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Structuring Venture Capital Financing: Amended NVCA Model Agreements

Special Issues Faced by Certain Industries, Strategic Investors, and Foreign Investors

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Trends in Early Stage Financing

- Median amounts raised continue to rise until the 3rd quarter
  - 1st Quarter 2022 - $2.7 Million
  - 2nd Quarter 2022 - $4.5 million
  - 3rd Quarter 2022 - $2.8 million
- Average amounts raised through the sale of SAFE's has increased
- Median amounts raised in "pre-seed" round of Convertible Notes has declined
  - 1st Quarter 2022 - $2.75 million
  - 2nd Quarter 2022 - $1.51 million
  - 3rd Quarter 2022 - $2.8 million
- Median amounts raised "post-seed round" declined from
  - 1st Quarter 2022 - $4.0 million
  - 2nd Quarter 2022 - $1.5 million
- Early stage 3rd quarter numbers are declining for the 3rd straight quarter to $13.5 billion but still above 2020 levels
- Convertible note and SAFE rounds are becoming a "phase" and not an "event"
- Median pre-money valuation reached $10.5 million in 3rd quarter 2022

Venture Capital Deal Structures

Convertible Note Financing

- Definition – A debt instrument that converts into equity upon the occurrence of certain events.
- Key Issues
  - Amount
  - Interest – 3%-8%
  - Maturity – 12-18 months
  - Discount – 10%-20%
  - Valuation Cap
  - Change of Control Premium Prior to Maturity
  - “Qualified Financing” – How much is required to Trigger Automatic Conversion?
  - “Most Favored Nation” provisions so all current investors get terms at least as good as new investors

Venture Capital Deal Structures

SAFE

- Definition – Simple Agreement for Future Equity
  - Equivalent to a Pre-Paid Option/Warrant
  - Variable Pre-Paid Forward Contract
- Similarities to Convertible Note
  - Conversion into Equity
  - Valuation Cap
  - Discount
  - Change of Control Before Qualified Financing

Venture Capital Deal Structures

- Differences from Convertible Note
  - No Interest
  - No Maturity Date
  - The SAFE documentation is simpler but no longer simple
- Key Issues with SAFE's
  - Conversion – pre-money vs. post money valuation (count all SAFE money for purposes of conversion)
  - Inclusion/Exclusion of option pool increase in SAFE conversion calculation
  - Pro Rata Rights -pre-emptive right equivalent
  - Representations and warranties – the standard Y-combinator SAFE includes few representations
  - Most Favored Nation ("MFN")
  - Amendment of SAFE's – require holder or majority of SAFE holders

Venture Capital Deal Structures

- Dangers of Convertible Notes and SAFE’s –
  - Multiple rounds of Convertible note or SAFE financings with valuation caps
  - Do It Yourself Approach
  - Surprise Dilution
  - Liquidation preference can become windfall if capped conversion valuation (can create Preferred Stock subseries with liquidation preference equal to investment amount)

Venture Capital Deal Structures

Convertible Equity

- Series Seed Financing – a streamlined series of convertible preferred stock with no dividend rights, anti-dilution protection, registration rights and limited protective provisions.
  - Less documentation
  - Less complexity
  - Gives the seed investors a liquidation preference and pre-emptive rights
- Convertible Preferred Stock –
  - Typical preferred stock that converts into shares of common stock
  - Series A Preferred funding rounds typically range from $2 million to $20 million with the average round size $15 million with an average pre-money valuation of $23 million
- Participating Preferred Stock – not current "market" but can significantly increase pre-money valuation

Creating A Venture Capital Term Sheet

Term Sheet

Key document setting forth summary of terms (if execution desired, cover letter of intent often included)

- Nonbinding
- Three categories of terms
  - Economics of the Deal
  - Decision Making/Control rights
  - Reasonable market investor protections
- No-shop period and investor expense reimbursement often requested
- If foreign investor, obtaining CFIUS clearance or qualifying for exemption

Creating A Venture Capital Term Sheet

Terms that Impact Economics of the Deal

- Type of Securities
- Amount of Investment
- Pre-Money Valuation (includes or excludes prior SAFEs or Convertible Notes)
- Price per share (pre-money valuation divided by fully diluted pre-money shares outstanding)
- Pro Forma Capitalization
- Dividends – cumulative vs. non-cumulative, payable only if declared or also upon conversion or liquidation
- Rights Upon Liquidation – Participating (with our without cap) vs. Convertible securities
- Redemption rights – at cost (with our without accrued dividends) vs. fair market value
- Employee Equity/Stock Option Pool – part of or after pre-money valuation

