as well as amendments or waivers to any awards granted under an equity compensation plan (it is noted that this provision is bracketed, indicating it is negotiable); and
- Changing the number of votes that any director can cast (other than 1 vote per director).

The change to the equity compensation plan provisions is interesting as previously, except to the extent required by law or specifically negotiated, decisions regarding equity compensation plans and awards under such plans have been reserved for the board of directors. Assume, for example, a sufficient number of shares of common stock are authorized to allow for an increase to the number of shares reserved under an equity compensation plan. If this provision is included in the Charter, in addition to board approval, a company will also need to obtain stockholder approval, and the vote required will consist of only the investors.

Board Protective Provisions. Perhaps the most significant change to the protective provisions found in the IRA requiring approval of the Board of Directors of the company was the removal of the requirement that the board approve related party transactions between the company and directors, officers and employees of the company. While this provision has typically been a negotiated point in many transactions in our experience, particularly where strategic investors are involved, its deletion suggests a continued shift in the power balance towards companies and founders.

Qualified Small Business Stock

Consistent with increasing awareness of significant tax benefits relating to qualified small business stock (**QSBS**), as well as complexities in determining eligibility for QSBS tax treatment, the NVCA agreements include expanded provisions relating to QSBS. In particular, the model IRA now includes a detailed information reporting form to be completed by the company and provided to investors.

Statutory Information Rights / Books and Records Rights

The model IRA also includes an alternative (negotiable) provision waiving statutory information rights. This deletion relates to continuing attempts by investors to utilize statutory information rights to seek access to company books and records. While attempts to reduce litigation are always laudable, in our view the inclusion of this clause reflects heightened concern with the relative power balance between investors and the company and its founders.

Agreement Specific Changes[1][1]

Term Sheet

The term sheet is the starting point for any VC financing, as the terms that are agreed upon here will serve as guideposts for the terms to be included in the definitive agreements to be executed in connection with closing. The NVCA model term sheet has been updated to reflect the material changes to offering terms and the NVCA Agreements.

In addition to changes related to the governance and CFIUS provisions described above, the offering terms section of the term sheet has been updated to reflect changes in the Series A marketplace that have occurred over the past several years, including:

- Y Combinator developed Simple Agreements for Future Equity (**SAFEs**) are now contemplated as converting at the closing as part of the financing, which makes sense given the proliferation of SAFEs as the leading instrument for startups raising pre-seed and seed financings.
- Treatment of “promised stock options” as an increase to the agreed upon post-money available option pool. The dilutive impact of stock options promised to new hires that have not yet been approved by a company’s board of directors has traditionally been a point of negotiation between founders and investors in VC financings. The updated term sheet seeks to clarify that such “promised stock options” will increase the available option pool post-closing, thereby further diluting founders and other existing stockholders, by adding, in brackets, a requirement that the available option pool percentage include only “unallocated and uncommitted” options. Inclusion of this provision will eliminate a company’s ability to take a different position with respect to such promised options.

Certificate of Incorporation

The Charter is a publicly filed document which authorizes the different classes of capital stock of a corporation and further describes the rights, preferences and privileges of such classes. It must be filed with the Secretary of State of Delaware (or other state of incorporation) prior to closing a venture capital financing transaction. Notable updates were made to stockholder protective provisions sections of the NVCA model Charter (as described above) and dividends.

The dividends section was updated to include a provision for “fixed rate” dividends, payable only if declared by the board. A fixed rate dividend provides investors with the ability to receive a percentage, usually 6% - 8% of the per share purchase price, prior to and in preference to any other dividends. This is the most common dividend formulation used in practice, however the prior version of the Charter required free drafting or pulling from prior precedent in order to incorporate this concept. As a practical matter, early-stage tech companies rarely pay dividends to stockholders.

Stock Purchase Agreement

The SPA is the contract by which investors purchase, and a startup sells, preferred stock. The SPA contains the basic necessary information on the purchasers, number of shares being sold, price per share and closing date. In addition, the SPA contains a host of representations and warranties made by the company and the investors and certain conditions which must be met prior to the closing of the financing.

