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BRIDGING THE POND

U.S. VENTURE CAPITAL DEALS FROM A GERMAN MARKET PERSPECTIVE

DIFFERENCES / KEY NEGOTIATION ISSUES / DEAL TERM TRENDS

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VC & TECH BRIEFINGS GERMANY

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ORRICK LEGALNINJA SERIES

About the Orrick Legal Ninja Series – OLNS

In substantially all the major world markets, we have dedicated technology lawyers who support young German technology companies on their growth trajectory through all stages. As one of the top tech law firms in the world, we are particularly committed to bringing the American and German entrepreneurship ecosystems closer together.

For this purpose, we launched the Orrick Legal Ninja Series ("**OLNS**") back in 2019. With this series, we will provide overviews of current legal trends and take deeper dives on certain legal topics particularly relevant for start-ups and their investors.

This series will be co-authored by a multidisciplinary team of lawyers from our national and international offices. It is our goal to tap into the rich reservoir of the venture capital, corporate venture capital and technology know-how of our international platform and make it available to the exciting German entrepreneurship and innovation scene.

Why "Ninja Series"? This title might simply reflect the fact that some of us watched a little too much TV in the 1990s. But, seriously, "Ninja" has come to signify "a person who excels in a particular skill or activity." That's what the Orrick Team strives for when it comes to providing tailored advice to growing tech companies and their investors. We hope that the OLNS also empowers you to be a Ninja entrepreneur.

If you'd like to discuss further, please contact us. We would love to learn about your experiences with these topics, so please share them with us. We constantly strive to evolve and grow to best serve our clients.

We hope you enjoy this eleventh edition of our series.

On behalf of the Orrick Team,

Sven Greulich
Orrick – Technology Companies Group, Germany

A. Bridging the Pond – U.S. (NVCA) Deals From a German Market Perspective

I. Preface

"Between grand theft and a legal fee, there only stands a law degree" (anonymous). Early in our careers, we quickly learned that lawyer-bashing brings people together. You are welcome.

So, now that we have your attention, we want to talk about venture capital ("**VC**") deal-making in the United States and why, despite the much higher hourly rates for top VC lawyers in the United States as compared to (continental) Europe, the implementation of VC financings is generally much more efficient in the New World, both with respect to timing and costs.

In the U.S. ecosystem, the National Venture Capital Association ("**NVCA**") and, in particular, its model legal documents have great influence. The NVCA is an organization that represents the U.S. VC community. It advocates policies that encourage innovation and long-term investment. Most important for the purposes of this Guide, the NVCA is a resource for venture capital-related data and template documentation. Unlike in Germany, where standardization efforts are still in the early stages and the few attempts made so far to bring some order to the German documentation wilderness have not really caught the market (yet), in the United States, the NVCA documentation is the undisputed benchmark.

For transparency, Orrick is a so-called 'NVCA Industry Partner' of the NVCA, sponsors NVCA programs and has contributed to the revisions of the NVCA documentation.

Drawing on our experiences with literally thousands of VC financings on both sides of the pond, we have put together this Guide to offer founders and investors with a "German market" background an introduction to U.S. VC deals and help them understand where U.S. deals differ from a typical German financing. This Guide is not intended to be a stand-alone document but augments and is augmented by other editions of our Orrick Legal Ninja Series, notably the OLNS edition[1] that deals with the establishment of U.S./German holding structures (a.k.a. the famous "flip").

So what can be found in this eleventh edition of OLNS? Chapter A.II presents the topic in a broader context, introduces the NVCA, and briefly dives into the importance of its standard documents and deal term analyses for the start-up scene in the United States and beyond. To provide our readers a frame of reference, Chapter A.III contrasts the (structure and flow of the) NVCA documentation with a "typical" German market financing round documentation and answers the question: "Okay, so where in the U.S. documentation do I find the matters and topics addressed in a typical German market investment agreement or shareholders' agreement?" Chapter A.IV then highlights some of the key differences in economic and control terms between U.S. and German (early-stage) financings, before Chapter A.V summarizes the items that, according to our experiences, get negotiated the most in downturned markets. While we will throughout this Guide share our thinking on evolving deal term trends in U.S. financings, Chapter A.VI provides a more structured summary of some current deal term trends we observe in our U.S. practice when looking at deals in the post-2020 and 2021 VC frenzy.

1 You can find all editions of the OLNS here: www.orrick.com/en/Practices/Orrick-Legal-Ninja-Series-OLNS.

Given the current market headwinds, Chapter A.VII takes a deep dive into the structuring and implementation of down rounds in a U.S. company. This first deep dive is followed by a second one in Chapter A.VIII on the most important CFIUS considerations for non-U.S. investors when closing U.S. financings (the CFIUS regime is the U.S. variation of what is usually referred to as 'foreign direct investment rules', *i.e.*, provisions restricting the investment of foreigners in certain domestic technology or infrastructure assets).

Obviously, this Guide cannot cover all relevant topics, and it only presents our humble views. Each company and each investor is different, and this Guide is not a substitute for proper legal advice on a case-by-case basis. Honestly, talk to your lawyer; it will make her happy (we are social creatures, not quite like normal humans but not so different after all...).

> "Please don't do anything stupid and kill yourself. It would make us both quite unhappy. Consult a doctor, lawyer and common-sense specialist before doing anything in this book."
>
> *Tim Ferriss*, Tools of Titans

II. The NVCA and the NVCA Documentation

1. THE NVCA

Founded in 1973 and headquartered in Washington with a regional office in San Francisco, the NVCA is an organization of venture investors, including VC partnerships, corporate venture groups, seed capital, growth equity firms and university innovation funds. It sees itself as the voice of the U.S. VC and start-up community, and as such the NVCA advocates for public policy that supports the American entrepreneurial ecosystem. The NVCA has set itself the lofty goal to empower the next generation of American companies that will fuel the economy of tomorrow. In support of these activities, the NVCA conducts research, hosts educational and networking programs, and serves as an information clearinghouse for its members. It makes available the results of its research in various publications, such as its *Annual Economic Impact of Venture Capital Study*, *Job Creation Survey*, *Expert Analysis of Legislative and Regulatory Issues* and other scholarly works.

2. THE NVCA DOCUMENTATION

Probably one of the things the NVCA is best known for is its library of standard documents to implement VC financings.

2.1 Purpose and Adoption (the United States and Beyond)

Officially called the "NVCA Model Legal Documents," this set of industry-embraced model documents is widely used in U.S. start-up financings to speed up and streamline the negotiation and drafting process and provide for a level playing field. In the NVCA's own words, these standard documents

- reduce transaction costs and time;
- reflect, guide and establish industry norms;
- avoid bias toward the VC or the company/entrepreneur;
- present potential options, reflecting a variety of financing terms;
- include explanatory commentary where necessary or helpful;
- anticipate and eliminate traps for unenforceable or unworkable provisions; and
- provide a comprehensive set of internally consistent financing documents.

NVCA's updates to the model forms (for the latest updates from 2022, please see further below) attempt to:

- track developments in applicable law;
- reflect market practice at a particular time with drafting options to facilitate negotiations and allow parties to efficiently achieve a closing of a transaction; and
- reflect "best practices" in the industry (establishing, or established by, industry norms and benchmarks).

As the vast majority of VC-backed start-ups are incorporated in Delaware, the NVCA standard documents are drafted under Delaware law and several of the more legal (vs. economic) revisions over the years in fact result from changes in Delaware (case) law.

WE ARE A DELAWARE COMPANY – WELL, HOLD MY MAI TAI…

For the legally minded — we know you are only reading along because we mentioned Mai Tais but wait for it: Given that many U.S. start-ups are incorporated in Delaware but might have their place of business in California, one needs to be aware that even for companies incorporated in Delaware, California corporate law may still apply.

This is the case if the respective start-up qualifies as a "Quasi-California" corporation.

What Is the Issue? California has its own corporate law that it attempts to apply to companies organized in other jurisdictions, namely the California Corporation Code ("**CCC**"). Under Section 2115 CCC, a company incorporated elsewhere is still subject to certain provisions of the CCC (*i.e.*, it is a "Quasi-California" company) if it fulfills a two-prong test:

First Test: Are more than 50% of its voting securities held of record by persons having addresses within the state of California? Thus, if more than 50% of the voting securities are held by non-Californians, one can stop any further analysis and California corporate law will not apply.

Second Test: Has the company done more than 50% of its business in California in the last fiscal year? Here, a three-factor formula including (a) property, (b) payroll and (c) sales is applied:

- the property factor is a fraction, the numerator of which is the average value of the corporation's real and tangible personal property owned or rented and used in California during the taxable year and the denominator of which is the average value of all the corporation's real and tangible personal property owned or rented and used during the taxable year;
- the payroll factor is a fraction, the numerator of which is the total amount paid in California during the taxable year by the taxpayer for compensation and the denominator of which is the total compensation paid everywhere during the taxable year; and
- the sales factor is a fraction, the numerator of which is the total sales of the corporation in California during the taxable year and the denominator of which is the total sales of the corporation everywhere during the taxable year.

This "doing-business" test takes the average of the property factor, the payroll factor and the sales factor and, if it is greater than 50% during its latest full taxable year, the "doing-business" test is satisfied. If, for example, the property factor is 80%, the payroll factor is 70% and the sales factor is 20%, the company would be at 56.7% on average on the "doing-business" test and would be a "Quasi-California" company.

Why Does It Matter? There are a number of differences between the corporate laws of California and Delaware. The biggest area where the two corporate laws diverge is that California requires that each class of stock has an approval right over certain actions and measures, including redemption of shares and in particular an acquisition of the company. So, you could have a company that has been through many rounds of preferred financing, the investors control 80% or 90% of the shares, but the founders still have a block on the sale of the company if they are not subject to a drag-along or other contractual requirement to vote in favour of the sale. Another important difference is that California corporate law provides for a very broad definition of "distributions to shareholders" (including, for example, share repurchases and redemptions) and sets stricter requirements for permissible distributions than Delaware law (which generally permits companies to pay dividends or make redemptions as long as the corporation is solvent following the transaction). Under California law, directors are liable to the company for illegal distributions if they acted willfully or negligently with respect to such a distribution.

Interestingly, the Delaware courts have held that California's "Quasi-California" statute is unenforceable in Delaware, but there is no decisive similar California caselaw, so practitioners still care about this potential issue.

And Why Mai Tai? Did you know that according to Wikipedia, the Mai Tai cocktail was (allegedly) invented in Oakland, California, in 1944 by a guy named Victor J. Bergeron at his restaurant, Trader Vic's?

So, is everyone working on the basis of the NVCA forms? Well, generally yes… kind of.

While the NVCA term sheet is a very useful resource and tracks many important deal terms, in its lengthy form it is rarely used in practice as most investors rely on their much shorter (usually only two pages or so) own version and often simply reference "customary provisions in line with [market standards/the NVCA documentation]." That being said, the NVCA term sheet remains an important benchmark, and we will use it later in this Guide to explain the main differences between German and U.S. financings. The other NVCA documents are, however, widely used. Many law firms — at least those with a meaningful footprint in the VC-space — have introduced their versions of the NVCA forms, *i.e.*, work on the basis of the NVCA forms but have made some changes in their template documents. However, comparisons to the baseline NVCA documents are easy and quickly highlight the changes.

> In the last two years, start-up and venture capital stakeholders have downloaded the Enhanced Term Sheet nearly 40,000 times.
>
> *Kelsey Chase*, co-founder and president of Aumni – authors' note: this statement was made as of June 2022

The NVCA documentation also got international wings. In Canada, the Canadian Venture Capital and Private Equity Association (CVCA) has adapted the NVCA model of legal documents for use in Canada (we can only assume that the Canadian drafts are much more polite)[2].

In other countries, the NVCA inspired and augmented the launch of own VC standard legal documents, *e.g.*, in the United Kingdom, Ireland and Singapore[3]. In other countries such as the Cayman Islands, the NVCA documents are regularly used or relied on in lieu of a country-specifically adopted version.

2.2 The Current Library and the 2022 Updates

The first set of NVCA standard documents was created in the early 2000s, and the documents have been updated since then at irregular intervals. These forms are maintained by a group that is primarily comprised of law firms and VC investors and that generally meets on an annual basis.

As of this writing, the library of the NVCA model documents include, among others, the following core documents:

- Model Term Sheet (updated June 2022);
- Certificate of Incorporation (updated September 2020);
- Voting Agreement (updated March 2022);
- Stock Purchase Agreement (updated September 2020);
- Right of First Refusal and Co-Sale Agreement (updated September 2020); and

2 See www.cvca.ca/research-insight/model-legal-documents/.

3 **United Kingdom:** www.bvca.co.uk/Policy/Industry-guidance-standardised-documents/Model-documents-for-early-stage-investments; **Ireland:** www.ivca.ie/our-industry/guidelines-documents/; and **Singapore:** www.svca.org.sg/model-legal-documents.

- Investors' Rights Agreement (updated June 2022). Like the revised term sheet, the revised Investors' Rights Agreement contains updated market data on certain deal terms (the Investors' Rights Agreement now benchmarks 13 deal terms).

These documents are at the core of what comprises typical U.S. VC financing documentation (for an overview see Chapter A.III) and will be presented in more detail in this Guide. In addition, the NVCA has published other model documents that have also gained widespread adoption but that we will only occasionally refer to in this Guide. These documents include:

- the model legal opinion;
- the management rights letter (updated July 2020); and
- the indemnification agreement (updated July 2020).

Most of the documents were updated in 2020 and thereafter. In 2022, the NVCA published what it calls the "Enhanced Model Term Sheet 3.0." This revised version of its model term sheet was accompanied by an update of the NVCA's Investors' Rights Agreement. These enhanced forms were created in partnership with Aumni, an investment analytics firm. Besides template wording, the documents contain 2021 analytics and trends data on many deal terms. In particular, the term sheet now benchmarks 33 deal terms, including the following new ones that were previously unavailable in the NVCA data set:

- median major investor threshold value;
- median months in between financing rounds;
- median percentage change in the amount raised between financing rounds;
- percentage of 20% or less convertible discount;
- percentage of 8% or less dividend rate;
- median percentage change in option pool shares;
- median percentage change in valuation between rounds;
- percentage of *pro rata* rights for Major Investors (as explained below); and
- percentage of employee vesting.

However, it needs to be noted that the underlying data set does not include deals after 2021. Against the prevailing difficult funding environment and challenging macro landscape, these statistics need to be taken with a grain of salt. For example, according to the service provider *Pitchbook*, VC deal count in the United States for Q1/2023 fell more than 25% from the Q1/2022 record, and many other economic benchmarks such as average pre-money valuation and median deal sizes also took a more or less pronounced nosedive. As we will see in Chapter VI, since early 2022, we have noticed a clear shift towards more investor-friendly terms in our practice. An observation that holds true both for economic as well as control terms though when looking at the various funding stages a more nuanced picture emerges. We will come back to that but suffice it to say that the 2021 deal data shown in the NVCA term sheet might not always give a correct or complete picture of the current market.

III. A First Orientation and Where to Find What

In this Chapter, we will give a brief overview of the core documents that make up a typical U.S. VC financing. As we will see, the NVCA has split the relevant provisions around the economics of the deal and control over the company across several distinct legal documents. To provide a quick orientation to those of our readers with a "German market" background, we will look at the structure of a typical German investment agreement and shareholders' agreement as the two core deal documents and show where the relevant matters usually get addressed in the NVCA standard documents. In the next Chapter, we will look at some notable differences between U.S. and German deals in more detail.

1. OVERVIEW

U.S. financing rounds usually include the following agreements:

Certificate of Incorporation: The company's *Certificate of Incorporation* (also referred to as a Charter for corporations under the jurisdiction of certain states other than Delaware) is the only publicly filed document of the five core documents presented here. The Certificate of Incorporation sets forth the bedrock principles governing the company, certain of the rights and privileges vested with the preferred stock and, in particular, rights regarding dividends, liquidation preference, protective provisions and anti-dilution protection. When a new class of (preferred) stock is issued or the number of authorized shares is increased, these changes need to be reflected in the company's Certificate of Incorporation (that is why the filing of the revised and restated Certificate of Incorporation — usually with the State Secretary of Delaware — is an important first step in the closing of a U.S. VC financing).

Stock Purchase Agreement: The new investors and the company will enter into a *Stock Purchase Agreement* under which the new investors will purchase preferred stock.

This Stock Purchase Agreement will identify, among others, the number of shares of preferred stock being sold to the investors, the purchase price per share of preferred stock to be paid by the investors and the conditions to be satisfied prior to the closing of the financing transaction. It will also contain the representations and warranties given by the investors and the company, including the validity of the preferred stock being purchased and, in most cases, a rather extensive list of operational and financial representations and warranties (did we mention that representations and warranties are one of the lawyers' favorite sandboxes — we will come back to this and where market practices differ on both sides of the Atlantic).

Investors' Rights Agreement: An *Investors' Rights Agreement* grants certain rights to the investors, which typically include information rights, preemptive rights in case of future issuance of new securities and registration rights pursuant to which the investor can require the company to publicly register the company's common stock (and sometimes preferred stock) with the U.S. Securities and Exchange Commission ("**SEC**") in connection with or following an initial public offering ("**IPO**") of the company. Unlike in Germany, certain of these rights are usually reserved for the larger investors, called the "Major Investors" (see below under Chapter A.IV.3.2.2). The Investors' Rights Agreement can also include relevant provisions around the founders' lock-up, the company's Employee Stock Ownership Plan ("**ESOP**") and board observer rights.

Voting Agreement: In a separate *Voting Agreement*, the parties stipulate how the stockholders will appoint and remove directors on the company's board of directors. These agreements usually also contain provisions regarding the stockholders' obligations to vote in favor of exit transactions (known as a drag-along), provided that certain criteria are fulfilled (*e.g.*, approval of the transaction by the board, a majority of common stock and a majority of preferred stock).

Right of First Refusal and Co-Sale Agreement: Finally, the parties may enter into a separate *Right of First Refusal and Co-Sale Agreement*, which states that if the founders or certain other holders of common stock (usually referred to as "Key Holders" – note that in most cases investors will want the term "**Key Holders**" to include major common stock or option holders in addition to the individuals who actually founded the company) propose to sell their shares to a third-party buyer, the company will have a primary right of first refusal and the holders of preferred stock (usually, this right is limited to the Major Investors) have a secondary right of first refusal to match the third-party offer or, alternatively, the holders of preferred stock have a co-sale right (also here, such right is usually limited to the Major Investors) to participate in the sale by selling their preferred stock to the third-party purchaser on a *pro rata* basis. Typically, in U.S. financing rounds, the right of first refusal obligation is imposed only on the founders or other Key Holders' shares as opposed to German financing rounds where the right of first refusal obligation has to be observed by all stockholders (subject to certain exceptions).

Core NVCA Financing Documents	Core BVCA Financing Documents	Core Financing Documents in a Typical German Financing Round
1. Certificate of Incorporation	1. Articles of Association	1. Articles of Association
2. Stock Purchase Agreement	2. Subscription Agreement	2. Investment Agreement
3. Investors' Rights Agreement	3. Shareholders' Agreement	3. Shareholders' Agreement
4. Voting Agreement		
5. Right of First Refusal and Co-Sale Agreement		

CLOSING PUNCH LIST

Below is the skeleton of a closing memorandum for a typical U.S. VC financing (although it might make some of our readers cry, keep in mind that all the documents listed below can be signed electronically, respectively executed by a mere exchange of executed signature pages, no wet ink signatures are required — did anybody mention a notary?). This is a bare-bones list; other actions or deliverables may be and often are required as part of a financing using the NVCA forms.

A. Matters Completed Prior to the Closing

1. The board of directors needs to approve (i) the amended and restated Charter, (ii) the Stock Purchase Agreement and (iii) the sale of a certain number of shares of preferred stock at a certain purchase price to the investors.
2. After the board of directors has acted and deemed it advisable, the stockholders of the company, by written (note that in the United States, "written" form includes electronic signature tools like DocuSign™) consent, need to approve the amended and restated Charter. All board and stockholder approvals may be accomplished by written consent for Delaware corporations.
3. The company needs to file the restated Certificate of Incorporation/Charter with the Secretary of State of the state of Delaware.

B. Matters Completed at the Closing

1. **Stock Purchase Agreement:** The company and the investors execute and deliver the Stock Purchase Agreement.
2. **Investors' Rights Agreement:** The company, the founders, the existing investors (if any) and the incoming investors execute and deliver the (revised) Investors' Rights Agreement.
3. **Right of First Refusal and Co-Sale Agreement:** The company, the founders, the existing investors (if any) and the incoming investors execute and deliver the (revised) Right of First Refusal and Co-Sale Agreement.
4. **Voting Agreement:** The company, the founders, the existing investors (if any) and the incoming investors execute and deliver the (revised) Voting Agreement.
5. **Further Company Documents:** The company usually delivers executed copies of the following documents to the investors: compliance certificate, legal opinion from the company's outside counsel, a certificate of the company's secretary certifying as accurate copies of the Certificate of Incorporation, the bylaws, and resolutions of the Board and the stockholders.

   The company will also either deliver a notice of issuance of stock or stock certificates in the name of the investors with respect to the number of preferred stock purchased by them in the financing.
6. **Payments:** Finally, the investors wire the purchase prices and the company needs to confirm receipt of funds.

