

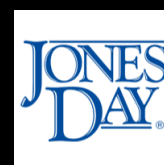


# **The Legal 500 Country Comparative Guides**

## **United States VENTURE CAPITAL**

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This country-specific Q&A provides an overview of venture capital laws and regulations applicable in United States.

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## UNITED STATES VENTURE CAPITAL



The views and opinions set forth herein are the personal views or opinions of the authors; they do not necessarily reflect views or opinions of the law firm with which they are associated.

### **1. Are there specific legal requirements or preferences regarding the choice of entity and/or equity structure for early-stage businesses that are seeking venture capital funding in the jurisdiction?**

While there can be certain advantages to initially organizing as an LLC (see our discussion of tax incentives below), most entities seeking venture capital funding do so as a corporation. A vast majority of these corporations are formed in the State of Delaware.

Corporations are attractive to venture capital investors because, among other things, there are standard form investment documents that investors are comfortable with, many funds can only invest in an LLC or other pass through entity if they first implement a corporate “blocker” entity into their fund structure, and there is a comfort level with the various governance and economic terms of an investment in a corporation. Additionally, corporations are subject to the detailed statutes, court decisions and regulations of the jurisdiction in which the corporation is formed. Because venture capital firms make investments in many different companies, they tend to find the consistency and predictability of the same documentation, statutes, court decisions and regulations applying across all of their investments to be attractive.

### **2. What are the principal legal documents for a venture capital equity investment in the jurisdiction and are any of them publicly filed or otherwise available to the public?**

Most venture capital investments are made through a standard set of documents. While there are variations among different law firms, a majority of venture capital

investments are now made through the suite of documents provided by the National Venture Capital Association (NVCA). While the specific terms of each agreement are tailored to each transaction, the suite of documents and the typical terms include:

- Stock Purchase Agreement – Establishes the principal terms of investment (e.g., price per share, amount to be purchased by each investor, etc.), includes representations and warranties from the company and the investors and establishes the mechanics and conditions to closing the investment.
- Amended and Restated Certificate of Incorporation – Filed in the state of the company’s incorporation and creates the securities to be purchased by the investor and establishes certain key rights associated with those securities, including economic, governance and voting rights.
- Voting Agreement – Obligates investors and key common holders to vote their shares for the appointment of specified directors and for the sale of the Company if approved by certain classes of stockholders.
- Investors Rights Agreement – Grants investors certain registration rights in connection with a future public offering of the company’s securities, provides investors with certain negotiated management updates and financial information regarding the company’s performance, and grants investors pre-emptive rights in connection with future stock issuances by the company.
- Right of First Refusal and Co-Sale Agreement – Grants the company and investors rights of first refusal and investors co-sale rights in connection with future transfers of company securities by the founders and other large employee stockholders. Investors are typically

not subject to these same right of first refusal and co-sale restrictions.

Other than the Amended and Restated Certificate of Incorporation which must be filed in the state in which the company is incorporated, the transaction documents are not required to be publicly disclosed and are generally not publicly available.

**3. Is there a venture capital industry body in the jurisdiction and, if so, does it provide template investment documents? If so, how common is it to deviate from such templates and does this evolve as companies move from seed to larger rounds?**

The NVCA has created template versions of each of the standard investment agreements identified above. While these agreements are used as the starting place for many venture financing transactions, they are tailored in each transaction to fit the specific terms agreed upon between the company and the investors.

**4. Are there any regulatory frameworks in respect of companies offering shares for sale that need to be considered, for example any restrictions on selling and/or promoting the sale of shares to the general public?**

Companies seeking to raise venture capital, or issue any securities, must either register those shares with the U.S. Securities and Exchange Commission (SEC) or satisfy certain SEC and state law exceptions/exemptions from registration. Registering securities with the SEC is a very expensive, complex and time-consuming process, and fortunately there are several federal exemptions/exceptions that govern most venture capital transactions. Section 4(a)(2) of the Securities Act of 1933 provides that no registration is required for sales of securities that do not involve a public offering. Regulation D under the Securities Act further exempts issuances of securities in limited offerings – which are generally offerings to “accredited” investors, without any general solicitation or advertising, and with prohibitions on resale of such securities by the investor. It is worth noting that companies using the Regulation D exemption are required to file a notice (Form D) with the SEC within 15 days of the first closing disclosing certain information about the offering. In addition to the U.S. federal securities rules, companies are required to comply with the securities laws of each U.S. state (known as “blue

sky” laws) in which they are offering securities. These can often be satisfied by filing the same Form D used for the federal exemption with each state in which an investor is located. It is important that companies consult with their securities counsel in advance of offering or selling securities in the U.S. to ensure compliance with federal and state securities laws.

