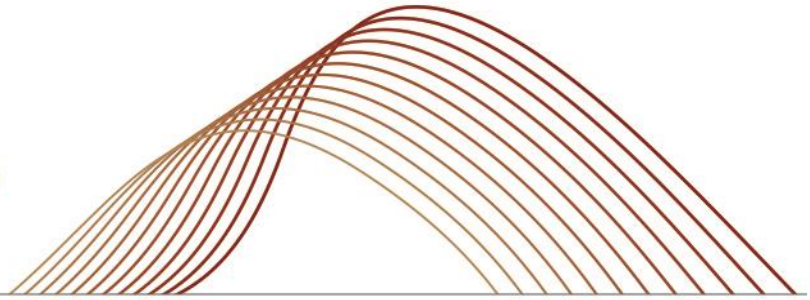
PAUL HASTINGS

STAY CURRENT



May 2018

Follow **@Paul_Hastings**

Smarter, Faster, Stronger: A New Suite of VC Model Docs

By Samuel A. Waxman, Jordan L. Goldman & Tyler Thiret

In March 2018, for the first time in four years, the National Venture Capital Association updated its model legal documents, which have become the standard in the venture capital industry. Many changes are utilitarian, such as the addition of several customized optional representations and warranties in the stock purchase agreement, provided to accompany different types of deals across various industries. Other changes are more noteworthy. Below, we highlight the main substantive changes to the NVCA model documents, which will change how investors and companies negotiate and think about venture capital investments.

Cryptocurrency Makes Its VC Debut

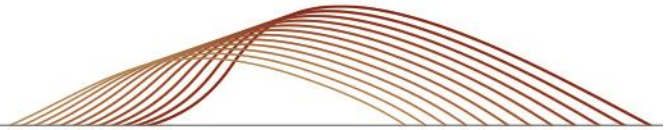
The first major addition to the model certificate of incorporation references the increasingly headline-worthy world of digital and cryptocurrencies. The drafters have added a protective provision requiring an affirmative vote of the requisite holders in order for the company to sell, issue, or distribute digital tokens or cryptocurrencies. Footnote 35 adds more color, suggesting that to avoid the engagement in a cryptocurrency issuance by an individual member of management, the voting agreement could include a restrictive covenant limiting the ability of management to do so.

These augmentations to the certificate reflect the rising popularity of digital and cryptocurrencies, especially among the venture/startup community. According to the Financial Times, over $6 billion worth of digital tokens have been sold since the start of 2017, and an ever-increasing roster of companies is capitalizing on the blockchain craze (among them juice companies, e-cigarette manufacturers, and the former Long Island Iced Tea Corp., which last December officially changed its name to Long Blockchain Corp.).

Digital currency remains, however, a volatile industry. In a 50-day period from late 2017 to early 2018, after hitting an all-time high near $20,000, bitcoin lost 65 percent of its value, while the crypto market as a whole lost 60 percent. Given the up-and-down nature of crypto valuation, there is an inherent logic in the inclusion of a protective provision limiting a board of directors' ability to issue digital currencies, since many venture investors may not be comfortable investing in a company that intends to employ a cryptocurrency strategy.

Additional Armor Fortifies the Protective Provisions

The protective provisions have been augmented to lend even more comfort to the VC investor. The provision requiring shareholder approval for the creation of debt securities is bolstered to include



shareholder approval for the creation of any lien or security interest, or the incurrence of other indebtedness. Beyond a protection against merely issuing debt securities, the new provision further restricts the ability of a company to leverage its assets without the approval of the requisite holders, giving stronger protection to preferred equity investors. We expect that this provision will not be without controversy, as putting up business assets as collateral for even a basic loan will now be much more difficult.

Further, a company now cannot permit a subsidiary to create or issue capital stock without preferred investor approval. Giving the preferred investors a veto here prevents the creation of a minority ownership position at the subsidiary level, maintaining the value and power of the preferred shares. These changes are a double-edged sword. Matters that previously would have been basic business decisions (incurring moderate levels of debt or allowing a subsidiary to issue stock) now will require shareholder approval as opposed to just a board-level decision, making it potentially tougher for a company to run its business.

