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Modeling the Market: The National Venture Capital Association Revises its Model Documents

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The National Venture Capital Association (**NVCA**) published on July 28, 2020 an updated suite of model venture capital financing documents that reflect the current events shaping the investment climate, and for the first time, embedded analysis of market terms directly in the NVCA's model term sheet.[1] Venture capital funds, professional investors, emerging companies and their respective advisors will benefit from the summary analysis contained in this article which highlights the most significant changes to the primary model financing documents.

The NVCA's updates are timely because venture capital investing remains strong despite the challenges of 2020. Pitchbook reports 2,893 U.S. venture capital deals with an aggregate of $45.20B of capital raised as of the second quarter of 2020, representing approximately a 17% reduction in deal count and a 2% increase in aggregate dollars raised over the same period in 2019. Economic uncertainty looms in the market, as does the specter of increased governmental interest in foreign investments in certain emerging businesses.[2]

Efforts to revise the model documents clearly predate recent media fanfare regarding forced divestitures of popular mobile applications, yet a common theme flowing throughout the revised documents centers on the recently adopted regulations implementing the Foreign Investment Risk Review Modernization Act of 2018 (**FIRRMA**), which took effect on Feb. 13, 2020. While a full discussion of FIRRMA and the expanded powers of Committee on Foreign Investment in the United States (**CFIUS**) is outside the scope of this publication, the NVCA has established a framework through which investors and founders can negotiate compliant non-controlling foreign investments in U.S. businesses involved in certain critical technologies, infrastructure, or the personal data of U.S. nationals.

The following chart outlines the most significant changes to the primary model financing documents – the Term Sheet, Certificate of Incorporation, Stock Purchase Agreement (**SPA**), Investors' Rights Agreement (**IRA**), Voting Agreement (**VA**), and Right of First Refusal Agreement (**ROFR**).

Summary of Significant Change	TPHS Takeaway
Term Sheet	

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The model term sheet now includes market insights regarding how often certain frequently negotiated deal terms are included in venture capital financing documents.	transactions, from over 17,000 unique investors. They provide increased transparency regarding Series Seed through Series D investment rounds that may ultimately frame negotiations and increase acceptance of market standards.
Market Analytics Bracketed language was added to the pre-money valuation section that establishes an “unallocated and uncommitted” employee option pool representing X% of the post-money capitalization.	The bracketed language in 35,000 “venture” stock options, which are typically included in employment offer letters that are outstanding during the period of negotiation. If the bracketed language is included, the promised stock options would not come out of the post-money employee option pool, but would further dilute founders and existing stockholders.
Amount Raised The amount raised now specifically includes the conversion of Simple Agreements for Future Equity (SAFEs)	This addition recognizes the frequency with which companies have raised capital using SAFEs, particularly in place of series seed investment rounds or convertible notes.
Closing Condition A closing condition that requires obtaining CFIUS clearance was added.	This change is consistent with the focus of other changes throughout the model legal documents, which collectively highlight the importance of being vigilant in navigating the CFIUS landscape.
Certificate of Incorporation	
Alternative Dividends An alternative dividend section was added to provide a fixed rate of return, which is non-cumulative, does not accrue, and is only payable when, as and if declared by the company’s board of directors. It is paid in addition to *pari passu*/shared dividends with holders of common stock.	This dividend formulation (or derivations of it) is commonly utilized in practice, and is a welcome addition to the form because it is consistent with giving the board discretion to issue dividends.
Stockholder protections Preferred stockholder approvals were added for adoption of, and changes to, incentive compensation plans; changes to the number of votes a director is entitled to cast; and the adoption of provisions that are inconsistent with any other provision requiring specific director consent.	The additional preferred stock protective provisions represent incremental changes that largely supplement and are consistent with the intent of existing protections for preferred stockholders, and are intended to ensure the company’s corporate governance obligations are consistent with state corporate governance laws.
Specific Director Consent Stipulates that a matter requiring specific director approval must be in the Certificate of Incorporation.	The revision reflects the holding in *Sinchareonkul v. Fahnemann*, 2015 WL 292314 (Del. Ch. Jan. 22, 2015) that Section 141(d) of the DGCL requires that a provision requiring specific director approval for certain actions must be in the Certificate of Incorporation, and such a provision in an agreement (in that case a joint venture agreement) or the bylaws is not valid

