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Venture Capital 2025

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USA: Law and Practice

D. Scott Bennett, Nicholas A. Dorsey, Virginia M. Anderson and Ellen H. Park
Cravath, Swaine & Moore LLP

USA

Law and Practice

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Cravath, Swaine & Moore LLP has been known as one of the premier US law firms for more than two centuries and maintains offices in New York, London and Washington, DC. The firm advises technology companies, venture capital investors and other advisers and capital sources on a wide range of pivotal transactions. Cravath's corporate clients include venture capital- and private equity-backed businesses across software, hardware, fintech, blockchain and digital assets, artificial intelligence, biotechnology, medical devices, cleantech and renewables and other developing areas, and its investor representations include venture capital and growth equity firms, corporate venture capital arms and other institutional partners. The firm's interdisciplinary venture capital & growth equity practice focuses on venture investment rounds and other financing arrangements, including preferred equity, SAFEs, venture debt and traditional and synthetic royalty arrangements; joint ventures, collaboration agreements and licensing arrangements; and employee tender offers and other pre-IPO liquidity events.

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1. Trends

1.1 VC Market

The AI sector drove momentum in the venture capital market throughout the past year. Databricks, a data and AI company, raised USD10 billion in a funding round, valuing the company at more than USD62 billion. The investment was the largest round of the year, topping the USD6.6 billion raised by OpenAI in October 2024 at a post-money valuation of USD157 billion. Other generative AI companies, including xAI and Anthropic, also raised significant rounds, with xAI raising two rounds of USD6 billion each and Anthropic raising two rounds of USD4 billion each. At the beginning of 2025, OpenAI also announced the Stargate Project, a joint venture which will seek to invest USD500 billion over the next four years in new AI infrastructure in the United States.

Due in part to these notable transactions in the AI sector, venture capital deal values rose to USD209 billion in 2024 despite deal volumes falling to the lowest level since 2019. US exit values rebounded to USD149 billion in 2024. M&A activity accounted for more than 50% of the total US exit value, which has remained relatively unchanged since last year.

While the AI sector is widely expected to continue driving venture capital deals in 2025, there are also reasons to believe that the US venture capital market more generally may rebound over the course of the year. The perception of a more business-friendly regulatory environment has been expected to fuel a rise in capital markets activity. However, the beginning of 2025 has been tumultuous, as investors have become concerned about slowing growth in the market and rising prices, largely tied to rapidly changing policy from Washington, DC around tariffs, federal spending and broader geopolitical uncertainty.

Many companies paused fundraising efforts in 2023 and 2024 at the risk of facing a decreased valuation, but will need to raise additional capital soon to extend their runways. Undeployed capital at investment firms (also known as *"dry powder"*) has hit record levels (estimated to have reached USD308 billion in the USA at the end of 2024), which is also pressuring these firms toward near-term investments.

1.2 Key Trends

Amid a challenging climate for venture capital activity, some growth companies have thrived in the financing market while many others have struggled. For companies that have faced financing challenges, *"down round"* raises, *"cramdowns"* and investor-friendly deal terms have been used in increasing frequency in order to close financing rounds. Bridge financing solutions and alternative financing solutions have also remained prevalent.

For trending companies, particularly in the AI sector, investors have accepted less-favourable deal terms and are turning to creative structuring solutions to participate in funding rounds. The use of special purpose vehicles (or SPVs), in particular, is a growing trend.

Down Rounds, Cramdowns and Investor-Friendly Deal Terms

Down rounds – ie, equity financings where a company sells equity at a valuation that is lower than a valuation achieved in the immediately preceding raise – accounted for 15% of completed financing rounds in 2024.

A *"cramdown"* describes a situation in which existing investors lead a new financing that includes terms that may be severely punitive to non-participating investors by including other features such as forced conversions, pay-to-play mechanisms, super-priority liquidation preferences and special voting rights. Cramdowns may be a means for affecting a down round.

In light of a subdued market for venture capital investments, certain deal terms have also become increasingly investor-friendly. For example, liquidation preferences – ie, fixed payouts for investors upon the occurrence of a liquidation event like a sale or other exit – are typically set at 1x their investments in competitive market environments. In recent years, however, some investors have been able to obtain 2x or even 3x multiples. Terms granting investors participating liquidation preferences – ie, the right to share in additional proceeds after the fixed liquidation preference is returned – and cumulative dividends have also become more common.

Bridge Financings

Growth companies have also been utilising convertible debt and Simple Agreement for Future Equity (SAFE) instruments as forms of bridge financing to avoid down round valuations. These tools, which are traditionally used by companies to raise capital prior to their first priced equity round with outside investors, allow investors to put in capital that will convert into shares of the company at a discount to a subsequent priced equity round.

Alternative Financing Solutions

Some growth companies are utilising venture debt – ie, loans specifically designed for venture capital-backed growth companies – to fund their operations and defer a priced financing round and/or equity valuation. Venture debt is also frequently accompanied by an equity component, such as warrants in the company.

Asset-based lending provides growth companies with the ability to borrow funds secured by their underlying assets. This option is particularly useful for companies that have significant assets (such as accounts receivable) on which to secure a loan, but may lack the cash flows typically required for a traditional loan.

Other options include financing on the basis of annualised recurring revenue, royalty arrangements or registered IP, licensing and collaborations as well as other strategic partnerships coupled with a capital infusion from the external partner.

Uptick in SPV Activity

The use of SPVs is rising among investors. SPVs aggregate funds from multiple investors for a specific business purpose. In the venture capital community, SPVs allow investors to pool funds and participate in a funding round through a single investment vehicle. A growing number of venture capital firms themselves are also beginning to use SPVs as a means to pool funds from co-investors and invest in larger funding rounds or secondary transactions that would otherwise be outside of their investment parameters.

1.3 Key Industries

As noted in **1.1 VC Market**, the AI sector has continued to drive significant activity in the space. In 2024, venture capital funding in AI increased by 29%, accounting for roughly 46% of total deal value.

The software sector in the USA, which includes software-based AI companies, saw the highest numbers in terms of both deal number and combined deal value in 2024, with 5,560 deals and USD89 billion in proceeds in the sector. The commercial products and services sector posted the second-highest number of deals and the second-highest total deal values in 2024, with 2,065 deals and USD29 billion in proceeds.