**5. Are there any general merger control, anti-trust/competition and/or foreign direct investment regimes applicable to venture capital investments in the jurisdiction?**

A number of regulatory requirements are potentially applicable to venture capital financings and should be carefully analysed by both parties at the term sheet phase of the transaction. In the United States, venture capital investors and the companies receiving investments from those firms will need to determine, based on the value of the holdings of each investor (including any shares held from prior investments made by that investor), the size of the respective parties and certain other factors, whether a filing under the Hart-Scott-Rodino Antitrust Improvements Act of 1976 (HSR) will need to be made prior to completing the investment.

Additionally, in the event the investment is being made by a foreign controlled investor (including via participation in a fund) into a U.S. business, the company and the investor will need to determine whether the transaction falls within the jurisdiction of the Committee on Foreign Investment in the United States (CFIUS) and, if so, whether a filing will need to be made with CFIUS prior to completion of the transaction.

It is important that companies and investors consult legal counsel with deep experience in both HSR and CFIUS matters before proceeding with any financing.

**6. What are the prevailing tax incentives or structures offered to venture capital investors in the jurisdiction, if any?**

The U.S. government and many state and local governments offer tax incentives to investors in small businesses in various geographic locations and emerging industries, including clean tech, electric vehicle, semiconductor and various life sciences sectors. These incentives are highly industry- and location-specific and so are difficult to characterize in this chapter.

However, there is one broadly applicable, and potentially very valuable, tax incentive that should be considered by all founders of emerging growth companies, as well

as venture capital investors – “Qualified Small Business Stock,” or “QSBS.” Section 1202 of the U.S. Internal Revenue Code provides that investors in QSBS companies can achieve up to 100% federal tax relief for the greater of \$10,000,000 or 10x the investor’s tax basis in the stock upon its sale. Among other requirements, in order to qualify as QSBS, the investment must be (1) in a corporation (not an S corporation or partnership) that has had gross assets of no more than \$50 million at all times prior to the investment, and (2) must be held for at least 5 years. Companies in certain industries, such as banking, consulting, insurance, farming, hotels and restaurants, are excluded from QSBS tax treatment.

We often advise founders of emerging growth companies to consider initially organizing their businesses as LLCs or partnerships and then flip to a corporation after they have increased the value of the business closer to the \$50,000,000 gross asset level in order to enhance the potential value of QSBS tax treatment. For example, if a founder who owns 100% of her company initially organizes her business as a corporation at a time when the company’s gross assets are only \$500,000, the maximum tax benefit she would generally be eligible for will be \$10,000,000 (the greater of \$10,000,000 or 10x the value of the investment (here, \$5,000,000)). If that same founder initially organizes her business as an LLC with gross assets of \$500,000, grows her business to \$30,000,000, and then flips to a corporation, she would be eligible for up to \$300,000,000 in QSBS tax treatment (the greater of 10x the value of her investment at the time of the flip to a corporation, and \$10,000,000). The above examples are illustrative only and are subject to various other requirements under Section 1202, including, importantly, that she hold her corporation stock for at least 5 years after the LLC is converted to a corporation.

There are also many other factors that founders need to consider when deciding whether to organize their companies as LLCs, partnerships or corporations, including their personal tax profile, whether investors will prefer to invest in one form of organization or another, and the types of equity incentives they plan to offer future employees. The key takeaway is that founders should carefully consider whether to initially organize their business as an LLC, partnership or corporation and not default automatically to a corporation, and should consult with their attorneys and tax advisers before taking any action.

## **7. What is the process, and internal approvals needed, for a company issuing**

## **shares to investors in the jurisdiction and are there any related taxes or notary (or other fees) payable?**

Approval by the company’s board of directors (or comparable governing body) is required for issuances of securities, including equity issuances. Subject to the specific provisions of the company’s organizational documents, such approval typically can be obtained either by written consent or at a meeting. In certain instances, stockholder approval will also be required for an equity issuance. Two common examples where stockholder approval is required are: (1) Where, in connection with the issuance, the number of authorized shares needs to be increased, requiring the stockholders to approve an amendment to the certificate of incorporation (or comparable governing document); and (2) a stockholder or group of stockholders (e.g., preferred stockholders, or a series thereof) has a specific approval right over an equity issuance. Finally, it is not uncommon for waivers from existing stockholders to be required in connection with a new issuance—such as waiver of pre-emptive rights or antidilution protection.

Generally, there are no taxes or notary fees in connection with stock issuances, including in venture financings.

## **8. How prevalent is participation from investors that are not venture capital funds, including angel investors, family offices, high net worth individuals, and corporate venture capital?**

Participation from “non-venture capital fund” investors is increasingly prevalent. Investments by angel investors and high net worth individuals, has become very common, particularly in early seed stage financings, and will likely continue to grow in the future. Participation from family offices and corporate venture capital investors (CVCs) has increased in recent years, particularly CVC investments, and we anticipate that this increased involvement by CVCs will continue.