C. Matters Completed After the Closing

1. The company ensures compliance with the respective state securities law authorities.
2. The company files a Form D notice of sale of securities with the SEC.

2. WHERE TO FIND WHAT

The table below lists the main economic and control considerations that a comprehensive VC deal documentation will usually address (post the term sheet stage) and shows where such provisions can be found in typical German market documentation and where corresponding provisions can be found in the NVCA set of documents[4].

Topic	In Germany, Details Can Be Found Here	In the United States, Details Can Be Found Here	Further Information in Chapter
ECONOMIC TERMS			
Pre- and post-money valuation	Investment Agreement	Stock Purchase Agreement (in that the pre-money valuation is implied by the purchase price of the stock)	N/A
ESOPs, VSOPs and co.	Investment Agreement (to the extent such programs are relevant for the pre-money valuation) and shareholders' agreement (as it relates to the implementation, amendment and economic burdens of the program)	Stock Purchase Agreement (the size of the ESOP; details of the program are in the plan itself, as adopted by each company's board and stockholders)	N/A
Investment amount and issuance of new shares	Investment Agreement	Stock Purchase Agreement	A.IV.1
Mode of payment as well as default provision	Investment Agreement	Stock Purchase Agreement	N/A
Secondary share sales	Investment Agreement (sometimes separate agreement)	Separate agreement	N/A
Representations, warranties and remedies in case of breach	Investment Agreement	Stock Purchase Agreement	A.IV.2.2
Anti-dilution protection	Shareholders' Agreement	Certificate of Incorporation	A.IV.1, A.VI.2.2
Preference dividends	Shareholders' Agreement	Certificate of Incorporation	A.IV.1, A.VI.2.1
Liquidation preferences	Shareholders' Agreement	Certificate of Incorporation	A.IV.2.1, A.VI.2.1

4 The order in which the terms are presented in this table follows the structure of our publication, "OLNS#9 – Venture Capital Deals in Germany," that presents these topics in detail for German market VC financings and is available at https://media.orrick.com/Media%20Library/public/files/insights/2021/OLNS9-VC-Deals-in-Germany.pdf.

Topic	In Germany, Details Can Be Found Here	In the United States, Details Can Be Found Here	Further Information in Chapter
CONTROL TERMS			
Board (composition)	Shareholders' Agreement and articles of association	Voting Agreement	A.IV.3.1
Investor majority and investor veto rights	Shareholders' Agreement, articles of association and (as the case may be) the rules of procedure for the management	Certificate of Incorporation (protective provisions) Investors' Rights Agreement (board matters requiring preferred director approval (if any))	A.IV.1
Information and monitoring rights	Shareholders' Agreement	Investors' Rights Agreement	A.IV.3.2
Share transfer provisions	Articles of association (all transfers require at least shareholders' approval)	No equivalent (may be contained in the bylaws)	A.IV.1
– RoFR	Shareholders' Agreement	Right of First Refusal and Co-Sale Agreement	A.IV.1, A.IV.2.1.1
– Drag-along	Shareholders' Agreement	Voting Agreement	A.IV.2.4
– Tag-along	Shareholders' Agreement	Right of First Refusal and Co-Sale Agreement	A.IV.2.4
IPO-related provisions	Shareholders' Agreement (if any)	Investors' Rights Agreement	A.IV.2.5
Founder vesting and leaver events	Shareholders' Agreement	These matters are addressed outside the aforesaid financing documents and usually found in so-called "Founders' Common Stock Purchase Agreement(s)" or "Stock Restriction Agreement(s)," as applicable	A.IV.2.3
ESG and diversity covenants (as the case may be)	Shareholders' Agreement	Investors' Rights Agreements or side letters with the respective investors	N/A

IV. Differences Between NVCA and German Market Deal Terms

1. IT ALL STARTS WITH A TERM SHEET

We assume that most of our readers will be well versed with the contents of a "typical" German market term sheet for a Series A financing. Against that background, and in order to establish a frame of reference, in this Chapter we will summarize some observations that a "German" reader might have when looking at the NVCA model term sheet. Later in this Guide, we will go deeper on some of these aspects.

Before we get started, when reading through the NVCA term sheet, one has to keep in mind that it maps to the other NVCA model documents and thus groups for convenience relevant provisions according to the particular model documents in which they may be found. Clearly, the NVCA standard is longer than a "typical" term sheet in a U.S. financing (which are often only 2-3 pages long). However, the NVCA document provides not only for alternatives (reflecting more company-/founder-friendly vs. more investor-friendly terms) but has been set up as a fairly comprehensive road map for the document drafters.

> Term sheets are not meant to be fair, they are meant to be negotiated.

In the table on the following pages, the text in the left column is taken from the NVCA's "Enhanced Model Term Sheet v3.0" (without the annotations in the footnotes), while the column on the right is a snapshot of some initial observations from an outsider's — read German — perspective (not that Germans are outsiders per se… except for our national football team that recently "played" itself into quite an outsider's role, but we are getting off track here).

NVCA Term Sheet	Observations From a German Practitioner
TERM SHEET FOR SERIES A PREFERRED STOCK FINANCING OF [INSERT COMPANY NAME], INC. **[_________, 20__]**	
This Term Sheet summarizes the principal terms of the Series A Preferred Stock Financing of [_________], Inc., a [Delaware] corporation (the "**Company**"). In consideration of the time and expense devoted and to be devoted by the Investors with respect to this investment, the No Shop/Confidentiality provisions of this Term Sheet shall be binding obligations of the Company whether or not the financing is consummated. No other legally binding obligations will be created until definitive agreements are executed and delivered by all parties. This Term Sheet is not a commitment to invest and is conditioned on the completion of the conditions to closing set forth below. This Term Sheet shall be governed in all respects by the laws of [_________].	German market term sheets usually contain similar disclaimers and only have provisions such as 'exclusivity/no-shop,' 'confidentiality,' 'venue and governing law' that are legally binding. Interestingly, according to the law of certain jurisdictions such as Delaware or New York and some others, entering into a "nonbinding" term sheet may, in fact, create an enforceable obligation to negotiate in good faith to come to agreement on the terms set forth in the term sheet.
OFFERING TERMS	
Security: Series A Preferred Stock (the "**Series A Preferred**").	The NVCA term sheet assumes that the stock being issued in this round will be shares of Series A Preferred. The stock is preferred, which means it comes with additional rights and privileges compared to the shares of common stock (usually issued to the founders and employees). The remainder of the model term sheet largely summarizes such preferences and privileges and establishes some general rules about the interplay between the various stockholders/groups of stockholders. Throw in a few provisions on the process until closing of the financing round and *voilà*, the famous NVCA term sheet. See, it isn't that difficult after all... that is of course before we get into the details but let's continue. That is just another sidebar to address another phenomenon that sometimes irritates German investors when dealing with U.S. companies. Founders Preferred Stock ("**FP**") is a class of stock sometimes issued to founders of a company that, in their hands, is identical to common stock but the FP automatically converts to preferred stock when sold in a secondary in connection with a bona fide preferred stock financing. FP comes with benefits for founders and the company: a sale of FP avoids the risk of an adjustment to the company's 409(a) value that might occur when a founder sells common stock at an elevated price; a sale of FP avoids the risk of a QSBS violation that might occur when the company converts common stock to preferred stock as part of a secondary sale; and FP can later be converted to high-vote stock if the company belatedly wants to entrench founders with higher voting rights but did not incorporate with dual class common stock. However, certain investors have been pushing back against the inclusion of FP in company charters. Some well-known U.S. accelerators do not like FP, as they are normally allocated common stock as part of their investment and want their portfolio companies' founders to hold the same securities as they do to increase alignment.

NVCA Term Sheet	Observations From a German Practitioner
Closing Date: As soon as practicable following the Company's acceptance of this Term Sheet and satisfaction of the conditions to closing (the "**Closing**"). [*provide for multiple closings if applicable*]	Unlike in Germany, signing and closing in the United States can and often do occur simultaneously. Once the closing conditions are met, signing and closing can occur at a time mutually agreed upon by the company and investors.
Conditions to Closing: Standard conditions to Closing, including, among other things, satisfactory completion of financial and legal due diligence, qualification of the shares under applicable Blue Sky laws, the filing of a Certificate of Incorporation establishing the rights and preferences of the Series A Preferred, [obtaining CFIUS clearance and/or a statement from CFIUS that no further review is necessary,] [and an opinion of counsel to the Company].	German market term sheets usually provide for some closing conditions as well. In fact, they are technically more precisely described as "signing conditions" due to the two-staged closing process in German deals where the new shares need to be registered first with the commercial register. A few U.S. particularities are worth mentioning here: • In a nutshell, Blue Sky laws are state-level, anti-fraud regulations that can require issuers of securities to be registered and to disclose details of their offerings. Blue sky laws create liability for issuers, allowing legal authorities and investors to bring action against them for failing to live up to the laws' provisions. Thus, a qualification of shares under applicable Blue Sky laws means that the respective shares have been filed with the relevant state security office. Often these state laws are pre-empted by U.S. federal securities laws and only a copy of the federal filing must be made with the relevant states. • As outlined above, the closing process in a U.S. deal requires the filing of an amended and restated Certificate of Incorporation for the start-up to create and subsequently sell the new Preferred Stock. Unlike the registration of newly issued shares in a German GmbH with the commercial register, the filing of an updated Certificate of Incorporation is a matter of a business day or two. • Re CFIUS: The Committee on Foreign Investment in the United States ("**CFIUS**") is an interagency committee authorized to review certain transactions involving foreign investment in the United States and certain real estate transactions by foreign persons in order to determine the effect of such transactions on the national security of the United States. For start-up investments, this means that in case a financing round involves foreign investors, a CFIUS filing may be mandatory with respect to certain investments (*e.g.*, some transactions involving "critical technologies"), or only voluntary but advisable with respect to others. Drawn with a broad brush, CFIUS can come into play when a foreign investor intends to obtain (i) access to material non-public technical information, including through a board seat, observer, or nomination right, (ii) more than 10% of the voting rights in a U.S. start-up or (iii) control over decision-making at the company, including with respect to company technologies, data and infrastructure. We will provide a more comprehensive overview of CFIUS considerations later in this Guide (see Chapter A.VIII). That being said, if CFIUS review is a concern in a certain investment, the documentation will likely contain more detailed provisions about the filing and clearance process and what conditions or restrictions need to be accepted, including a disclaimer on board representation, information rights, etc.

NVCA Term Sheet	Observations From a German Practitioner
Investors: Investor No. 1: [______] shares ([__]%), $[________] Investor No. 2: [______] shares ([__]%), $[________] [as well other investors mutually agreed upon by Investors and the Company]	
Amount Raised: $[_______], [including $[_______] from the conversion of SAFEs/principal [and interest] on bridge notes]	The NVCA documentation no longer provides for milestone drafting options. Such options were included in its 2018 version to allow investors in life sciences transactions to condition their investment on specified milestones being achieved, but they were removed in the 2020 overhaul.
Pre-Money Valuation: The price per share of the Series A Preferred (the "**Original Purchase Price**") shall be the price determined on the basis of a fully-diluted pre-money valuation of $[____] (which pre-money valuation shall include an [unallocated and uncommitted] employee option pool representing [__]% of the fullydiluted post-money capitalization) and a fullydiluted post-money valuation of $[_____].	German market term sheets contain similar provisions. The concept of "fully diluted" means this value is spread over all of the company's shares, options, warrants, convertible securities, etc., when determining the per share price to be paid by investors in the financing. In Germany, employee participation programs are usually structured as virtual stock/phantom stock programs, and no real shares or options for real shares will be issued. However, their economic impact on the fully diluted purchase price calculation is similar. Investors often require a top-up to the stock plan to a specified percentage of the post-money shares. Even though the percentage is stated as a post-money percentage, the additional shares associated with the top-up are counted in the pre-money shares for purposes of determining the purchase price per share. In other words, this top-up will dilute the existing stockholders and not the new investors.
CERTIFICATE OF INCORPORATION	
Dividends: [*Alternative 1:* Dividends will be paid on the Series A Preferred on an as converted basis when, as, and if paid on the Common Stock.] [*Alternative 2:* Non-cumulative dividends will be paid on the Series A Preferred in an amount equal to $[____] per share of Series A Preferred when and if declared by the Board of Directors.] [*Alternative 3:* The Series A Preferred will carry an annual [__]% cumulative dividend [payable upon a liquidation or redemption]. For any other dividends or distributions, participation with Common Stock on an as-converted basis.]	Dividends rarely come into play in start-up land. Only the language in Alternative 3 of the NVCA term sheet obliges the start-up to pay dividends. The other alternatives merely stipulate (from a German perspective clarifies…) that if the company decides to pay dividends, the holders of Series A Preferred will participate alongside the common stockholders (and under some alternatives, prior to the common stockholders). In U.S. deals, the parties should, however, consider carefully the implications of an investor requesting "cumulative dividends" (Alternative 3). A cumulative dividend is a right to receive a fixed amount or a percentage of a share's par value or purchase price periodically without regard to the company's earnings or profitability. A cumulative dividend must be paid, whereas a regular dividend, also called a noncumulative dividend, may or may not be paid. In the column on the left, Alternative 1 is equivalent to what applies under statutory law in Germany. Alternative 2 is economically equivalent to a liquidation preference with a computational annual interest coupon that we sometimes encounter in Germany (*e.g.*, a 1x non-participating liquidation preference with a 5% computational interest p.a.). "Real" preferred dividends such as in Alternative 3 are extremely rare in Germany.

NVCA Term Sheet	Observations From a German Practitioner
Liquidation Preference: In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows: • [*Alternative 1 (non-participating Preferred Stock)*: First pay [__ times] the Original Purchase Price [plus [accrued and] declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed *pro rata* to holders of Common Stock.] • [*Alternative 2 (full participating Preferred Stock)*: First pay [__ times] the Original Purchase Price [plus accrued and declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock *pro rata* on an as-converted basis.] • *[Alternative 3 (cap on Preferred Stock participation rights)*: First pay [__ times] the Original Purchase Price [plus accrued and declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock *pro rata* on an as-converted basis until the holders of Series A Preferred receive an aggregate of [____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).]	German market term sheets will also always stipulate what kind of liquidation preference shall be attached to the newly issued preferred shares. Worth noting: German investors are often irritated if SAFEs, convertible loans or the like state that they convert into *Shadow Preferred Stock*, *SAFE Preferred Stock* or the like instead of "*standard*" preferred stock. Here is the background in a nutshell: The Certificate of Incorporation sets forth the liquidation preference each share of preferred stock is entitled to receive as a specific USD amount which is equal to the price per share the relevant investor has paid for the relevant shares while German financing documents do usually not put a "price tag" on the liquidation preference. If, for example, the company issues Series A preferred stock to (i) new money investors at the price per preferred stock of the priced round and to holders of SAFEs with identical conversion terms at a discounted price per preferred stock, the shares of preferred stock issued will be sub-divided into Series A-1 Preferred Stock and Series A-2 Preferred Stock with each sub-series providing for its own initial purchase price/share as the amount of liquidation preference. In other words, the term *Shadow Preferred Stock* or *SAFE Preferred Stock* does not mean that a SAFE or convertible note investor is getting an inferior class of shares as compared to the new money investors. The sub-division of share classes merely reflects the different per share liquidation preference and the conversion price for purposes of price-based anti-dilution protection which both equal the the relevant purchase price per share while having the identical rights, privileges, preferences and restrictions as the other shares of the same series of preferred stock.
A merger or consolidation (other than one in which stockholders of the Company own a majority by voting power of the outstanding shares of the surviving or acquiring corporation) or a sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the Company will be treated as a liquidation event (a "**Deemed Liquidation Event**"), thereby triggering payment of the liquidation preferences described above unless the holders of [__]% of the Series A Preferred elect otherwise (the "**Requisite Holders**"). [The Investors' entitlement to their liquidation preference shall not be abrogated or diminished in the event part of the consideration is subject to escrow or indemnity holdback in connection with a Deemed Liquidation Event.]	Interestingly, the text of the NVCA term sheet makes no explicit reference to a change-of-control event structured as a stock sale rather than a merger. While in the United States acquisitions of a controlling stake in a technology company are usually implemented through the merger statutes, the question arises why change-of-control share sales are not considered Deemed Liquidation Events under the NVCA documentation and how investors seek protection against the threat of a circumvention of their liquidation preferences. We will come back to these questions in Chapter A.IV.2.1. The bracketed last sentence in this provision is meant to ensure that the preferred stockholders always receive their liquidation preference, even if some or all of the portion of the purchase price is contingent consideration. The holders of preferred stock shall not be required to "hope" that the contingent consideration will ultimately be paid so that they can get their full preference amount. Rather, the contingent consideration shall be ignored for the distribution of the initial consideration, *i.e.*, the initial consideration (without any escrow or indemnity holdback) shall, as a first priority, be used to satisfy the liquidation preference in full. Whether the contingent consideration is then forfeited or paid, the result would be an allocation that is consistent with how the Certificate of Incorporation would allocate whatever the ultimate purchase price turns out to be.

NVCA Term Sheet	Observations From a German Practitioner
Voting Rights: The Series A Preferred shall vote together with the Common Stock on an as-converted basis, and not as a separate class, except (i) so long as [insert fixed number or %] of the shares of Series A Preferred issued in the transaction are outstanding, the Series A Preferred as a separate class shall be entitled to elect [______] [(_)] members of the Board of Directors ([each a] "**Preferred Director**"), (ii) as required by law, and (iii) as provided in "Protective Provisions" below. The Company's Charter will provide that the number of authorized shares of Common Stock may be increased or decreased with the approval of a majority of the Preferred and Common Stock, voting together as a single class, and without a separate class vote by the Common Stock.	This provision deals with several aspects that are also frequently addressed in a German market term sheet (though in a slightly different way): • In Germany, preferred shares usually (if at all) convert to common shares on a 1:1 ratio while this ratio does usually not change over time (*e.g.*, as means of anti dilution protection as is the case in the United States) and it is therefore not necessary to stipulate that they shall vote on an "as-converted basis" (though it is advisable to stipulate in the company's articles of association that the division in share classes shall not require any separate class votes). • The preferred shareholders' representation on the company's (advisory) board is also a standard feature (stipulated in the shareholders' agreement and the articles of association). However, as we will see, a German advisory board is something quite different from a U.S. board of directors. The last sentence in this paragraph of the NVCA term sheet has the following background: at least for companies incorporated in Delaware (this is not possible for California corporations), it is possible to agree that no separate class vote by common stockholders shall be required to authorize shares of common stock. This term sheet provision removes a block on future financings that the holders of common stock would otherwise have (unless the non-preferred holders constitute an overall majority as most amendments require an absolute majority in addition to any class or series votes).
Protective Provisions: So long as [*insert fixed number* or %] shares of Series A Preferred issued in the transaction are outstanding, in addition to any other vote or approval required under the Company's Charter or Bylaws, the Company will not, without the written consent of the Requisite Holders, either directly or by amendment, merger, consolidation, recapitalization, reclassification, or otherwise: (i) liquidate, dissolve or wind up the affairs of the Company or effect any Deemed Liquidation Event; (ii) amend, alter, or repeal any provision of the Charter or Bylaws [in a manner adverse to the Series A Preferred Stock]; (iii) create or authorize the creation of or issue any other security convertible into or exercisable for any equity security unless the same ranks junior to the Series A Preferred with respect to its rights, preferences and privileges, or increase the authorized number of shares of Series A Preferred; (iv) sell, issue, sponsor, create or distribute any digital tokens, cryptocurrency or other blockchain-based assets without approval of the Board of Directors[, including the Investor Directors]; (v) purchase or redeem or pay any dividend on any capital stock prior to the Series A Preferred, other than stock repurchased at cost from former employees and consultants in connection with the cessation of their service, [or as otherwise approved by the Board of Directors[, including the approval of [at least one] Preferred Director]; or	German market term sheets usually provide for similar veto positions (sometimes they are only dealt with later in the long-form documentations), although a few observations are called for: • In Germany, when it comes to investor's veto rights, we often see a distinction between (i) more "fundamental" measures that get assigned to the shareholders' meeting and require, among others, approval of a certain preferred majority (these matters are usually set forth in the company's articles of association) and (ii) more operational matters for which the company's management board requires the approval of the advisory board and that are often set forth in the shareholders' agreement or the rules of procedure for the management board. From the list on the left, in Germany, the measures under limb (i), (ii), (iii), (v) and (ix) would fall in the competence of the shareholders' meeting (by operation of law or per contractual arrangements), while the matters under limb (iv), (vi), (vii) and (viii) are frequently assigned to the advisory board for review and approval.