Recent changes to the SPA focus on the representations and warranties sections and include:

- Deletion of the concept of “founder reps” from the SPA. Founders will no longer have to fear making representations and warranties in their individual capacities which, if untrue, could be a source of personal liability.
- Revisions to the company data privacy representation and new CFIUS representations for companies and investors.

The changes to the data privacy representation were spurred by the adoption of new privacy laws like the California Consumer Privacy Act (**CCPA**) and General Data Protection Regulation (**GDPR**). This new representation holds the company to a higher standard with respect to privacy and its handling of personal information in light of the obligations and potential penalties under the CCPA and GDPR. Companies that collect credit card information or process credit card payments should pay special attention to these changes. Further, companies that have experienced a data breach or similar incident will now likely have to disclose the breach or incident as an exception to this representation.

Investors’ Rights Agreement

The IRA contains the key rights to which investors in a venture capital financing are entitled. In sum, these include: registration rights, information rights, inspection rights, observer rights, if applicable, and participation rights. In addition, the IRA includes post-closing covenants which are limitations on company actions and obligations imposed on the company.

Certain changes to the IRA are described above in the “generally applicable provisions” heading of this alert. Additional changes include:

- The definition of “competitor” has been limited to allocation of rights to future stock issuances and not for transfer restrictions and information rights;
- In catching up to the times, the definition of “Immediate Family Member” has been expanded to include life partner or similar statutorily-recognized domestic partner;
- The board observer right has been modified to remove the “trust and to act in a fiduciary manner” language which many felt was misplaced given that board observers do not have fiduciary duties;
- Termination provisions have been modified so that information rights do not terminate in an acquisition where private shares of stock are the deal consideration unless investors receive the same information rights;

- The obligation to hold board meetings on a specific schedule either monthly or quarterly was removed;
- The right to conduct activities section now stipulates that nothing in the IRA prohibits investors from purchasing shares from competitors; and
- Compliance covenants – such as Foreign Corrupt Practices Act, CFIUS and Real Property Holding Corporation – have been added or expanded.

Voting Agreement

The VA contains director election rights and the drag-along, which requires stockholders to vote in favor of an acquisition if certain triggering events are met.

Material changes to the VA include:

- Removal of the requirement that each stockholder vote to ensure the size of the board of directors remain at a given number of directors;
- Removal of the investor representation that none of the "bad actor" disqualifying events is applicable to such person with the right to designate or participate in the designation of a director as this is covered in other documents; and
- Expansion of the exceptions to the drag-along covenant to prohibit enforcement of the drag-along if non-service provider stockholders are required to sign a release of claims.

Indemnification Agreement

The Indemnification Agreement provides the circumstances under which a company will indemnify officers and directors for claims and expenses related to their roles as either an officer or director of the company. The Indemnification Agreement has been updated to provide for changes to General Corporate Law of the State of Delaware (**DGCL**) in 2020.

The 2020 changes:

- Define which officers are required to be indemnified by the company including (i) the President, CEO, COO, CFO, CLO, Controller, Treasurer or Chief Accounting Officer, (ii) any individual identified in public filings as one of the most highly compensated officers of the company or (iii) any individual who, by written agreement with the corporation, has consented to be identified as an officer;
- Modify how investors and venture capital funds with the right to appoint a director are indemnified under the Indemnification Agreement, although these changes generally afford the appointing stockholder the same protections as the prior version; and
- Relate to how expenses are treated under the Indemnification Agreement.

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This summary is for informational purposes only and not for the purpose of providing legal advice. Further, the above summary is not intended to be a substitute for a full reading of the NVCA Agreements and consultation with counsel. The opinions expressed in this summary are the opinions of the individual authors and may not reflect the opinions of Crowell & Moring LLP or any other attorneys at Crowell & Moring LLP.

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[1] Modifications to the Right of First Refusal and Co-Sale Agreement generally relate to CFIUS provisions and are not described in detail in this alert.

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