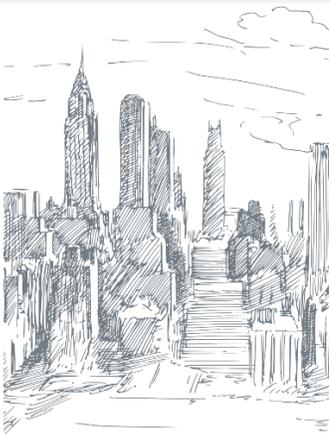


## Documentation of a Venture Capital Preferred Financing: The National Venture Capital Association Templates

Michael Sussman, May 2016

The working group of the National Venture Capital Association (the “NVCA”) has done a service by drafting and publishing on the NVCA website ([www.nvca.com](http://www.nvca.com)) as a “Resource” under “Model Legal Documents” many of the documents used for a venture capital corporation (the “VC Corporation”) to enter into an initial or a follow-on preferred stock financing. As noted, this provides a base set of templates that avoid the need in many cases to reinvent the wheel, and that are fair to both the VC Corporation and its preferred first stage lenders (the “Lenders”).

Of course, care needs to be taken to note that these documents are a starting point, and will need to be tailored to the specific situation, both as a legal and as a practical matter. But they indeed are a good starting point and can save considerable drafting time and cost.



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### DELAWARE CORPORATIONS

The NVCA templates assume that the entity established by venture capitalist firms is a Delaware corporation, even if its primary office is not located in Delaware. While the majority of venture capital firms are in fact Delaware corporations, not all are, and a preliminary determination to go this route is necessary.<sup>1</sup>

Among the advantages of the corporate form, as opposed to a limited liability company (“LLC”), partnership or some other form, is that shareholders are normally insulated from liability beyond the shareholder’s agreed contribution.<sup>2</sup> But a corporation may be taxed on its income, and shareholders may be taxed on their dividends, leading to the famous “double taxation” problem.<sup>3</sup> Venture capitalists, however, often do not issue dividends, and although preferred stock distributions may be taxed as income, most lenders prefer to deal with a corporation.

Another possibility, especially for venture capital firms that do not have much of a ramp-up period and are likely to issue dividends from the outset, is an LLC. Members of such a company that are not involved in the day-to-day management of the firm are usually insulated from liability beyond the agreed contribution, but for tax purposes the LLC can be a pass-through. Therefore the members are usually taxed, but the LLC is not (although a filing is required).<sup>4</sup>

<sup>1</sup> If the firm will not be a Delaware corporation, the NVCA templates may still be a starting point, but of course will require revision based on the choice of entity and jurisdiction.

<sup>2</sup> This limitation, in certain circumstances, such as a known impending bankruptcy that is ignored, may be “pierced”, but this article does not cover those circumstances.

<sup>3</sup> The tax consequences of the form of organization, except in these general terms, are beyond the scope of this article.

<sup>4</sup> Partnerships are also possible, but are almost never used for these purposes and are not discussed herein.

Delaware is chosen because it has a well-developed and flexible body of law and a good court system.<sup>5</sup> Nevertheless, California, which is one of the few jurisdictions that hosts many venture capital firms (New York and Massachusetts being others), has a corporate law that applies certain rules to out of state firms that are located in California.<sup>6</sup> The NVCA template Certificate of Incorporation indicates in the comments some of these rules.

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## NVCA DOCUMENTS

The NVCA has published the following templates, and this article will briefly discuss them:

- the Term Sheet;
- the Stock Purchase Agreement;
- the Certificate of Incorporation (the "Certificate");
- the Indemnification Agreement;
- the Investor Rights Agreement;
- the Management Right Letter;
- the Right of First Refusal and Co-Sale Agreement (the "Right of First Refusal Agreement");
- the Voting Agreement; and
- the Model Legal Opinion.<sup>7</sup>

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## TERM SHEET

Perhaps the first document to be negotiated with the Lender is the Term Sheet for the deal. It sets forth the agreements between the VC Corporation and the Lenders.

The Term Sheet is usually non-binding, with the exception of the no-shop and confidentiality clause. The no shop and confidentiality clause are normally binding to give the Lenders time to do due diligence and negotiate definitive documents.<sup>8</sup> The rest of the Term Sheet is subject to this due diligence and execution of definitive documents, as well as any conditions precedent to closing contained therein.

The Term Sheet will normally set forth in (detailed) summary the agreements on what will go into the charter regarding the preferred stock, represented by the Certificate and any Indemnification Agreement, the Stock Purchase Agreement, the Investor Rights Agreement (which often requires delivery to the Lenders of a Management Rights Letter), the Right of First Refusal and Co-Sale Agreement, the Voting Agreement and any other documents to be executed or delivered at closing, such as the Legal Opinion.