NVCA Term Sheet	Observations From a German Practitioner
(vi) [adopt, amend, terminate or repeal any equity (or equity-linked) compensation plan or amend or waive any of the terms of any option or other grant pursuant to any such plan; (vii)] create or authorize the creation of any debt security[, if the aggregate indebtedness of the Corporation and its subsidiaries for borrowed money following such action would exceed $[____] [other than equipment leases, bank lines of credit or trade payables incurred in the ordinary course] [unless such debt security has received the prior approval of the Board of Directors, including the approval of [at least one] Preferred Director; [or] (viii) create or hold capital stock in any subsidiary that is not wholly-owned, or dispose of any subsidiary stock or all or substantially all of any subsidiary assets; [or (ix) increase or decrease the authorized number of directors constituting the Board of Directors or change the number of votes entitled to be cast by any director or directors on any matter].	• In Germany, investors will frequently ask for further veto rights for certain measures that are often assigned to the shareholders' meeting, including vetos on transformation measures, conclusion of enterprise agreements (*e.g.*, control or profit and loss transfer agreements), issuances of any shares (irrespective of whether the rights and preferences of such shares are senior or junior to those of existing preferred stock), and creation and acquisition of subsidiaries, etc. Under Delaware law, the authorization of another series of preferred stock with rights senior to those of the Series A preferred stock as to dividends, liquidation and redemption would generally not constitute an amendment that adversely affects the Series A Preferred. Accordingly, the NVCA Certificate of Incorporation template contains additional restrictions specifically dealing with the authorization of senior or pari passu stock. There is a divergence of interest between the company and the investors with respect to whether specified corporate acts should be subject to approval by the investors' designee to the board of directors. Other formulations could be: requiring the vote of a supermajority of the board of directors, or a majority of the non-management directors. These provisions should also be harmonized with the protective provisions (*i.e.*, the special investor approval rights requiring approval by stockholders representing the Requisite Holders) to avoid overlap. In determining whether stockholder approval (the protective provisions) or director approval is appropriate for a given matter, a number of factors should be considered, *e.g.*, (i) the directors, (unlike an investor), are constrained by their fiduciary duties to the Company when making decisions, (ii) as a practical matter, Board approval is often easier to obtain than stockholder approval, (iii) the proportion of preferred shares held by funds whose partners sit on the board of directors and (iv) if consent rights are contained in the Certificate of Incorporation an act by the company without such prior consent may be void or voidable rather than simply a breach of contract.
Optional Conversion: The Series A Preferred initially converts 1:1 to Common Stock at any time at option of holder, subject to adjustments for stock dividends, splits, combinations and similar events and as described below under "Anti-dilution Provisions."	The conversion ratio is not relevant in German market deals. However, in the United States, the conversion ratio is used, *inter alia*, to implement anti-dilution protection rights (in the United States, such rights are not implemented through the issuance of additional preferred stock such as we would expect it in Germany but, rather, through an adjustment of the conversion ratio). Against this background, a voluntary conversion is the right of preferred stockholders to convert their shares into common stock at any time. So, why would an investor want to do this? Converting preferred shares (at a ratio of 1:1 or 1:>1 *e.g.*, in case of a down round protection adjustment) means that the investor forgoes all the privileges and preferences from its preferred shares. The main reason to do this is when the time of an exit arrives. Another reason can be to obtain the majority of votes vested with the common stock in order to control the common majority.

NVCA Term Sheet	Observations From a German Practitioner
Anti-dilution Provisions: In the event that the Company issues additional securities at a purchase price less than the current Series A Preferred conversion price, such conversion price shall be adjusted in accordance with the following formula: CP2 = CP1 * (A+B)/(A+C) Where: CP2 = Series A Conversion Price in effect immediately after new issue CP1 = Series A Conversion Price in effect immediately prior to new issue A = Number of shares of Common Stock deemed to be outstanding immediately prior to new issue (includes all shares of outstanding common stock, all shares of outstanding preferred stock on an as-converted basis, and all outstanding options on an as-exercised basis; and does not include any convertible securities converting into this round of financing) B = Aggregate consideration received by the Company with respect to the new issue divided by CP1 C = Number of shares of stock issued in the subject transaction	While the concept of an anti-dilution protection is also a standard feature in German market term sheets, there are a couple of differences: • In the United States, receiving additional preferred shares right away in case of a down round getting implemented like under a German market anti-dilution protection would be detrimental for the investor from a tax perspective. • Rather, in the United States, the conversion ratio gets adjusted, *i.e.*, once converted (usually in case of an IPO or upon distribution of the liquidation proceeds), the investor will receive a proportionally higher number of common shares. Until then, when it comes to exercising voting rights, the investor is protected, as the stockholders will exercise their voting rights on an "as-converted basis." • Unlike in Germany where the investor needs to make a cash payment of EUR 1.00 for each new preferred share it receives under the anti-dilution protection, no such payments are required in Delaware.
The foregoing shall be subject to customary exceptions, including, without limitation, the following: (i) securities issuable upon conversion of any of the Series A Preferred, or as a dividend or distribution on the Series A Preferred; (ii) securities issued upon the conversion of any debenture, warrant, option, or other convertible security; (iii) Common Stock issuable upon a stock split, stock dividend, or any subdivision of shares of Common Stock; (iv) shares of Common Stock (or options to purchase such shares of Common Stock) issued or issuable to employees or directors of, or consultants to, the Company pursuant to any plan approved by the Company's Board of Directors [including at least [one] Preferred Director(s)], and other customary exceptions.	Similar exceptions from the anti-dilution protection can also be found in German market deals.
Mandatory Conversion: Each share of Series A Preferred will automatically be converted into Common Stock at the then applicable conversion rate in the event of the closing of a firm commitment underwritten public offering [with a price of [___] times the Original Purchase Price] (subject to adjustments for stock dividends, splits, combinations and similar events) and [gross] proceeds to the Company of not less than $[______] (a "**QPO**"), or upon the written consent of the Requisite Holders.	Such provisions usually do not come up in German market term sheets, and they need to be seen and understood in the wider context of the importance of registration rights in the United States (see Chapter A.IV.2.5). While in case of an "unqualified" IPO, holders of preferred stock can convert their preferred stock into common stock, in case of a qualified IPO, such conversion occurs automatically. The criterion that makes an IPO a qualified IPO is the amount of the proceeds raised and the offering price of the shares. The amount of proceeds raised can be stated as a gross or net number. Note that underwriter discounts, commissions, etc., can be as high as 7—10% of the gross proceeds.

NVCA Term Sheet	Observations From a German Practitioner
[*Pay-to-Play:* Unless the Requisite Holders elect otherwise, on any subsequent [down] round, all holders of Series A Preferred Stock are required to purchase their *pro rata* share of the securities set aside by the Board of Directors for purchase by such holders. [A proportionate amount/all] of the shares of Series A Preferred of any holder failing to do so will automatically convert to Common Stock and lose corresponding preferred stock rights, such as the right to a Board seat, if applicable.]	Pay-to-play provisions are very rare in German market term sheets. Except in certain heavily structured financing, they also tend to be the rare exception in U.S. deals, an observation that holds true at least during the latest bull market. According to data from the service provider Aumni for deals until the end of 2021, pay-to-play provisions showed up only in 0.2—5.9% of all financings (depending on series of financing with pay-to-play provisions somewhat more frequent in later rounds). With a more challenging funding environment, such provisions might appear more often in the quarters to come though one has to note that also during the VC winters after the dot.com crash and in the wake of the 2008/2009 recession, these provisions never really became a standard feature of typical VC deals. Assuming a pay-to-play provision that provides for a mandatory conversion of (all or a portion of) the preferred stock into common stock, careful consideration must be given to whether such converted shares should lose (all) the contractual rights provided under the various ancillary agreements typically involved in a preferred stock financing (*e.g.*, registration rights, preemptive rights, information rights, etc.).
[*Redemption Rights:* Unless prohibited by applicable law governing distributions to stockholders, the Series A Preferred shall be redeemable at the option of the Requisite Holders commencing any time after the five (5)year anniversary of the Closing at a price equal to the Original Purchase Price [plus all accrued/declared but unpaid dividends]. Redemption shall occur in three equal annual portions. Upon a redemption request from the holders of the required percentage of the Series A Preferred, all Series A Preferred shares shall be redeemed [(except for any Series A holders who affirmatively opt out)].	German market term sheets do not provide for such redemption rights. German capital maintenance rules set restrictions on shareholders' rights to request a redemption. Rather, in order to give investors an "emergency out" (*e.g.*, in case of zombie companies or to facilitate fund winding down), investors in Germany are frequently given a put option to sell and transfer all their preferred shares to a founder for a total consideration of EUR 1.00. That being said, redemption rights for investors are also rare in the United States, as they can be devastating for the company, and redemption features may also have important tax consequences, including potentially negative effects on efforts to maintain QSBS status.
STOCK PURCHASE AGREEMENT	
Representations and Warranties: Standard representations and warranties by the Company customary for its size and industry. [Representations and warranties regarding CFIUS.]	We will revisit the entire topic of representations, remedies and disclosure concepts in more detail below (see Chapter A.IV.2.2), but please note that it is standard in U.S. deals that only the company (*i.e.*, not the founders or other executives) will give (operational and financial) representations and warranties. Breaches will most frequently be compensated only in cash rather than in shares or a combination thereof (just as it is common in Germany).
[*Regulatory Covenants (CFIUS):* To the extent a CFIUS filing is or may be required: Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("CFIUS") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/declaration]].	See comments above.

NVCA Term Sheet	Observations From a German Practitioner
Counsel and Expenses: [Company] counsel to draft applicable documents. Company to pay all legal and administrative costs of the financing [at Closing], including (subject to the Closing) reasonable fees (not to exceed $[_____]) and expenses of Investor counsel.	According to data from the service provider Aumni, the median lead investor counsel fee cap for deals in 2021 amounted to $25k for Seed financing, $35k for Series A and $50-60k for Series B and beyond. According to our own data sets, these figures were still directionally correct for deals in 2022 and 2023 though fee caps tended to increase by approximately 10-20% during this time. Interestingly, despite the much higher hourly rates for legal counsel in the United States, the cost coverage in German deals is usually in the same brackets (on average between EUR 30-50k for plain vanilla transactions up until Series B). Two reasons might be that lead investors in the United States tend to do significantly less due diligence than what we see in German transactions and the level of standardization in legal documents is much lower in Germany. In addition, executing the deal documentation with the notarization requirements is more complex in Germany and usually involves more preparation time from the lawyers.
INVESTORS' RIGHTS AGREEMENT	
Registration Rights:	
Registrable Securities: All shares of Common Stock issuable upon conversion of the Series A Preferred and any other Common Stock held by the Investors will be deemed "**Registrable Securities**".	German term sheets are usually silent on registration rights matters. In fact, unless there are major U.S. investors on a German start-up's cap table, even the long-form documentation of a typical VC financing round at most contains very limited language around an IPO of the company. Not so with the NVCA model documentation, where registration rights provisions fill many pages, underlining the importance of this topic. According to data from Aumni for U.S. financings until end of 2021, depending on the stage of the company, registration rights were included in 65.1—99.4% of all financings (de facto beyond Series A, they are ubiquitous). We will unpack them later in this Guide and present the provisions around registration rights, what they mean and which ones really matter (see Chapter A.IV.2.5.1). Suffice it to say that in the United States, a registration rights provision ensures that the holders of preferred stock will have the opportunity to register and subsequently sell their shares in the public markets at an IPO of the start-up (note that unlike a GmbH, a U.S. Inc. can go public without any transformation or corporate reorganization being required). Only shares that are registered can get sold on the public market, and the company might have less incentive to help the investors make their shares fungible given that it receives no consideration in return. Against this background, these dense provisions spell out the prerequisites and the process to get investor shares publicly tradable.
Demand Registration: Upon earliest of (i) [three (3)-five (5)] years after the Closing; or (ii) [six (6)] months following an initial public offering ("**IPO**"), persons holding [__]% of the Registrable Securities may request [one][two] (consummated) registrations by the Company of their shares. The aggregate offering price for such registration may not be less than $[5-15] million. A registration will count for this purpose only if (i) all Registrable Securities requested to be registered are registered, and (ii) it is closed, or withdrawn at the request of the Investors (other than as a result of a material adverse change to the Company).	

NVCA Term Sheet	Observations From a German Practitioner
Registration on Form S-3: The holders of [[10-30]% of the] Registrable Securities will have the right to require the Company to register on Form S-3, if available for U.S. e by the Company, Registrable Securities for an aggregate offering price of at least $[3-5 million]. There will be no limit on the aggregate number of such Form S-3 registrations, provided that there are no more than [two (2)] per twelve (12) month period.	
Piggyback Registration: The holders of Registrable Securities will be entitled to "piggyback" registration rights on all registration statements of the Company, subject to the right, however, of the Company and its underwriters to reduce the number of shares proposed to be registered to a minimum of [20-30]% on a *pro rata* basis and to complete reduction on an IPO at the underwriter's discretion. In all events, the shares to be registered by holders of Registrable Securities will be reduced only after all other stockholders' shares are reduced.	
Expenses: The registration expenses (exclusive of stock transfer taxes, underwriting discounts and commissions will be borne by the Company. The Company will also pay the reasonable fees and expenses, not to exceed $[_____] per registration, of one special counsel to represent all the participating stockholders.	
Lock-up: Investors shall agree in connection with the IPO, if requested by the managing underwriter, not to sell or transfer any shares of Common Stock of the Company held immediately before the effective date of the IPO for a period of up to 180 days following the IPO (provided all directors and officers of the Company [and [1 – 5]% stockholders] agree to the same lock-up). [Such lock-up agreement shall provide that any discretionary waiver or termination of the restrictions of such agreements by the Company or representatives of the underwriters shall apply to Investors, *pro rata*, based on the number of shares held.]	
Termination: • [Upon a Deemed Liquidation Event [in which similar rights are granted or the consideration payable to Investors consists of cash or securities of a class listed on a national exchange]] [and/or after the IPO, when the Investor and its Rule 144 affiliates holds less than 1% of the Company's stock and all shares of an Investor are eligible to be sold without restriction under Rule 144 and/or] [T][t]he [third-fifth] anniversary of the IPO. • No future registration rights may be granted without consent of the holders of [a majority] of the Registrable Securities unless subordinate to the Investor's rights.	

NVCA Term Sheet	Observations From a German Practitioner
Management and Information Rights: A Management Rights letter from the Company, in a form reasonably acceptable to the Investors, will be delivered prior to Closing to each Investor that requires one. Any [Major] Investor (who is not a competitor) will be granted access to Company facilities and personnel during normal business hours and with reasonable advance notification. The Company will deliver to such [Major] Investor (i) annual, quarterly [and monthly] financial statements and other information as determined by the Board of Directors; [and] (ii) thirty (30) days prior to the end of each fiscal year, a comprehensive operating budget forecasting the Company's revenues, expenses, and cash position on a month-to-month basis for the upcoming fiscal year[; and (iii) promptly following the end of each quarter, an up-to-date capitalization table]. [A "Major Investor" means any Investor who purchases at least $[_____] of Series A Preferred.]	In German financings that do not involve U.S. investors, management rights letters usually do not come up. In fact, as we will see, most of the rights stipulated in a typical management rights letter are already granted to shareholders of a German GmbH either under applicable law or standard provisions of a typical shareholders' agreement for VC-backed start-ups. Provisions around the preparation of regular reports or information packages are a standard feature in German market deals. However, such provisions need to be seen against the background of a very comprehensive statutory information right for every single shareholder of a GmbH. We will revisit these differences in more detail later in this Guide (see Chapter A.IV.3.2).
Right to Participate Pro Rata in Future Rounds: All [Major] Investors shall have a *pro rata* right, based on their percentage equity ownership in the Company (assuming the conversion of all outstanding Preferred Stock into Common Stock and the exercise of all options outstanding under the Company's stock plans), to participate in subsequent issuances of equity securities of the Company (excluding those issuances listed at the end of the "Anti-dilution Provisions" section of this Term Sheet and shares issued in an IPO). In addition, should any [Major] Investor choose not to purchase its full *pro rata* share, the remaining [Major] Investors shall have the right to purchase the remaining *pro rata* shares.	Obviously, if the investor exercises this right, it will have an easier time getting capital committed for the next round. However, this provision cuts both ways, as it might leave little space for new investors in a future financing. Because of this, this *pro rata* participation right in U.S. deals is usually limited to the Major Investors (for a more detailed description of the "Major Investor" concept, see in Chapter A.IV.3.2.2). Though this solves the problem of crowding out the start-up's next round, it might also be considered as unfriendly by early backers of the start-up that cut smaller checks. In German market VC financings, such *pro rata* participation rights are usually granted to all shareholders. However, given that founders and early backers such as business angels will, for obvious reasons, often refrain from exercising such rights, the differences in practice are arguably limited. In Germany, a "gobble up" right for the shareholders that exercise their *pro rata* right is also a common feature.

NVCA Term Sheet	Observations From a German Practitioner
[*Matters Requiring Preferred Director Approval:* So long as the holders of Series A Preferred are entitled to elect a Director, the Company will not, without board approval, which approval must include the affirmative vote of [at least one/each of] the then-seated Preferred Directors: (i) make any loan or advance to, or own any stock or other securities of, any subsidiary or other corporation, partnership, or other entity unless it is wholly owned by the Company; (ii) make any loan or advance to any person, including, any employee or Director, except advances and similar expenditures in the ordinary course of business [or under the terms of an employee stock or option plan approved by the Board of Directors]; (iii) guarantee any indebtedness except for trade accounts of the Company or any subsidiary arising in the ordinary course of business; [(iv) make any investment inconsistent with any investment policy approved by the Board of Directors]; (v) incur any aggregate indebtedness in excess of $[____] that is not already included in a Board-approved budget, other than trade credit incurred in the ordinary course of business; (vi) hire, fire or change the compensation of the executive officers, including approving any option grants; (vii) change the principal business of the Company, enter new lines of business or exit the current line of business; (viii) sell, assign, license, pledge or encumber material technology or intellectual property, other than licenses granted in the ordinary course of business; or (ix) enter into any corporate strategic relationship involving the payment contribution or assignment by the Company or to the Company of assets greater than $[_______].]	As mentioned above, a German market documentation usually groups investor veto matters into two categories, *i.e.*, fundamental matters that require an approval by the shareholders' meeting with some form of a preferred majority and more operational matters that are assigned to the company's advisory board and, there, usually require the consent of certain advisory board members appointed by the investors. Against this background, the catalogue on the left does not appear unusual and actually rather lean when viewed through a German market lens. Such investor director veto rights have become common in U.S. deals but are usually quite heavily negotiated. Based on our experience, notably items (vi) and (vii) tend to get negotiated the most. Incorporation of a requirement that board consent include the approval by a "Preferred Director" is frequently seen as a compromise between requiring approval of the holders of preferred stock (*qua*-stockholders) and simply requiring board consent. However, investors need to be aware of the fact that any board-level approval of the Preferred Director (as opposed to stockholder approval by the holders of preferred stock) will be in such director's capacity as a member of the board of directors and therefore subject to the fiduciary duties of such director to the company.
Noncompetition Agreements: Founders and key employees will enter into a [one]-year noncompetition agreement in a form reasonably acceptable to the Investors.	German market term sheets usually do not stipulate non-compete provisions for key employees[5]. For founders, however, non-compete provisions are included in the shareholders' agreement and apply during the founder's tenure as a shareholder in the company (or at least while being in active service) plus a subsequent period of 12-24 months. A further parallel contractual non-compete undertaking for the founders is usually stipulated in their managing director service contracts with the company (including a similar post-contractual non-compete that requires a minimum compensation payment to the founder). We will come back to the main differences with respect to founder covenants below in Chapter A.IV.3.3.

5 With respect to the strict requirements under German law to agree on post-contractual non-compete undertakings, please see our Guide "OLNS#3 – Employment Law for Tech Companies (relaunched edition 2023)" that is available under www.orrick.com/en/Insights/2023/01/Orrick-Legal-Ninja-Series-OLNS-3-Employment-Law-for-Tech-Companies.

NVCA Term Sheet	Observations From a German Practitioner
Nondisclosure, Non-Solicitation and Developments Agreement: Each current, future and former founder, employee and consultant will enter into a nondisclosure, non-solicitation and proprietary rights assignment agreement in a form reasonably acceptable to the Investors.	In Germany, the long-form shareholders' agreement will usually contain a comprehensive IP assignment by the founders to the company coupled with a broad license for rights that cannot be assigned due to mandatory law. In addition, the founders' managing director service agreements (as the case may be) will also provide rights for the transfer of any future IP as well as non-compete and confidentiality covenants (such covenants are also a standard feature of the shareholders' agreement to which the founders are a party). Against this background, separate CIIAA (Confidential Information and Invention Assignment Agreements) are rare/not needed for the founders. The same holds true for key employees and consultants. IP rights created by them in the course of their employment or service will either be assigned or licensed under their employment/service agreement with the company or vest in the company by operation of law[6]. Consultants who have entered into a service agreement with the company will (or should) have comprehensive IP assignments and confidentiality undertakings included in their service contracts.
Board Matters: [Each Board Committee/the Nominating and Audit Committee shall include at least one Preferred Director.] The Company to reimburse [nonemployee] Directors for reasonable out-of-pocket expenses incurred in connection with attending the Board meeting. The Company will bind D&O insurance with a carrier and in an amount satisfactory to the Board of Directors. Company to enter into Indemnification Agreement with each Preferred Director with provisions benefitting their affiliated funds in a form acceptable to such Director. In the event the Company merges with another entity and is not the surviving entity, or transfers all of its assets, proper provisions shall be made so that successors of the Company assume the Company's obligations with respect to indemnification of Directors.	From a German law perspective, there are significant differences between a typical German market advisory board and a U.S. board of directors, and we will examine this in more detail later in this Guide (see Chapter A.IV.3.1.1). Suffice it to say here that the liability regime for a board of directors is significantly stricter, and that more nuanced duties and obligations apply to the Directors of a U.S. Board. That being said, a requirement to take out D&O insurance and out-of-pocket cost reimbursement is standard in Germany, while typical U.S. indemnification agreements are not common and would only provide, at best, very limited protection in case of the start-up's insolvency.
Employee Stock Options: All [future] employee options to vest as follows: [25% after one year, with remaining vesting monthly over next 36 months].	The NVCA term sheet stipulates a certain vesting scheme. The term sheet does not have to provide for any specific provisions for the strike price because such stock options need to be issued with a minimum strike price in order to comply with the provisions set forth in Section 409A of the United States Internal Revenue Code of 1986 (or in U.S. lawyers' parlance, simply referred to as the "Code"— like this was mankind's greatest and most important piece of legislation…). We are not really big fans of these provisions, either in U.S. nor German market term sheet, as they unnecessarily hamstring management when it comes to hiring decisions. If investors feel that they need such provisions to clarify expectations or set a benchmark, the parties should bake in some flexibility, *i.e.*, foresee that the (advisory) board can always allow for grants to beneficiaries upon different terms.

