ALERT MEMORANDUM

Venture Capital Investing: New NVCA Models, and New Challenges for Foreign Investors in Early-Stage U.S. Companies

October 7, 2020

Between July 28, 2020 and September 1, 2020, the National Venture Capital Association (the "NVCA") released updates to its model legal documents for use in venture capital financing transactions. This memorandum will explain the changes to these model forms and some of the reasons for, and implications of, such changes.

As background, the NVCA is an organization based in the U.S. whose members include venture capital firms, investors and professionals involved in investing private capital in early-stage companies. In an effort to promote consistent, transparent investment terms and efficient transaction processes, the NVCA has created model legal documents for venture financing transactions, and these models have been widely used in the U.S.

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Questions of Law and Jurisdiction

The model forms are configured for C corporations formed in Delaware, which has been the preferred jurisdiction of incorporation in venture capital, accounting for the vast majority of such companies. This preference is driven in part by the rich database of Delaware judicial precedent, particularly pertaining to corporate and business law matters. Given that venture-backed companies typically view their primary liquidity event as an initial public offering (an "IPO"), the selection of Delaware as the jurisdiction of incorporation also takes into account the benefits and flexibility that Delaware law offers to companies seeking IPOs (and between 80-90% of companies undertaking IPOs in recent years have been C corporations in Delaware). Delaware limited liability corporations ("LLCs") may provide an attractive alternative to companies or investors in certain circumstances, although to date, the NVCA has not published model forms configured for LLCs.

Note that even for companies incorporated in Delaware, certain California corporate laws may apply to the extent such companies are deemed to have significant operations or shareholders located in California. In particular, the California Corporations Code (the "CCC") may cause tension with, or contradict, the requirements of the Delaware General Corporation Law (the "DGCL"). This memorandum seeks merely to point out this potential challenge for "quasi-California" companies and does not offer a comprehensive analysis on the considerations. "Quasi-California" companies and their investors should take special care to understand how provisions of the CCC and DGCL may operate together and how such differences need to be addressed in the documentation to ensure that the provisions of the financing documents operate as intended by the parties.

Overview of the NVCA Model Forms

The NVCA periodically updates its model form documents, with the most recent update (prior to the latest changes in 2020) occurring in early 2018. The NVCA's updates to the model forms attempt to:

1. track developments in applicable law;
2. 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
3. reflect "best practices" in the industry (establishing, or established by, industry norms).

The suite of NVCA documents that have been updated since July 28, 2020 includes annotated models of the following:

1. Term sheet;
2. Certificate of Incorporation ("COI");
3. Share Purchase Agreement ("SPA");
4. Investors' Rights Agreement ("IRA");
5. Voting Agreement ("VA");
6. Right of First Refusal and Co-Sale Agreement ("ROFRCA");
7. Management Rights Letter;
8. Indemnification Agreement; and
9. Limited Partnership Agreement insert ("LPA Insert").

This memorandum will focus on the changes to the core financing documents themselves, including the SPA, IRA, VA and ROFRCA, as well as the COI and proposed LPA Insert.

The model forms' drafting options serve as a helpful basis to start negotiations, but they should be tailored to meet deal-specific requirements. Increasing care should be given as time elapses following the NVCA's last update to the model forms, as applicable law, regulation and market practice continue to develop.

I. Key Takeaways

As discussed in greater detail below, the 2020 changes have been driven by a variety of developments, including:

CFIUS[1]

— New approaches to address the evolving CFIUS review landscape, which sees an expansion of situations where venture-backed companies and their investors may need to seek approval from, or make filings with, CFIUS.

Law and market practice

— Updates to governance provisions to reflect Delaware case law, curtail certain powers of the board of directors and expand stockholder protective provisions.

— Updates to certain representations, warranties and covenants necessitated by the adoption of, or update to, certain laws, such as, in the data privacy space, the California Consumer Privacy Act ("CCPA") and General Data Protection Regulation ("GDPR").

— Expansion of provisions relating to Qualified Small Business Stock ("QSBS"), reflecting an increasing awareness of the tax benefits potentially available to early investors in a qualifying business.

— Updates to the "market stand-off" (or "lock-up") provisions relating to underwritten offerings, in particular to propose a "staged release" approach for lock-up restrictions, which could both increase investors' liquidity while minimizing potential liability for the company and its directors and officers under Section 11 of the U.S. Securities Act of 1933, as amended (the "Securities Act"). In addition, the provisions have been updated to reflect the Financial Industry Regulatory Authority ("FINRA") rules applicable to the underwriting banks (and replacement of the New York Stock Exchange ("NYSE") rules).