Creating A Venture Capital Term Sheet

Terms that Impact Decision Making/Control Rights

- Stock Voting Rights -one share, one vote on fully converted basis or something else
- Investor Protection/Veto Rights
- Board Representation
- Matters requiring approval of at least one Investor Director
- Any Non-compete or non-solicitation agreements

Creating A Venture Capital Term Sheet

Reasonable Market Investor Protections

- Representations and Warranties in Stock Purchase Agreement
- Anti-dilution protection – full ratchet or weighted average (based on shares outstanding or fully diluted)
- Mandatory Conversion upon IPO or requisite stockholder consent
- Registration Rights
- Preemptive Rights
- Information Rights
- Vesting of Founder securities
- ROFR on sale of securities by Founders
- Tag-Along/Drag Along Rights
- Covenants such as to maintain D&O insurance, Key Man insurance and not to engage in certain conduct
- Closing Conditions

Issues To Consider In Documenting A Venture Capital Financing

Documentation of Venture Financing Terms

- Certificate of incorporation (Charter)
- Stock purchase agreement (SPA)
- Investors' rights agreement (IRA)
- Voting agreement (VA)
- Right of first refusal and co-sale agreement (ROFR)
- Management rights letter (MRL)
- Director Indemnification agreement

NVCA Issues to Consider in Documenting A Venture Capital Financing – Form Investment Documents

- NVCA model forms created in the early 2000’s.
- Forms are maintained by a group of law firm attorneys and venture fund GC’s that generally meet yearly.
- The documents are drafted under Delaware law and the group always includes at least one Delaware counsel. Many of the revisions result from changes in Delaware law or key Delaware court decisions.
- Updates have been rolled out at irregular intervals.
- Goal was to create a common starting point. Many law firms have introduced changes in their form documents, but comparison to the baseline documents quickly highlights the changes
- The goal was to create balanced forms and present the most common variation(s) seen in the market.
- Reflects data gathered from more than 35,000 venture capital transactions

Issues to Consider Documenting a Venture Capital Financing – Certificate of Incorporation

- Recent material changes to model NVCA forms
  - Optional dividend clause that provides a non-cumulative and non-accruing dividend, payable when/if declared by the Board. It is paid in addition to pari passu dividends received with holders of Common Stock.
  - Additional protective provisions –
    - adoption of, and changes to, incentive compensation plans
    - changes to the number of votes a director is entitled to cast; and
    - adoption of provisions that are inconsistent with any other provision requiring specific director consent.
  - Any matter requiring approval by a specific director must be in the Certificate of Incorporation
- Other significant considerations

Issues to Consider Documenting a Venture Capital Financing – Stock Purchase Agreement

- Recent material changes to model NVCA forms
  - Deletion of option for founders as a party
  - Deletion of milestone closings was deleted.
    - Most common in life sciences
    - NVCA indicates that a life sciences SPA is forthcoming
  - Modifications to the definition of “knowledge” and “company’s knowledge” in the representations
  - Narrowed representation on open source
  - Expanded data privacy and data breach representations
  - Added CFIUS representation
  - Consent to electronic notice
- Other significicate considerations

Issues to Consider Documenting a Venture Capital Financing – Investor Rights Agreement

- Recent material changes to NVCA forms
  - Addition of CFIUS-related covenants
  - Qualified Small Business Stock (QSBS)
    - Company is now required to deliver to investors a certificate that its stock constitutes QSBS before a liquidity event.
  - Board Observers do not have fiduciary obligations to the company
  - Definition Of “Immediate Family Member”- updated to include life partner or similar statutorily recognized domestic partner.
  - Conditions on termination of information and observer rights
  - Waiver of statutory information rights
- Other significant considerations

Issues to Consider Documenting a Venture Capital Financing – Voting Agreement/RoFR Agreement

- Recent material changes to NVCA forms
  - Deletion of references to size of Board
    - Generally addressed in the Bylaws
  - Deletion of “bad actor” disqualifications
  - Required foreign investor disclosure as part of RoFR
  - A new exemption to the lock-up requirement for 10b5-1 plans
- Other significant changes

2021 Aumni Deal Term Survey

Deal Term	Frequency Across Series
Non-Cumulative Dividends	92.8-96.2%
1x Liquidation Preference	95.8%-99.1%
Participating Preferred	2.3%-13.1%
Broad-Based Anti-Dilution	87.8%-99.1%
Play-to-Play Provisions	0.2%-5.9%
Redemption Rights	4.5%-17.6%
Registration Rights	65.1%-99.4%
Pro-Rata Rights for All Investors in the Round	9.3%-17.9%
Right of First Refusal	74.5%-95.9%
Drag Along Rights	89%-92.2%