6 For details regarding the various types of IP (e.g., inventions/patents, copyrights, including copyrights in software) and ownership in an employment context, please see our Guide "OLNS#10 – University Entrepreneurship & Spin-offs in Germany – Set-up/IP/Financing and Much More" that is available under www.orrick.com/en/Insights/2022/11/Orrick-Legal-Ninja-Series-OLNS-10-University-Entrepreneurship-and-Spin-Offs-Germany.

NVCA Term Sheet	Observations From a German Practitioner
[*Limitations on Pre-CFIUS-Approval Exercise of Rights:* Notwithstanding anything to the contrary contained in the Transaction Agreements, Investors and the Company agree that as of and following the initial Closing and until the CFIUS clearance is received, Investors shall not obtain (i) "control" (as defined in Section 721 of the Defense Production Act, as amended, including all implementing regulations thereof (the "**DPA**")) of the Company, including the power to determine, direct or decide any important matters for the Company; (ii) access to any material nonpublic technical information (as defined in the DPA) in the possession of the Company; (iii) membership or observer rights on the Board of Directors of the Company or the right to nominate an individual to a position on the Board of Directors of the Company; or (iv) any involvement (other than through voting of shares) in substantive decision-making of the Company regarding (x) the use, development, acquisition or release of any of the Company's "critical technologies" (as defined in the DPA); (y) the use, development, acquisition, safekeeping or release of "sensitive personal data" (as defined in the DPA) of U.S. citizens maintained or collected by the Company, or (z) the management, operation, "manufacture" or supply of "covered investment critical infrastructure" (as defined in the DPA). To the extent that any term in the Transaction Agreements would grant any of these rights, (i)-(iv) to Investors, that term shall have no effect until such time as the CFIUS clearance is received.]	Like the other detailed CFIUS provisions, this provision got added to the NVCA model term sheet in its latest update from 2022 after the U.S. government had, over the last couple of years, tightened the rules applying to foreign direct investments in U.S. technology companies. That being said, the provision on the left is not standard in U.S. term sheets, as it is meant to address a situation in which the investor intends to close prior to obtaining CFIUS clearance. The foreign investor side letter language on point would override any aspect of the other transaction agreements that might, until CFIUS clearance is obtained, grant "control" of the company or access to aspects of the company that might create grounds for CFIUS jurisdiction (regarding the broad interpretation of "control" within the CFIUS framework, please see for details Chapter A.VIII).
[*Springing CFIUS Covenant:* [In the event that CFIUS requests or requires a filing/in the event of [ ]], Investors and the Company shall use reasonable best efforts to submit the proposed transaction to the Committee on Foreign Investment in the United States ("**CFIUS**") and obtain CFIUS clearance or a statement from CFIUS that no further review is necessary with respect to the parties' [notice/ declaration]. Notwithstanding the previous sentence, Investors shall have no obligation to take or accept any action, condition, or restriction as a condition of CFIUS clearance that would have a material adverse impact on the Company or the Investors' right to exercise control over the Company.]	Again, this is a rare provision in U.S. deals. It addresses the situation or concern that CFIUS may request a filing of the transaction at some future date or that a CFIUS filing may be required in the event of some future occurrence. A frequently cited issue is a case where a director is appointed by a certain class of shares and the foreign investor, for whatever reason, acquires the majority of the outstanding stock of such class of shares and thereby controls the appointment right for such Director. The NVCA notes in its annotation to this provision: "The further "notwithstanding" sentence ensures that while parties will cooperate to make the CFIUS filing, investor will not be obligated to accept CFIUS-required conditions on the deal that might frustrate the purposes of its investment (*i.e.*, the investor can abandon the proposed investment); more robust mitigation commitment language may be desirable from the perspective of U.S. companies or U.S. investors seeking to limit foreign investors' ability to abandon the transaction."
[Limitations on Information Rights: Notwithstanding anything to the contrary contained in the Stock Purchase Agreement, the Charter, the Investors' Rights Agreement, the Right of First Refusal And Co-Sale Agreement, and the Voting Agreement (all of the agreements above together being the "**Transaction Agreements**"), Investors and the Company agree that as of and following [Closing/the initial Closing], Investors shall not obtain access to any material nonpublic technical information (as defined in Section 721 of the Defense Production Act, as amended, including all implementing regulations thereof (the "**DPA**")) in the possession of the Company.]	To be included if investors are considered foreign investors under the DPA and intend to make an investment outside the jurisdiction of CFIUS. This assumes that investors intend not to obtain (i) a board seat, observer, or nomination right, (ii) more than 10% of the voting rights in the company or (iii) control over decision-making at the company, including with respect to company technologies, data and infrastructure.
[Other Covenants: Consult the NVCA Model Investors' Rights Agreement for a number of other covenants the Investors may seek; Investors should include to the extent they feel any may be controversial if not raised at the Term Sheet stage.]	

NVCA Term Sheet	Observations From a German Practitioner
RIGHT OF FIRST REFUSAL/CO-SALE AGREEMENT	
Right of First Refusal/ Right of Co-Sale (Take-Me-Along): Company first and Investors second will have a right of first refusal with respect to any shares of capital stock of the Company proposed to be transferred by current and future employees holding 1% or more of Company Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options), with a right of oversubscription for Investors of shares unsubscribed by the other Investors. Before any such person may sell Common Stock, he will give the Investors an opportunity to participate in such sale on a basis proportionate to the number of securities held by the seller and those held by the participating Investors.	When it comes to RoFR and co-sale (tag-along) provisions, market practices differ between the United States and Germany. In Germany, a first-level RoFR for the company is not that common (under German law, various restrictions apply regarding the acquisition by a start-up of its own shares). In addition, the RoFRs are often granted (i) with respect to proposed share transfers by every shareholders (including investors) and not only by major common stock or option holders (in the United States, these would be the so-called *Key Holders*) and (ii) to all shareholders and not just to investors. More prevalent are differences in the tag-along rights, where in Germany the financing round documentation is usually somewhat less investor-friendly and does not exempt their share sales from tag-along rights of other shareholders. For a more detailed discussion, see below in Chapter A.IV.2.4. Side note, the 1% de minimis threshold reflects market practices; otherwise, share transfers by really small stockholders (employees who might have exercised only a handful of stock options) could trigger the RoFR and co-sale process and result in unduly administrative burden. In addition, certain exceptions are typically negotiated, *e.g.*, estate planning or other de minimis transfers. Only occasionally, investors may also seek RoFR rights with respect to transfers by other investors in order to be able to have some control over the composition of the investor group (but that would be rather unusual in U.S. deals).
VOTING AGREEMENT	
Board of Directors: At the Closing, the Board of Directors shall consist of [_____] members comprised of (i) [*name*] as [the representative designated by [____], as the lead Investor, (ii) [*name*] as the representative designated by the remaining Investors, (iii) [*name*] as the representative designated by the Common Stockholders, (iv) the person then serving as the Chief Executive Officer of the Company, and (v) [___] person(s) who are not employed by the Company and who are mutually acceptable [to the other Directors].	This is a provision that can also be found in a similar fashion in a German market term sheet. While the appointment rights to the company's advisory board (assuming such an advisory board shall be established, which is standard once the total number of shareholders/investors has grown beyond a handful) are almost always stipulated in the term sheet, many term sheets go beyond that and also spell out the individuals who shall comprise the initial advisory board after closing of the financing round.
[Drag Along: Holders of Preferred Stock and all current and future holders of greater than [1]% of Common Stock (assuming conversion of Preferred Stock and whether then held or subject to the exercise of options) shall be required to enter into an agreement with the Investors that provides that such stockholders will vote their shares in favor of a Deemed Liquidation Event or transaction in which 50% or more of the voting power of the Company is transferred and which is approved by [the Board of Directors] the Requisite Holders [and holders of a majority of the shares of common Stock then held by employees of the Company (collectively with the Requisite Holders, the "**Electing Holders**"), so long as the liability of each stockholder in such transaction is several (and not joint) and does not exceed the stockholder's *pro rata* portion of any claim and the consideration to be paid to the stockholders in such transaction will be allocated as if the consideration were the proceeds to be distributed to the Company's stockholders in a liquidation under the Company's then-current Charter, subject to customary limitations.]	For a more detailed discussion about the NVCA drag-along provisions and why it is of less practical importance in the United States where majority acquisitions instead of full acquisitions are less of a problem and can be relatively easy implemented through the merger statutes, please see Chapter A.IV.2.1.2.

NVCA Term Sheet	Observations From a German Practitioner
OTHER MATTERS	
Founders' Stock: Buyback right/vesting for [__]% for the first [12 months] after Closing; thereafter, right lapses in equal [monthly] increments over the following [__] months.]	This provision deals with founder vesting, a potential revesting of an already vested portion of the founders' equity. We will explore the topic of founder covenants, founder leaver events, etc. and the differences between U.S. and German market standards in more detail later in this Guide (see Chapter A.IV.2.3 and A.IV.3.3).
[*Existing Preferred Stock:* The terms set forth above for the Series [_] Preferred Stock are subject to a review of the rights, preferences and restrictions for the existing Preferred Stock. Any changes necessary to conform the existing Preferred Stock to this term sheet will be made at the Closing.]	This provision only becomes relevant if this is not the first preferred stock issuance but a later round. Occasionally, we see such an open-ended "we will review" language also in German market term sheets though more often we encounter language that says "other terms generally in accordance with existing financing round documentation subject to review by the lead investor in good faith." In the end, the practical implications might not be that different though the later language is obviously more closed and defines the status quo as default and at least on paper requires the lead investor to justify any change requests.
No-Shop/Confidentiality: The Company and the Investors agree to work in good faith expeditiously towards the Closing. The Company and the founders agree that they will not, for a period of [_____] days from the date these terms are accepted, take any action to solicit, initiate, encourage or assist the submission of any proposal, negotiation or offer from any person or entity other than the Investors relating to the sale or issuance, of any of the capital stock of the Company [or the acquisition, sale, lease, license or other disposition of the Company or any material part of the stock or assets of the Company] and shall notify the Investors promptly of any inquiries by any third parties in regards to the foregoing. The Company will not disclose the terms of this Term Sheet to any person other than employees, stockholders, members of the Board of Directors and the Company's accountants and attorneys and other potential Investors acceptable to [________], as lead Investor, without the written consent of the Investors (which shall not be unreasonably withheld, conditioned or delayed).	German market term sheets include similar provisions. The standard period for the no-shop covenant in the United States is 30 days, similar to what we would expect in German market deals (though in the recent choppy environment, we also saw exclusivity periods of 45 days from time to time).
Expiration: This Term Sheet expires on [______ __, 20__] if not accepted by the Company by that date.	

2. A CLOSER LOOK AT SOME DIFFERENCES IN ECONOMIC TERMS

In this and the following Chapters, we want to take a closer look at some control and economic terms and concepts where — based on our experience — the differences between U.S. and German deals are particularly accentuated. By necessity, the below is a high-level summary of certain aspects and is not intended to capture the entire universe of provisions and issues addressed by the NVCA documents.

2.1 Liquidation Preference and Change-of-Control Share Deals

As we have already mentioned above, the text of the NVCA term sheet makes no explicit reference to a change-of-control event structured as a stock sale rather than a merger. While in the United States, acquisitions of a controlling stake in a technology company are usually implemented through the merger statutes, the question arises why change-of-control share sales are not considered Deemed Liquidation Events under the NVCA documentation and how investors seek protection against the threat of a circumvention of their liquidation preferences.

2.1.1 Share Deal Exits and the NVCA Documentation

The main reason that a sale of shares does not trigger the liquidation preference is that the NVCA documents are trying to avoid a situation where the Charter requirements upon a liquidation are triggered by something less than a "true sale" of the company. Under the standard NVCA documents, a Deemed Liquidation Event requires that the company either be liquidated or that the preferred stock be redeemable, scenarios that appear undesirable unless it's not a true sale of the company or its business. For example, a change-of-control (where the group controlling before the transaction does not control after the transaction) can occur via a very small secondary sale or even a primary issuance. In addition, the company has no effective method of controlling the flow of funds in a stock sale where stockholders sell shares that do not require the company to permit the transfer. So it cannot in its Charter represent to the holders of preferred stock that if a group of stockholders sells their shares, and the transaction is a change-of-control, that the funds will flow a certain way, *i.e.*, be distributed according to the liquidation preferences (it can, however, do so in the other cases of a Deemed Liquidation Event).

As explained later, in the United States, company acquisitions are often not structured as a share deal. That being said, from the perspective of a holder of preferred stock, there is nevertheless a risk that a group of controlling stockholders seeks to circumvent the liquidation preference by structuring the exit as a stock sale.

The standard NVCA documents contain certain protections for the holders of preferred stock for such a scenario, which may, however, not be adequate to protect the preferred stocks' liquidation preference in every case:

Allocation of Proceeds in a Drag-Along Scenario: If the Voting Agreement contains a drag-along right for a group of stockholders, the standard NVCA language will provide that holders of preferred stock cannot be dragged unless the aggregate consideration is allocated among the holders of preferred stock and common stock on the basis of the liquidation preference in accordance with the Company's Certificate of Incorporation (see Section 3.4 Voting Agreement).

Allocation of Proceeds in a Co-Sale Scenario: The standard co-sale right awarded to investors as contained in the Right of First Refusal and Co-Sale Agreement provides that if the relevant sale constitutes a change-of-control transaction, the terms of the stock purchase and sale agreement shall provide that the aggregate consideration from such sale shall be allocated to the sellers and the investors exercising their co-sale right on the basis of the liquidation preference in accordance with the Company's Certificate of Incorporation (see Section 2.2(d) Right of First Refusal and Co-Sale Agreement).

Sounds good, right? Well, not so fast....

The crux with the standard co-sale right is that it only applies to sales by so-called Key Holders (as, by the way, do rights of first refusal). The term "Key Holders," however, usually only includes major common stock or option holders in addition to the founders, but it usually does not include investors.

Worth noting in this context is also that the Right of First Refusal and Co-Sale Agreement will usually provide for a minimum shareholding requirement for an investor to be awarded the co-sale and other rights under the agreement. This threshold may sometimes align with the shareholding threshold for Major Investors (see Chapter A.IV.3.2.2), which means that smaller investors may never have or may (over time) lose their co-sale right if they fail to participate in future stock issuances.

2.1.2 Acquisition of a Technology Company Through the Merger Statutes

In the United States, instead of a share deal exit, an acquisition of a technology company (or other targets) is often implemented through a merger scheme because it can usually be accomplished quicker and with lower approval thresholds. The ultimate acquirer ("Parent"), a newly formed and wholly owned acquisition vehicle of the Parent ("Merger Sub"), and the company to be acquired (let's be creative and call it "Target") will enter into a merger agreement to implement an acquisition of the Target by the Parent.

The following is a simplified overview of how this works and assumes a standard so-called "reverse triangular merger" with the Target being a private U.S. Delaware corporation.

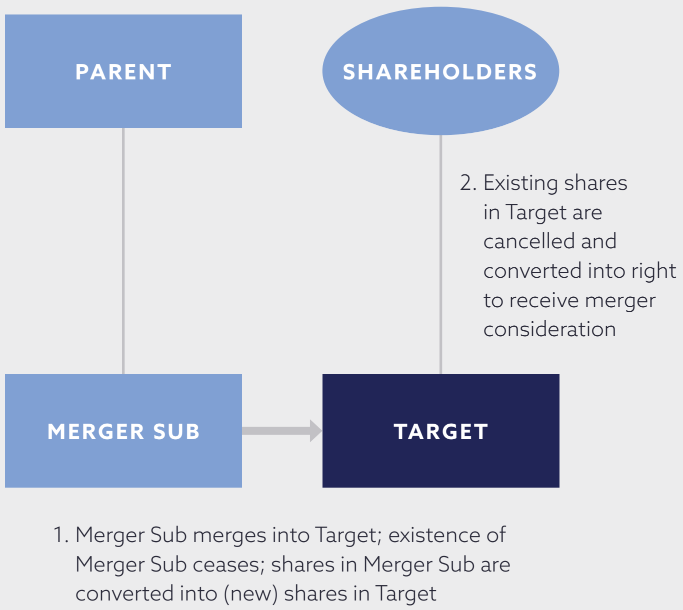
In a "reverse triangular merger," Merger Sub merges with and into Target, with Target as the "surviving" company in the merger and becoming a (wholly owned) subsidiary of Parent.

As part of the merger, each outstanding share of the Target automatically converts into the right to receive the merger consideration, and the equity interests of the Merger Sub convert into (100% of) equity interests of the surviving company. Each share of the Target will be cancelled and converted automatically into the right to receive an amount of the closing consideration, subject to conditions that may be set forth in the merger agreement (*e.g.*, execution of joinder agreements).

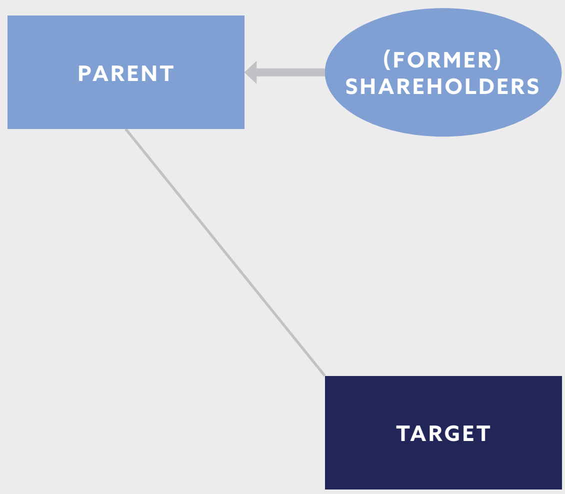
From a corporate perspective, a merger structure is often preferable to a share deal exit or an asset deal exit for the following reasons:

- The Parent acquires the surviving company with all its assets and liabilities (unlike an asset sale, where certain assets and liabilities may remain with the Target). A merger typically does not require as many third-party consents (unlike an asset sale, which may require third-party consent for the assignment of contracts comprising a portion of the assets).
- A merger is administratively simpler because it only requires a requisite percentage of the stockholders of the Target to approve the merger, which approval is then binding on all stockholders, subject to dissenters or appraisal rights (unlike a stock sale, which would require each of the stockholders to individually agree to sell their shares). Side note: Many drag-along provisions include a proxy and power of attorney provision, allowing the President of the Target to execute on behalf of the dragged stockholder if they do not comply with the drag-along obligation, and so getting dragged-along investors to execute the merger documents is not an issue. The bigger issue with depending on a drag-along is that, for most U.S. technology companies, not all stockholders are subject to the drag-along (In the United States, majority acquisitions tend to be more common than in Germany, where, for example, our GmbH laws give disgruntled minority stockholders more potential to cause trouble).

INITIAL STRUCTURE



FINAL STRUCTURE



2.2 Representations, Warranties and the Liability Regime

Let's turn to a topic that, at least in our experience, often takes quite a bit of time to negotiate in German VC financings despite the fact that, in practice, it is usually more of a hygiene factor. In our experience, in the United States like in Germany, it is the rare exception that investors enforce remedies in case of an alleged breach of a representation or warranty. Nevertheless, the representations and warranties are often heavily negotiated in preferred stock financings.

2.2.1 Scope and Concept of the NVCA Representations and Warranties

The representations and warranties of the company that are included in the NVCA template for the Stock Purchase Agreement cover a large swath of the company and its business operations, including financial statements, corporate authorization, liabilities, contracts, intellectual property rights, title to assets, employee matters, compliance with law and much more.

The primary purpose of the representations and warranties is to provide the incoming investor with a reasonably complete and accurate understanding of the current status of the company, its technology and business as well as past history and general legal risk profile so that the investor can make an informed decision about whether it wants to invest. The company is required to list any deviations from the representations on a "Disclosure Schedule" (sometimes also referred to as a *Schedule of Exceptions*), the preparation and review of which drives the due diligence process on both sides of the deal. Unlike in Germany, in the United States it is the standard to only rely on specific disclosures rather than considering the entire due diligence data room to be disclosed against the company's financial and operational representations and warranties (see below).