— Offers option to waive statutory inspection rights under Section 220 of the DGCL, allowing companies to tailor information and inspection rights granted to certain shareholders (and thus reduce potential claims from shareholders relating to demands for access to books and records).

— Memorializes language for fixed rate, preferential dividends for preferred stock holders.

Clarifications and drafting improvements

— Moves away from considering direct listings (*i.e.*, listings of the company's shares on an exchange without the use of an underwriter) as a likely exit strategy, perhaps with the view that underwritten listings are (and will continue to be) the dominant approach to public offerings (although recent examples of direct listings and rule changes may actually suggest a different trend, further discussed below).

— Amendments to registration rights mechanics designed to bolster protections and optionality for investors.

— Improvements to company representations to facilitate investors' diligence, and corrections to prior drafting that may have caused confusion.

II. General Themes

Governance provisions

Board powers

— There is increased attention to the decision by the Delaware Chancery court in *Sinchaereonkul v Fahnemann, C.A. No. 10543-VCL (Del. Ch. Jan. 22, 2015)*, that differential voting rights for directors of a Delaware corporation must be set forth in the COI, rather than any other document. As such, the NVCA has helpfully pointed out that special care should be taken while reviewing documentation, particularly when the IRA or other

[1] the Committee on Foreign Investment in the United States.

documents contemplate voting rights of the directors.

Questions of Law and Jurisdiction

Note that voting mechanics is one potential situation where a difference in approach between the CCC and DGCL may be problematic for "quasi-California" companies. Pursuant to Section 214 of the DGCL, if a corporation wants to permit cumulative voting, it must include an express provision to this effect in its certificate of incorporation . However, under Section 2115 of the CCC, corporations are required to permit cumulative voting, even if the right is not specifically contemplated in the constitutional documents of the company. Therefore, if a stockholder seeks to exercise its right to cumulate votes where such right is not contemplated in the company's certificate of incorporation, the company may find itself forced to violate the CCC if it denies the exercise of such right, or violating Section 214 of the DGCL if it allows it.

— There are changes narrowing the scope of certain board reserved matters, which reflect the continuing shift in the power balance from the board of directors towards companies' management and founders, including:

- Removal from the list of board reserved matters certain related party transactions between the company and its directors, officers and employees (in particular, those which are not contemplated in the underlying transaction, are more than $60,000 per year or are otherwise not in the ordinary course).
- Increase of the monetary threshold for strategic relationships involving payment, contribution or assignment—originally set at $100,000, but now suggested to be a value set between $500,000-$1 million.

— The DGCL requires, at a minimum, that 1/3 of the total directors of a company be present to constitute a quorum for board meetings. This means that for companies whose bylaws provide for more than 3 directors and for which only 1 such director is appointed at a given time, a quorum cannot be achieved. As such, the COI includes an additional right of the board to, out of administrative convenience, appoint additional directors in the first instance to ensure that board meetings can be held. Consider this together with the VA, which has removed the requirement that stockholders shall vote to ensure the size of the board remains a given size.

— Language requiring that board observers act "in a fiduciary manner" with respect to all information provided to it has been removed. We believe this was a correction, as board observers are not subject to the same fiduciary duties as directors under Delaware law, and confidentiality obligations will need to be imposed instead by contract.

Stockholder protective provisions

In line with the NVCA's approach to provide more optionality for protections of preferred stockholders, the list of matters requiring consent of the preferred holders has been expanded, in particular to include the following:

- any "merger or consolidation", an undefined concept which would capture a broader range of situations than covered in the "Deemed Liquidation Event" concept (which is typically a tailored formulation of company merger and sale events that give rise to redemption), including mergers without any independent economic substance but rather effected for the sole purpose of subverting the terms of the shares of preferred stock;
- changes to capital stock other than to shares that will rank junior to the preferred shares in terms of rights, preferences and privileges;

- changes to equity compensation plans, options or other grants pursuant to such plans; and
- changes to number of votes cast by each director, and any changes inconsistent with the redemption mechanics.

Changes driven by applicable laws

— In the IRA, optional language is included whereby holders waive any rights under Section 220 of the DGCL to inspect the company's books and records. The IRA provides robust information and inspection rights contractually, but these are available primarily to "Major Investors" (*i.e.*, investors who own a certain, typically large amount of stock). This is likely the result of evolving case law in recent years regarding what constitutes "books and records" and a "proper purpose", which has increased legal burden on companies.