## **9. What is the typical investment period for a venture capital fund in the jurisdiction?**

Venture capital funds typically do not have a standard investment period with respect to each investment and instead look for optimal exit windows through either an IPO or a sale of the company.

## **10. What are the key investment terms which a venture investor looks for in the jurisdiction including representations and warranties, class of share, board representation (and observers), voting and other control rights, redemption rights, anti-dilution protection and information rights?**

Venture investors will expect a broad set of operational representations and warranties from the company in connection with the purchase of securities from the issuer, including regarding capitalization, intellectual property ownership and non-infringement, litigation and employee matters, material agreements and various other matters. These representations and warranties are contained in the stock purchase agreement described above, which also provides details on the mechanics and conditions for the closing of the investment.

The suite of financing documents entered into in connection with each transaction will contain key investor rights, as well as preferences and privileges for preferred stock investors. The liquidation preference is the priority in which proceeds are distributed to the investors and other stockholders in a sale of the company or other liquidation. Anti-dilution provisions protect investors from dilution in the event of a future sale of securities at a lower valuation. Protective provisions require the consent of the preferred stock as a class, or a specific series thereof for certain company actions. Conversion rights provide for optional conversion of an investor's preferred stock into common stock, as well as certain circumstances in which all preferred stock is automatically converted into common stock, such as upon a specified investor vote or in connection with an IPO of a certain offering size or valuation.

Venture capital investors also expect certain rights with respect to future security issuances by the company, as well as sales or transfers of securities by existing stockholders. Pre-emptive rights afford investors the ability to purchase their pro rata portion of future financings by the company. Rights of first refusal and co-sale rights provide investors with the right to purchase securities being offered by the founders and certain other large employee stockholders or, in the alternative, to join in such sales. Venture capital investors will also often require the ability to force certain minority stockholders to approve a sale of the company through drag-along rights.

Investors will expect periodic and regular updates and financial information regarding the company's

performance to help monitor their investment. Additionally, certain investors (typically the lead investors) will receive the right to designate one or more representatives to the company's board of directors.

## **11. How common are arrangement/monitoring fees for investors in the jurisdiction?**

Arrangement and monitoring fees are very unusual in the emerging growth company/venture capital space. These types of arrangements are much more common in private equity control investments.

## **12. Are founders and senior management typically subject to restrictive covenants following ceasing to be an employee and/or shareholder and, if so, what is their general scope and duration?**

The legality of restrictive covenants, such as non-compete and non-solicitation restrictions, is determined on a state-by-state basis at present, although the federal government has proposed rules that would restrict the use of these covenants nationwide. In those states that allow restrictive covenants, typically founders and senior management, or at least a subset thereof that the investors view as most critical, are subject to some level of restrictive covenants governing their conduct after they are no longer employed or involved with the company. In such instances, state law typically limits the acceptable qualitative scope, geographic territory and duration of these restrictive covenants, especially non-competes. Generally speaking, the duration of such restrictive covenants is limited to one to two years and, to ensure compliance with state law, the qualitative scope and geographic territory of the restrictive covenants are typically narrowly tailored to only cover what is necessary to protect the company. Given the prevalence of venture-backed start-ups in California, it is worth noting that California has long generally prohibited non-competes, other than in certain situations in connection with a sale of the company (or an employee's stock in the company).

## **13. How are employees typically incentivised in venture capital backed companies (e.g. share options or other equity-based incentives)?**

Employees in venture-backed companies are typically incentivized through the issuance of options to purchase



shares of the company's common stock. These options are typically subject to vesting (most often time-based, but can include performance-based vesting, or a combination of the two) and are exercisable (typically, only with respect to vested shares) at a price not less than the fair market value on the date the option is granted.

#### **14. What are the most commonly used vesting/good and bad leaver provisions that apply to founders/ senior management in venture capital backed companies?**

In order to incentive founders and senior management to continue their work with the company, the stock, options or other securities issued to founders and senior executives is typically subject to time-based vesting requirements. In the event the founder leaves or is terminated by the company, any unvested stock or options held by that founder or senior manager would be subject to repurchase by/forfeiture to the company.

However, for founders and senior management, the unvested shares or options are frequently subject to some vesting acceleration in the event of a termination without cause or a sale of the company. These acceleration provisions are heavily negotiated and are bespoke to each situation. Acceleration for a termination without cause is typically some percentage of the unvested stock or options held by the founder/senior manager. Acceleration of vesting on a sale of the company can either be structured as a "single trigger"—upon completion of the sale transaction—or a "double trigger"—acceleration of vesting only if the founder/senior manager is terminated without cause within a certain period of time before or following completion of the sale. IPOs and other financing events do not typically trigger accelerated vesting.