In the NVCA documentation, these representations and warranties are only given by the company — not by the founders or other stockholders. In the United States, it is the absolute standard that the founders are not required to give any representations and warranties themselves, while this is — at least in the early financing rounds — common practice in Germany. Interestingly, the black tea-drinking and cucumber sandwich-loving cousin of the NVCA, the British Venture Capital Association (BVCA) moved to the U.S. model in its latest edition of the BVCA standard documentation published at the end of 2022, and no longer foresees founder representations and warranties. However, in our experience, so far, the adoption of this particular feature of the revised BVCA documentation is still lagging.

2.2.2 Limitations and Remedies in Case of a Breach

Without going into the details of how creative lawyers will try to avoid a potential breach of a representation and warranty actually resulting in a liability of the company, here are some of the main differences between U.S. and German deals when it comes to limitation and remedies.

Disclosure: In the United States, investors will reject the concept of full disclosure of the contents of the data room, whereas, in Germany, at least operational and financial representations and warranties are often qualified by the contents of the data room to which investors had access prior to entering into the financing documentation provided that such disclosure lives up to some kind of "fair disclosure" standard (which then gets defined in more detail in the investment agreement). Rather, U.S. investors will insist on specific disclosure concepts where any exceptions from the representations and warranties need to be spelled out in detail in an often rather lengthy disclosure letter from the company to the incoming investors.

Relevant Losses and Method of Settlement: Damages to be compensated are encompassing and include direct and indirect damages as well as other consequential damages. Losses are also only settled in cash. Unlike in many German market investment agreements, the NVCA Stock Purchase Agreement does not provide for an option to settle losses by issuing additional shares (or an adjustment of the conversion ratio of preferred stock to common stock like in a U.S. style anti-dilution protection).

Time Limitation: It is standard in the United States that breaches of representations and warranties are not subject to a certain limitation period and that any ensuing liability claims do not expire after a certain period. For example, clause 6.1 of the NVCA Stock Purchase Agreement reads: "Survival of Warranties. Unless otherwise set forth in this Agreement, the representations and warranties of the Company and the Purchasers contained in or made pursuant to this Agreement shall survive the execution and delivery of this Agreement and each Closing and shall in no way be affected by any investigation or knowledge of the subject matter thereof made by or on behalf of the Purchasers or the Company." In Germany, on the other hand, the limitation period usually ranges from 12–24 months for operational and financial guarantees and up to 4–6 years for fundamental guarantees.

2.3 Leaver Provisions

In early financing rounds, founders in Germany are expected to agree to a vesting of (a portion of) their shares. A vesting scheme is also a common feature in early U.S. financing rounds (usually implemented in a so-called Stock Restriction Agreement); unlike in Germany a double-trigger accelerated vesting in case of an exit transaction is standard for founders. Vesting provision can be heavily negotiated, with the primary issues revolving around:

- which founders and employees are subject to this vesting provision;
- what proportion of the shares will be subject to vesting;
- how long the vesting period is to last (usually 3–4 years); and
- whether monthly or other time period vesting should occur.

Founders are often deemed to have vested at least a portion of their stock that reflects service to the company prior to the investment. Founders also sometimes request that accelerated vesting occur in the event major milestones are met: the company is sold, or they are terminated without cause. The differences lie in the leaver provisions, *i.e.*, what happens if the founder leaves the company prior to expiration of the vesting period. In Germany, often a distinction is made as to why the founder left the company. If it is deemed that leaving was justified or done for a valid reason (*i.e.*, a "good leaver"), her vested shares can be kept; however, if the reason for leaving is deemed inappropriate (*i.e.*, a "bad leaver"), her shares can be lost. Frequently, in Germany, bad leavers lose all or a large portion of their vested shares.

Cases in which a beneficiary is usually considered a good leaver who can keep her vested shares include the following:

- The beneficiary dies or becomes permanently unable to perform her services. If you ever asked yourself why lawyers are usually not invited to dinner parties, then maybe labelling a dead beneficiary as a "good leaver" is part of the answer...
- The beneficiary is dismissed by the company without cause.
- The beneficiary resigns for good reason (the stockholders' agreement usually specifies what shall be considered a good reason, *e.g.*, having to take care of a sick close relative or reaching retirement age).

Cases in which a beneficiary is usually considered a bad leaver include the following:

- The beneficiary is dismissed for cause.
- The beneficiary materially violates compliance rules or a code of conduct.

In practice, probably the most important questions around good/bad leaver are how a founder who resigns voluntarily shall be treated and whether a good leaver can be requested to sell her shares for fair market value or a lower amount. German investors and founders will likely remember the fun they had when negotiating whether such a voluntary departure makes the founder a good, bad or better yet grey leaver.

Well, our American friends are missing out on that joyful experience. In the United States, founders are typically not subjected to these leaver terms. Founders can keep the vested portion of their common stock no matter the reason they left the company. Note that in the United States even for regular employees who will often get only stock options, the stock option plan will usually provide that vested stock options are only forfeited if the beneficiary is terminated for "cause" and "cause" is narrowly defined as cases of fraud, intentional material damage and frequently material breach of agreement and policies (with a cure period), etc.

Only occasionally we see a forfeiture of vested stock by founders or participants of a the company's stock plan who have been granted restricted stock right away instead of stock options in case of cause and then "cause" tends to be even more narrowly defined.

2.4 Co-Sale Rights and Tag-Along Rights

Bear with us, but a co-sale right and a tag-along right are not the same (though in practice these terms are often used synonymously). A co-sale right is a right to sell a *pro rata* portion of one's own shares if a co-stockholder sells its shares, while a tag-along right usually allows a stockholder to sell all of its shares in case of a change-of-control transaction.

The NVCA standard documents foresee a *pro rata* co-sale right in favor of the "(Major) Investors" to the extent the company does not exercise its right of first refusal and the (Major) Investors do not exercise their secondary refusal right. The NVCA documents also limit this right to cases where founders or key employees seek to sell shares of common stock, whereas usually there is no co-sale right in case of the contemplated sale of shares of preferred stock. In our experience, this standard approach usually does not vary a lot across deals. Sometimes, especially European investors will request co-sale rights also in case of the sale of preferred stocks by other investors; a request that is usually fiercely objected by U.S. investors.

Tag-along rights are often a focus of more intense negotiations when they are requested. Especially, European investors often seek them, sometimes not only in cases of change-of-control transactions but also if a minority shareholding is supposed to be sold to a competitor of the company. While such rights – usually called a "full tag-along right" (though technically "full co-sale right" would be more correct) are relatively common in Germany, they tend to be the exception in the United States.

2.5 Registration Rights

2.5.1 What Are Registration Rights and in Which Forms Do They Come?

The Investors' Rights Agreement is certainly one of the most legally dense transaction documents in the NVCA suit of documents. One of the main sections of the Investors' Rights Agreement focuses on registration rights. Registration rights are a contractual right requiring the corporation list the rightsholders' shares for sale to the public, which provides an investor who owns stock in a corporation the opportunity to sell its stock.

DO WE REALLY NEED ALL OF THIS FROM THE OUTSET?

Founders and early-stage investors might wonder if they really need to negotiate a complete set of registration rights in a seed or Series A Investors' Rights Agreement. One solution can be to simply state in the Investors' Rights Agreement that the early investors will get the same registration rights that the company will provide to future investors, once it is required to grant such rights in a subsequent financing.

Registration rights usually come in two varieties:

- **Demand Registration Rights:** A demand registration right allows a group of investors to force the company to file a registration statement with the U.S. SEC to register a portion of each of the demanding investor's securities so that the demanding investors can sell their shares on a public market.
- **Piggyback Rights:** A piggyback right allows the investors to register their securities for sale on a public market when either the company or another investor initiates the registration. In the typical colorful U.S. lingo, these investors are "piggybacking" on the already pending registration, so a demand registration is not necessary in these cases.

Demand rights, if exercised by the written request of the investors holding the requisite share of the company's "registrable securities" (the "requisite investors"), force the company to either evolve from a private company to a public company or, if the company is already public, register the rightsholders' securities for sale to the public. The company will want the required percentage to be high enough so that a significant portion of the investor base is behind the demand. Companies will typically resist allowing a single investor to cause a registration. Experienced investors will want to ensure that less experienced investors do not have the right to cause a demand registration. In our experience, demand registration rights are rarely exercised by investors.

The Investors' Rights Agreement will also define what the "registrable securities" are. In a nutshell, these are all kinds of shares of common stock held by the parties to the investors' rights agreement, *i.e.*, common stock issuable to the holders of preferred stock upon conversion of their preferred stock, common stock issuable as a dividend to the preferred holders and, if the founders or other key employees are parties to the investors' rights agreement, their common stock as well.

Demand rights pop up as either part of the company's (i) IPO pursuant to the Form S-1 or (ii) a qualified public offering (QPO) pursuant to the Form S-3.

- The Form S-1 demand rights require that upon the written request (a formal document) of the requisite investors, the company must file a Form S-1 with the SEC for the portion of registrable securities held by the requisite investors. The requisite investors have the right to request a demand registration either upon the date that is a set number of years after the date of the closing or a certain number of days after the effective date of the company's registration statement for the IPO, whichever is earlier. The time-based trigger is provided so that the investors could force the company to go public, which is rarely exercised. The alternate trigger is provided to allow the investors to exercise their demand rights after the lock-up after an IPO has expired (frequently, this is a period of 180 days).
- The Form S-3 demand rights provide the requisite investors with the ability to require the company to complete a qualified public offering for the sale of the investors' registrable securities of a minimum offering size. The purpose of the Form S-3 demand rights is to provide investors with additional liquidity after the IPO. Form S-3 is only available to companies that have been publicly reporting under the U.S. securities laws and are current in such reporting.

The registration rights will terminate upon specific triggering events, usually the earlier of (i) the closing of a Deemed Liquidation Event, (ii) after the IPO lock-up, once the investor has the right to sell all of its shares (subject to some limitations for larger stockholders who may face constraints from lock-up periods and transferability issues), or (iii) a number of years after the IPO.

Typically, Key Holders of common stock are not granted registration rights. In certain instances, it may be appropriate to grant Key Holders (*e.g.*, founders, significant early-round angel investors) piggyback and/or S-3 registration rights, although often they will be subordinate to investors on underwriter cutbacks. In some offerings, an underwriter may determine it can successfully market only a certain number of securities and must therefore reduce the size of the overall registration. When this happens, the holders of Registrable Securities are generally entitled to include their shares before anybody else (consider whether later series may want priority over earlier series).

2.5.2 Limitations

So, can the investors freely exercise their demand rights? Usually, the Investors' Rights Agreements will contain certain limitations on the demand rights. Such limitations might for example allow the company to determine in good faith to defer a registration subject to certain conditions being met. There is often also some limitation on the number of times that the company is required to comply with the investors' requests. Market standard is one Form S-1 registration statement during the term of the agreement and one to two Form S-3 registration statements during any given 12-month period.

Piggyback rights, on the other side, come into play when the company plans to register any of its securities in connection with a public offering. The company must then provide the investors with notice of the registration and allow the investors during a certain period of time to elect to participate in the offering. Though not very common, founders can also request piggyback rights for their shares.

2.5.3 Other Relevant Provisions

Here are some other relevant provisions around registration rights:

- There is usually a lock-up provision that restricts the investors from selling their securities following the public offering for a certain period of time of usually 180 days following the IPO. Because the principal investors in the company will be required by the underwriters to provide a lock-up agreement anyhow, the value of the lock-up covenant in the Investors' Rights Agreement is to ensure a similar lock-up of shares held by the smaller holders of company stock. Investors will, however, want to exempt any common stock acquired in the IPO or in the public market after the IPO from the lock-up provisions, so that they are not disadvantaged relative to other public market purchasers.
- It also needs to be noted that usually several of the investors' rights will be subject to the determination of the company's underwriter. The underwriter may cut back the registration rights, which will require the company and investors to set an order of priorities of who participates in the public offering.

3. A CLOSER LOOK AT SOME DIFFERENCES IN CONTROL TERMS

After having discussed some more economic matters where market practices differ or where the U.S. approach might perplex the unacquainted, let us now look at some more control-focused matters and concepts.

3.1 Boards, Board Representation and Related Matters

3.1.1 U.S. Boards – Some Basics

U.S. Boards of Directors and the German Advisory Board: When looking at the corporate governance of a German company from a U.S. perspective, one of the most fundamental differences is that U.S. corporate law follows the one-tier approach while German corporate law follows the two-tier approach. This difference needs to be kept in mind when talking about the "board," which has a different meaning under German corporate law. A German GmbH must have a management board (*Geschäftsführung*), which is responsible for representing the company and running its day-to-day operations.

In addition, a separate corporate body called an advisory board (*Beirat*) may be established to supervise, monitor, and advise the management board. In larger GmbHs, the establishment of a so-called supervisory board (*Aufsichtsrat*) as controlling body instead is mandatory. In such companies, one would normally not find a voluntary advisory board in addition to the supervisory board. This is the two-tier structure: In Germany, the management and the supervision are separated into two distinct corporate bodies of which the advisory board is optional (though frequent in VC-backed German start-ups) while the supervisory board would be mandatory (though in German start-ups supervisory boards tend to be the rare exception).

The Role of the Board in a Delaware Inc.: In a Delaware corporation, Delaware law requires that the business and affairs of the corporation be managed by or under the direction of the board of directors. Delaware Boards have broad discretion to exercise their business judgment to determine how they will discharge this responsibility, including what responsibilities should be delegated to management. Importantly, the role of the Board of a Delaware corporation also is regulated by aspects of the U.S. federal securities laws and securities exchange listing requirements.

The principal functions of many Boards include:

- reviewing and approving annual budgets, major strategies, plans and objectives of the company, including business plans, capital expenditures and R&D budgets;
- advising and instructing the company's management, especially its chief executive officer, on significant issues affecting the company;
- with respect to publicly traded companies and late-stage private companies, establishing and overseeing effective auditing procedures so that the board of directors will be adequately informed of the company's financial status (including selecting independent auditors and establishing audit committees when appropriate);
- monitoring the performance of management, evaluating the accomplishments of management and selecting and removing corporate officers (including the President/CEO);
- setting executive compensation;
- amending the company's Charter and bylaws;
- approving capital raising activities;
- approving material contracts;
- approving the company incurring indebtedness (such as a convertible note financing or a credit facility);

- approving acquisitions, mergers or other extraordinary activities; and
- approving all grants of equity.

The board of directors delegates the authority for managing the day-to-day operations to the company's management and officers.

AND WHAT ARE THE "OFFICERS"?

A U.S. corporation operates in its day-to-day business through its agents rather than its Directors. And officers are the principal agents of a corporation. Corporate officers receive their grant of authority from the board of directors and are appointed by simple board resolution.

The statutory minimum number of corporate officers in Delaware is two (and those can be the same person) and most young tech companies will get started by simply appointing a "President/CEO" and a "Secretary."

President and CEO: The top management function is vested by the Board in the President or CEO. Although some corporations appoint two separate individuals to serve as President and CEO (and there is no clear guidance as to which position would have greater authority), most early-stage corporations have one person serving in both capacities. The CEO reports directly to the board of directors and is responsible for executing the strategies set in place by the board and overseeing the management and performance of all corporate agents. The CEO/President is also the face of the company and expected to sign most of the company's documents. In many early-stage corporations, the CEO also serves on the board of directors, often serving as its chairperson.

Secretary: Simply put, the Secretary is expected to maintain the organizational documents of the corporation and must certify as to the validity of these documents for various transactions including any financings.

Other Roles: A corporation can appoint a variety of additional officers in different roles. The most common role other than President/CEO and Secretary is the Chief Financial Officer/Treasurer who can be put in charge of the corporation's finances. At later stages, many technology companies also appoint a Chief Technology Officer or Chief Legal Officer.

The board of directors is responsible for corporate governance. With respect to publicly traded companies and late-stage private companies, the directors must make sure the company has adequate policies and guidelines in place to comply with applicable law.

3.1.2 Duties, Duties and some more Duties

In the following, we present first a general overview of duties that directors and officers (and to some extent controlling stockholders) need to observe in the United States. Later in this Guide (see Chapter A.VII.4) we will turn to some start-up specific questions and discuss ways to mitigate the ensuing liability risks that arise in a distressed sale of the company or an insider-led down round.

Delaware common law maintains that directors, officers and, in certain instances, controlling stockholders owe fiduciary duties of care and loyalty to the corporation they serve and its stockholders.

- **Duty of Care:** Directors and officers of a Delaware corporation have a duty to act with the "amount of care which ordinarily careful and prudent men would use in similar circumstances." Gross negligence is the standard by which the Delaware courts measure satisfaction of the duty of care; *i.e.*, a reckless indifference to or a deliberate disregard of the whole body of stockholders or actions that lack the bounds of reason. Therefore, prior to making a business decision, it is the directors' obligation to inform themselves of all material information reasonably available to them, take sufficient time (in their business judgment) to understand and consider relevant issues, and, if necessary, in their business judgment, obtain advise from experts (such as counsel and financial advisors) and officers.

FULFILLING THE DUTY OF CARE – SOME GENERAL GUIDELINES

To satisfy the requirements of the duty of care, the board of directors must engage in a deliberative process. This may include the following:

- Act with the deliberation that is appropriate under the circumstances and be sure to "do their homework."
- Read all background materials made available to the board of directors.
- Attend and be prepared for all board and committee meetings; participate actively in board and committee meetings, discuss the pros and cons of proposals and voice any concerns.
- Inform themselves of all material information reasonably available to them prior to making a decision, including outside financial, legal, tax, accounting and other experts as appropriate. Directors may, in good faith, rely on records and reports of the company, experts and professionals.
- Take sufficient time to understand and consider relevant issues and ask appropriate questions. Inquire into areas that seem to merit concern or follow-up.
- Spend the time in deliberation appropriate to the magnitude of the decision.
- Ask probing questions to management and third-party experts.
- Become familiar with the company's business and management.
- Learn about and evaluate the existence and availability of alternatives.
- Carefully review and correct minutes of all board and committee meetings.

As permitted by Delaware law, the certificates of incorporation of high growth technology companies based in Delaware typically include a provision eliminating a director's personal liability for monetary damages due to a breach of the duty of care. An exculpation provision of this kind regularly leads to the dismissal of most lawsuits alleging a breach of fiduciary duty by the director in their personal capacity.

- **Duty of Loyalty:** The duty of loyalty requires that directors act in the best interests of the company with honesty and integrity and lack of self-dealing, fraud or conflicting personal interest. The duty of loyalty requires directors to fully disclose any interest in, or relationship with, the counterparty of any transaction considered by the board of directors. The duty of loyalty is intended to protect the company from a director or officer "us[ing] their position of trust and confidence to further their private interests." The duty of loyalty also requires that directors make corporate opportunities available to the corporation rather than take such opportunities for their personal gain (subject to some exceptions).
- **Duty of "Good Faith":** For the past decade or more, Delaware courts have debated whether the duty to act in good faith is an independent fiduciary duty or "only" a component of the duties of care and loyalty. The most recent jurisprudence on the matter distinguished the "concept of good faith from the duty of care and duty of loyalty" and established good faith as an element of the duty of loyalty. The Supreme Court of Delaware has not explicitly defined good faith and instead chosen to outline two categories of behavior constituting bad faith. The first category includes "fiduciary conduct motivated by an actual intent to do harm."

Under the second category, bad faith is established when "the fiduciary intentionally acts with a purpose other than that of advancing the best interests of the corporation, where the fiduciary acts with the intent to violate applicable positive law, or where the fiduciary fails to act in the face of a known duty to act, demonstrating a conscious disregard for her duties." The latter category may be applicable in circumstances where a director's actions are more culpable than gross negligence without a traditional self-interest conflict.

- **Duty of Oversight:** As a component of the duty of care, directors have a duty to exercise care in overseeing that management is properly executing their assigned tasks. This duty of oversight is not recognized by Delaware courts as a fiduciary duty on its own. The Delaware Supreme Court has held that a director breaches her duty of oversight when she has "utterly failed to implement any reporting or information system or controls [or] ... having implemented such a system or controls, consciously failed to monitor or oversee its operations thus disabling themselves from being informed of risks or problems requiring their attention."
- **Duty of Disclosure:** Like the duty of oversight, the duty of disclosure is not an independent fiduciary duty but a subset of the duties of care and loyalty. Under Delaware common law, directors have a fiduciary duty to "disclose all material information to stockholders when seeking stockholder action" (*e.g.*, such as in proxy solicitations or self-tender offers).

3.1.3 Liability Risks and Means to Mitigate Liability Risks for the Directors

Against the background of this comprehensive set of duties applicable to the directors, let us now turn to options to mitigate potential liability risks for the individuals involved.

- The Delaware courts have established the business judgment rule that is supposed to provide the directors a safe harbor by restricting legal review of their actions in hindsight subject to certain prerequisites being fulfilled.
- In addition, the financing round documentation for VC-backed companies will provide for additional layers of protection in the form of (mandatory) D&O insurance and indemnification agreements.

Interestingly, the default wording in the NVCA's Certificate of Incorporation only authorizes "the Company to provide indemnification of (and advancement of expenses to) directors, officers and agents of the Corporation (and any other persons to whom General Corporation Law permits the Corporation to provide indemnification) through Bylaw provisions, agreements with such agents or other persons, vote of stockholders or disinterested directors or otherwise, in excess of the indemnification and advancement otherwise permitted by Section 145 of the General Corporation Law." This provision authorizes the indemnification of directors, officers and agents of the corporation, but does not require it. Investors who can appoint members of the board of directors often request that more detailed, mandatory indemnification provisions be included in the Certificate of Incorporation or bylaws, and/or indemnification agreements and insurance coverage.