— Due to increasing awareness of significant tax benefits relating to QSBS, as well as complexities in determining eligibility for QSBS tax treatment, the SPA and IRA include expanded provisions relating to QSBS, including a detailed information reporting form to be completed by the company for the investors' benefit. This inclusion suggests that the NVCA is attempting to strike a balance between enabling tax benefits for certain shareholders while ensuring that the burdens of maintaining QSBS status do not unduly dominate corporate policy. Note that the QSBS regime can be very advantageous for founders or other qualifying early stage investors who, if holding the company's stock for a specified period, may be exempt from having to pay U.S. federal income tax on realized gain up to a certain amount, but may not be relevant to investors who are not subject to U.S. tax on capital gains from the sale of stock in the first instance.

— Reflecting the evolution of data privacy practice and laws, including the CCPA and GDPR, the company's data privacy representation has been expanded, requiring companies to comply not only with their own written policies, but also their public written statements and industry standards and recognizing a broader scope of activities in which the company may be considered to engage with "personal information". There is an additional representation about the occurrence of accidental, unlawful or unauthorized actions relating to both "personal information", as well as unauthorized access to or disclosure of the company's confidential information (which means companies will need to disclose any such incidents against this representation).

Other general improvements, clarifications or developments in practice

Representations, Warranties and Covenants

— A number of changes to the representations and warranties seem aimed at driving the diligence process for potential investors. For example:

- A blanket company representation is proposed, confirming that all common stock and stock options held by service providers are subject to a customary vesting schedule (over 4 years with a 1 year cliff). This is a simpler approach than previously contemplated, which required that the company provide comprehensive capitalization information of the company (including details on outstanding common stock and all stock options (as well their vesting schedules)), which investors would need to sift through.
- The representation relating the company's use and distribution of open source code has been expanded by the inclusion of a more robust (and up-to-date) formulation of what "open source code" entails.

— An additional company representation and covenant has been added confirming that the company is not a "U.S. real property holding company" (a "USRPHC") as defined in the Internal Revenue Code of 1986, as amended (the "Code"), and the company will be required to confirm

whether an investor's interest constitutes a U.S. real property interest upon request. Although not commonly an issue in venture capital investments, the inclusion of the representation is customary and reflects market practice (particularly if there are foreign investors involved in the financing, as they may be subject to a tax withholding requirement for transferring interests in a USRPHC). The inclusion of the covenant is in response to changes in tax law, requiring venture capital funds to report to a transferring limited partner the extent to which a sale would generate U.S. tax obligations.

— To complement a standard company representation, a covenant has been added in relation to the company's compliance with the U.S. Foreign Corrupt Practices Act of 1977, as amended (the "FCPA"). This covenant was included in earlier versions of the model IRA, and removed during the 2018 update (without explanation, but potentially due to low adoption given that early-stage companies face practical challenges in implementing a costly and time-consuming compliance program such as for the FCPA). Its re-inclusion remains bracketed, suggesting that this should be a negotiated option—one which needs to be considered in light of the company's size and international footprint.

— As cybersecurity becomes an increasing focus for companies globally, a covenant has been added that includes prescriptive options, with a baseline requirement that the company (i) implement access controls on protected data, (ii) design reasonable safeguards designed to protect the confidentiality, integrity and availability of its technology and systems, and (iii) undertake to implement periodic updates and training programs for its employees.

Initial Public Offerings

— The NVCA has stripped out provisions and guidance relating to direct IPO listings (*i.e.*, listings done without the assistance of underwriters), and focuses on underwritten IPOs. From discussions around the 2018 update of the model forms, we would expect the rationale for this to be that direct listings are not common. However, while IPOs are still dominated by traditional underwritten offerings, there has in fact been a noticeable uptick in direct listings since 2018 (*e.g.,* Spotify, Slack, Palantir and Asana), which may have contributed to the NYSE's decision to make a number of rule changes that were ultimately approved by the SEC on August 26, 2020—immediately after the NVCA began releasing its updated model forms. Following the new SEC rules, our view is that the use of direct listings will continue to increase.[2]

— The NVCA has suggested that companies consider a "staged release" for investors from lock-up restrictions to mitigate the impact of a longer lock-up period and deflationary pressures on a company's stock price that are often brought about by all of the locked-up investors being released simultaneously. In addition, if certain investors are indeed released and sell under Rule 144, this can protect the company and its directors and officers from liability under Section 11 of the Securities Act (for false or misleading statements) which would otherwise apply if shares are acquired in connection with the company's registration statement.