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<sup>5</sup> The author is not a Delaware lawyer.

<sup>6</sup> The author is not a California lawyer.

<sup>7</sup> The certificate and agreements to which reference is made herein may be "amended and restated" if they amend prior certificates or agreements, generally when they are drafted and executed in respect of follow-on issuances of preferred stock such as Series B and above.

<sup>8</sup> A choice of law should be made in the Term Sheet because in some jurisdictions a court may require good faith negotiations even in cases where the Term Sheet is expressed to be non-binding, and the choice of law may be important in such cases. See Term Sheet, footnote 1.

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## STOCK PURCHASE AGREEMENT

The Stock Purchase Agreement, although relatively lengthy because of the need to be clear about various issues, is actually a simple document. As the notes to this template state, the main things covered are the number of shares being sold, the price and the representations and warranties made by the VC Corporation, and its founders in some cases, to the buyers of the stock. The characteristics of the stock and other matters are usually set forth in other documents.

The representations and warranties that are sought and given, together with the disclosure schedule, are often a reflection of the diligence that is permitted and done, and often the greater the diligence the less stringent are the representations and warranties. But the representations and warranties often act as means of allocating the risk that they are not true, and the issue to be negotiated is what happens if they are breached. If that breach occurs or is discovered prior to closing, then there is no obligation of the investors to close.

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## CERTIFICATE OF INCORPORATION AND INDEMNIFICATION AGREEMENT

By the time of the preferred financing contemplated by these agreements, a venture capital firm has often been established, and often in addition to the capital contributed by the founders, it has raised “friends and family” financing. A preferred lender is likely to require that the corporate documents be amended to contemplate such financing. Hence the template Certificate is “Amended and Restated”. The amendment of the Certificate would normally need to be approved by the shareholders, and the amendments are usually negotiated with the lender.

The template leaves out a “no impairment” clause, a general provision that seeks to ensure that the certificate cannot be circumvented, that can be misused by minority investors. Moreover, the template does not include a “blank check” provision, allowing the Board of Directors to issue other preferred at will within the shareholder approved limits.

The template does include a typical “pay to play” provision that penalizes preferred holders that do not participate in future fundraisings.

Cumulative voting for directors must be considered. In Delaware, it is possible to prohibit cumulative voting, but under California law, according to the notes to the template, the shareholder gets to decide. This California law may apply to foreign corporations, even if the non-California (e.g., Delaware) corporation prohibits cumulation by the shareholder. Certain other California rules may apply to non-California corporations located in California.<sup>9</sup>

Officers and directors of the VC Corporation, and in some cases the VC Corporation, the fund, investors and/or employees or agents may be indemnified against third-party claims, and in such cases may have an indemnification agreement. This indemnification probably does not cover ant-fraud under the securities laws, and certain criminal and quasi-criminal acts.

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<sup>9</sup> See notes to template.

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## INVESTOR RIGHTS AGREEMENT AND MANAGER RIGHTS LETTER

The Investor Rights Agreement provides for rights of the investor that are not set forth in the terms of the preferred stock or elsewhere. These might include the right of the investor to receive certain information and to observe Board meetings, the right to require registration of common stock and convertible preferred stock with the SEC, the right to match an offer received for stock of the VC Corporation, the right to make other shareholders participate in any sale of the securities and the right and other obligations of the VC Corporation that benefit the investor, such as holding certain kinds of insurance, having certain employee restriction agreements, providing certain vesting arrangements for stock option plans and certain director approval requirements.

A Management Rights Letter provides evidentiary support to the claim that a fund invested in a VC Corporation managed under the agreement (and therefore a “venture capital investment”) is exempted from the Employee Retirement Security Act of 1974 requirements. The letter sets forth certain Board or observer and comment rights, as well as information rights, for investors.

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## RIGHT OF FIRST REFUSAL AND CO-SALE AGREEMENT

The right of first refusal grants the VC Corporation a right to buy common or preferred stock first if a “Key Holder”, or perhaps any investor, purports to transfer the stock. If the right of first refusal is not exercised, the right of co-sale allows an investor to sell stock alongside the transferring holders. There are many iterations of these agreements, and the applicable procedures and rules, of course, but the agreement is a good starting point and includes a number of alternatives.

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## VOTING AGREEMENT

Investors will have an interest in ensuring that the VC Corporation’s shareholders agree on the way that the VC Corporation will be run at a shareholder level, and to keep the VC Corporation from changing control without their authorization. Hence, the Voting Agreement.

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## MODEL LEGAL OPINION

Each law firm may have its own model legal opinion, but this template shows a basic set of opinions about the VC Corporation and its stock.

## FOR MORE INFORMATION

For further insights or to engage us for advice, please feel free to contact us.

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