Business Judgment Rule and Entire Fairness Doctrine: A breach of any of the directors' or officers' fiduciary duties would enable the stockholders of the corporation (or any of them) to bring a claim against the director or officer personally. Against the wide scope of these duties (that keep being developed and fine-tuned by the Delaware courts), Delaware case law has established the business judgment rule as a safe harbor for directors to prevent inertia for fear of liability risks. Under this rule, a director's action is deemed valid if the director has acted on a basis of information, in good faith, and in the true belief that her action was in the company's best interest and has not taken that action in breach of her fiduciary duties. Delaware corporate law further stipulates that directors can rely in good faith on information, opinions, reports or statements from officers, employees, board committees' members or any other person (also outside the company's organization) regarding matters the director reasonably believes are within that person's professional or expert competence, provided that the person has been selected with reasonable care by or on behalf of the company.

Under Delaware law, due to the business judgment rule, courts may not second-guess the merits of a board of directors' business decision unless an adverse party proves, by a preponderance of the evidence, that the decision involved a breach of fiduciary duty. It is important to note that in limited circumstances, judicial review of directors' decisions is heightened under (i) the so-called entire fairness doctrine or (ii) an enhanced scrutiny standard.

- As decisions of officers were not protected by the business judgment rule and officers could be held liable for any breach of the duty of care that they committed, in late 2022, Delaware amended its corporate laws. The amended Delaware General Corporation Law ("**DGCL**") now allows corporations to limit the personal liability of certain senior corporate officers for money damages for breaches of their fiduciary duty of care.

  Prior to this amendment, Delaware only allowed for such "exculpation clauses" — which must be set forth in the Certificate of Incorporation — for corporate directors. This disparity resulted in increased litigation against officers for alleged breaches of duties of care when such claims against directors were not available. (As a matter of policy, Delaware law still does not permit exculpation of claims against directors or officers for breaches of the duty of loyalty.)
- If the adverse party successfully overcomes the business judgment rule presumption, the directors must prove the "entire fairness" of their actions. The court also applies the entire fairness standard of review when a controlling or dominating stockholder stands on both sides of a transaction or when a majority of directors are personally interested or conflicted in a transaction. We will discuss a few cases concerning the entire fairness doctrine below that are particularly relevant to VC-backed start-ups.

Under Delaware law, when proving entire fairness, directors must establish that the transaction in question involved fair dealing and the payment of a fair price. The fair price aspect essentially means that under the circumstances no higher price could be obtained. The fair dealing analysis considers the transaction's procedural aspects that are protective of disinterested or minority stockholders, such as the board process, timing, structure, type of stockholder approval, extent of disclosure and manner of execution of a transaction. Delaware courts have placed the burden to demonstrate the entire fairness of a transaction on the company, but the burden shifts to the challenger if the board of directors either (a) had established an independent committee of directors with broad powers (including the power to unilaterally reject a transaction) to negotiate and evaluate the transaction, retain independent financial and legal advisors and which ultimately engages in arms'-length bargaining over the terms of the transaction or (b) submits the transaction for approval by a majority of the minority stockholders.

In the last few years, the Delaware courts have also developed a doctrine (known as "**MFW**") that would enable a board of directors to obtain business judgment rule protection for a transaction that the Board approved that otherwise would require establishing entire fairness where certain procedural requirements are satisfied in addition to both employment of such an independent committee and obtaining such a majority of the minority vote.

The enhanced scrutiny standard of review is an intermediate standard that lies between the business judgment rule and the entire fairness doctrine and applies in the context of sale of control transactions or defensive conduct by directors.

Indemnification Agreements: Under certain circumstances, directors can minimize/limit their liability for breaches of fiduciary duties, and directors and officers can enter into indemnification agreements with the corporation, pursuant to which the corporation will defend, at the cost of the company, relevant directors and officers against incoming claims.

Indemnification means that the company advances and/or reimburses the directors or officers for costs incurred with claims arising out of their actions when serving the company, such as attorney fees. This is important so that the individual is encouraged to take risky business decisions, even if those decisions are ill-informed, reckless or patently wrong. If a director had to bear all costs herself, she likely would be reluctant towards taking the necessary business decisions, and that assumes that qualified and motivated people could be reluctant to assume such important roles in a company in the first place given how – at least from a Continental European perspective – litigation trigger-happy the United States is.

Customarily, indemnification agreements cover the following scope:

- **Third-Party Proceedings:** The company indemnifies the director or officer against expenses, judgments, fines and amounts paid in settlement concerning actions that were brought by third parties, such as governmental authorities enforcing antitrust or privacy laws.
- **Proceedings by or in the Right of the Company:** Because the directors' and officers' actions might not only entitle third parties to damages, but the company might also suffer a loss, it is vital to also extend the indemnifications to costs arising from actions by the company or in its rights. However, under Delaware law, directors and officers may not be indemnified where such a claim is settled or results in director of officer liability.
- **Success on Merits:** If the director was successful on the merits or otherwise in a defense of a proceeding by the company or a third party, the costs arising from this suit are also part of a customary indemnity clause (keep in mind that despite the numerous fee shifting exceptions according to the American Rule of Costs it is still the default that each party of a civil law litigation is responsible for paying its own attorney's fees).
- **Witness Expenses:** The director might also participate in another proceeding, *e.g.*, as a witness, so that corresponding costs should be covered as well. However, the applicable indemnification provision must explicitly state this.

A customary indemnification agreement — the standard published by the NVCA is widely used for U.S. start-ups — will also stipulate that the indemnity should be granted to the fullest extent permitted by applicable law. However, if the director's actions are not covered by this definition and she is therefore liable, she can still be reimbursed by a D&O insurance policy taken out by the company, subject to deductibles and coverage limitations set forth in such a policy. D&O insurance is also advisable as indemnification claims of a director against her company in case of the company's insolvency would generally be treated as unsecured claims payable only to the extent that other unsecured claims are payable as part of an approved plan of reorganization. D&O policies may also insure against liabilities where indemnification is not allowed under Section 145 DGCL.

Additionally, it is customary to grant the directors and officers who have been sued in such capacity an advance of expenses, to be borne by the company, so long as the director or officer provides an undertaking to reimburse the company if the director or officer is not indemnified for such expenses. Under Delaware law, there is no right to such an advance. But against the background that a director or officer will often not be in the financial position to bear the costs of a proceeding herself, it is advisable and widely accepted practice in the United States to include a respective clause in an indemnification agreement or the Charter or bylaws of the company mandating such an advance. This provision should stipulate that the company is obliged to pay the advance in a specific period of time (*e.g.*, not later than 30 days) after being notified about the action. To avoid uncertainty and disputes between the company and the director or officer, we also recommend that the advance is granted irrespective of whether the individual director would be able to repay the costs or not.

BOARD SIZE MATTERS – GETTING IT RIGHT

A source of constant confusion for some clients is figuring out the size of the board of directors in a U.S. corporation. This isn't referring to the merits of a three-person board vs. a five-person board, nor about the best composition of a board of directors – this is laser focused on what should be the simple matter of figuring out the current number of authorized board seats. Section 141 DGCL says: "The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the Certificate of Incorporation fixes the number of directors, in which case a change in the number of "directors shall be made only by amendment of the certificate."

The usual method of fixing the board size is to have the initial bylaws of a company set a board size and provide that such number can be changed by resolution of the Board. This provides maximum flexibility for the existing Board to adjust the number of authorized directors as needed (keeping in mind that most venture financing rounds will impose a protective provision requiring preferred stockholder approval to change the number of directors). In connection with a financing or other inflection points when the Board is expanded, care should be taken to properly record the Board's resolution to fix a new board size BEFORE attempting to elect or appoint new directors. It is also important to note that a resolution REDUCING the size of the board does not have the effect of removing directors already in office. Directors leaving the board in this case must deliver written notice of resignation and such notification cannot come retroactively (that is "I resign as of a month ago").

Often an amended and restated Charter will contain a provision allocating a certain number of board seats to one or more preferred stock series, other seat(s) to directors elected by the common stockholders and then state that the common and preferred stockholders voting together will elect the remaining directors. This language DOES NOT FIX THE BOARD SIZE. Thus, take care to ensure that the proper board resolutions are adopted to set the authorized number at the correct size to accommodate the allocated seats and the desired number of additional seats elected by all stockholders. Take additional care to comply with any pre-existing protective provisions regarding the number of authorized directors to ensure that the appointments and elections done in connection with the financing take the full and desired effect.

3.1.4 Board Appointments and the NVCA Documentation

The size of the board of directors is typically fixed in the bylaws (which permits it to be amended without the need for a Certificate of Incorporation amendment), though it could be fixed in the Certificate of Incorporation. The Voting Agreement also typically obligates the parties to vote to fix the size of the Board at a specified number of directors.

Where a class or series is given the right to elect a director in the Certificate of Incorporation,

- such director may only be properly elected to the board of directors by that class or series; and
- Delaware law provides that the removal of that director other than for cause must be affected by the vote of the stockholders of the applicable class or series and not by the stockholders generally. Likewise, it is important to replace any such director by either (i) the vote of the stockholders of the applicable class or series or (ii) if the class or series is given the right to elect multiple directors, the remaining director(s) elected by such class or series.
- One little drafting tip: The NVCA documentation foresees the option for investors to convert their preferred stock into common stock. One of the potential reasons might be that investors want to gain control over board seats that are filled by the holders of common stock. The standard NVCA language would not prevent such an outcome. However, sometimes founders will request the NVCA language to be adjusted along the following lines: "one (1) person designated from time to time by a majority of the holders of record of the shares of common stock (excluding Investors holding Common Stock received via an optional conversion of Preferred Stock), which individual shall initially be [___]."

3.2 Management Rights Letters and Information Rights

3.2.1 Management Rights Letters

In venture capital investments involving U.S. investors (and, as we will, see potentially non-U.S. investors that have U.S. pension funds as financial sponsors) management rights letters are a standard feature. With such letter agreements the company and the investors agree on certain "management rights" for the investor, which in turn allows the investor to avoid certain onerous regulations.

What Is It and Why Does It Matter? To put it simply, venture capital firms operate through an agreement between general partners who discover, research and make investments in companies and limited partners who provide the funding for the investments. Such limited partners often include pension plans, public venture funds, endowments, hedge funds, or other large organizations holding capital acquired strictly for investment purposes.

U.S. pension plans are subject to the U.S. Employee Retirement Security Act of 1974 (usually simply referred to as "**ERISA**") and ERISA imposes restrictions on the investment of pension plan assets, and since many VC funds have limited partners that are pension plans, these restrictions often apply to such funds as well. Specifically, pension plans that are subject to ERISA are required to follow certain rules when their funds are invested in venture funds. For example, the assets of a U.S. pension plan ERISA must be held in trust. Moreover, the persons responsible for managing those assets have significant fiduciary duties under ERISA and cannot engage in certain transactions prohibited by ERISA. This means that in case a pension plan covered by ERISA wants to invest in a venture capital fund, then all of the fund's assets — such as its investments in portfolio companies (read: the start-ups) — are treated as assets of the ERISA Plan, absent an exemption.

As a result, the trust requirement applies, the management of the fund is treated as an ERISA fiduciary, and the general partners behind the VC fund do not like that at all. The ERISA requirements are considered onerous as they would include managers of the fund personally becoming fiduciaries under ERISA with respect to any private pension plans that invest in the fund and becoming subject to a set of strict prohibited transaction rules and conflict-of-interest and self-dealing issues (as a result of the VC fund manager's receipt of performance fees in the form of its carried interest).

Are There Exemptions Available? That is why when a VC fund takes in investors who are themselves subject to ERISA, the fund will want to avoid the assets of the fund from also becoming subject to ERISA. There are two exemptions available.

- **The Not Significant Participation Exemption (a.k.a. the 25% test):** A venture firm's funds can be exempt from ERISA if they limit partnership participation of ERISA benefit plans to 25% or less. However, this still places restrictions on the makeup of many VC firms. In addition, the U.S. Department of Labor, which is charged with administering ERISA, has issued regulations that contain certain exemptions from the plan assets rules.
- **The Venture Capital Operating Company Exemption (a.k.a. "I need an MRL"):** Under another exemption, a venture fund is not deemed to hold ERISA plan assets if it qualifies as a venture capital operating company (in legalese a "**VCOC**"). To qualify as a VCOC, the fund must have at least 50% of its assets invested in venture capital investments. This is all super interesting (or boring, depending on whether you studied law or did something meaningful with your life...) but what does this all have to do with management rights letter? Wait for it… An investment in a portfolio company qualifies as a venture capital investment if the venture capital fund obtains certain management rights with respect to the portfolio company.

  "Management rights," in turn, are defined as contractual rights running directly from the portfolio company to the fund that give the fund the right to participate substantially in, or substantially influence the conduct of, the management of the portfolio company.

So, in a nutshell, in order to build a case for an exemption from the ERISA Plan asset rules, a venture capital fund will generally ask each of its start-ups to sign a management rights letter in connection with the fund's initial investment. Side note: In addition to obtaining management rights, the fund is also required to actually exercise its management rights with respect to one or more of its portfolio companies every year, but that goes beyond the purposes of our humble Guide.

What Is in a Typical Management Rights Letter? The management rights letter is a letter from the start-up to the investor confirming that subject to closing of the financing (in the United States the purchase of preferred stock), the investor shall be entitled to a couple of contractual management rights. Such rights usually include the following and come in addition to any information, inspection and other rights provided to investors in the remainder of the financing round documentation:

- Right of the investor to consult with and advise the management of the company on significant business issues and the right to have general meetings with the management (in each case unless the investor is already represented on the Board).
- Right to examine the books and records of the company and inspect its facilities.

- Right to address the board of directors and receive copies of board materials provided that typical management rights letters will make an exemption for materials (or meetings) if the board of directors determines in good faith, upon advice of outside counsel, that such exclusion is reasonably necessary to preserve the attorney-client privilege, to protect highly confidential proprietary information, or for other similar reasons.

Rights that a fund secures and shares with other investors do not count as management rights for purposes of meeting the VCOC exemption (*i.e.*, the rights must be individual to the fund, so, for example, co-investment funds and related co-investment funds should be individually stated as beneficiaries in the management rights letter).

As U.S. pension funds also invest in non-U.S. venture capital funds, such funds also occasionally require management rights letters. However, as these investors might qualify as "foreign persons" within the meaning of the CFIUS rules, special attention needs to be paid to the rights such investors shall obtain either in the management rights letter or in other parts of the financing round documentation. The reason is that certain rights a foreign investor might get with respect to the company may subject their investment to CFIUS jurisdiction. Examples of such rights include (i) "control" of the company as that term is broadly defined in the CFIUS regulations, (ii) access to "material non-public technical information" in the company's possession, or (iii) "involvement" in "substantive decision-making" by the company regarding certain matters (each as further defined and specified in the CFIUS regulations – note that the CFIUS rules explicitly allow the provision of mere financial information regarding the start-up's performance). That being said, cutting back on the typical management rights letter's provisions to avoid a CFIUS filing requirement will need to be balanced against the risk that the more rights that are removed, the less clear it will be that the VCOC exemption will be satisfied.

3.2.2 Information and Reporting Rights – This Whole "Major Investor" Thing…

In the United States, it is typical to limit certain investor rights to the "Major Investors." In a nutshell, the "Major Investor" term sets forth a certain share ownership threshold over rights which investors are entitled. This is in line with industry practice and market expectations. The rational is that the Major Investor rights reflect the risk-reward balance, *i.e.*, investors with higher stakes have more to lose and should get a more favorable treatment to help them protect their investment and influence the company's direction.

The Major Investor threshold is often set at a percentage that would allow the smaller institutional investor not to be excluded (we generally recommend limiting the number of Major Investors in the early stages to no more than four investors or so). Against this background and drawn with a pretty broad brush, the percentage threshold usually ranges from about 2.5 to 5% in Seed financings to approx. 1.5% in late-stage financings (these thresholds refer to the fully diluted ownership percentage).

The relevant rights reserved for the Major Investors include, in particular, the following:

- **Information Rights:** In stark contrast to the situation in Germany, where even the smallest shareholders in a GmbH have extensive information rights under mandatory law, such information rights (the same applies to reporting requirements) can and will usually get severely restricted. For example, usually only the Major Investors are entitled to receive the company's (audited) annual financial statements (including balance sheets, statements of income and cash flows, and statements of stockholders' equity) as well as its (unaudited) quarterly financial statements. Likewise, only the Major Investors will be provided with the budget and business plan for the next fiscal year as well as intra-year revised budgets. Many Investors' Rights Agreements also provide for a catch-all information right that allows the Major Investor to request other information relating to the financial condition, business, prospects, or corporate affairs of the company, subject to certain exceptions (for example, the board of directors may refuse such information if it deems it detrimental to the interests of the company).
- **Inspection Rights:** Per the optional language in the Investors' Rights Agreement, the stockholders waive any rights under Section 220 DGCL to inspect the company's books and records and this otherwise applicable comprehensive inspection right gets replaced by a more specific contractual inspection right limited to Major Investors. This is likely the result of evolving case law in recent years regarding what constitutes "books and records" and a "proper purpose" pursuant to Section 220 DGCL, which has increased legal burden on companies. Under the NVCA model documentation and in line with U.S. market practices, (usually) only a Major Investor has the right to inspect the start-up's properties, books of account, and records, and to discuss the company's affairs, finances, and accounts with its officers during normal business hours. Again, while the company must allow such inspections and discussions as reasonably requested, it is not obligated to provide access to any information that it considers to be confidential or a trade secret, or that would adversely affect the attorney-client privilege between the company and its counsel.
- **Observer Rights:** The right to appoint an observer to the start-up's board of directors is in most cases not only reserved to Major Investors but might in fact be further restricted to Major Investors who hold a certain ownership in the company beyond what is required to establish Major Investor status.
- **Pro Rata Subscription Right/Right of First Offer:** If the company intends to offer or sell any new securities, it must first offer these to the Major Investors and the Major Investor can usually apportion the right of first offer among itself, its affiliates, and beneficial interest holders. Arguably, this is the special right with the biggest economic punch and a marked deviation from what we would expect in a typical German VC-financing.

3.3 Founder Non-Compete Covenants

Founders' and key employees' (post-contractual) non-compete covenants are tricky in the United States. In practice, they often tend to have a term of one-year though some states in the United States may allow up to two years. That being said, there is quite a bit of legal uncertainty. The reason for this is that the enforceability of such non-compete restrictions (other than in connection with the sale of a business) is governed by state law and most notably prohibited in California. Some states require additional consideration as compensation for signing and/or enforcing a non-compete (*e.g.*, Massachusetts requires additional consideration for non-competes that are added after the commencement of the employment relationship). And many states also require that there be a protectable interest (*i.e.*, the employee has had access to trade secrets or other highly confidential information) as a condition for enforcing a non-compete.

Against this background, especially in the technology-focused sector of the industry, non-compete agreements are only one tool in U.S. employers' toolboxes. Notably, in the United States, investors and companies rely instead on the more robust so-called Confidential Information and Invention Assignment Agreements (CIIIAA). Many employers also use what are known as "golden handcuffs" whereby any employer can claw back bonuses or the employee forfeits deferred compensation and future bonuses if they go to work for a competitor. Many of these deterrents do provide a disincentive for an employee to go to work for a competitor.

As *Albert Einstein* said: "Free competition is the most powerful force in the universe." Okay, he did not really say that but he did leave us quotes and sound bites for almost everything and one wonders why he did not have a famous quote on competition. But we are getting off track again. What we wanted to alert our readers to is the following interesting development in U.S. law making.

On July 9, 2021, President Biden signed an "Executive Order on Promoting Competition in the American Economy," which encouraged the Federal Trade Commission (the "**FTC**") to "exercise the FTC's statutory rulemaking authority under the Federal Trade Commission Act to curtail the unfair use of non-compete clauses and other clauses or agreements that may unfairly limit worker mobility." In accordance with the President's Executive Order, in January 2023, the FTC announced a proposed rule that would ban non-compete clauses in employment contracts. This would be a remarkable change in law in the United States. The rule would override any conflicting state laws and apply

- to all workers, including C-suite officers; and
- retroactively, such that any non-compete provisions in already existing employment agreements would be unenforceable, and the employers would be required to tell employees that the provisions no longer applied.

The FTC made it clear that the rule should not affect other types of restrictive covenants such as non-disclosure and customer non-solicitation agreements unless they are so unusually broad in scope that they, in effect, function as non-competes.

The FTC solicited public comments on the rule for three months and received over 16,000 comments, many fiercely critical. Most concerns voiced include adverse impact on protection of IP and disincentivizing investment in employee training. The next step will be for the FTC to publish a final rule, and the rule would then go into effect 60 days thereafter. There is no deadline for the FTC to publish the final rule. We think it is unlikely that any rule will be issued prior to the end of this year. Legal challenges are likely to delay any subsequent enforcement.

V. Summary #1 – Downturn Market Term Sheets – Deal Term Changes and Compromises

The table below summarizes some of the most relevant deal term changes one can expect if the current market headwinds persist and compares them to what used to be "market" only a little while ago while also presenting some potential compromises between company and founders on the one side and more risk-adverse investors on the other.