— The lock-up restriction provides for additional standard carve-outs, including for shares of common stock acquired in the IPO or on market after the IPO, and sales pursuant to a trading plan under Rule 10b5-1.

[2] For further details on the changes and implications of the direct listing regime, please see our latest alert memorandum published on this subject on our website at: https://www.clearygottlieb.com/news-and-insights/publication-listing/direct-listings-20-primary-direct-listings.

Registration Rights

— There have been a number of drafting improvements in the registration rights provisions, which offer more practical default approaches for investors on previously negotiated points. For example:

- The NVCA now suggests that investors seek to use actual cut-off dates for exercising demand registration rights as opposed to time periods that are tied to the date of the applicable IRA. The NVCA noted that this is intended to prevent inadvertent perpetual roll-forwards.
- Form S-3 demand registration rights are subject to two thresholds: (i) a specified percentage of holders must make the demand, and (ii) the anticipated aggregate offering price needs to be of a sufficient size (which was increased from a range of $1 million – $3 million to a range of $3 million – $5 million). The NVCA now suggests removing the floor for requisite votes from holders, as the monetary threshold is increasingly seen as sufficient (and Form S-3 demand rights are not a large imposition to begin with). While the monetary thresholds for Form S-3 demand registrations have increased, note that the monetary threshold for Form S-1 demand registrations remains the same ($5 million – $15 million).
- Holders are not required to make representations, warranties or indemnities in relation to a potential registration, except as they relate to such holder's ownership and authority and capacity to enter into the underwriting agreement or intended method of distribution. In addition, the IRA now confirms that the liability of such holders are several and not joint, and limited to an amount equal to the net proceeds from the offering it receives. This approach was often negotiated in practice, and it is now simply codified as a drafting option.

— Companies still have an ability to decline a demand registration request to avoid certain materially detrimental effects to the company, but the NVCA has removed a pro-company alternative drafting option which would allow the company to decline such a request simply if the CEO believes it may be "materially detrimental to the company and its stockholders for such registration". Other typical limitations remain, but are much more objective and specifically described (*e.g.*, there must be material interference with an M&A transaction, registration would result in premature disclosure that the company has a bona fide reason to keep confidential, or registration would render company unable to comply with securities laws). The removal of the pro-company alternative is likely a result of it not being widely accepted in practice.

— Companies are required to give notice to their shareholders of any company-initiated registration, which investors have an option to piggyback on. However, the NVCA has expanded the scope of potential exceptions, which may now include IPOs and demand registrations (in addition to registrations relating to the grant of securities to employees and SEC Rule 145 transactions).

— Holders are indemnified against damages arising from the company's untrue statements or omissions of material facts in any registration statement, or violation of applicable securities laws, except when such deficiency is caused by the company's reliance on actions or information furnished by the holders or underwriters that itself contains omissions. Holders are able to restore indemnification protection if information they fail to furnish is subsequently corrected prior to or concurrently with the sale of registrable securities.

— The termination of registration rights have been more narrowly tailored, contributing to the survivability of holders' rights. In particular:

- Registration rights may be terminated upon only those "Deemed Liquidation Events" that result in holders receiving consideration in the form of cash and / or publicly traded securities, or if holders otherwise continue to receive comparable registration rights from the

acquiring or surviving company, as the case may be.

- Registration rights will be terminated in respect of a holder when Rule 144 becomes an available option for such holder to effect a sale. However, a drafting option is included to confirm that such termination shall only apply to a holder that holds less than 1% of outstanding capital stock of the company. This would preserve registration rights for larger holders who may be subject to lock-ups and other constraints on transferability.
- Registration rights may be terminated following expiry of a 3–5 year period following the IPO (as opposed to counting this from the date of the IRA, which will result in shorter survival periods in practice).

Other changes

— New standard drafting for preferred stock fixed rate dividends, which may be paid upon declaration of the board, in preference to payment on other classes of stock, and in addition to *pari passu* / shared dividends with holders of shares of common stock of the company. This concept has been utilized in practice already, with rates typically between 6%–8% of the applicable share purchase price, and the drafting is merely a codification of what market participants commonly negotiated. Note that in some cases, the company may limit preferred holders to receive only the specific dividend (and not also participate in the subsequent *pari passu* / shared dividends), but this may not be particularly problematic for preferred holders as many early-stage companies do not typically pay dividends in any case.