Stock Purchase Agreement	
Parties to SPA Founders are no longer suggested to be party to the SPA or to make any personal representations.	The updated SPA reflects the market's general acceptance that founders should not bear personal liability to investors after Series Seed, except where the founders are receiving liquidity from a transaction or where there are heightened due diligence concerns (e.g., ownership of intellectual property).
Multiple Closings The concept of "milestone closings" that occur in the event of certain milestones, which is most common in life science transactions, was deleted.	The revision clarifies the section regarding multiple closing contemplates successive capital raising transactions with the same terms and a "tranched" closing where investments are made over time and/or upon the occurrence of certain milestones. [The NVCA publishes a separate SPA for life sciences transactions where tranched milestone closings are common.][3]
Definition of Knowledge The definition of "Knowledge," was expanded to include knowledge individuals would have if they reasonably perform their job. The definition of "to the Company's knowledge" was expanded to include actual knowledge as determined under US patent law.	The expansion of the defined term "Knowledge" is protective of investors, as it reasonably clarifies that a person's actual knowledge after reasonable investigation assumes he or she has all requisite knowledge expected of someone in his or her role with the company. The reference to actual knowledge of a patent right does not expand the phrase of "to the Company's knowledge", but rather makes clear the definition is not intended to exclude the knowledge threshold established under patent law.
Intellectual Property Representation The representation regarding the company's use of open source software was narrowed to only require disclosure if the use of open source software would: • require any company intellectual property be disclosed or distributed in source code form or be licensed for the purpose of making derivative works; • require any restriction on the consideration to be charged for the distribution of any company intellectual property; • create any obligation for the company with respect to the company intellectual property, or grant to any third party any rights or immunities under any	Although the representation is narrower than the prior iteration, it is consistent with the evolution of recent market standards and focuses on eliminating burdensome disclosure rather than shifting risk to the investors. Instead, the language is more precisely tailored to require disclosure of uses of open source software that could reasonably concern investors or could cause an investor to initiate a breach claim under the prior iteration of this representation.

company intellectual property; or

• limit, restrict or condition the company with respect to its use or distribution of any company intellectual property.	
Data Privacy The data privacy representation was revised to make clear it covers all personal information and personal data (not just "personally identifiable information") and to require disclosure of any noncompliance with law, including laws regarding unfair and deceptive marketing and communications with consumers. A representation was added that the company has not experienced any unauthorized use or access of personal information requiring disclosure to a government authority or affected persons, or unauthorized access of the company's confidential information and trade secrets.	The data privacy representation revisions regarding non-compliance with law do not expand the disclosure obligations of the company, but rather clarify what the representation should include. For instance, the prior iteration required disclosure of non-compliant uses of personal information, which would have included uses that did not comply with state and federal prohibitions on unfair and deceptive trade practices, and the new language explicitly covers this type of situation. The revisions also address new considerations and risks stemming from privacy laws, such as the General Data Protection Regulation and the California Consumer Privacy Act. This language will shed light on the reliability of the company's data protection and monitoring programs, which is, and should be, an ever-increasing focus of investors.
CFIUS A new representation was added that the company's activities and ownership do not trigger CFIUS filing requirements.	This representation is intended to address whether CFIUS' mandatory filing regimes apply to the transaction, although CFIUS may nonetheless intervene if the transaction will result in a foreign party holding greater than a 9.9% ownership interest of the company. If the company cannot make the full representation, it should consider whether any of the representations are accurate, which by themselves may reduce the filing obligations. From a practical perspective, if the company cannot make the full representation, careful consideration should be given to how CFIUS' review may impact the transaction timeline and overall deal cost, and prompt additional diligence to understand the operational constraints under the Defense Production Act.