The Plugging of a Business Judgment Rule Hole

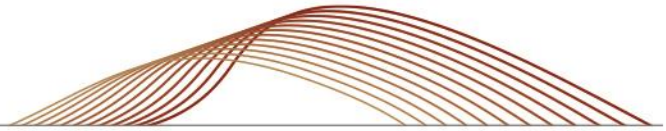
One addition to the certificate comes in response to years of vague rulings by the Delaware Chancery Court surrounding a board of directors' decision to limit the amount of a company's funds that may be used to redeem mandatorily redeemable stock. Under Delaware case law, a board of directors can elect not to redeem stock if the company does not have the economic surplus to do so (provided for by statute), or if redemption would threaten the company's ability to function as a going concern (provided for by common law). However, defining sufficient surplus or the ability to function as a going concern is not an exact science. Delaware courts have concluded that it is up to the business judgment of a board to make this determination, granting wide leeway to the board and offering little certainty to VC investors looking to make certain that a redemption will go through as promised.

In order to combat this, the latest NVCA model certificate provides for a punishment to a company should its board decide that a full redemption is not in the company's best interests. A new Section 6.4, titled "Interest," provides that if any preferred stock is not redeemed for any reason, all unredeemed shares are to remain outstanding and entitled to all of their rights and preferences. The company is further required to pay interest on the redemption price at the maximum rate allowable under applicable law. Now, even if partially redeeming the stock is in the best interests of the company, and the board was informed and acting in good faith (thus satisfying the tests laid out by the Court of Chancery), there is still a consequence to the board's actions. This prevents an end-around utilized by some companies to not only avoid redeeming mandatorily redeemable stock, but to do so without any financial ramification, making this addition one of the strongest of the new protections provided in the latest NVCA certificate.

New Mechanics for Multiple Closings

Many venture transactions incorporate the concept of multiple closings to take place upon the completion of certain achievements by the business. In life sciences investments particularly, successful testing or approvals of certain drugs are frequently the triggers for the obligation of investors to buy more shares in a company. The prior draft of the NVCA model stock purchase agreement provided a general layout for a milestone closing, but the concept receives much more detailed treatment in this turn of the model stock purchase agreement (albeit in the footnotes).

There is now a detailed optional mechanic to penalize a purchaser upon the failure to purchase additional shares at a milestone closing by forcing a conversion of such defaulting purchaser's



preferred shares into common shares at a lower rate than the conversion rate provided in the certificate (a mechanic the NVCA has dubbed a "special mandatory conversion"). The drafters anticipate gamesmanship by the preferred holders who consider defaulting on a milestone closing purchase, as the lower conversion rate could prompt holders to simply elect to convert voluntarily prior to their default. To combat this, the drafters suggest an additional covenant by the purchasers that they will not elect to convert preferred shares into common before a milestone closing. Meanwhile, further language allows purchasers to opt into additional milestone closing shares if a purchaser defaults on its obligations. By allowing each purchaser who did not default on its obligation under a milestone closing to elect to purchase the excess shares from defaulting purchasers, both company and investor alike are protected. A company will still obtain the funding that it is due after it achieves a milestone event, and investors will be assured that the company has the money it needs to keep their investment valuable.

Related to milestone closings, another new footnoted provision contemplates the sale by an investor of the right to participate in a future tranche of a transaction. The proposed language makes clear that if a transfer of shares takes place, the transferee also assumes the shareholder's obligation to purchase shares in a subsequent tranche.

Also important for transactions with multiple tranches or closings that may be years apart or subject to milestones with indefinite closing dates, an addition is made in Section 6.15, allowing for the termination of the purchaser's closing obligations. This new section provides that purchasers may terminate their obligations under the agreement if, prior to closing, either (a) the company consummates a deemed liquidation event, (b) an initial public offering occurs, or (c) the company goes into receivership or bankruptcy or becomes insolvent.

As venture transactions become more complex and are ever more subject to satisfaction of contingencies down the line from an initial closing, provisions like these will be valuable tools in the arsenal of a VC attorney.

Intellectual Property: More Weapons in an Already-Powerful Arsenal

IP has always been one of the cornerstones of any venture investment. Whether it is in the life science industry, technology, or multimedia, most VC investments target companies that get their value from the unique or innovative IP they own. According to Forbes, intangible assets make up about 80 percent of the value of an average business, and that number is closer to 90 percent for early-stage companies. It makes sense, then, that much of the redraft of the model stock purchase agreement would focus on bolstering the assurances surrounding company IP.