Exit activity in the USA was similarly driven by the software sector, with 517 deals and USD60 billion in deal value. The pharma and biotech sector experienced the second-highest number of exits by deal value, with USD40 billion across 82 deals.

2. Venture Capital Funds

2.1 Fund Structure

Sponsor and Investor Roles

Venture capital funds in the USA are typically organised as limited partnerships or limited liability companies (pass-through for tax purposes) and structured as private, closed-end, pooled investment funds, with exceptions for evergreen structures adopted by certain well-established venture capital fund sponsors. Fund terms are typically long, given the asset class, and commonly last at least ten years.

Investors (limited partners, or LPs) are passive with limited liability. Fund governance is vested in the general partner (GP) or managing member, subject to limited remedies exercisable by LPs. Day-to-day management of fund operations and investment advisory functions may be delegated to a management company (an affiliate of the GP that employs the sponsor's personnel).

Structuring

The simplest venture capital fund structure is a single Delaware-organised entity for all investors. More varied investor and investment profiles may result in additional parallel funds or funds organised in a primary-feeder structure, each across various jurisdictions. There is typically flexibility for funds to create alternative investment vehicles in respect of one or more specific investments for participation by some or all investors as needed for legal, tax, regulatory or similar reasons.

Governing Documentation

Like the private funds industry broadly, venture capital funds are primarily governed by an operating agreement – either a limited partnership agreement or limited liability company agreement – that sets out the fund's economic and governance terms.

Individual investors acquire fund interests pursuant to a subscription agreement, which includes standard representations and warranties, certain disclosures and a questionnaire for self-reported information about the investor's legal, tax and suitability status, such as *"accredited investor"* and *"qualified purchaser"* status.

There may also be an investment management agreement in place to document the payment of the management fee to the management company in exchange for the investment management services it provides to the fund.

Finally, certain investors may request to enter into side letters from the fund to memorialise certain preferential treatment around economics, governance and transparency or other requirements related to their specific legal, regulatory and tax circumstances.

2.2 Fund Economics

The primary forms of economic participation for fund sponsors and their principals include management fees and carried interest. The most common closed-end venture capital fund features are summarised here – although exact economic packages vary depending on a variety of factors, including the fundraising environment, sponsor maturity, negotiating leverage, investment strategy and fund structure.

Capital Mechanics
Venture capital funds generally employ a commitment/drawdown structure. Investors make capital commitments to the fund, which may be called or *"drawn down"* (as a capital contribution) in one or more instalments over time. The permitted uses for contributed capital typically include new investments, fees and expenses, follow-on investments, and reserves, with the bulk of capital drawn down during the three-to-five-year investment period for new investments and reserves. Venture capital funds also commonly have generous recycling and reinvestment provisions to redeploy capital from investments realised during the life of the fund.

Fees
Management fees are asset-based fees charged throughout the life of a fund. Structures vary widely – although a common model consists of an annual fee (usually 1–3%), charged quarterly, on the basis of capital commitments during the fund's investment period and on the basis of invested/contributed capital thereafter. Fees are typically more important earlier in the life of the fund, as investments are being made and no profits are being realised, and allow the sponsor to cover expenses (including salaries) and maintain operations. In recent years, management fees have become an important source of additional revenue supporting increasing manager enterprise value.

The sponsor and its principals may also receive certain portfolio company remuneration and transaction fees (eg, directors' fees) directly, which are commonly – but not always – offset against management fees.

Carried Interest
The main method of profit sharing in venture capital funds is the allocation of carried interest to the sponsor. With increasing sophistication and size over time, venture capital fund documents have experienced some convergence with the broader private equity funds market, including its distribution-based carried interest structure. As a result, the precise structure of venture capital fund carried interest deals also varies widely – although there are some commonalities. This is particularly the case with regard to the idea of a carried interest *"waterfall"*.

Under the carried interest *"waterfall"*, gains are allocated according to a specified order of priority as between the GP and each LP, with investors typically receiving a return of invested capital and a preferred return (or hurdle return) before the sponsor receives any share of the profits. Owing to the risk-return profile of venture capital funds, carried interest rates tend to be higher than in the private equity industry more broadly, ranging anywhere from 20–30%. Higher rates tend to correspond with more LP-favourable preferred return or hurdle structures before sponsors can earn their full carry rate.

Venture capital funds tend to make distributions only once the entire portfolio is fully realised or once allocated gain has reached a certain threshold, and it is very common practice for distribution timing to be entirely at the sponsor's discretion. However, an increasing number of venture capital funds are starting to follow the private equity distribution-based model and return capital as and when investments are realised.

Investor Protections
Venture capital fund investors are typically locked up for a long duration with no role in the

day-to-day governance of the fund and limited remedies against sponsors. As such, the core investor protections are structural in nature. By way of example, investors rely heavily on economic alignment from capital commitments of the sponsor and exclusivity/deal flow covenants. Management fees may step down over time to guard against perverse incentives from the non-deployment of capital, and the carried interest and distribution structure further protects against the sponsor taking profits before investors have achieved some minimum level of return. Some operating agreements also include specific investment-level restrictions, such as concentration limits and outright prohibitions.

Actual investor remedies vary from fund to fund, but often include the concept of a suspension period wherein new investments may not be made following certain events such as the death, disability or termination of one or more specified key persons, *"cause"*, or a change in control of the sponsor. Suspension may lead to the early termination of the fund's investment period. Some funds have GP removal rights for serious misconduct and others include the right to terminate and wind up the fund entirely.

2.3 Fund Regulation

Regulation of venture capital funds in the USA generally follows the regulation of the broader private funds industry, with some additional exemptions available to venture capital strategies, as described here.

Investment Company Act

Venture capital funds typically rely on exemptions from being considered an investment company under Section 3(c)(1) and/or Section 3(c)(7) of the US Investment Company Act (the *"1940 Act"*) to avoid registration as an investment company thereunder. Both exemptions require that the fund interests not be publicly offered.

Section 3(c)(1) funds must be beneficially owned by no more than 100 persons (or 250 persons if *"venture capital fund"* with no more than USD10 million in aggregate capital contributions and uncalled committed capital), without any independent sophistication requirement. The issue of counting beneficial owners for Section 3(c)(1) purposes is not straightforward, as it may involve looking through certain entities and is subject to *"integration"* with other similar pools of capital under certain circumstances.