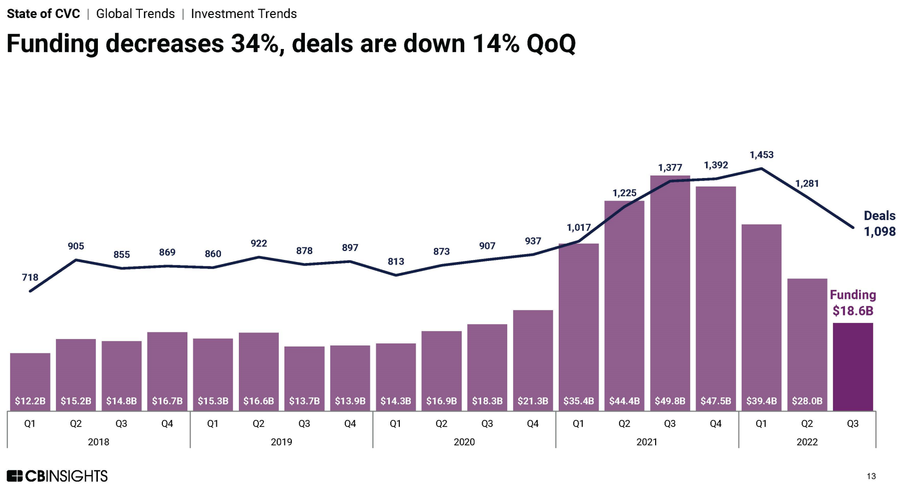
2021 Aumni Deal Term Survey

- Main Takeaways
  - Deal terms have largely converged around a single set (85%+) of generally company friendly terms
  - Deal terms do not vary significantly by funding round

Special Issues When Dealing With Strategic Investors/Corporate Venture Capital

- Unique Profile of CVCs as Venture Investors
  - Strategic Concerns
  - Competitive Concerns
  - Funding Uncertainties
  - Not Uniform
    - Depends on how the CVC is structured and funded

- After a roaring 2021, activity has cooled down



Venture Funds vs. Strategic Investors/CVCs

- Venture funds generally have a narrow focus – maximize returns to LPs
- Strategic Investors/CVCs – financial return may be one of a number of goals. Others may include:
  - Identifying and gaining an inside track on potential acquisitions
  - Creating tighter partnerships with promising suppliers and customers
  - Provide business units with intelligence on cutting edge developments
- Strategic Investors/CVCs may be future competitors

Venture Funds vs. Strategic Investors/CVCs

- Strategic Investors/CVCs have a wide variety of structures
  - One-offs
  - Venture units that invest off balance sheet
  - Independent venture units with separate legal entities
  - Some companies outsource investment activities
- Financing for Strategic Investors/CVCs may be a yearly allocation, a dedicated fund or require deal-by-deal corporate approval

Unique Deal Terms For CVCs
Active v. Passive Role

- **Board Seat**
  - Potential for conflict of interest due to director's fiduciary obligations
  - Corporate opportunity doctrine
  - Limited impact of a single seat
- **Observation rights**
  - Will usually be subject to Board right to recuse observer due to competitive concerns or need to preserve the attorney-privilege
- **Information rights only**
  - ensure that that the rights include information required by the CVC's financial reporting and in the time-frame required by the CVC
  - Rights usually limited to Major Investors (defined by a minimum holding)
  - Management Rights Letter – a backdoor way to ensure theses rights in perpetuity
- **Confidentiality obligations**
  - Inherent to Board seat, usually covered in the investor rights agreement for shareholders
  - Potential limitations on the ability to share within the CVC
  - Potential limitations on the identity of the director/observer

Unique Deal Terms For CVCs
Acquisitions – Strategic Rights

- **Notice of sale by venture**
- **Right of first offer/negotiation**
- **Right of first refusal (ROFR)**
  - Global
  - Acquisition by competitor
- **Full option to acquire**
  - When does the option kick in?
  - How is value determined?
- **Additional concerns**
  - Access to relevant data
  - Timeframes for exercise of rights

Unique Deal Terms For CVCs
Other Investment Terms

- **Protective Provisions**
  - **Implemented at the Board or Shareholder Level**
  - **Potential provisions**
    - Sale of the company
    - Investment by competitors
    - Entering into agreements with competitors
- **Publicity Rights**
  - Coordination with corporate's PR and investor relations teams
- **Pro Rata Rights**
  - Often limited to "Major Investors", CVC's may want an "exemption"

Special Issues To Consider For Foreign Investors (CFIUS)

