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THE BVCA'S NEW STANDARD FORM MODEL DOCUMENTS:

10 key takeaways for growth companies and investors

The British Private Equity and Venture Capital Association, or BVCA, has revised and relaunched its model documents for early-stage investments. Although specifically designed for Series A financings, the model documents are widely used throughout the growth company ecosystem in the UK (and further afield) and provide the skeleton for the corporate and constitutional arrangements of most privately held businesses backed by institutional growth capital at all stages from seed to pre-IPO.

We explore below 10 key takeaways from the model forms for investors and founders alike.

1. Founder vesting and claw-back

Previously, a founder would lose only their unvested shares if they were a "Bad Leaver" (which was defined broadly to include resignation and termination for cause) and would keep their vested shares. If they were a "Good Leaver" (i.e., not a Bad Leaver), they kept all their shares.

The new construct differs in a number of important respects, generally in a more investor-friendly way.

- Founders who are ***Good Leavers*** will lose their unvested shares, but not their vested shares upon leaving ***BUT*** founders who are ***Bad Leavers*** will lose all their shares.
- The definition of "***Bad Leaver***" has, however, been tightened up in situations where a founder resigns, is dismissed for gross misconduct, is convicted of a serious criminal offence or commits a breach of their restrictive covenants.
- The standard vesting schedule remains ***48 months*** (but this time period is generally negotiated, including to take into account vesting schedules from previous funding rounds).
- There is an option to include a ***one-year cliff*** (so if the founder ceases to be an employee or consultant within the first year following the raise, they effectively lose all their shares even if they are a Good Leaver).

We expect these provisions to be heavily negotiated, particularly in attractive rounds where institutional VCs are competing on terms.

In particular, it seems likely that founders will resist applying the new "Bad Leaver" definition to capture voluntary resignation if the consequence is for the founder to lose all of their shares (which does not seem consistent with the monthly time vesting schedule that is generally negotiated).

Relatedly, the new model forms permit a founder to appoint themself as a director while they remain an employee or consultant, but ***this right falls away if they leave the business***. Again, we expect the circumstances in which this right falls away to be negotiated in competitive or later stage rounds when a founder with a significant ownership stake would expect to retain an appointment right for so long as they remain a significant shareholder.

2. Consent rights over future fundraisings and constitutional amendments

In later stage companies, voting and "investor majority" control is generally spread among a wide group of investors from different rounds holding different share classes.

Financing rounds at all stages from seed to pre-IPO generally involve amendments to the articles of association, which need the support of 75% of voting shareholders plus the support of 75% of each class of voting shareholders where there is a proposed change to the rights of that class of shares.

In practice, this allows a 25%+1 minority (or even a 25%+1 minority of a particular share class) to effectively block the terms of a new financing round or hold out for further upside to the existing shareholders. In the warmer market conditions of 2020-2021, this was rarely a practical cause for concern, but as valuations have fallen and VCs have been faced with down rounds in their portfolio companies and increased scrutiny

from their limited partners, ***outsized leverage for a minority in a fundraising context potentially poses a real "hold out" risk*** for founders and growth companies seeking to extend their runway.

The new documents address this risk by requiring, subject to customary minority protections, existing shareholders to agree amendments (and certain other corporate actions) which have been approved by: (i) the board; (ii) the investor majority; and (iii) holders of 50% of equity shares in issue. Interestingly, this provision is not just limited to changes in the context of new financing rounds, but to all amendments of a company's articles of association.

3. Pre-emption rights

Companies typically have "pre-emption" rights in their documents, which effectively give existing shareholders a right of first refusal in new fundraisings. Waiver of these rights is in practice necessary to complete any new financing round. The new documents contain a lower level of protection for investors by ***reducing the ability to disapply these from 75% of voting shareholders to only investor majority consent***. They also contain potential provisions that could only apply pre-emption rights to certain investors (e.g., those holding over a certain percentage).

To provide a counterbalance, the documents include a new provision that has the effect of overriding (or rendering void) a waiver of pre-emption rights where certain (but not all) holders of pre-emption rights go on to participate in the financing following a waiver. The aim of this is to avoid a situation where, for example, in the context of a Series A round, a lead investor from the Series Seed round grants investor majority consent to waive pre-emption rights for all the Series Seed investors, but then goes on to participate in the Series A in its own capacity.

In this situation, the pre-emption rights of the other Series Seed investors would be re-engaged (unless individually waived). It will be important for companies to be mindful of these mechanics when making allocation decisions to existing investors in financing rounds.

For institutional growth investors (particularly multi-stage funds), these pre-emption rights are among the most important commercial terms, and we accordingly ***expect these provisions to be highly negotiated in transactions*** by investors (including potentially for concerned investors seeking hardwired rights for themselves only inside letters).

4. Drag-along in M&A exits

Future-proofing constitutional documents to prepare for an M&A exit is a difficult task. Getting it wrong carries a real cost, as minority investors could seek a price for their cooperation and consent and thereby hold an entire exit "hostage".

It is important that the drag-along provisions achieve a balance by ***allowing an appropriate majority to be able to force an exit but still providing appropriate protection for other investors*** that they will not be required to enter into inappropriate contractual provisions with a purchase (e.g., a non-compete or non-solicit, which would not be an appropriate restriction on an institutional growth investor).