— Expanded definition of "Immediate Family Members" to include life partners or similarly statutorily-recognized domestic partners, which reflects the evolving view on intimate relationships in the U.S., and as a result, expands the scope of potential permitted transferees or assignees.

— Continuation of equivalent information rights post-acquisition where consideration received is private shares of purchaser stock.

— Clearer acknowledgement that investors permitted to evaluate or invest in competitor companies.

CFIUS-driven changes

Approach to CFIUS-related provisions in venture capital documents

To understand the substantive changes in the NVCA model forms driven by CFIUS considerations, it is helpful to first understand the evolution of the CFIUS rules and the current paradigm, particularly as it relates to foreign investors in venture capital deals. The 2018 Foreign Investment Risk Review Modernization Act ("FIRRMA") and implementing regulations made significant changes to CFIUS procedures, most notably introducing mandatory notifications.

The regulations are quite recent and continue to evolve, and it is too early to say that settled market practice has developed. However, the drafting options provided in the NVCA forms should be considered an illustrative approach, and additional or different approaches may be appropriate in more complex cases.

The general approach of the NVCA forms is to address transactions in which foreign persons are not expected to obtain governance rights in the target by providing binding representations and covenants that CFIUS will not have jurisdiction over an investment by any party in a target company, meaning that foreign ownership and governance rights with respect to the company are strictly limited. It would be a mistake, however, to view these provisions as driving the commercial arrangements among the parties rather than reflecting and memorializing them; the question of what transaction is intended (in light of the costs and benefits of a potential CFIUS notification) is prior to the question of whether the provisions are appropriate. It certainly is not the case that either the law or the market forbid foreign investors from acquiring influence over U.S. companies.

It is also important to note that these representations and covenants are neither necessary nor sufficient to eliminate risk of CFIUS intervention altogether—CFIUS's jurisdiction is broad and highly discretionary, and therefore it is difficult to deal in absolutes. Parties may agree as a matter of diligence on what the facts are, but how CFIUS will use its considerable discretion to apply its broadly written rules to those facts is less certain. Even where the parties agree that a CFIUS filing is unnecessary or undesirable, it may be more appropriate to deal with the issue by diligence, negotiation of governance provisions, and assessment of the transaction rather than conclusory contractual provisions that treat questions of judgment as questions of liability.

If CFIUS does have jurisdiction over a transaction, that fact is not necessarily fatal. Except for a relatively small subset of transactions subject to mandatory notifications, CFIUS often does not review transactions over which it may have jurisdiction, and parties may decide to proceed without a notification in appropriate cases. Even if a notification is required or advisable, it may be rational to proceed with a transaction despite the timing and cost considerations.

Evolution of the CFIUS rules

In August 2018, shortly after the NVCA published the prior versions of its model documents in early 2018, FIRRMA was signed into law. Among other things, FIRRMA introduced mandatory notifications and codified and clarified CFIUS practice over the decade or so since the previous significant reform, as well as expanding CFIUS's already broad jurisdiction over non-controlling investments in the technology, data, and infrastructure sectors.

In particular, under FIRRMA, foreign investments in U.S. businesses involving specified "critical technology", "critical infrastructure" or "sensitive personal data" ("TID U.S. Businesses") are now potentially mandatory. FIRRMA established mandatory filings for investments by any foreign person into U.S. businesses that develop, manufacture, or test "critical technology" as well as acquisitions by foreign persons in which a foreign government owns 49% or more of a 25% or greater stake in other TID U.S. businesses. Failure to comply with the mandatory CFIUS notification requirement is subject to penalties up to the value of the transaction. Further, and importantly for non-U.S. investors in venture capital deals (which are typically conducted on an accelerated timeframe without conditions to closing), FIRRMA extended the CFIUS review timeline and introduced a mandatory 30-day waiting period for transactions that trigger a mandatory CFIUS notification.

FIRRMA also expanded CFIUS's jurisdiction over TID U.S. Businesses. Under the previous rules, TID U.S. Businesses were already an area of focus, and while the CFIUS regulations nominally speak of acquisitions of "control," CFIUS has long had a broad interpretation of the term in practice that reached acquisitions of as little as 15% with proportionate board representation. Under FIRRMA, even below these levels, if a foreign investor receives certain non-controlling rights (*e.g.*, director/observer rights, access to material nonpublic technical information, or involvement—which may include non-binding consultation—in decision-making related to the critical technology/infrastructure/data), CFIUS may review the transaction. On the other hand, FIRRMA also clarified and reaffirmed an exemption from CFIUS jurisdiction for passive foreign investment through U.S. private equity funds.