- In 2018 the CFIUS statute and regulations were changed to introduce for the first time a mandatory filing obligation for certain non-controlling venture capital investments by foreign persons in certain “TID” businesses. Before that CFIUS was largely a voluntary system that only applied where a foreign person acquired “control” (defined broadly) over a US business.
- The penalty for failing to file could be up to the value of the transaction. To date, no such penalties have been imposed, but CFIUS has new enforcement authority so it may just be a matter of time. Recently CFIUS announced a policy on fines and penalties, suggesting more penalties will be imposed in the future.
- It is important to engage a CFIUS specialist early on in the investment process because of the need for specialized due diligence and the negotiation of specialized CFIUS clauses.
- The NVCA has published updated CFIUS clauses that are often the reference for negotiations and are often uses to make sure a transaction is not a “covered transaction” for CFIUS purposes and no CFIUS filing is required.

Special Issues To Consider For Foreign Investors (CFIUS)

- CFIUS has more resources to review transactions that were not subject to the mandatory filing requirements but were covered investment transactions for CFIUS purposes. In some cases, CFIUS is going back years and in certain cases involving Chinese acquisitions of companies with sensitive personal data is requiring divestiture.
- The Office of Investment Security Monitoring & Enforcement (Monitoring & Enforcement) protects the integrity of the United States' open investment policy by leading CFIUS activities and efforts to: monitor foreign investments in the United States that are not voluntarily submitted to CFIUS for review ("non-notified" transactions); enforce CFIUS's mandatory declarations regulations ("non-declared" transactions); oversee compliance with CFIUS mitigation agreements, conditions, and orders; and, administer and enforce civil monetary penalties for violations of applicable CFIUS regulations and mitigation agreements, conditions, or orders.

Special Issues To Consider For Foreign Investors (CFIUS)

- Non-Notified Transactions: CFIUS utilized various methods to identify non-notified/non-declared transactions in 2020 including interagency referrals, tips from the public, media reports, commercial databases, and congressional notifications. Potential methods for improving the identification of non-notified/non-declared transactions include increased training and attention of staff across CFIUS member agencies to help increase coordination and effective identification of transactions of interest to pursue, particularly for those personnel involved in the non-notified work. Separately, increasing public awareness of the CFIUS tip mailbox hosted by the Department of the Treasury could further improve identification of non-notified transactions. There were 135 transactions identified through the non-notified/non-declared process in 2021 that were put forward to the Committee for consideration. From the transactions identified, 8 resulted in a request for filing. This is an increase from 2020 (117) in the number of transactions reviewed but a decrease (13) in the number for which a filing was requested.

Special Issues To Consider For Foreign Investors (CFIUS)

- Members of the public may contact Monitoring & Enforcement with any tips, referrals, or other relevant information at CFIUS.tips@treasury.gov; in particular:
  - identification of a contemplated or completed foreign investment in, or an acquisition of, a U.S. business or real estate that may be within CFIUS's purview;
  - incidents that may imperil or constitute an apparent violation of an existing CFIUS mitigation agreement or order; or
  - other issues requiring the attention of Monitoring & Enforcement relating to foreign investment and national security.

Special Issues To Consider For Foreign Investors (CFIUS)

- It is important to conduct specialized due diligence to determine if the investor is a foreign person for CFIUS purposes.
- There are different mandatory filings rules for foreign persons with a substantial foreign government interest (49% percent government ownership of 25% interest).
- There are exceptions available for certain private investment funds managed by US managers.
- There are exceptions available for certain Excepted States (Australia, Canada, New Zealand and UK) and certain Excepted Investors of those Excepted State but these rules are very technical and need to be carefully examined by a CFIUS specialist.

Special Issues To Consider For Foreign Investors (CFIUS)

- It is also important to conduct specialized due diligence to determine if the Company is a so-called Critical Technology, Critical Infrastructure or Sensitive Personal Data Business ("TID Business")
- If there is no substantial interest of a foreign government, then the mandatory CFIUS rules are only applicable if the Company has "critical technology."
- Even if the Company has "critical technology" there are workarounds involving not allowing the foreign person to have a board or observer or access to material non-public technical information or other forms of control over the US business. The NVCA has language for this purpose in the model IRA.
- The determination of whether the mandatory rules apply turns on whether an export license would be required for the foreign person's country. This now requires a detailed export control analysis.
- Even if no mandatory CFIUS filing is required, it is critical to assess the risk that CFIUS will review the transaction post closing. While CFIUS cannot unwind the transaction, it can require a divestiture by foreign persons, which it has only done in a small percentage of cases. CFIUS can also impose lesser mitigation measure to address any national security issues, such as restricting access by foreign persons or imposing a US voting trust, proxy or special security agreement.