Section 3(c)(7) funds have no limitation on the number of beneficial owners. However, all investors must be *"qualified purchasers"* under the 1940 Act, which includes a range of categories of persons deemed financially sophisticated based on the value of *"investments"* owned.

Regulation of Investment Advisers

Venture capital fund sponsors are also subject to regulation under the US Investment Advisers Act of 1940 (the *"Advisers Act"*), typically as an *"exempt reporting adviser"* under Section 203(l) (the *"venture capital funds exemption"*) or Section 203(m) (the *"private fund adviser exemption"*).

Under the venture capital funds exemption, investment advisers that advise solely one or more venture capital funds are exempt from registration as an investment adviser. The definition of *"venture capital fund"* under the Advisers Act is a private fund that demonstrates that it pursues a venture capital strategy, is subject to certain strict limitations on the fund's investment holdings (including leverage), and generally prohibits redemptions.

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Under the private fund adviser exemption, an investment adviser that acts solely for one or more *"qualifying private funds"* and manages less than USD150 million of private fund assets is exempt from registration as an investment adviser.

While exempt reporting advisers are not subject to registration as an investment adviser under the Advisers Act, they are still required to make a basic filing on Form ADV with the SEC and are subject to some of the Advisers Act's substantive requirements, including broad anti-fraud provisions, pay-to-play requirements, the requirement to maintain written policies and procedures to prevent the misuse of material non-public information, and record-keeping obligations, as well as individual state law regulation.

Other Regulatory Regimes

Venture capital funds must also offer their interests in compliance with US securities laws, which generally results in their interests being offered to investors under Rule 506(b) of Regulation D (described in **7.1 Securities Offerings**) or – with increasing frequency – by means of general solicitation under Rule 506(c).

Other regulatory schemes applicable to venture capital funds include those relating to the US Securities Exchange Act of 1934 (the *"Exchange Act"*), the US Commodity Exchange Act, the US Employee Retirement Income Security Act of 1974, various AML and privacy laws, and the US Bank Holding Company Act of 1956.

2.4 Particularities

Challenging Fundraising Environment

The private funds industry as a whole was significantly impacted by the unexpectedly persistent high interest rate environment and slowdown in M&A and IPO activity in the USA. This has led to a particularly difficult fundraising environment for venture capital funds, with more established and successful managers receiving coveted allocations from increasingly selective investors facing significant liquidity constraints and over-allocations to private funds. This is likely to persist for a period of time even after interest rates fall and M&A and IPO activity renews once market confidence returns to the USA. In addition, extensive investor diligence and scrutiny over venture capital sponsors is likely to constitute the new normal, as LPs get used to the benefits of increased negotiating leverage in the down market.

Increased Regulatory Scrutiny

While venture capital fund managers have long enjoyed complete or substantial exemption from 1940 Act and Adviser Act regulation, the regulatory landscape has shifted and regulatory scrutiny over the private venture capital industry has been increasing. By way of example, the SEC has demonstrated a willingness in recent years to increase its examination and enforcement activity in respect of exempt reporting advisers. In addition, as venture capital fund sponsors seek to diversify their investment strategies for greater flexibility and attract greater levels of reliable institutional capital, many sponsors have elected to register voluntarily as investment advisers and become subject to the full complement of the Advisers Act regulation.

Structuring Innovations

Venture capital funds comprise a vast range of strategies, life cycles (eg, seed stage or growth stage), and industries. Sponsors take different approaches to investing, with some routinely leading funding rounds and others investing more passively. Some hands-on sponsors are helping to create companies by investing in and alongside accelerators, *"labs"* and incubators, as well as developing relationships with and taking stakes in founders at the earliest possible stage. This increasing diversity and sophistication should lead to more specialised venture capital fund vehicles, the proliferation of customised accounts and overlapping strategies, evergreen funds and increased interest in asset and portfolio sales across different funds managed by the same sponsor – all of which increase the attendant potential conflicts of interest that need to be managed.

The industry, more broadly, has been exploring new models of holding onto companies for the long term throughout their entire life cycle – from inception through to post-IPO – while providing current opportunities for carry crystallisation and investor liquidity. While these liquidity strategies are not nearly as popular as they have been in the more traditional private equity space – likely due to the comparatively greater flexibility for longer hold periods in venture capital funds as compared to traditional private equity funds and the depressed valuations in recent years – there is a renewed optimism around exploring liquidity solutions in the venture capital space, as evidenced by increasing secondaries transaction volume (including, in particular, large multi-asset continuation vehicle fundraisings) and optimistic fundraisings for dedicated secondaries funds targeting venture capital strategies. These structures include secondaries transactions (such as continuation funds), GP stakes and net asset value (NAV) financing, which recognise the current reality of increased pressure to provide liquidity for LPs who have been struggling to make new allocations (even to successor fund vintages for the same sponsor) because low exit transaction volume has limited their return of capital in recent years.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

The level of due diligence conducted by venture capital investors in the USA can vary greatly depending on, among other things, the relevant investment round, company valuation and the size of investment as well as the overall interest by potential investors.

Scope

Diligence is typically led by the lead investor in a given investment round, while other investors generally focus on key issues or issues that are specifically relevant to their fund. In early rounds, the main focus is on:

- capitalisation matters, such as the company's capitalisation table, convertible securities, investors' rights agreements, pre-emptive rights, voting agreements and the like, as well as any outstanding indebtedness;
- alignment of the incentives of founders and key employees with those of external stockholders through appropriate employment and equity compensation arrangements; and
- ownership of IP needed to run the business, including patents, licence agreements and IP assignment agreements with founders and employees.

In later rounds, more robust legal and business diligence is conducted, including detailed review of financials, material contracts, employment agreements, litigation and regulatory matters.

When conducting diligence on AI companies, investors may also evaluate whether the technology is truly *"generative AI"* or simply machine learning. Generative AI creates new content (making such technology more valuable), while machine learning analyses data for predictions and classifications. This additional diligence could help mitigate the risk of overstating the use of generative AI, also known as *"AI Washing"*, when in fact a company is using less-sophisticated computing or has AI solutions that are not yet fully operational.

Process

Due diligence review customarily begins with a document review process in which the lead investor provides a due diligence request list to the company and, in turn, the company populates a virtual data room with the requested materials. There is often back-and-forth between the company and investor for various follow-up requests based on findings. Diligence sessions may also be scheduled with management and cover topics such as a business overview, the valuation model or regulatory matters.