Consent to Electronic Notice The company and investors consent to receive electronic notices in connection with the SPA, provided that such consent is automatically revoked if the e-mail address provided by an investor is undeliverable.	This provision is not technically required, as electronic notice is the default standard under the Delaware General Corporation Law as of August 2019. However, it provides investors protection by automatically revoking the efficacy of notice provided to an incorrect or undeliverable address, while also protecting the company by causing purchasers to covenant to notify the company of any change in his or her email address.
Investors' Rights Agreement (IRA)	
CFIUS and Foreign Investor Updates The company newly covenants to ensure foreign investors will not obtain certain rights or greater than a 9.9% ownership interest in the company if it operates in certain industries; and that investors newly covenant to notify the company before such investor or its affiliates obtain certain rights or voting interests which could implicate national security (i.e., in regard to the Defense Production Act).	The potential impact of these revisions, which relate to CFIUS' authority with respect to a transaction, remains to be seen. In practical terms, sophisticated foreign persons may negotiate around the triggering threshold in spite of the balancing test of control rights. Alternatively, even if a foreign person is implicated, a national security issue may not be present.
Qualified Small Business Stock (QSBS) The company is now required to deliver to investors a certificate that its stock constitutes QSBS before a liquidity event. In exchange, investors agree the company will not be liable if the company's determination that its stock qualifies as QSBS is incorrect, unless such determination was rendered in a grossly negligent or fraudulent manner.	These updates are intended to simplify the QSBS provision, which previously allowed the company to elect to either provide a similar certificate to investors or to provide investors the necessary information for determining the applicability of QSBS to the company's stock (even though the nature of such information was not specified). Now, the company is obligated to deliver the certificate, but is not exposed to significant liability absent gross negligence or fraud.
Board Observers Board observers no longer have fiduciary obligations to the company.	This modification is intended to reflect the reality that board observers do not have the right to participate in board decisions. This modification places the burden to monitor information flows on the board of directors, and reduces the imposition on board observers, particularly those who sit on multiple boards.
Real Property Holding Company The company newly covenants to provide upon request a statement indicating whether an investor's ownership interest constitutes a "real property interest" under the U.S. tax code.	This change flows from recent revisions to the tax code, which require a venture capital fund to report to a transferring limited partner the extent to which a transfer of interest would generate U.S. tax obligations.
Definition Of "Immediate Family Member" The definition of "Immediate Family Member" has been updated to include life partner or similar statutorily recognized domestic partner.	This change reflects the increasing recognition of the diversity of domestic partnership types.
Termination of Information and Observer Rights Provides that the termination of certain rights in a Deemed Liquidation Event is conditioned upon the	This revision is intended to protect investors and provide them with compensation upon the occurrence of certain events.

investors receiving cash or publicly traded securities (a true liquidity event) or if comparable rights are provided by the acquiring or successor entity.	
Waiver of Statutory Information Rights This section provides that the investor has waived any rights such he might otherwise have had under Section 220 of the Delaware General Corporation Law to inspect for any proper purpose and to make copies and extracts from the company's stock ledger, a list of its stockholders and its other books and records or the books and records of any subsidiary.	A Delaware court may still hold this provision enforceable, given the trend to enforce private agreements between sophisticated investors.
Voting Rights Agreement (VA)	
Size of Board References to the size of the board of directors were deleted.	This revision reflects the reality that the size of the board is most often fixed in a company's bylaws rather than contractually agreed upon by investors.
"Bad actor" disqualifications The investor representation that none of the "bad actor" disqualifying events are applicable to the individual with the right to designate or participate in the designation of a director were deleted.	This revision focuses on determining if investors are bad actors to prevent the issuer from being precluded from relying on Rule 506 for future offerings or future sales in the same offering if the applicable investor is or becomes a 20 percent beneficial owner of the issuer's voting securities.
Right of First Refusal	
CFIUS The updated ROFR requires disclosure of foreign investors in the company and places limits on the percent of ownership interests they can obtain.	As echoed in the IRA, the potential outcome of these CFIUS revisions remains to be seen, as sophisticated foreign persons may negotiate around the triggering threshold, in spite of the balancing test of control rights, or even if a foreign person is implicated, a national security issue may not be present.
Lock-up A new exemption was added to the lock-up provision that permits the establishment of "10b5-1 plans."	This exemption for the establishment of a 10b5-1 plan is equitable as it is consistent with the intent of the lock-up – to reduce the likelihood of a stock price being depressed by large sales form company insiders – while providing such sellers with access to pre-planned liquidity.

In addition to the primary financing documents discussed above, the NVCA also updated its model Management Rights Letter, Indemnification Agreement, and Limited Partnership Agreement and a few other ancillary documents. For more information regarding the NVCA's model legal documents and the impact of the recent revisions, please contact: Matthew Greenberg, James Jumper, or Christopher Miller.

[1] In August and September 2020, the NVCA made additional minor editorial revisions to the model Term Sheet, Certificate of Incorporation, Stock Purchase Agreement, Investors' Rights Agreement, and Right of First Refusal Agreement.

[2] PITCHBOOK DATA; Retrieved from Pitchbook database, August 19, 2020 (Criteria: All VC deal types for US and Globally (including the US) from January 2019-2020 YTD).

[3] Note to Draft: The NVCA indicates a model Stock Purchase Agreement for life science transactions with tranched closings is available.

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