While we are still relatively early in this new cycle, in the next we will then take a look at some recent deal term trends to illustrate where and how the power dynamics started to shift.

> Let's keep a little optimism here.
>
> *Han Solo*, Return of the Jedi

	Clause	Market Standard in the Golden Days	Changes in a Downturn Market	Potential Compromises
CONTROL TERMS	**Veto Rights**	While there was a clear trend to more founder-friendly terms, German market approval catalogues were nevertheless rather extensive and tended to be broader than in the U.S.	Even tighter restrictions can be expected	
CONTROL TERMS	**Forced Exits/ Redemption**	Majority-initiated exit options were common	Minority-initiated investor exit options might get added Redemption	• Minority-initiated investor exits made subject to certain conditions (*e.g.*, majority shareholder(s) do not initiate exit within certain time period) • Appointment of corporate financial advisor • Put options for minority shareholders at certain percentage of FMV in case majority shareholder(s) do not initiate exit within certain time period (very rare in Germany and will often collide with German corporate law)

	Clause	Market Standard in the Golden Days	Changes in a Downturn Market	Potential Compromises
ECONOMIC TERMS	**Tranched Investment Rounds**	Rather uncommon	Instalment payments in accordance with achievement of certain milestones added (so far, still very rare in the U.S.)	Particular importance should be given to a clear definition of the relevant milestones triggering the additional payments
	Liquidation Preference	1x non-participating preference is the standard	>1x and/or participating preference become more common	• Capped participating liquidation preference • Multiple liquidation preference with a "catch-up" for the common shares • Sometimes event-based fall-away provisions can be negotiated
	Dividends	Non-cumulative on an as-converted basis if and when declared by the board	Non-cumulative dividends in a certain minimum amount paid on the preferred shares if and when declared by the board. Still very rare are the more draconian cumulative dividends of [6-8%] that come on top of any distributions in which the preferred shares participate on an as-converted basis	
	Anti-Dilution Protection	Broad-based weighted average clauses are most common	Move (return) to narrow-based or even full-ratchet clauses	• Time limit for full-ratchet, then weighted average (narrow-based) • "Narrow-based" clauses instead of full-ratchet (balanced approach) • "Half-ratchet" – half of the conversion price • Pay-to-play mechanisms to be added • Management top-ups/ carve-outs
	Pay-to-Play Provision	Rather uncommon	Occasionally added (at least in the earlier rounds)	Pay-to-play consequences can be mitigated, *e.g.*, only loss of certain veto or board rights but retain (part of) the liquidation preference
	Redemption Rights	Used to be rare (even rarer in Europe)	Might see a come-back	Tranched or capped redemption rights

VI. Summary #2 – Current U.S. Deal Term Trends (2022 and 2023)

1. THIS TIME IS DIFFERENT – MAYBE…

The story of U.S. VC financings in 2021 was written in the financial pages with records in invested dollars and realized exits (both M&A and IPOs). In 2022, the VC story was driven by headlines. Russia's attack on Ukraine, the ensuing geopolitical and anti-globalization climate, high inflation and increasing interest rates were all body blows to late-stage tech company valuations, exit markets and the overall funding environment. Deal activity dropped sharply across many industries and a return to the prior status quo seems unlikely.

At the end of Q1/2023, the NVCA reported that indices tracking the supply of capital showed that the supply of available venture funding exceeded demand by a ratio of nearly 1.5 to 1. It is not unlikely that this chasm might still widen a bit before returning to the long-term trendline. Yes, the VC sector entered 2023 with record levels of committed capital but it remains to be seen if this supposedly dry powder does not turn out to be muddier than expected. Plus, the full impact of the failures of some of the most active banking institutions in the start-up sector that began in mid-March 2023 remains to be seen.

Against this background, it will come as no surprise that for investors, terms on new rounds have become increasingly favorable — a change from the operator-friendly terms that had normalized in recent years. In this Chapter, we want to take stock and give a first snapshot of some trends in VC deal terms that we saw unfold since early 2022. We will focus on changes in legal terms as changes in valuations, deal volumes and shifts in funding mixes away from late-stage financing towards the earlier stages have been analyzed elsewhere (see in particular the quarterly updates from *Pitchbook*).

> “It's ugly out there. The collapse of high-tech stocks in the public markets has had a ripple effect on private equity. Some professional investors have simply shut down the window on new investments and are focusing entirely on attempting to salvage their walking wounded and/or liquidate hopeless investments. The amount of liquidity in the sector remains enormous by historical standards, and deals are getting done. The money is there but it is very nervous money in the opinion of this observer, and no one wants to be written up in the trade press as the bozo who invested in [Fill_in_the_name_of_your_ favorite_.com_disaster]. There are private asset managers, who have never seen a rainy day, traumatized by the catastrophes in their portfolios. Now, nobody is about to take up collections for the impoverished VCs.”
>
> *Joseph W. Bartlett*, Founder of VC Experts.com

FUN FACT: The quote above is not from Q1/2023, not even from Q1/2020 but dates back to 2009 or to put it in the words of one of the wittiest thinkers of recent decades:

> It's like déjà vu all over again.
>
> *Yogi Berra*, baseball legend – nota bene, while the authors are pretty confident to have explained the nuts and bolts of NVCA deals to the German readers in a hopefully comprehensive way, we are not so sure about the rules governing baseball...

2. SOME CHANGES IN LEGAL TERMS

Here is a snapshot of some recent developments and our (more or less educated) guestimate of things to come.

> You can predict all you want, but everybody knows what predictions get you.
>
> *Hope Solo*, legendary American goalie and not related to Han Solo...

2.1 Liquidation Preferences and Dividends

A lower investors' risk appetite was indicated by some shifts in the liquidation preferences.

- **Seniority:** While *pari passu* liquidation preferences tended to be the norm in U.S. financings until the end of 2021, more recently in financing rounds beyond Series B, we saw senior liquidation preferences more often and in the very late financing rounds in significantly more than 50% of such financings. Although the numbers have also come up a bit, up until Series B, *pari passu* liquidation preferences are agreed upon more than 80% of the time.
- **Multiple:** While the shifts in seniority were relatively pronounced, so far, multiples of more than 1x are rare and are largely concentrated on the late stages and down round scenarios. Overall, we would say that in the most recent quarters about 10–20% of all financings we worked on saw liquidation preference multiples of >1x (then mainly in the range of 2x–3x).

  Even more remarkably, so far, we have seen across all stages only very few participating liquidation preferences. While we are still too early in the cycle to make a more robust assessment, we think that only about 3–5% of all financings saw participating liquidation preferences and those were almost always very special cases.
- **Dividends:** Finally, while accruing dividends effectively increase the liquidation preference of the preferred stock and one could have expected an upswing in such provisions given the more investor-friendly environment, so far, the trend over the last years that saw such provisions in only 5–10% of all financings seems intact.
- **Escrows (maybe...):** Assuming that the M&A market will continue to become more and more a buyer's market in the years to come, an interesting minutia is how escrow accounts, in order to secure the company's indemnification obligations to the acquirer, are dealt with in the context of the liquidation preference.

How shall the (initial) deductions from the exit considered to fund the escrow be allocated among the stockholders of the company. A common approach is to allocate an escrow *pro rata* among all stockholders, but one can also allocate the escrow in a manner that ensures that the holders of preferred stock always receive their liquidation preference, even if some or all of the escrow is forfeited.

2.2 Anti-Dilution Protection and Pay-to-Play

- While broad-based weighted average dominated the financing rounds of 2021 and into 2022, from the middle of 2022 on we saw a shift to more narrow-based anti-dilution. While in the current data set we would estimate the broad-based weighted average anti-dilution provision to account for approximately two third of all deals, the majority of the rest is narrow-based weighted average while full-ratchet provisions appeared only in about 5% of all our deals after it was basically nonexistent in prior years.
- When looking at our deals since early 2021, we do not yet see a significant uptick in pay-to-play provisions. They remain the rare exception and only show up in less than 3% of all of our financings. However, as discussed above, many of the recent later stage financings were down rounds and a some of these down rounds featured typical pay-to-play elements such as the elimination of legacy investors' rights or a conversion of preferred stock to common stock. Thus, while specific pay-to-play provisions remain the rare exceptions, pay-to-play mechanics play de facto a material role in challenging financing environments.

2.3 Exit-Related Provisions

- **Redemption Rights:** While we want to be cautious here, we saw most recently an uptick in redemption rights (at least in their staged form) in later financing rounds, partially as a compensation for the incoming investors agreeing to a slight up-round or a flat-round. That being said, so far such provisions are still relatively rare (we would say about 10% for Series B and beyond).
- **Drag-Along Rights:** So far, we have not seen relevant changes in these provisions when comparing the 2022 and 2023 years to prior years but as explained before drag-along rights are not of particular importance in the United States.

VII. Deep Dive #1 – U.S. Down Rounds

Given the current funding environment, we do not need a crystal ball to predict more down rounds, be they insider-led or led by a new lead outside investor (these transactions are also referred to as "structured financing rounds" or "recapitalization transactions)."

> Down rounds are like crimes; the statistics are consistently underreported.
>
> *Max Cantor*, partner at Orrick

1. INTRODUCTION AND CUSTOMARY DOWN ROUND PROVISIONS IN U.S. DEALS

When looking at our own data set of deals we advised in 2022 and 2023

- Less than 15% of our financings were flat or down rounds but numbers have increased slightly since Q4/2022. That being said, about a quarter of the very late-stage financing rounds Series D and beyond were down rounds.
- About 15–20% of Series B+ financings were extension or insider-led financing rounds.
- We saw an increasing use of creative tools to avoid outright down rounds, including:
  - Increase of senior liquidation preferences and >1x (see below).
  - Variable and floating valuations (very rare outside the life science sector).
  - Warrants (up to 25% of the current financing round).

Down rounds can come in many flavors, so the following paragraphs can only give a brief overview. In a nutshell, a down round is a financing at a price per share less than the prior round price (*i.e.*, valuing the company at less than the last round). A recapitalization often refers to a down round in which the company is "recapitalized," usually in a way that negatively impacts the holders of common shares (notably the founders) and frequently the nonparticipating preferred investors as well. If implemented, down rounds and recaps can be highly dilutive: in U.S. financings in particular, we see that existing preferred stockholders who do not participate in the refinancing of the company are typically heavily diluted, with their preferred shares often being converted to common shares at a, say, 10-for-1 ratio. Thus, non-participating stockholders often lose some or all of their preference rights — for example, anti-dilution rights can be eliminated/waived, and liquidation preferences can be wiped out (or reduced) for non-fully participating investors, etc.

Recaps often also include other burdensome terms (beyond heavy dilution). These may include restrictive operating covenants, changes in the corporate management and corporate governance, in particular changes in the company's advisory board and often dismissal of founder managing directors or at least assignment of new (read diminished) roles for founders as well as obligations to implement severe cost cuttings (including lay-offs) to reduce the burn rate.

2. DOWN ROUNDS AND ESOPS

In the United States, employee participation programs or employee stock option programs (ESOP) are often set up as "real," *i.e.*, equity-based, employee stock option programs. A stock option gives a beneficiary the right to buy stock at a specified exercise price (or strike price). The beneficiary pays the exercise price and then receives the company stock. In a down round, holders of common stock often get heavily diluted, which obviously has a detrimental effect on the motivation of founders, not to mention the ESOPs on key executives.

Obviously, one option is to "reload" the option pool and other tools, including the following (which all require proper legal advice and tax analysis before implementing):

- **Repricing:** existing options, *i.e.*, resetting/reducing the strike price ensures that management team's options are not "underwater" (*i.e.*, out-of-the-money).
- **Management Carve-Out Plans:** given that option holders in the United States will receive shares of common stock, "heavy" liquidation preferences can give management pause because their common shares are at the bottom of the liquidation waterfall (also referred to as the "liq pref stack"). One way to provide management with an "up stack" incentive at the top of the waterfall is via a so-called Management Carve-Out Plan. These plans sit below debt, but above equity and effectively "carve out" value that otherwise would go to stockholders and transfer that value to designated managers and key employees. This is done by providing participants in the plan with a right to payments at, and contingent on, a sale of the company.
- **Retention Bonuses:** in some cases, key personnel who are at risk (or financially struggling) may be offered retention bonuses to keep them inside the fold.

3. THE ROLE OF THE BOARD IN AN INSIDER-LED DOWN ROUND

Delaware courts have decided several notable cases concerning the fiduciary duties of Boards that approve inside rounds or down rounds. Such case law helps paint a picture of what start-up board members need to observe to avoid liability risks in these extreme circumstances.

Companies that are running out of cash or experiencing wide valuation fluctuation may need to raise funds in an emergency "inside round" or "down round." No one wants to do a down round, particularly an insider-led down round, but we might well see more of these in the wake of the current Ukraine war, inflation bedevilling Western democracies and the prospect of an economic recession. An insider-led down round is not your mother's Series A/B/C financing. It is a much more involved, complicated and risky process that involves high stakes and often happens over a very compressed time frame. Tensions may run high between management and investors (and even between investors who came in at different stages as they have a divergence of interests — and differences in ability to continue funding their portfolio companies).

Down rounds are particularly risky for insider-led investors and their director designees. This is particularly true in "investor dominated" Boards where the participating board members/their funds are leading a dilutive transaction. Insider-led down rounds — particularly when viewed after the fact — can look unnecessarily punitive (remember: hindsight is 20-20), even if the parties believed at the time that the terms were the "best available" and that there were no other viable alternatives.

Against this backdrop, in an inside down round:

- **The Board Process Is Very Important:** particularly a thorough board process to consider deal proposals, review alternatives, meet regularly, and demonstrate care and diligence by the Board in discharge of their duties to secure stability for the company, while negotiating the best possible financing terms. Some best practices that should be followed are presented below.
- **Conflicts Will Be Abound:** Investors, Board and management must be aware that these deals likely will give rise to potential conflicts and duty of loyalty claims and, as a result, real risk of a director or officer being held liable for a breach of fiduciary duty. Accordingly, all known conflicts and related party interests should be disclosed to the Board and ultimately to the stockholders in obtaining deal approvals (as our grandmothers already knew, "sunlight cures [most] problems").
- **Special (Disinterested) Board Committees Can Help.** If possible — and that is a BIG if — it's preferable to appoint a special committee of independent directors who are not leading (or planning to invest) in the round to negotiate the deal terms with the insiders leading the round. However, in many venture-backed companies it will often not be possible to designate a true disinterested board committee where VCs have a large number of seats and management teams may be conflicted by management carve-out plans, equity reloads, retention bonuses and the like.

Here are some best practices for handling and approving insider-led down rounds:

- These deals receive heightened scrutiny as noted. Ideally, and if possible, an independent board committee (and otherwise an independent director and/or executive) will be tasked with negotiating the terms of any insider-led down round to obtain the best possible terms. Ideally, and if possible, this would be done in conjunction with a market check to determine what third-party funding options are available (if any) as this may help provide valuation and other goal posts and validate a decision to accept an insider-led down round.
- If possible, obtain an independent, third-party valuation to support decisions around valuation (note: good in theory, but rarely done in practice).
- The independent board committee (or director or executive, as applicable) ultimately should recommend the proposed deal to the full board and obtain approval, including of a majority of the disinterested directors (if any).
- Proposed deals should then be offered to all accredited stockholders and presented to the stockholders for approval. Ideally, a supermajority of disinterested stockholders would approve. But if not possible, then in most cases a simple majority of all stockholders will suffice to move forward — if not reduce risk. It is therefore of heightened importance that the company makes real efforts to obtain the consent of as many common and otherwise disinterested stockholders as possible.
- Ideally solicitation of stockholder approval plus rights offering would be done via an information statement that complies with certain disclosure and timing requirements (including, in the case of a Delaware corporation, U.S. federal securities law and Delaware law fiduciary duty disclosure requirements) and market standards.

4. EXCURSUS – THE ROLE OF THE BOARD IN A DISTRESSED SALE OF THE START-UP

While we are at it, let's have a look at some further case law that is very relevant for the duties and liability risks of directors in a "not-so-ideal" exit scenario, *i.e.*, the sale of the start-up for less than the sum of the preferred liquidation preferences (or if you want to be cool, just say "pref stack"... come to think of it, lawyers have a weird concept of coolness that somehow got stuck in the 1980s).

The famous 2013 Trados decision involved the acquisition of TRADOS Inc. ("**Trados**") by SDL plc ("**SDL**") for $60 million in cash and stock. Trados' preferred stockholders received $52.2 million as partial payment for a liquidation preference that the transaction triggered, and Trados management received $7.8 million through a management incentive plan ("**MIP**"). The common stockholders did not receive any merger consideration, although they would have received $2.1 million in the transaction if Trados management did not have the MIP. When the board approved the transactions, five of the seven Trados directors were designees of preferred stock investors, and the other two directors were members of Trados management and beneficiaries of both the MIP and post-closing employment agreements with the buyer.

A common stockholder claimed that the Trados directors had breached their fiduciary duties, so the stockholder sought a common stock appraisal under Delaware law. Based on documents, which the plaintiff obtained in discovery in connection with such appraisal, the plaintiff filed with the Delaware court a breach of fiduciary duty claim, arguing that Trados' Board of directors should have rejected the transaction because it had a fiduciary obligation to continue operating Trados on a stand-alone basis to maximize the corporation's value for the common stockholders' benefit.

The plaintiff's breach of fiduciary claims survived a motion to dismiss, and the case went to trial. At trial, the defendants had to prove that their actions were entirely fair because the court found that six of Trados' seven directors were not disinterested and independent.

The court's fair dealing analysis held that the Trados Board dealt with the common stockholders unfairly when it negotiated and structured the transaction because "no contemporaneous evidence suggest[ed] that the directors set out to deal with the common stockholders in a procedurally fair manner." Also, according to the court, the MIP skewed the transaction's negotiation and structure in a manner adverse to the common stockholders. Without the MIP, according to the court, the two management directors' personal financial interests would have aligned with the other common stockholders' interests because the management directors, who held common stock, would have had an incentive to critically evaluate the transaction's effects on the common stock. The court also found that the board's failure to obtain a fairness opinion or to seek the advice of an investment banker to present the alternatives available to Trados constituted strong evidence of unfair dealing.

Although the Trados Board failed the fair dealing prong, the court believed that the evidence on fair price supported the defendants. The court determined that, at the time the Trados Board approved the merger, the Trados common stock had no economic value, and Trados did not have a realistic chance of generating a return for its common stockholders. The Trados court held that the test for entire fairness is not bifurcated; to prevail the plaintiffs must show both the lack of a fair price and the absence of a fair process. The defendants' evidence on price fairness was ultimately persuasive to the court, and the court held that the approval of a transaction in which the holders of common stock received no consideration did not in and of itself constitute a breach of the board's fiduciary duty.

VIII. Deep Dive #2 – CFIUS Considerations for Non-U.S. Investors

In this last Chapter, we want to briefly highlight some regulatory requirements that might apply to investments by German and other non-U.S. investors in U.S. technology companies and that should be reviewed early on as they might have important consequences for the overall transaction timeline and the transaction documentation, notably what rights can be granted to such an investor.

This is a potentially complex topic and we will limit ourselves to the most practical regulatory matter applicable to typical VC minority investments, *i.e.* CFIUS filings. Note that there are a several additional regulatory regimes that might require a filing in certain cases. For example, regulatory scrutiny will be heightened for transactions that fall within the scope of the U.S. Defense Production Act.

1. WHAT IS CFIUS AND WHY DOES IT MATTER FOR U.S. VC FINANCINGS?

The Committee on Foreign Investment in the United States ("**CFIUS**"), a multi-agency body composed of several U.S. government parties, mandates the disclosure of certain foreign investment transactions. In cases, where it can be argued whether or not a transaction must be filed, the parties may opt for a voluntary filing to avoid later legal uncertainty.

If any of such transactions pose a threat to U.S. national security, they can be blocked by the U.S. President upon recommendation by CFIUS. However, there is no requirement to suspend any given transaction until completion of the review, unless the government issues transaction-specific instructions for the parties to do so. That being said, to obtain legal clarity, parties may condition closing of transactions on a favorable disposition with CFIUS if the analysis show that CFIUS rules may be relevant for a certain investment.

> While CFIUS sometimes might appear to be very broad and unpredictable, this approach is pretty similar to other foreign direct investment control regimes, including Germany: There are specific transactions (mostly depending on the domestic target's activity) which require mandatory filings while considerations need to be taken of whether to file voluntarily in particular in cases where more than 25% of the voting rights are acquired.

A negative decision cannot be appealed as U.S. courts have no jurisdiction to reverse a presidential finding that a transaction threatens U.S. national security.

2. WHAT ARE THE RELEVANT SECTORS?

Of particular importance are sectors that include "critical technology," "critical infrastructure" and "sensitive personal data," *i.e.*, the so-called "TID (Technology, Infrastructure, Data) U.S. businesses." You may wonder if this is really start-up related stuff. Well,… yes. Here are just a few recent examples of transactions where CFIUS has acted to unwind foreign investments: Beijing Kunlun's acquisition of the gay dating app Grindr (sensitive personal data), iCarbonX's majority stake in PatientsLikeMe (personal healthcare information), ByteDance's acquisition of Musical.ly (*i.e.*, TikTok) (personal information), or Beijing Shiji Information Technology's acquisition of StayNTouch (personal information).