The overall process typically runs over the course of a couple weeks, but can also take significantly more or less time. Additionally, companies with significant negotiating leverage may impose a limitation on scope of requests or time devoted to the diligence process.

Representations and Warranties

A company's representations and warranties in the transaction's definitive agreements also play a critical role in the due diligence process. A company must disclose any exceptions to its ability to make its representations and warranties in a separate *"disclosure schedule"*, guiding investors to certain material contracts, legal and regulatory issues and the like.

3.2 Process

In the USA, the lead time required to complete a new financing round can vary, but typically takes between two and four weeks to proceed from initial drafts to executed documents. This assumes that a term sheet with key terms is agreed upon in advance and the documentation is based on the US National Venture Capital Association (NVCA) forms, which leads to significantly increased efficiency. If the growth company already has outstanding convertible preferred stock (see **3.3 Investment Structure**), the process can take even less time.

Working With New Investors

Transaction documentation is typically based on the NVCA form documents. Company counsel will ordinarily prepare initial drafts of the documentation – although practice is mixed, particularly when the company is issuing its first series of convertible preferred stock. The company is often required to pay the investors' legal fees in connection with the investment, subject to a cap.

New lead (or *"anchor"*) investors will typically utilise their own legal counsel to negotiate the transaction documentation. Lead investors often engage outside counsel. The second-largest investor may also engage separate counsel, depending on the size of their investment. Smaller investors often leverage their own in-house legal teams, generally follow the terms negotiated by the lead investors, and focus their diligence on any areas of particular focus for their fund or on key areas specific to the deal.

Role of Existing Stockholders

Existing stockholders have a limited role in the new financing round, except as investors in the round and/or for purposes of consenting to the financing. A growth company typically must obtain the consent of existing stockholders to initiate a new financing round, even if the new financing is not senior to the existing financing in the liquidation preference waterfall (see **3.5 Investor Safeguards**).

Such consent can take multiple forms. In some instances, the holders of a majority of all convertible preferred stock voting together as a single class must approve a new financing round. In other instances, a majority of the convertible preferred stock must approve a new financing round on a series-by-series basis. As a practical matter, the lead investor(s) in the previous financing rounds will usually have board representation and be apprised of the company's fundraising efforts already.

3.3 Investment Structure

Common stock is generally reserved for founders, employees and a limited number of early investors. Venture capital investors and other third-party investors will typically invest through convertible preferred stock and/or other convertible instruments.

Convertible Preferred Stock

The rights associated with convertible preferred stock typically follow the NVCA form documents and are primarily economic or governance-based in nature.

Economic Terms

Key economic terms include:

- conversion rights, typically into common stock at a 1:1 ratio (with an automatic conversion in certain circumstances);
- a liquidation preference, which determines the order of investor payouts resulting from a liquidity event;
- voting rights to vote alongside holders of common stock on an *"as converted"* basis;
- dividend rights, typically in the form of a right to receive the same dividends paid to holders of common stock;
- a right to participate in new security offerings;
- corporate event-based anti-dilution protections, ensuring that holders are not disadvantaged by stock splits, stock dividends or other similar events; and
- price-based anti-dilution protections, often consisting of downward adjustments to the purchase price of the shares previously purchased by preferred stockholders in the event of a down round equity financing.

A handful of these economic terms of are discussed under **3.5 Investor Safeguards**.

Pay-to-play provisions are also occasionally seen. A pay-to-play provision requires investors to participate in subsequent financing rounds on a pro rata basis or else have their existing preferred stock converted to common stock.

Governance Terms

Key governance terms include:

- rights to elect a certain number of board seats; and
- stockholder and director veto rights over certain fundamental corporate actions, such as the issuance of senior and/or pari passu securities, mergers, payment of dividends, stock redemptions and actions adverse to the rights of the convertible preferred stock.

These governance features are discussed under **3.6 Corporate Governance**.

Other Terms

Additional rights that do not fit squarely within the *"economic"* or *"governance"* buckets include:

- drag-along rights, which require investors to participate in a sale of shares approved by a specified threshold of convertible preferred stock and other specified parties;
- a right of first refusal (ROFR) for investors and/or the company to purchase shares of common stock proposed to be sold by certain stockholders (typically the founders and other key holders);
- tag-along or *"co-sale"* rights, which allow investors to participate in a sale of their shares if an ROFR is not fully exercised; and
- registration rights, which allow preferred stockholders to participate in (and, in certain situations, require the company to facilitate) registered offerings of their securities (allowing their securities to be freely sold in the public markets).

These are discussed in **6.1 Investor Exit Rights**.

Other Convertible Instruments

Other convertible instruments, such as convertible notes and SAFE instruments, are commonly used by growth companies in the USA before their first priced equity round. Upon their first priced equity round (sometimes subject to a minimal capital raise requirement), the instruments convert into equity at either a discount to the priced round or subject to a valuation cap.

Investors in these instruments typically include *"friends and family"*, *"angel investors"* and a limited number of venture capitalists that invest in early stage growth companies. Although investors in these convertible instruments do not benefit from the same rights as those given to actual common stockholders or preferred stockholders, large investors may seek information rights, board observer rights or other rights typically reserved for other equity holders.

The SAFE was created by Y Combinator, which maintains three versions of the SAFE for USA companies:

- a discount SAFE;
- a valuation cap SAFE; and
- *"Most Favoured Nation"* (MFN) SAFE, which provides that any better terms granted to a subsequent investor will automatically apply to the SAFE.

There is no standardised form convertible note in the US – although law firms sometimes maintain their own forms.

3.4 Documentation

Growth company financing rounds in the USA typically follow the NVCA form documents. The typical suite of financing documents includes:

- a stock purchase agreement that covers the purchase of stock, sets forth any closing conditions, and includes representations and warranties of the parties;
- a ROFR and co-sale agreement that subjects the sale of stock by certain stockholders to a ROFR in favour of other investors and/or the company and, in the event the proposed stock is not so purchased, permits such investors a right to *"tag along"* in the proposed sale;
- a voting agreement that provides stockholders with the right to designate certain members to the board of directors (*"board designees"*) and the right to *"drag along"* other investors in a sale of the company if specified conditions are met;
- an investors' rights agreement that specifies the rights and privileges granted to stockholders (including information rights, registration rights and pre-emption rights) and specifies any matters requiring the approval of the

preferred stockholders' board designee(s); and
- a certificate of incorporation, or a charter, that:
  - (a) defines the rights, preferences, privileges and restrictions of each class and series of stock; and
  - (b) typically addresses dilution protections, voting rights, dividend rights, liquidation preferences and preferred stock conversion rights.