Regulations released by the U.S. Department of the Treasury (the "Treasury") implementing most of the FIRRMA provisions (the "Final Regulations") became effective on February 13, 2020. The 2020 NVCA model forms were published after these Final Regulations, but before the latest rule on mandatory notification for critical technology transactions published by the Treasury on September 15, 2020 (the "Critical Technology Rule"). The Critical Technology Rule comes into force on October 15, 2020 and significantly alters the scope of mandatory notification requirements for foreign investments into U.S. critical technology companies. In particular, the Critical Technology Rule eliminates the focus on whether "critical technologies" are used, or designed for use, in specified industries, and

instead focuses on whether the specified technologies are (1) subject to a subset of U.S. export controls (those other than the least restrictive set of dual-use controls) and (2) require a license for export to the buyer. In other words, the Critical Technology Rule expands mandatory filings in critical technology businesses to all industry sectors if the target's business involves critical technology and that critical technology would require a license or authorization for export (real, or hypothetical) to the principal place of business or country of nationality of the foreign person investor or any foreign person holding 25% or more in the investor's ownership chain (including holding companies).[3] This does not apply only to goods and technologies actually exported by the target, but those sold only in the U.S. market or even not sold at all (*e.g.*, proprietary manufacturing technologies that are only used internally by the target and would not be sold). In addition to expanding the scope of mandatory filings in a way that could potentially be relevant to any venture capital target in the U.S., the Critical Technology Rule makes the CFIUS analysis much more complicated, as an export control analysis must first be conducted by the target company.[4]

Although not directly relevant to the NVCA model form documents, for completeness we note that FIRRMA and subsequent implementing regulations also introduced CFIUS filing fees for full CFIUS notices (short-form CFIUS declarations are not subject to fees). The fees for a transaction valued at $5 million or more, but less than $50 million, are $7,500, but increase to $75,000 above $50 million, $150,000 above $250 million, and $300,000 above $750 million. The highest tier fee is unlikely to be relevant for venture capital investments, but a fee of $75,000 or $150,000 (combined with the potential delay of a mandatory filing) may be a significant consideration for some foreign investors accustomed to completing venture capital deals at relatively low cost.

Current mandatory filing requirements

Following the latest CFIUS regulations coming into force on 15 October, mandatory CFIUS filings will be required where a foreign investor seeks to have either of the following:

(i) "control" over a U.S. business, broadly defined as the power to determine important matters affecting the business (and in practice often viewed as anything outside the presumptive safe harbor for investments that are under 10% and wholly passive, and therefore better understood as "substantial influence"), or a non-controlling stake in a U.S. business for which such foreign investor will have a board or observer seat, the ability (*de facto* or contractual) to participate in substantive decisions regarding critical technology, or access to material non-public technical information ("MNPTI"), if (a) the target U.S. business produces, designs, tests, manufactures, fabricates or develops "critical technologies" (technology subject to U.S. export controls, other than the least-restrictive category applicable to dual-use goods), and (b) an export license or other authorization would be required to export the target company's "critical technologies" to the country(ies) of the investor(s) or any entity that directly or indirectly owns 25% or more of the investor (and the country(ies) do not qualify for one of the three license exceptions included in the Critical Technology Rule), or

(ii) at least 25% of the direct or indirect voting equity in a TID U.S. business where a foreign government

[3] Thus, all entities in the chain must be eligible for license-free export from the U.S. to avoid a mandatory notification. The Critical Technology Rule also includes exemptions from the mandatory CFIUS filing requirement if the critical technology qualifies for one of three license exceptions under the U.S. export control laws, including the license exception relating to strategic trade, which broadly exempts many exports to specified U.S. allies and major defense partners.

[4] In addition to expanding the mandatory filing regime, the new CFIUS regime has imposed a number of new features, which are described in greater detail in our alert memorandum published at: https://www.clearygottlieb.com/news-and-insights/publication-listing/cfius-shifts-focus-of-critical-technology-mandatory-notifications-to-export-controls.

has at least 49% of the direct or indirect voting equity of such foreign investor.