The previous BVCA model articles included a requirement that "dragged" sellers would only be obliged to give title and capacity warranties and not otherwise contribute to sell-side liabilities. This has proved difficult to implement in practice in M&A exits and often led to a potentially perverse outcome that, for example, consenting sellers had to stand behind escrows or contractual protections given to a purchaser with no way to require the dragged sellers to contribute in proportion.

The new documents contain material enhancements in these respects. They require all dragged shareholders to contribute to sell-side obligations (including transaction expenses, warranties, and indemnities, as well as any purchase price adjustment mechanism) in proportion to the shares held. The liability of dragged shareholders is capped at the purchase price received and dragged shareholders do not have to give business warranties or enter into non-compete or non-solicitation covenants (unless they were an employee or consultant of the company).

We generally expect these provisions to be attractive to both companies and shareholders, although the precise terms will be subject to negotiation (particularly in later stage rounds). By way of example, institutional investors in later stage rounds might agree a "drag-along" valuation floor which will need to apply net of any sell-side liabilities for which they may be responsible under the terms of the new drag-along clause.

Companies looking to incorporate these revisions into existing drag-along clauses will need to be careful as there are fiddly rules around alterations made to articles by a majority of shareholders against a dissenting minority.

5. Corporate governance and undertakings

The new model shareholders' agreement includes a number of new undertakings focused on ***enhancing standards of corporate governance and regulatory compliance*** and generally aligning company standards with the expectations of institutional VCs and private capital firms.

These include:

- an undertaking to adopt a code of conduct governing appropriate workplace behaviour, a diversity policy and an anti-harassment and discrimination policy;
- an undertaking to complete a data protection compliance audit and to implement any remediation that may be required;
- a number of ESG-related undertakings, including in respect of climate and diversity and inclusion policies and best ESG practices.

We expect these undertakings to vary significantly in practice depending on the sector-focus and maturity of the company and the approach of lead investors. ***The key point is that the undertakings entered into are realistic and achievable for the relevant companies***. For example, an undertaking to "comply with all applicable laws and regulations" is, on one level, hard to argue against. But on another level, undertaking to a full ongoing compliance audit of every law and regulation that might possibly be applicable and putting in place compliance procedures may not be practically possible or appropriate for many growth companies.

6. Warranties and disclosure

The new model form provides that ***warranties will only be given by the company and not also by the founders***. This is a positive development for founders, who had previously been required to stand behind the warranties with a portion of their salary (although this was often negotiated out).

On limitations of liability, there is no longer a "de minimis" (i.e., minimum monetary threshold before a warranty claim can be brought) on warranty claims and the time period for claims to be notified has been set at 18 months rather than two years. Later stage companies may consider it appropriate to retain a de minimis, in line with the customary position in European M&A documents.

In contrast to the general position in European M&A transactions, where everything put in the data room that investors use for due diligence is - in principle - deemed to generally qualify the warranties, the default position in the model form is that only matters specifically disclosed will qualify the warranties. The disclosure burden on companies at the Series A stage should be relatively limited given the short history of most companies at that stage but may be more material for later stage businesses closer to exit.

7. New holding company

We have increasingly seen companies include provisions in their articles empowering a company to interpose a new holding company between it and its shareholders where the board and investor majority so agree. This has now been formalised in the model forms.

Although at first glance a dry legal structuring point, including this flexibility is critical for corporate groups as they grow, in particular for groups approaching IPO (it is quite common for UK companies to use an overseas holding company when completing an IPO on a US exchange, for example). Failure to get the structuring right could give a minority shareholder an unintended veto over an IPO.

From an institutional investor's perspective, it is important to ensure that any individually negotiated rights (for example, those contained in any MRL or side letter) are replaced on identical terms at the new holding company level.

8. Compulsory transfers

The updated model articles provide for a broader set of circumstances in which a company can force through a compulsory transfer of a shareholder's shares.

Investee companies can mandate a transfer where a disqualifying event has occurred, such as the death, bankruptcy, liquidation or administration of a shareholder, but also where there is a change of control over one of the investee company's shareholders.

In these circumstances, the company is empowered (with the consent of the investor majority) to compel the shareholder to transfer its shares to a permitted transferee. Series A shareholders (or ordinary shareholders whose shareholding has resulted from a conversion of Series A shares) are carved out of this compulsory transfer provision.

9. IPO lock-up

The spirit of this amendment is in line with the general ethos of the new model forms, which focuses on providing companies with greater control over their cap table. Angel and other investors who hold ordinary

shares need to be careful of these restrictions in the context of personal and structuring planning, or if seeking liquidity for a portfolio, so that they avoid unintentionally triggering these restrictions.

The model articles have been updated to include an obligation on shareholders to agree lock-up restrictions with the underwriters on any IPO for up to a maximum of 180 days (the market standard lock-up period following an IPO). This is a sensible inclusion and again potentially helps minimise minority “hold-out” risk.

10. Further model documents

The BVCA has announced that it is intending to publish new model documents, in particular a form for an MRL (or management rights letter), which is effectively a side letter giving certain large investors additional priority rights. We welcome the publication of a standard form MRL; at present institutional growth investors have very different expectations and the publication of a model form will enable founders to benchmark expectations on investors’ reporting requirements and preferential rights.

Please reach out to any of the Slaughter and May Venture Capital and Growth Company team below or your usual contact at Slaughter and May if you would like to discuss how these changes could affect your fundraising or investment plans or documents.

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