The NVCA updates these form documents from time to time, including several notable updates in October 2023.

3.5 Investor Safeguards

There are a number of safeguards built into the NVCA form documents that are utilised to protect venture capital investors from a downside scenario. There are also additional levers that can be built into these safeguards to provide further downside protection. These protections are often influenced by fluctuations in the venture capital market oscillating between investor-friendly conditions and company-friendly conditions.

Pre-Emption Rights

Pre-emption rights permit stockholders to participate in an upcoming financing round in order to preserve their ownership level in the company and avoid dilution caused by new securities being issued. If any stockholder with pre-emption rights chooses not to purchase its full pro rata share of the new securities being issued, the remaining stockholders with pre-emption rights are granted the right to purchase such securities. In the USA, pre-emption rights are commonly only given to the major investors in the company.

Anti-Dilution

Broad-based weighted-average anti-dilution provisions are standard in the USA. These provisions protect preferred stockholders from a down round financing by adjusting the rate at which the preferred stock converts into common stock based on the sale price used in the down round as well as the number of shares sold in the down round. The formula used to determine the conversion rate is based on the number of shares deemed outstanding immediately prior to the down round. For *"broad-based"* provision, the number of shares deemed outstanding includes shares reserved for issuance under outstanding options and warrants.

Narrow-based weighted-average anti-dilution is similar, but excludes shares reserved for issuance under outstanding options and warrants in the number of shares deemed outstanding for purposes of the formula. By including fewer shares in the formula, there is a larger anti-dilution adjustment for the preferred stockholders.

In very rare, distressed situations, preferred stockholders may be able to secure *"full ratchet"* anti-dilution provision, which adjusts the conversion rate solely based on the sale price used in the down round. This results in the largest anti-dilution adjustment for preferred stockholders and is the least favourable outcome for common stockholders (who are not granted the same protection).

Liquidation Preference

Venture capital investors hold their interests in convertible preferred stock, which receives a senior liquidation preference, prioritising payouts to such holders over payouts to common stockholders in the case of a sale or winding-up of the company. *"non-participating liquidation preference"* is most common and provides that preferred stockholders have a right to receive the higher of:

- an amount equal to the purchase price of their stock; and
- their pro rata share of the proceeds resulting from the liquidity event.

In a distressed situation, and more frequently in recent years as a result of a more challenging fundraising environment, investors are sometimes able to secure a liquidation multiple and/or participation on their liquidation preference. *"2x participating preferred"*, for example, would allow an investor to recoup twice its initial investment and then participate in any distributions made to the common stock pro rata. Participation with the common stock could also be subject to a cap on the overall return the holder may receive in the liquidity event or be *"fully participating"*.

Dividends

Preferred stockholders typically have rights to receive dividends on an *"as converted to common stock"* basis when, as and if paid on the common stock. Variations of these dividend rights are less common, but include a fixed dividend payment required before the company can pay dividends on the common stock and cumulative dividends that accrue at a fixed rate over time.

Upon a sale or winding-up of the company, the holders of convertible preferred stock would be entitled to their liquidation preference plus any declared and/or accrued but unpaid dividends before the common stock is entitled to receive anything. These investor-friendly variations have become slightly more common under recent market conditions.

3.6 Corporate Governance

Investors negotiate for a variety of minority protections that come in the form of stockholder and director approval rights over specified fundamental actions proposed to be taken by the company. Directors (including those designated by a specific investor or group of investors) are subject to fiduciary duties and, as such, must act in a manner they believe is in the best interest of the company and all of its stockholders (and not just in the best interest of the investors that nominated them). As a result, both the company and investors may carefully consider which matters are voted on by investors in their capacity as stockholders as opposed to in their capacity as directors.

Stockholder Approval Rights

Special stockholder approval rights typically require the approval of the holders of either a majority of all convertible preferred stock voting together as a single class or a majority of a specific series of convertible preferred stock.

Actions customarily subject to special stockholder approval include:

- extraordinary transactions, such as mergers and asset sales;
- liquidating, dissolving or winding up the company;
- the issuance of senior and/or pari passu securities;
- amendments to the company's charter in a manner adverse to the outstanding convertible preferred stock; and
- payment of dividends.

Board Designees and Approval Rights

Investors are usually granted the right to designate at least one director (a *"preferred director"*) to the board of directors. This right is typically held by the holders of a majority of each individual series of convertible preferred stock or by the holders of a majority of all convertible preferred stock voting together as a single class.

Special director approval rights require that specific board actions be approved by the company's board of directors, whereby the vote must include the director(s) designated by the preferred stockholders.

Actions customarily subject to special director approval include:

- incurrences of certain types of indebtedness;
- hiring, terminating or changing compensation of executive officers;
- sales of material technology or intellectual property; and
- entry into material corporate strategic relationships.

Other Considerations

Growth companies also maintain a regular dialogue with their lead investors and often leverage their expertise inside and outside the board room. Advice and input provided by investors can help inform the direction and priorities of management and can also vary by sector. Venture capital funds in the USA that focus on biotech/life sciences companies, for example, are typically *"industry players"* that can offer significant expertise.

3.7 Contractual Protection

Transaction documentation in the USA includes a fairly standardised set of representations and warranties as a result of the widespread use of NVCA forms.

Growth companies provide a robust set of customary representations and warranties relating to, among other things, proper organisation, due authorisation of the transactions, capitalisation, government consents and filings, litigation and other liabilities, IP, material contracts, property, financial statements, tax matters, employee matters, insurance, Committee on Foreign Investment in the United States (CFIUS)-related matters, and valid issuance of shares. Sometimes, industry-specific representations are also included.

Investors also provide a limited set of customary representations and warranties that are primarily designed to help ensure the company's securities are being sold with a proper exemption from US securities law registration, including representations with regard to *"accredited investor"* status, sufficient disclosure of information, and purchasing of shares for the investor's own account.