Addressing CFIUS risk in the NVCA model documents and potential issues

The NVCA approach is to include in deal documents a variety of representations and undertakings confirming that the CFIUS mandatory filing criteria are not met (with a particular focus, in the first instance, on confirming that the target company is not engaged in activities involving "critical technologies"), and ensuring that a foreign person does not obtain any of the rights that would trigger CFIUS jurisdiction. Determining whether or not these criteria are satisfied will require a holistic analysis on a case-by-case basis and is complicated by the fact that CFIUS's analysis, particularly with respect to control, is often opaque, highly discretionary and sometimes inconsistent, and as a practical matter it is not subject to meaningful external review. The other approach we have commonly seen is a diligence-based approach in which each of the parties assesses the CFIUS risk and determine whether to include CFIUS filing provisions in the agreement but do not attempt to allocate liability should CFIUS seek a filing.

The approach adopted in the NVCA model forms reflects an approach we have seen in the market that is hyper-conservative in attempting to avoid any possibility of CFIUS review, but we see a number of issues with this approach, especially for parties with greater CFIUS experience:

— CFIUS has, and historically has used, very broad discretion in interpreting its own rules and in "stretching" to reach transactions that raise either political or national security concerns. CFIUS does not provide reasoned decisions to the parties, and judicial review is extremely limited and so far has not been a practical constraint. It also is often quite unclear whether a U.S. entity might have some risk of being deemed a "foreign person" as a result of minority influence over the entity (for example, board members appointed by non-U.S. persons or

In an effort to address CFIUS risk, the NVCA model forms contain:

— **Representations by the target company** that it does not deal with "critical technologies".
— **Covenants by the target company** that no foreign person will have demand registration rights, hold more than 9.9% of the outstanding voting shares of the company (which may need to be expanded to aggregate multiple investors owned by the same foreign government) or receive any "DPA Triggering Rights" (*i.e.*, rights that could result in transferring "control" or non-controlling interests that could otherwise trigger CFIUS jurisdiction), with a note that board observer rights may be inconsistent with a "passive investment" for CFIUS purposes.*, **
— **Representations by the investors** to confirm they are not a "foreign person".
— **Covenants by the investors** to notify the company in advance of permitting an affiliated foreign person from obtaining "DPA Triggering Rights" and, by key holders, not to transfer to a foreign person if it would result in the transfer of a DPA Triggering Right, without board consent.

*The CFIUS regulations explicitly indicate that an investment that affords the investor a board observer seat is not solely for the purpose of passive investment. This is important if an investor is trying to qualify for the CFIUS safe harbor pursuant to which investments at 10% or less that are undertaken solely for the purpose of passive investment are presumptively (but not definitively) not subject to CFIUS review.

**The NVCA also suggests an optional obligation to notify investors and limit the rights of foreign investors if re-categorization by the U.S. government or changes in business activities result in the company later being deemed to be engaged in "critical technologies", with the aim of preempting the need for any potential future filing. Unless designed to apply to a company that currently has no foreign investors but might do in the future, this provision appears to misapprehend the nature of the mandatory CFIUS review, which is assessed at the time of investment (as was confirmed in the recent revisions to the critical technology rules). Subsequent developments cannot render a previous investment subject to notification.

foreign executives).[5] CFIUS also has the ability to determine that a foreign party has *de facto* influence regardless of its formal legal rights (for example, a major investor in a private equity fund). As a result, making definitive representations as to the ability of CFIUS to exercise jurisdiction over a transaction can be quite problematic (and legal opinions will generally be unavailable).

— It is also true that simply because a transaction could be reviewed by CFIUS does not, unless the parties fail to make a mandatory notification, mean that anything improper has occurred; it is quite common for parties to investments that could theoretically be reviewed by CFIUS to decide that the risk of a review is minimal and proceed. It is also worth noting that if there is no CFIUS closing condition, the risk of CFIUS review falls primarily upon the foreign investor (which may be forced to give up governance rights or divest its stake to an acceptable buyer), not upon the company (which will not be forced to return the funds post-closing), much less other investors.

— Representations are not a defense to CFIUS review and of course have no impact on CFIUS. They simply assign liability to one party or another if CFIUS makes an unexpected decision.

— While small, passive transaction participants (or those without much experience with the CFIUS process) may be content to make these representations, larger and more sophisticated participants often view CFIUS matters as a question for diligence and mutual risk assessment rather than flat representations resulting in a breach of the agreement if CFIUS—which ultimately is beyond the control of any party—unexpectedly decides to review a transaction.