Founder/key employee stock is also almost always subject to a right of first refusal in favor of the company and the company's investors should the founder or key employee desire to sell their shares. These rights of first refusal are often set forth in the ROFR/Co-Sale Agreement described above, as well as the company's bylaws and equity incentive plans.

#### **15. What have been the main areas of negotiation between investors, founders, and the company in the investment documentation, over the last 24 months?**

Over the last 24 months, the main areas of negotiation have shifted slightly due to increasingly challenging

economic conditions. In this context, enhanced or more favorable liquidation preferences, series-based protective provisions and anti-dilution rights have become areas of increased focus for investors. Key areas of negotiation that remain constant regardless of economic conditions include valuation of the company (which tends to move in parallel to broader economic conditions), board composition, scope of protective provisions and exit rights.

#### **16. How prevalent is the use of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction?**

Use of these instruments by early-stage emerging growth companies is very prevalent but in our experience varies somewhat by geographic location and industry. While SAFEs are used by investors and companies in the Eastern United States, they are much more prevalent in California and the Western United States. Conversely, convertible debt has been used less often in the Western United States but is common in the Eastern United States—though we have seen a significant uptick in the use of convertible notes in the Western United States over the past two years as investors seek greater control and protections. In the United States as a whole, SAFEs are the more commonly used instrument. As noted above, there is also a difference in what types of instruments are used based on "maturity" of an industry. For example, in newer industries such as the financial technology industry and AI, SAFEs are much more common but in more longstanding industries like the medical device industry, convertible debt may be comparatively more common.

#### **17. What are the customary terms of convertible debt (e.g. convertible loan notes) and advance subscription agreement/ SAFEs in the jurisdiction and are there standard from documents?**

Convertible notes and SAFEs share certain characteristics. Namely, both are structured and generally intended to convert into the next priced round of financing at a discount, pursuant to a valuation cap, or the more investor-favorable of the two. Due to the ongoing economic environment, investors are becoming more aggressive, resulting in lower valuation caps and higher discounts off the price paid by subsequent equity investors. SAFEs are generally more company-favorable because they do not have to be repaid in cash—they only convert if and when there is a priced round of

financing. Because SAFEs are simpler instruments, negotiation is limited beyond the key terms mentioned above. With convertible notes, however, there are other important terms to be considered, including interest rate, maturity date, security and repayment terms if the note has not converted by the maturity date. Unlike SAFEs, convertible notes are true debt and have to be repaid if they do not convert prior to maturity. For SAFEs, there is also an industry-standard form document, but no standard form documentation exists for convertible notes –making notes more complicated and expensive.

### **18. How prevalent is the use of venture or growth debt as an alternative or supplement to equity fundraisings or other debt financing in the last 24 months?**

Over the last 24 months, use of venture and growth debt has decreased sharply due to the Silicon Valley Bank collapse, a slowdown in overall investment activity, macroeconomic fluctuations and higher interest rates. It is anticipated that debt financings will increase in the coming years relative to the recent low utilization as venture and growth debt still has significant advantages compared to equity financings, including avoiding dilution and granting control rights to outside investors.

### **19. What are the customary terms of venture or growth debt in the jurisdiction and are there standard form documents?**

Customary terms of venture and growth debt include the following: amortization period, interest rates, equity incentives (e.g., warrants), scope of affirmative and negative covenants, security, and default triggers and remedies. Generally, venture or growth debt interest

rates are above commercial rates, covenants can be expansive in scope and there are extensive default triggers and remedies. Companies also need to be mindful of the cost components beyond repayment of the principal amount and associated interest, including any upfront fees to arrange the facility and back-end or final payment fees. There are no standard form documents for venture or growth debt—they vary by lender and by the circumstances of the borrower.

### **20. What are the current market trends for venture capital in the jurisdiction (including the exits of venture backed companies) and do you see this changing in the next year?**

In 2023, total U.S. venture capital deal value and number of deals were very similar to 2019, and far off the robust pace set in 2021. In our view and experience, this did not mean that the market was particularly unhealthy – but rather a return to a more normal level of deal activity. Certain industries fared better than others, including AI and cleantech.

On the other hand, the 2023 M&A and IPO exit market for venture-backed companies was close to non-existent—hitting at least a 10-year low in deal value, with acquisitions outpacing a very limited number of IPOs. It is too early to tell if venture capital investments and exit transactions will rebound significantly in 2024, but there does appear to be some indication of renewed momentum in mid-market M&A, as well as early to mid-stage venture capital transactions. We expect (hope) that the deal environment will be healthier in the second half of 2024, but there are many variables including interest rates, stock market fluctuations and the U.S. election in November 2024 that will bear on the direction of the market over the next several months.

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