Closing of a financing is typically conditioned on the accuracy of the representations and warranties, compliance with any pre-closing covenants, execution of other investment documents (such as the voting agreement and investors' rights agreement), and sometimes delivery of an opinion of company counsel. Pre-closing covenants and other undertakings typically only appear when regulatory approval is required, such as CFIUS or antitrust approval.

In the event that closing conditions are not satisfied by one of the parties (eg, if a party breaches its representations or fails to satisfy its pre-closing obligations), the non-breaching party is not required to close the transaction. The non-breaching party may also sue for damages, with monetary damages being the most typical remedy. In the event that the transaction does close, representations and warranties typically survive the closing, and the non-breaching party may also sue for damages post-closing. In practice, this fact pattern is unusual, as it results in a lawsuit between the company and its stockholder. When a limited survival period is negotiated for general representations and warranties, between six months and two years is common; longer survival periods may be negotiated for specific categories, such as tax representations.

4. Government Inducements

4.1 Subsidy Programmes

Investment in growth companies in the USA is often focused on qualifying for benefits under the *"Qualified Small Business Stock"* (QSBS) regime. This is discussed in further detail in **4.2 Tax Treatment**.

Several states in the USA also offer an angel tax credit, whereby an investor is given a tax credit if they make investments in certain start-up companies. Bills have been proposed to create a federal angel tax credit, but none have been passed.

As discussed in **4.3 Government Endorsement**, there is also a variety of government programmes in the USA that help facilitate equity investment in growth companies without the use of the US tax regime.

4.2 Tax Treatment

Growth companies in the USA are often incentivised to help their investors receive the tax benefits available under the QSBS regime, which is generally available only to early stage companies. Under these rules, individual investors may exclude all or a substantial amount of gain upon the ultimate disposition of QSBS stock.

There are numerous technical requirements to qualify as QSBS, including:

- that the business is organised as *"C"* corporation under the US Internal Revenue Code (the *"US Code"*)
- that the investor acquires the stock at its initial issuance; and
- that at such time the corporation conducts an active business and has less than USD50 million of value in gross assets.

Certain businesses are not eligible for QSBS, including many professional services and banking businesses. Even once stock qualifies as QSBS, additional rules apply to the business as well as transfers involving QSBS that must be considered to ensure QSBS stock retains its status as such.

The favourable benefits available to QSBS are the subject of current political attention and legislative reform proposals.

4.3 Government Endorsement

The US Department of Treasury runs the State Small Business Credit Initiative (SSBCI), which consists of USD10 billion in government funding that is distributed to US states, territories and tribal governments in order to provide capital to small businesses and start-ups. There is a specific programme within the SSBCI for venture capital, whereby the funding is used either:

- to provide capital directly to businesses in the form of equity investments; or
- to provide funding to venture capital firms.

There are also a number of state-by-state programmes in the USA that allocate resources directly to small businesses owned by underserved or under-represented groups, such as veterans, minorities, women, or people with disabilities. New York, for example, has the Minority- and Women-Owned Business Enterprise Program for businesses owned by women and/or minorities in New York State, and prioritises these businesses for state procurement. Other programmes prioritise specific industries. Government endorsement programmes are the subject of current political attention.

5. Employment Incentives

5.1 General

Growth companies in the USA seek to encourage the long-term commitment of founders and key employees through the issuance of equity awards. Equity awards incentivise employees to remain with the company long enough for their awards to vest and to work diligently to ensure maximum value upon settlement.

5.2 Securities

Equity awards are generally issued with vesting conditions based on the passage of time (usually three to four years, often with a one-year *"cliff"* and monthly or quarterly vesting thereafter) and, in some cases, the achievement of Key Performance Indicators. Typical forms of equity awards in the USA include restricted stock, stock options and restricted stock units (RSUs). Growth companies may also award phantom equity and profits interests.

Restricted Stock

Restricted stock is actual stock subject to vesting conditions – the non-satisfaction of which results in forfeiture of the stock. Restricted stock is generally granted to founders and key employees at the start of a company's development. Restricted stock differs from stock options and RSUs, which are contractual rights to receive/purchase shares upon vesting.

Stock Options

A stock option is a contractual right to purchase stock via payment of an exercise price, which is equal to the fair market value (FMV) of the underlying shares at the time of grant upon vesting. Stock options are generally granted to employees slightly later in the company's development than restricted stock. Companies often issue incentive stock options (ISOs) but may also issue non-qualified stock options (NQSOs) (see **5.3 Taxation of Instruments**).

Restricted Stock Units

An RSU is a contractual right to receive stock upon vesting without payment of an exercise price or otherwise. RSUs are generally awarded to employees later in the company's life cycle when the company's valuation has risen or to address dilution concerns.

Phantom Equity

Phantom equity is a contractual right to receive cash tied to the performance of the company's stock. Phantom equity is generally awarded only in unique situations.

Profits Interests

A profits interest is an equity-like.interest in the future profits and capital appreciation of a company. It is granted to founders and key employees in companies structured as partnerships or limited liability companies. Economically, profits interests function similarly to stock options.

5.3 Taxation of Instruments

When deciding among equity award alternatives, a growth company must consider the tax consequences for employees, including the amount, character (whether ordinary or capital) and timing of income inclusion as well as the ability to satisfy tax withholding obligations.

Restricted Stock

Generally, restricted stock is not taxed at grant and is taxed at ordinary income rates on the FMV at vesting (minus any amount paid for the shares). These amounts are generally subject to tax withholding. Employees may have difficulty satisfying these tax obligations, given that the stock is likely illiquid and the FMV may have increased. To avoid this consequence, employees frequently make an election under Section 83(b) of the US Code to be taxed at ordinary income rates on the FMV (minus any amount paid for the shares) at the time of grant. Capital gains rates apply upon disposition of the stock. If, however, an employee forfeits the restricted shares following a Section 83(b) election, the taxes paid may not be recovered and a capital loss may be unavailable. To be effective, a Section 83(b) election must be made within 30 days of the grant date.

NQSOs and RSUs

NQSOs and RSUs are not taxed at grant. NQSOs are taxed at ordinary income rates at exercise on the *"spread"* between the exercise price and the FMV. Similarly, RSUs are taxed at ordinary income rates at settlement based on the FMV. These amounts are subject to tax withholding. Capital gains rates apply upon disposition of the stock.