— Due diligence is necessary to ensure that the company understands the scope of the representations and has conducted the necessary supporting analysis, including analysis of relevant export control classifications (and, if relied upon, eligibility for applicable license exceptions), but we would expect some target companies to push back on this request because, in practice, many early stage companies may not be prepared to conduct (or pay for) this analysis. Any such analysis would need to be done in close cooperation with the relevant personnel at the target company.

— The covenants that other, or future, investors will not be permitted to acquire positions that could trigger a CFIUS filing, or that holdings will not be transferred if a CFIUS filing could result, should be carefully considered. Some of the restrictions have an obvious economic impact, and if their effect is that the mere possibility of future CFIUS review eliminates potential investors, they could in practice operate as a substantial constraint on future fundraising or investor exits. Investors will also wish to consider the possibility that they themselves could receive foreign investment that could change their status for CFIUS purposes.

In light of the absence of bright-line rules governing the CFIUS process, providing flat representations as to whether CFIUS will have jurisdiction over a transaction (including whether a party may be deemed controlled by a foreign person and whether agreed investment rights may give rise to de facto control) may be problematic, whether it is the investor, company or the sponsor being asked to give such representations. Whether and why investments should be structured with the goal of completely eliminating the possibility of CFIUS review for any future investor is also unclear. Parties should carefully consider the extent to which the model provisions are necessary or appropriate for a particular transaction rather than just copying and pasting the provisions into the relevant documents.

[5] Purchasers should be aware that a U.S. entity can be a "foreign person" under the broad standards of "control" described above, and a U.S. company with a significant foreign investor (even one well short of majority control) may not be able to make this representation with confidence. The investor representation (that it is not a foreign person) is also broad enough to cover consultation by the purchaser with any foreign person regarding any of the specified decisions regarding the company.

CFIUS considerations for funds

The NVCA has offered the LPA Insert, which offers approaches in the fund investment context that:

- Permit the GP to take actions necessary or appropriate to ensure the partnership does not become a foreign person, and ensure the partnership's investments are not covered transactions, including by structuring the partnership or investments allocable to a foreign LP in a manner that would reduce the likelihood of the partnership being deemed to have entered into a transaction within the jurisdiction of CFIUS.
- Require each LP to acknowledge that it has provided, and will continue to provide, the GP with representations or information relevant to determining whether the LP is a foreign person. Foreign LPs must confirm that they do not have rights or powers that may be considered a "DPA Triggering Right".
- Require each LP to notify the GP of any actions that may result in it becoming a foreign person, or may result in a foreign government holding a "substantial interest" in the LP. Further, LPs must also cooperate with GP information requests and those of CFIUS or U.S. government authorities on matters related to CFIUS.

However, LPs may be uncomfortable:

- giving GPs discretion to alter the agreed structure and rights of a limited partnership that were negotiated with CFIUS considerations in mind;
- assuming contractual liability for issues that are within the discretion of CFIUS or the GP/company; and/or
- providing certain financial and other sensitive information (especially sovereign-related LPs).

III. Unexpected Approaches

Absence of LLCA options

During the 2018 update, the NVCA drafters considered including a form or framework for an LLC agreement, as an alternative option to Delaware C corporations. However, the NVCA has again chosen not to make available such materials.

LLCs offer a distinct advantage in flexibility—allowing parties to customize the configuration of fiduciary duty mechanics, whereas in Delaware C corporations, fiduciary duties cannot be waived or circumvented (although stockholders may, to some extent, achieve a similar outcome by waiving claims in particular instances).

However, certain tax considerations (including QSBS advantages[6] for post-sale/IPO capital gains), combined with greater familiarity and perceived simplicity, have historically driven many venture-backed companies and their investors to prefer Delaware C corporations.

Even if there are good reasons to prefer an LLC, the absence of NVCA LLC model forms to simplify drafting and negotiation will likely reinforce this preference.

Removal of life sciences concepts

The NVCA removed milestone drafting options (included in 2018 to allow investors in life sciences transactions to condition their investment on specified milestones being achieved), plus related guidance on how to draft a "Use of Proceeds" section for life sciences companies, and an explanatory footnote on how to address a potential accounting issue that may arise in milestone based transactions. The NVCA has not yet offered an explanation for this reversal in approach.

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[6] Note that special care should be given when assessing tax advantages, as there may be a misconception that only Delaware C corporations can take advantage of the QSBS qualification, when in fact, LLCs have the potential to do so as well if electing to be treated as corporations for U.S. federal income tax purposes (as opposed to partnerships).