If the start-up's activities fall within the scope of a TID sector, this may lead to an obligation to notify non-controlling investments to CFIUS (see below).

For typical VC-investments, transactions in "critical technologies" will likely be the most relevant sector followed by investments in "critical infrastructure."

- So what are "critical technologies?" Well, ..., in short, critical technologies include technology according to the International Traffic in Arms Regulations ("**ITAR**") and certain categories of controls under the Export Administration Regulations ("**EAR**"). Briefly speaking, items include defense articles and associated technical data including, *inter alia*, weapons or military equipment (ITAR) or certain commodities, software and technology that are on the so-called "Commerce Control List" that are export controlled for a reason other than merely anti-terrorism.
- The "critical infrastructure" includes specified systems and assets, whether physical or virtual, so vital to the United States that the incapacity or destruction of such systems or assets would have a debilitating impact on national security. In particular, CFIUS may review certain transactions involving U.S. businesses that perform specified functions (*i.e.*, owning, operating, manufacturing, supplying, or servicing) with respect to critical infrastructure across sectors such as telecommunications, utilities, energy, and transportation, each as identified in an appendix to the regulations.

Just for the sake of completeness (we are technology lawyers after all), CFIUS also holds the right to review certain real estate transactions.

3. WHEN DOES CFIUS BECOME RELEVANT?

Generally speaking, CFIUS has jurisdiction over any transaction resulting in

(i) a foreign person,

(ii) exercising control,

(iii) over a U.S. entity that operates in a relevant sector.

The relevant sectors have already been discussed above, so when looking at VC-investments in U.S. companies, the ensuing questions are when an investor qualifies as a "foreign person" and when does the investor "exercises control" over the start-up.

3.1 Foreign Person

A foreign person is individual who is not a U.S. citizen, a non-U.S. government, or a legal entity that is (i) organized under the laws of a country other than the United States if either its principal place of business is outside the United States or its equity securities are primarily traded on one or more foreign exchanges, or (ii) controlled by non-U.S. citizens or governments. "Principal place of business" is defined as "the primary location where an entity's management directs, controls, or coordinates the entity's activities, or, in the case of an investment fund, where the fund's activities and investments are primarily directed, controlled, or coordinated by or on behalf of the general partner, managing member, or equivalent." You are correct, this is very broad. Speaking of broad...

3.2 Exercising Control

So, let's get to the final requirement — probably one of the global legal industry's favorite ambiguous concepts, *i.e.*, "control." Is there a comprehensive and understandable explanation? Well, "I wish I could, but I don't want to." (*Phoebe Buffay*, FRIENDS)

The concept of "control" under the CFIUS regulations is very broad and subjective. It is defined as "the power, direct or indirect, whether exercised or not exercised, to determine, direct, or decide important matters affecting an entity."

Generally, in order to be considered a "passive investment" not subject to CFIUS jurisdiction, the foreign investor will need to stay below 10% of outstanding voting shares. But this threshold is not a panacea. Rather, an investor may gain control also when holding less than 10% but being entitled to certain other rights. Here, CFIUS will in particular review any "covered investment," *i.e.*, any investment affording any of the following "triggering rights":

- access to any material nonpublic technical information in the possession of the TID U.S. business;
- membership or observer rights on the board of directors or equivalent governing body of the TID U.S. business or the right to nominate an individual to a position on the board of directors or equivalent governing body; or
- any involvement, other than through voting of shares, in substantive decision-making of the TID U.S. business regarding (i) sensitive personal data of U.S. citizens, (ii) critical technologies or (iii) critical infrastructure.

If a foreign investor intends to avoid obtaining any rights that might trigger CFIUS intervention, the investor may need to avoid obtaining access to any "material non-public technical information," (by way of an observer appointment right, information or inspection rights or otherwise). However, these limitations should not impact the foreign investor's ability to obtain financial information about the performance of the U.S. business. As a practical matter, to avoid legal uncertainty, it may be preferable in some cases to expressly provide that a foreign investor will be limited to receiving financial information regarding the performance of the company.

4. MANDATORY AND VOLUNTARY FILINGS

Similar to other foreign direct investment regimes, CFIUS filings can be mandatory or voluntary. While most of the transactions are voluntary (but require an analysis if such filing is advisable), submitting a filing to CFIUS at least 30 days before closing is mandatory if the transaction at hand falls within one of the following situations:

- A foreign party acquires a voting interest of 25% or more ("substantial interest") in a TID U.S. business and a single foreign government holds (directly or indirectly) 49% or more of the voting interest in the acquirer.
- A foreign party acquires control or covered non-controlling interest in a TID U.S. business that produces, designs, tests, manufactures, fabricates or develops one or more "critical technologies," where an export, reexport or retransfer of this technology to the foreign investor or a foreign person holding a substantial interest or control stake in a foreign investor would require U.S. regulatory authorizations.

This alternative essentially ties the mandatory filing obligation to U.S. export control requirements, thereby particularly affecting investors from countries like China or Russia, which are subject to far-reaching U.S. export control restrictions.

Other than, *inter alia*, under German FDI rules, the investor and the start-up are usually equally responsible for submitting the notification to CFIUS. Violating a filing obligation may lead to fines imposed on the parties, possibly amounting to the transaction value.

In cases where a filing is not mandatorily required, the parties involved have the option to voluntarily approach CFIUS and seek clearance to avoid legal uncertainty by CFIUS reviewing the transaction at some point in the future.

There are differences of the submissions to CFIUS in scope:

- A CFIUS "notice" is a full-form filing resulting in a definitive opinion by CFIUS regarding the national security risks associated with the transaction but may take four to five months to obtain.
- A CFIUS "declaration" is a short-form filing that may not result in a definitive opinion by CFIUS but is intended to be able to be obtained within 30 days.

Obtaining CFIUS clearance in advance of closing is usually not a legal requirement. However, submitting a CFIUS filing and then closing before the review process is completed creates regulatory risks. Hence, if timing permits, the filing should be submitted 30 days before closing. But be aware that the preparation of a CFIUS filing might require substantial time and effort. While CFIUS has a tiered filing fee structure for formal CFIUS notices, no fee is required for short-form declarations.

CFIUS often conditions clearance of a transaction on contractual measures to which transaction parties commit that, in CFIUS' view, adequately mitigate identified national security concerns. CFIUS may consider mitigation measures proposed by parties.

5. WHEN IS THE U.S. NATIONAL SECURITY THREATENED?

The risk assessment carried out by CFIUS must result in national security concerns to justify a blocking decision by the President of the United States. As to the scope of this criterion, CFIUS may consider factors like the country of origin of the investor, the history of the investor complying with U.S. laws and regulations, potential implications on production in the United States of certain items, the likelihood of sensitive data of U.S. citizens being exposed, the likelihood of cybersecurity vulnerabilities, etc.

In this regard, President Biden in 2022 also emphasized the importance of taking into account, among other factors, supply chain resilience and security, third-party ties, cybersecurity and data protection as well as future advancements and applications in technology that could undermine national security.

A FEW TAKEAWAYS FROM CFIUS' RECENT ACTIVITIES

#1 Every investment by a foreign investor in a U.S. company should be assessed to determine whether it falls within CFIUS's jurisdiction and, if so, whether the investment may trigger a mandatory filing with CFIUS.

#2 U.S. companies and foreign investors should conduct a thorough CFIUS risk assessment. It is advisable for a U.S. company to conduct due diligence on potential foreign investors.

#3 Even if a transaction does not require a filing with CFIUS, CFIUS may still have jurisdiction over a transaction. Parties should always consider whether a voluntary filing with CFIUS may be advisable.

#4 Only transactions that are reviewed and cleared by CFIUS enjoy a "safe harbor." If a transaction is within CFIUS's jurisdiction and the parties close without obtaining CFIUS clearance, CFIUS may disturb the transaction, even years after closing.

#5 CFIUS is more likely to closely examines foreign investments in engagement with U.S. technology companies and other sensitive industry companies. While it is hard to predict what will result in a CFIUS concern, a recent CFIUS-related Executive Order mentions microelectronics, artificial intelligence, biotechnology and biomanufacturing, quantum computing, advanced clean energy, and climate adaptation technologies among the areas affecting U.S. national security. While CFIUS considers TID U.S. businesses more sensitive from a national security perspective, a company does not need to be a TID U.S. business to draw CFIUS's attention.

#6 The foreign investor's jurisdiction is not the only factor CFIUS considers as part of its "threat" analysis.

#7 CFIUS' non-notified transactions department has grown significantly over the past years and has become very active. CFIUS relies on various sources, including press releases about transactions to find transactions within its jurisdiction.

#8 CFIUS' outreach post-closing in case of a foreign investment presents risks to not just the foreign investor but also to the U.S. company – time, energy, expense of negotiating with CFIUS and possibly onerous so-called national security agreements (basically agreements to address CFIUS' concerns in order to avoid even stricter measures such as divestment orders) or potential fire sale of foreign investor's stock may interfere with company's operations, including raising additional funding.

B. Our International Platform for Technology Companies

The leading German legal data base JUVE **nominated** us **for Private Equity and Venture Capital Law Firm of the Year** in Germany 2021 and 2019, and named our partner Sven Greulich one of the top VC lawyers in Germany (2022/2023)

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PitchBook Q1 2023

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Orrick counsels more than 3,700 venture-backed companies and 90+ unicorns as well as the most active funds, corporate venture investors and public tech companies worldwide. Our focus is on helping disruptive companies tap into innovative legal solutions. We are ranked #11 firm for global M&A volume (MergerMarket) and the #1 most active law firm in European venture capital (*PitchBook*).

The 2022 State of European Tech Report prepared by *Atomico* in partnership with *Slush*, Orrick and HSBC Innovation Banking (at the time SVB UK), is the deepest, data-led investigation into the European tech ecosystem and empowers us all to make data-driven decisions in the year to come.

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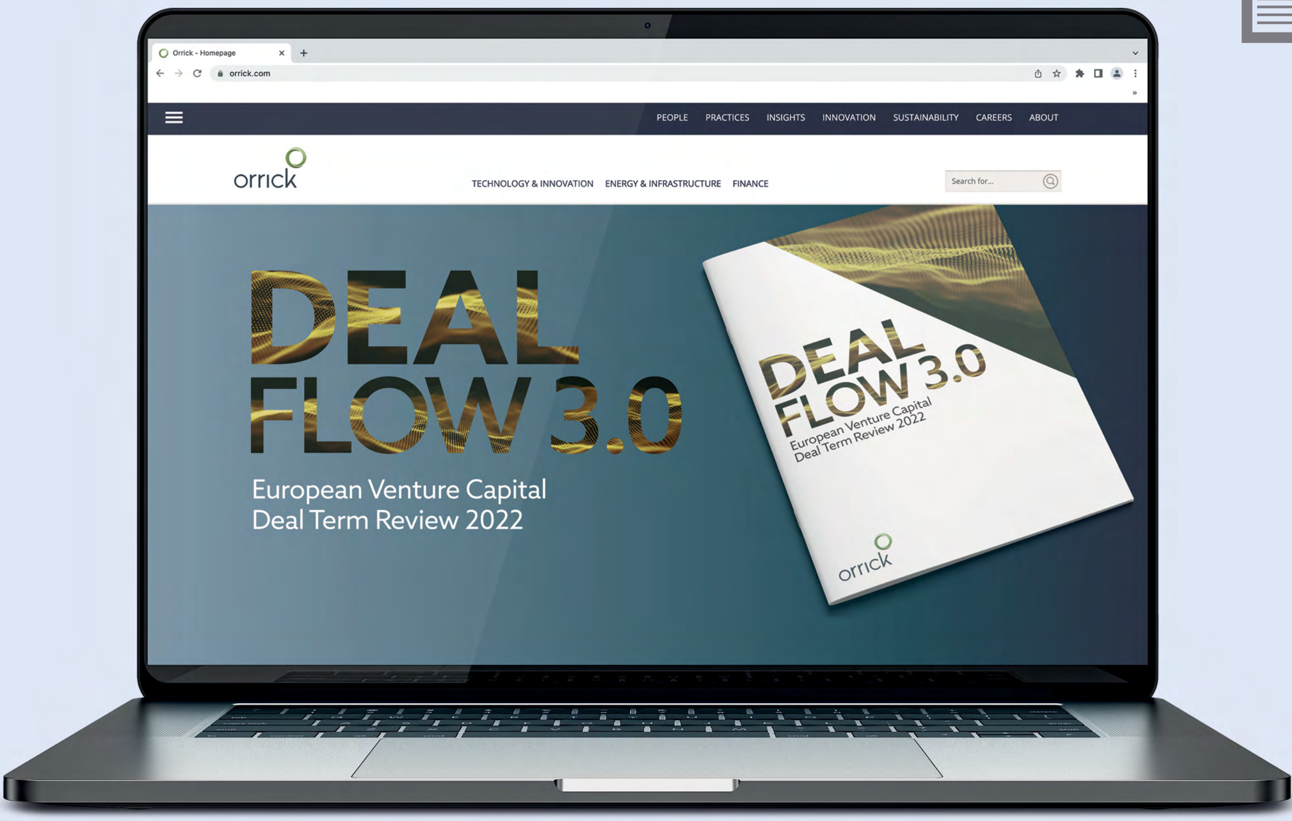

We analyze our closed venture financing transactions and convertible loan note financings across our European offices, to offer strategic insight into the European venture capital market:

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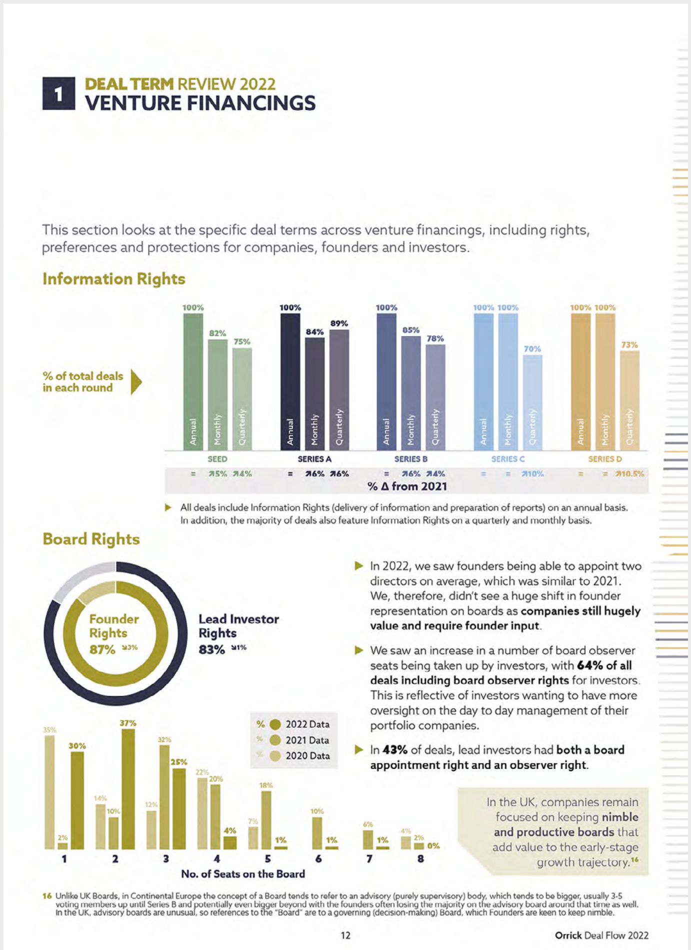
Deal Flow 3.0 with our analysis of the 2022 deal terms is available at orrick.com.


1 DEAL TERM REVIEW 2022
VENTURE FINANCINGS

This section looks at the specific deal terms across venture financings, including rights, preferences and protections for companies, founders and investors.

Information Rights

All deals include Information Rights (delivery of information and preparation of reports) on an annual basis. In addition, the majority of deals also feature Information Rights on a quarterly and monthly basis.

Board Rights

In 2022, we saw founders being able to appoint two directors on average, which was similar to 2021. We, therefore, didn't see a huge shift in founder representation on boards as **companies still hugely value and require founder input**.

We saw an increase in a number of board observer seats being taken up by investors, with **64% of all deals including board observer rights** for investors. This is reflective of investors wanting to have more oversight on the day to day management of their portfolio companies.

In **43%** of deals, lead investors had **both a board appointment right and an observer right**.

In the UK, companies remain focused on keeping **nimble and productive boards** that add value to the early-stage growth trajectory.[16]

12 Orrick Deal Flow 2022

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> Orrick is reimagining how to use data in the delivery of legal services.
>
> *Reena Sengupta*, RSG Consulting

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Previous Issues in this Series

www.orrick.com/en/Practices/Orrick-Legal-Ninja-Series-OLNS

OLNS #1 — Venture Debt for Tech Companies
May 2019

Venture Debt is a potentially attractive complement to equity financings for business start-ups that already have strong investors on board.

This is a highly flexible instrument with very little dilutive effect for founders and existing investors.

OLNS #2 — Convertible Loans for Tech Companies
August 2019

Due to their flexibility and reduced complexity compared to fully-fledged equity financings, convertible loans are an important part of a start-up's financing tool box. In a nutshell: a convertible loan is generally not meant to be repaid, but to be converted into an equity participation in the start-up at a later stage.

OLNS #3 — Employment Law for Tech Companies
January 2023
(this revised edition replaces Dec 2019 issue)

Young technology companies are focused on developing their products and bringing VC investors on board. Every euro in the budget counts, personnel is often limited, and legal advice can be expensive. For these reasons, legal issues are not always top of mind. But trial and error with employment law can quickly become expensive for founders and young companies.

OLNS #4 — Corporate Venture Capital
March 2020

Corporates are under massive pressure to innovate to compete with new disruptive technologies and a successful CVC program offers more than capital – access to company resources and commercial opportunities are key features that justify CVC's prominence. This guide serves to share best practices for corporates and start-ups participating in the CVC ecosystem and also to ask important questions that will shape future direction.

OLNS #5 — Venture Financings in the Wake of the Black Swan
April 2020

In the current environment, all market participants, and especially entrepreneurs, need to be prepared for a softening in venture financing and make plans to weather the storm. In this guide, we share some of our observations on the most recent developments and give practical guidance for fundraising in (historically) uncertain times. We will first provide a brief overview of the current fundraising environment, and then highlight likely changes in deal terms and structural elements of financings that both entrepreneurs and (existing) investors will have to get their heads around.

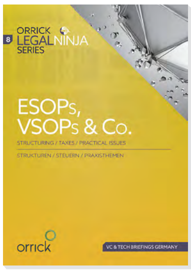
OLNS #6 — Leading Tech Companies Through a Downturn
May 2020

Steering a young technology company through a downturn market is a challenging task but if done effectively, the start-up can be well positioned to benefit once the markets come back. While OLNS#5 focused on raising venture financing during a downturn, in this guide, we want to give a comprehensive overview of the legal aspects of some of the most relevant operational matters that founders may now need to deal with, including monitoring obligations and corresponding liabilities of both managing directors and the advisory board, workforce cost reduction measures, IP/IT and data privacy challenges in a remote working environment, effective contract management and loan restructuring.

OLNS #7 — Flip it Right: Two-Tier U.S. Holding Structures for German Start-ups

January 2021

Operating a German technology company in a two-tier structure with a U.S. holding company can have great advantages, most notably with respect to fundraising in early rounds and increased exit options and valuations. However, getting into a two-tier structure (be it through a "flip" or a set-up from scratch) requires careful planning and execution. This guide shows you what to consider and how to navigate legal and tax pitfalls.



OLNS #8 — ESOPs, VSOPs & Co.: Structuring / Taxes / Practical Issues

June 2021

OLNS#8 provides a comprehensive overview of equity-based and Employee-ownership programs (or in short "ESOPs") play a critical role in attracting and retaining top talent to fledgling young companies. Stock options reward employees for taking the risk of joining a young, unproven business. This risk is offset by the opportunity to participate in the future success of the company. Stock options are one of the main levers that start-ups use to recruit the talent they need; these companies simply can't afford to pay the higher wages of more established businesses. With OLNS#8, we want to help start-ups and investors alike to better understand what employee ownership is, structure them in a way that is congruent with incentives, and implement them cleanly.

OLNS #9 — Venture Capital Deals in Germany: Pitfalls, Key Terms and Success Factors Founders Need to Know

October 2021

Founding and scaling a tech company is a daunting challenge. OLNS#9 summarizes our learnings from working with countless start-ups and scale-ups around the world. We will give hands-on practical advice on how to set up a company, how (not) to compose your cap table, founder team dynamics and equity splits, available financing options, funding process, most important deal terms and much more.

OLNS #10 — University Entrepreneurship & Spin-offs in Germany – Set-up / IP / Financing and Much More

November 2022

German universities are increasingly becoming entrepreneurial hotbeds, but university spin-offs face some unique challenges, some of which could – with the right support systems and policies in place – be considerably less stressful. OLNS#10 helps founders by providing them with an overview of how to get a university-based start-up off the ground. We will discuss founder team composition and equity-splits, the composition of the first cap table, important considerations for the initial legal set-up (founder HoldCos and U.S. holding structures) as well as financing considerations. We will also return again and again to the specifics of IP-based spin-offs, especially when it comes to how a start-up can access the university's IP in an efficient manner.

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