Like restricted stock, NQSOs and RSUs present issues for employees with limited liquidity to satisfy these tax obligations. Employees often hold NQSOs until a liquidity event (such as an IPO or M&A transaction). Growth companies often award double-trigger RSUs, which are subject to time-based vesting conditions plus a requirement that a liquidity event occurs within a certain period. If properly structured (including with respect to Section 409A of the US Code), taxation is postponed until the liquidity event.

ISOs

ISOs generally are not taxed at grant or at exercise. If the shares are held until the later of two years after grant or one year after exercise, the eventual disposition is taxed at capital gains rates. If these holding periods are not met (a *"disqualifying disposition"*), ISOs are taxed at ordinary rates on the spread at the time of exercise.

ISOs also present concerns under the alternative minimum tax (AMT), to which high-income individuals such as founders and key employees may be subject. Unlike in the regular tax system, AMT does not exclude an option's spread at exercise from income. AMT may also raise issues upon a disqualifying disposition, particularly where such disposition occurs following the year of exercise.

Phantom Equity

Phantom equity awards are taxed at ordinary income rates when paid.

5.4 Implementation

Equity Pool

Venture capital investors generally expect the growth companies they invest in to increase or *"refresh"* the size of their employee equity incentive pool at the time they invest. This becomes a key topic of negotiation because it is ultimately a question of company valuation.

Investors in US growth companies expect existing shareholders in the company to bear the dilution caused by increasing the size of the equity incentive pool. As a result, investors are motivated to have the equity incentive pool be as large as possible in order to limit their risk of being diluted at a later point in time. Changes to the equity incentive pool often require approval of investors and so founders are motivated to have the incentive pool accurately reflect their hiring needs before the next equity financing, but nothing more (given that they and other existing shareholders are ultimately the ones being diluted).

Ultimately, an equity incentive pool equal to approximately 10–20% of the fully diluted post-money valuation of an early stage growth company is typical.

Founders' Stock

Investors may also demand that any stock held by the company's founders that is not subject to vesting prior to their investment be subjected to a reverse vesting schedule (usually between three and four years, often with a one-year *"cliff"* and monthly or quarterly vesting thereafter) at the time of their investment. Under this arrangement, founders continue to hold their stock, but lose any unvested shares if they leave the company before becoming fully vested.

6. Exits

6.1 Investor Exit Rights

There are a handful of contractual exit rights and restrictions that are built into the NVCA form documents in order to provide some guardrails around secondary sales as well as facilitate exit opportunities that are supported by a critical mass of the existing stockholder base. In the recent, challenging exit environment, investors are even more focused on company growth strategies and exit plans (if any). However, the industry has not yet seen significant shifts in negotiated exit rights.

ROFR and Transfer Restrictions

Founders and other key holders of common stock are typically only permitted to sell their shares to a third party if they first provide the company and/or preferred stockholders with an ROFR to purchase the shares proposed to be transferred. Sometimes this ROFR applies with regard to proposed sales by preferred stockholders as well. The company generally has the right to exercise the ROFR first and, if it does not exercise its right with regard to all of the shares proposed to be sold, the preferred stockholders have a right to purchase the remaining shares.

In the event that any preferred stockholders do not elect to exercise their right in full, the participating (purchasing) stockholders have the right to purchase the additional shares. If the company and preferred stockholders do not collectively exercise their ROFR rights with regard to all of the shares proposed to be sold, then all of the subject shares may be sold to the third party (subject to any tag-along rights, as described later in this section).

There are customary exceptions that generally apply to the application of the ROFR, including for estate planning purposes.

Sometimes, growth companies also subject all of their common stock – or both preferred stock and common stock – to blanket transfer restrictions in their by-laws. In the case of a blanket transfer restriction, customary exceptions will generally apply, including for estate planning purposes. There may also be a carve-out for transfers first subject to an ROFR in favour of the company.

Tag-Along/Co-Sale Rights

If an ROFR is not exercised in full by the company and/or preferred stockholders, preferred stockholders are typically granted a right to participate – or *"tag along"* in the proposed sale pro rata.

Drag-Along Rights

In the case of *"sale of the company"* that is approved by a specified set of parties (typically, the holders of a majority of convertible preferred stock, the holders of a majority of common stock held by certain key individuals, and the board of directors), the remaining stockholders are usually obligated to vote in favour of the transaction. *"sale of the company"* typically includes a sale of at least 50% of the outstanding voting power of the company, a merger, a sale of all or substantially all of the company's assets or another similar transaction resulting in the change of control of the company.

Registration Rights

Preferred stockholders are also typically granted *"registration rights"*, which allow stockholders to cause the company to register their shares for public resale pursuant to a registration statement. These registration rights take a few different forms. *"Demand"* registration rights give stockholders the right to compel the company to register their securities for public resale. *"Shelf"* registration rights give stockholders the ability to demand that the company file a registration statement to register their securities for sale on a delayed or continuous basis once the company's shares are already publicly traded. *"Piggyback"* registration rights give stockholders the right to register their securities alongside either the company or other holders that initiate a registration of securities.

6.2 IPO Exits

IPO exits are usually driven by existing investor demand for liquidity or perception of access to capital in the public markets as compared to the private markets. An IPO is the most common route for companies in the USA to become publicly traded. For growth companies that have no immediate need for capital, a direct listing of existing investors' securities (with no primary issuance by the company) is also an option. A de-SPAC transaction – whereby a private company becomes public through a merger with an existing publicly traded special purpose acquisition company (SPAC) – is a third alternative for exiting into the public markets; however, this path has fallen out of favour in recent years.

The Nasdaq and the NYSE are the primary listing venues in the USA. Both exchanges have various requirements that must be satisfied in order to qualify for trading, including financial, liquidity, reporting and governance related requirements, some of which overlap with SEC requirements. Accommodations are available for foreign private issuers listing in the USA and often allow such issuers to follow home country governance requirements in lieu of the requirements of the relevant exchange.

6.3 Pre-IPO Liquidity

While pre-IPO investors and employees with stock have generally committed their capital and/or equity awards to the company until an eventual liquidity event, there are various pathways that may be available to liquidate their position prior to such event. Particularly as IPO and M&A activity is constrained, pre-IPO liquidity options have become an increasingly vital component of the venture capital ecosystem.