The reinforcement to company IP ranges from the basics (the definition of "company intellectual property" itself now includes a footnote 14 with expanded language specific to life science transactions, flushing out the scope of patent rights) to the more complex. The company representations regarding IP in Section 2.8 are greatly reinforced. The representation that the company owns the rights to IP without infringing on the rights of others is expanded to include the rights of employees or consultants, or the academic or medical institutions with which they are affiliated. Additionally, the new draft contains more detail with respect to what IP rights employees or consultants have assigned to the company, and there is a new representation that no government funding or facilities or those of an educational or research institution, or funding from third parties, was used to develop company intellectual property, and further, that no person who has developed company intellectual property has performed services for the government or an educational or

research institution. These latter representations are obviously more onerous on the company, and perhaps impossible to make if a company was incubated at the university level. The end result of these more complicated and difficult representations, though, is that VC investors have greater clarity in terms of what they are buying and what they are willing to pay for it. These representations relate directly to the business foundations of a VC deal, because if other entities and institutions may lay claim to the IP of an investment target, a VC investor will have greater leverage in the negotiations and further protections down the road if an undisclosed third party asserts ownership of a company's IP.

Further Investor Control and Protection

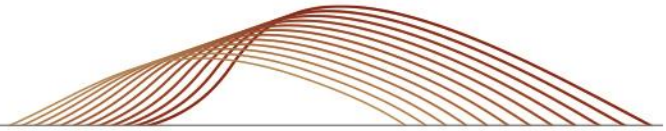
The changes to the investors' rights agreement shore up protections already offered to preferred shareholders. The first has to do with the withdrawal of a demand for registration in Section 2.1(d). In the event that the company has deferred its demand registration requirements under the mechanics of Section 2.1(c), the initiating holders may withdraw their demand during this deferral period, and such registration will not be deemed "effected." This guarantees that until the registration actually happens, it will not be considered "effected" for the purposes of the demand registration process. As the timing of registration is crucial, and preferred investors wish to retain the right to demand registration as long as possible, this will be a welcome change. The drafters also clarify somewhat murky language around the termination of registration rights held by investors, by noting in Section 2.13 that the termination of registration rights due to the availability of a Rule 144 exemption applies only after the consummation of the IPO.

Even more preferred investor control is offered with respect to investor information rights. In a bracketed addition in Section 3.1(e), there is now the option to give the preferred director the right to approve the yearly budget of the company, which may be a popular ask for lead investors receiving a board seat. And in Section 3.5's confidentiality provision, the exclusion to confidentiality obligations relating to legally required disclosures is spelled out in more detail—rather than allow for disclosure of confidential information simply "as required by law," investors are permitted to disclose confidential information as required by "law, regulation, rule, court order or subpoena." Under the prior wording, there was much more room for error and potential litigation around whether an information disclosure was actually required under the law. This redraft removes the gray area and allows for a much broader safe zone for disclosure at the behest of a government or regulatory entity.

In an important change for smaller startups, it is now mandatory for a company to obtain directors and officers insurance and key man insurance. The employee stock covenant in Section 5.3 now includes language that employee stock agreements cannot be amended in a way that would be inconsistent with the requirements of Section 5.3 without approval of the board, including a Series A director. The drafters also added a clarification that the company cannot waive its right of first refusal on transfers of employee stock without board approval.

Conclusion: A Stronger, Faster, More Agile Suite of Documents

After a four-year wait, these are welcome changes to the NVCA model documents. From providing language to allow drafters to more easily tailor the agreements to particular transactions, to adding reinforcement to key areas of the documents, the latest drafts not only reflect the necessity for quick transactions and bespoke solutions to unique problems facing VC investors, but they anticipate needs that will arise in this ever-evolving industry. It seems that these changes should suit the VC world well—at least for the next four years.



Samuel A. Waxman is a partner with Paul Hastings LLP.

Jordan L. Goldman and Tyler Thiret are associates at the firm.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact either of the following Paul Hastings New York lawyers:

Samuel A. Waxman
1.212.318.6031
samuelwaxman@paulhastings.com

Jordan L. Goldman
1.212.318.6643
jordangoldman@paulhastings.com