Special Issues To Consider For ESG/Impact Investors

- While there are a growing number of impact venture capital firms that focus on ESG/impact issues (see membership of Impact Capital Managers, a trade association of impact venture capital firms), we are beginning to see more concern over ESG issues from traditional venture capital firms, as well as certain private equity firms.
- ESG due diligence is becoming more commonplace, importing some of the due diligence concepts and checklists from Europe that has traditionally had a greater focus on ESG issues. This is because of reputational concerns over investing in or acquiring a company with a bad ESG track record.
- ESG/impact investors often require reporting on ESG issues using key third-party or proprietary key performance indicators (KPIs). In some cases, third-party validation is required.
- Only a minority of impact investors are “baking” ESG/impact into their documentation, which still tends to be standard documentation based on the NVCA forms. Examples include redemption rights if KPIs are not being met or there is fundamental mission drift from the ESG thesis underlying the investment decision.

Menu of ESG Due Diligence Areas

E is for "Environment"	S is for "Social"	G is for "Governance"
• Greenhouse gas emissions • Climate change • Energy use • Water use • Pollution • Hazardous waste • Recycling • Sustainability	• Corporate giving and philanthropy • Working conditions • Workplace health and safety • Compensation and benefits • Internal pay equity • Employee opportunity • Labor and human rights • Child and forced labor • Diversity and inclusion • Supplier practices	• Board structure and composition (including tenure and diversity) • Executive compensation • Shareholder rights • Enterprise risk management • Audit oversight • Disclosure and reporting • Ethics and compliance • Privacy and cybersecurity

Integrating ESG into the investment process

CDC 70 Investment works 1948-2018

	SCREENING	DUE DILIGENCE	INVESTMENT DECISION	INVESTMENT AGREEMENT	OWNERSHIP AND MONITORING	EXIT
OBJECTIVES	• Confirm compliance with the fund's policy and exclusion list. • Identify key ESG issues early. • Plan DD process and allocate resources. • Build common understanding with the company.	• Assess the ESG risks and opportunities to allow the fund's IC to make an informed decision considering: (1) ESG factors; and (2) the company's and fund manager's capacity to address risks and capitalise on opportunities.	• Enable the fund's IC to make an informed investment decision that takes ESG factors into account.	• Secure and formalise commitments from the company to meet applicable ESG requirements including ESG Action Plans. • Protect the fund from reputational, financial and/or legal damage.	• Guide/assist the company to ensure its ongoing compliance with applicable standards, implementation of the ESG Action Plan and improvement of ESG performance. • Stay informed and respond to new developments and/or risks.	• Link evidence-improved ESG performance to company's value. • Engage with buyers on ESG and prepare reference materials. • Ensure company's ESG management system is self-sustaining.
ACTIVITIES	• Ensure compliance with fund's policy and exclusion list. • Identify key ESG risks and opportunities. • Build a common understanding with the company. • Categorise E&S. • Plan DD.	• Define scope of DD. • Perform desk review. • Assess company's CCTR. • Conduct site visits. • Engage ESG experts (if appropriate). • Agree ESG Action Plans. • Ensure influence and oversight. • Prepare DD report. • Provide input for the IC.	• Make an investment decision taking into account ESG factors.	• Negotiate ESG terms with the company. • Incorporate ESG terms in the shareholders agreement (or equivalent document).	• Build on the relationship established during DD. • Regularly monitor: oversee and support the company on ESG matters. • Manage unplanned events. • Prepare for exit.	• Plan the exit. • Prepare relevant ESG documentation for potential bidders.
OUTPUTS	• Identification of 'no-go' and key ESG issues. • Initial E&S categorisation. • ESG section in the screening memorandum for the IC.	• Final E&S categorisation. • Due diligence report. • ESG Action Plan(s). • Summary of finding for the IC. • DD reports, ESAP and supporting material saved.	• IC decisions minuted. • Conclude satisfactory completion of conditions precedent. • Update the IC in case of material changes post-IC.	• Shareholder's agreement or equivalent that includes appropriate ESG clauses and clearly outlines how ESG matters will be handled during the life of the investment.	• Appropriate influence and oversight. • Record monitoring engagements. • Annual ESG reporting and reporting to investors. • Non-routine event communications.	• Financial model taking into account ESG aspects. • Information memorandum including information on the company's ESG performance and improvements over past years.

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Abbreviations: CCTR, commitment, capacity and track record; DD, due diligence; ESG, environmental, social and governance; E&S, environmental and social; IC, Investment Committee.

Thank You

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