Liquidity Options

Secondary transactions are often the only viable exit strategy for pre-IPO investors and for long-time employees looking to cash out their equity. In addition to privately brokered sales, digital trading platforms are growing in popularity. Some of the more prominent digital trading platforms used for trading private securities in the USA include EquityZen, Forge Global and the Nasdaq Private Market.

Tender offers are another, more structured option.

Corporate repurchases, also known as share buybacks, are a type of tender offer in which a company offers to repurchase shares from its current stockholders. This type of tender offer can be advantageous to a growth company looking to provide liquidity to its employees or stockholders and buy back shares as a means of *"cleaning up"* its cap table, particularly if there is a large number of current (or former) employee stockholders who hold a small number of shares.

Third-party investors may also conduct tender offers as a means to purchase equity from existing stockholders. Company-facilitated third-party tender offers have also become more prevalent, particularly as companies seek to respond to existing stockholders' desire to monetise on what is otherwise desirable private company stock. In the case of a company-facilitated third-party tender offer, the company may help pool interest from multiple existing and/or potential new investors in order to facilitate the third-party tender offer process.

Regulatory Considerations

Tender offers and secondary sales need to comply with US securities laws, in addition to any transfer restrictions imposed by the company itself.

US securities law requires that all offers and sales of securities in the USA – including secondary sales by existing investors – be registered with the SEC, unless an exemption applies. The most common exemptions for secondary sale transactions fall under Rule 144 and Section 4(a)(7) of the US Securities Act of 1933 (the *"Securities Act"*) and *"Section 4(1 1/2)"*.

Rule 144 provides a safe harbour that allows the public resale of restricted securities (securities obtained through unregistered offerings) and control securities (securities held by affiliates of a company) if the offering complies with certain conditions. Section 4(a)(7) is another codified exemption that allows for the private resale of securities specifically to accredited investors. *"Section 4(1 1/2)"* resales, unlike Rule 144 and Section 4(a)(7), are not codified within the US securities laws. However, *"Section 4(1 1/2)"* resales are a commonly used method developed within the US market to facilitate legally compliant resales of securities without formal registration with the SEC.

Private tender offers in the USA, whether initiated by the company or a third-party, must also adhere to several technical requirements under Section 14(e) of the Exchange Act, including:

- that the offer stay open for at least 20 business days;
- that the offeree make no material misstatements or omissions in the context of the tender offer; and
- that prompt payment be made after the tender offer closes. *"Tender offer"* is not a defined term under US securities laws. Instead, it is a determination based on specific facts and circumstances, and takes into account factors such as a solicitation for a substantial percentage of the company's stock, as well as a fixed price and a limited duration offer.

7. Regulation

7.1 Securities Offerings

In the USA, all companies must comply with US securities laws. The Securities Act requires all securities offerings to be registered with the SEC unless there is an applicable exemption for such offering. One such exemption is Section 4(a)(2) of the Securities Act, which exempts the registration of securities that will not be offered to the public (also known as *"private placement"*). The exemption is intended to apply to sales to a limited number of sophisticated investors who are presumed able to fend for themselves.

Regulation D was adopted under Section 4(a)(2) as a formal safe harbour from securities registration. There are various rules under Regulation D that issuers may rely on for their private offerings, but the most commonly used exemption is Rule 506. Under Rule 506(b), companies can raise an unlimited amount of proceeds through sales to an unlimited number of accredited investors and up to 35 non-accredited investors, so long as they do not make any general solicitations, advertise or market the sale of their securities. Rule 506(c) allows companies to advertise in connection with their securities offering, but requires the company to take reasonable steps to verify the accredited investor status of participating investors. In March 2025, the SEC issued a no-action letter and updated its Compliance and Disclosure Interpretations to provide guidance on the application of minimum investment amounts as a factor in determining whether an issuer has satisfied the requirement to *"take reasonable steps"* to verify a purchaser's accredited investor status under Rule 506(c). Specifically, if (i) the purchaser agrees to make a minimum investment of USD200,000 (in the case of a natural person) or USD1 million (in the case of an entity), (ii) the purchaser provides certain representations (eg, that it is an accredited investor) and (iii) the issuer does not have actual knowledge of any facts indicating that the purchaser's representations were untrue, then the issuer can reasonably conclude that it has satisfied the *"reasonable steps"* requirement. Companies that offer securities pursuant to Regulation D are required to file a Form D with the SEC within 15 days following the first sale. Form D requires information such as the identity of the issuer, the type of offering, the total offering amount and the exemption(s) being relied upon.

Rule 701 under the Securities Act also provides a safe harbour from registration in the event that a private company grants equity securities to its employees pursuant to a benefit plan or other compensation agreement. To be able to rely on Rule 701, a company must itself grant the securities to its employees and must not be subject to reporting requirements under US securities laws.

7.2 Restrictions

CFIUS

The Committee on Foreign Investment in the United States (CFIUS) is authorised to review certain transactions involving foreign investment in the USA, so as to determine the effect of such transactions on US national security. If CFIUS identifies a risk to US national security arising from a transaction, it may negotiate or impose mitigation measures or – in rare cases – recommend that the US President prohibit the transaction.

CFIUS has the authority to review:

- any transaction that could result in a foreign person controlling a US business;
- certain non-controlling but non-passive investments by foreign persons in US busi-

nesses that deal with critical technologies, critical infrastructure or sensitive personal data (*"TID US Businesses"*) and
- certain transactions involving real estate in the USA located within a specified distance of certain airports, maritime ports or sensitive US government facilities.

Certain transactions involving a TID US Business must be notified to CFIUS at least 30 days prior to the completion date of the transaction. Transactions may also be submitted to CFIUS voluntarily in order to obtain a CFIUS *"safe harbour"*, which provides greater certainty that the US government will not impose mitigation measures or force the foreign investor to divest its interest in the US business in the future.

There is no revenue or turnover threshold for CFIUS review. CFIUS may review any transaction within its jurisdiction, regardless of the value of the transaction. As a result, CFIUS can – and regularly does – review venture capital transactions and other transactions involving early stage companies.

Other Potential Restrictions

Depending on the industry in which a foreign venture capital investor is investing, in addition to CFIUS there may also be industry-specific regulatory reviews or requirements arising at the US federal or state levels. Examples of targets that may implicate such reviews or requirements include entities operating in the telecommunications and financial services sectors, as well as companies that provide defence-related products or services, among others.

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