



CVCA model documents: Use freely and with caution

Corporate Update

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For early stage companies and small businesses, one of the key factors to successful growth is securing adequate, appropriate funding. Particularly for those with immediate and long-term growth potential, venture capital is a very common form of private early stage financing. The term “venture capital” will be one which is familiar to most entrepreneurs, however the structure that such an early stage investment may take is not always as easily known.

The Canadian Venture Capital and Private Equity Association (CVCA) is a Canadian organization with a mandate to provide strategic information, professional development, and advocacy tools to the venture capital and private equity industry, which counts some of Canada’s major banking institutions, leading accounting and law firms, and premier venture capital/private equity groups as its members. Part of the CVCA’s mandate also includes the provision of model legal documents that are commonly used in early stage venture capital and private equity transactions, which are available for free on their website.

CVCA model documents: What are they for and when to use them?

The CVCA model documents are Canadianized versions of the model legal documents prepared by the National Venture Capital Association (NVCA), a U.S.-based organization that has a substantially similar mandate as the CVCA. These

documents have been provided by the CVCA in an effort to guide and establish industry norms within the Canadian venture capital and private equity industry as it relates to early stage investment.

The model documents have been drafted to provide a comprehensive set of terms that offer a wide range of potential options when it comes to early stage investment, which allow companies and investors to customize their transaction for their specific circumstance and anticipate and eliminate unfavourable terms in the parties' particular context. The CVCA also aims to provide some comfort to those using the model documents that the increased use of these documents will promote market consistency within venture capital and private equity investment transactions in Canada, with the objective of reducing transaction costs and time between term sheets and definitive deal.

However, it is important for entrepreneurs (and those looking to invest in early stage startups) to keep in mind that the model documents are designed to suit a certain form of transaction: venture capital. While the nomenclature is bound to shift, CVCA documents work great for a Series B financing, but are likely too heavy for a pre-Seed angel investment round.

Most commonly used model documents

Parties wishing to use the CVCA model documents in their investment transaction will most likely come across the following documents:

Term sheet

The model term sheet (also called a "letter of intent" or "memorandum of understanding") is a preliminary document that sets out the intended terms in principle of a potential investment by an investor in a company, and serves as a roadmap for the drafting of definitive binding legal documentation. Term sheets are meant to reflect, at a high level, the deal structure and key deal terms, and are often not legally binding on the parties unless otherwise specifically stated within the term sheet. For example, the CVCA model term sheet does create legally binding obligations, including an obligation to engage in good faith exclusive negotiations for a set period of time, and a restriction on the sharing of confidential information.

The CVCA model term sheet is very comprehensive, and goes well beyond high level deal structure. And for good reason. You will find specific share rights and conversion mechanics set out in the CVCA model term sheet, as well as a general overview of the rights found below in the Voting Agreement, Investors' Rights Agreement, and Right of First Refusal & Co-Sale Agreement. As each of these items is itself comprehensive and contains specific terms, it is important to establish at the term sheet level the agreement structure and key terms that are being proposed.

Stock purchase agreement

The CVCA model stock purchase agreement sets forth the terms of purchase and sale of preferred shares in the company to an investor. This agreement includes basic terms relating to the purchase price and timeline for closing, very comprehensive representations and warranties of the company, modest representations and warranties of the investor, and conditions in favour of each party to closing the deal, which often include the entry into other forms of agreement that relate to the operation of the company following closing (such as a voting agreement, right of first refusal agreement, USA and/or investor's rights agreement).

The CVCA model stock purchase agreement does not provide information relating to the rights and restrictions of the shares to be sold, however much of the complexity of the share rights will have been provided in the CVCA model term sheet. The CVCA model stock purchase agreement also does not provide rights or obligations dictating the relationship of the parties in running the company together following closing, as that is dealt with in the various agreements described below.

Voting agreement

A voting agreement sets out an arrangement between the potential investor(s) and the existing shareholders of the company as to how the shares of the parties involved will be voted in connection with the investor's acquisition of shares in the company. The CVCA model voting agreement is relatively broad, but key terms may include voting rights and restrictions with respect to (i) how to vote on elections or removals of board members, (ii) how to vote regarding increasing the number of authorized shares of the company, and/or (iii) drag along rights forcing all shareholders to vote

in a manner consistent with key shareholders.

Right of first refusal and co-sale agreement

The CVCA model right of first refusal and co-sale agreement sets out a mechanism by which key shareholders must first offer their shares for sale to the company, rather than immediately selling them to a third party, and the company may choose whether or not they wish to purchase all or a portion of the shares to be sold. This particular model document additionally provides a grant of a secondary refusal right to individual shareholders to purchase shares not purchased by the company when the key shareholder(s) propose to sell such shares.

If the shares are not purchased by the company or the other shareholders, then the key selling shareholder(s) may freely sell those shares to a third party. Such agreements allow shareholders to control who becomes a new shareholder of the company and simultaneously allows them to increase their shareholdings in the company when another shareholder leaves.

Investors' rights agreement

The CVCA model investors' rights agreement provides a comprehensive set of terms an investor can choose to carve out for itself when stepping in as a shareholder of the company following its investment. Such rights may include: (i) rights to information of the company, including the right to receive financial information, inspect company records, and attend meetings of management/committees/the board, (ii) registration rights (usually more of a concern for investors with large blocks of shares in companies that will be going public), which may allow investors to compel the company to make certain registrations when selling shares on a public stock exchange, and (iii) rights of first refusal and/or pre-emptive rights, which operate to either provide some rights to increase shareholdings/restrict the ability of unapproved third party shareholders to become investors in the company, and/or prevent dilution of the investors' equity in the company, respectively.

Unlike the Voting Agreement and the Right of First Refusal and Co-Sale Agreement, which are often (but not always) intended to be signed by all shareholders, the Investors' Rights Agreement is typically between the investors and the company, though key shareholders (such as founders) are often included here as well.

Unanimous shareholders agreement (USA)

For anyone familiar with a typical Canadian corporate structure, the above agreements may be confusing. This tripartite arrangement of agreements is more common in the U.S. due to the prevalent use of the NVCA model documents in venture capital transactions in the U.S., and is present in the CVCA model document structure as a result, and in recognition that U.S. venture capital investors will be more familiar with this structure when investing in Canadian entities.

More commonly in Canada, we will use a "unanimous shareholders' agreement" (or simply a "shareholders' agreement", in jurisdictions like British Columbia that don't have a USA concept built into its corporate legislation). A USA is entered into by shareholders of a company to provide for specific rights and obligations of the shareholders beyond what is already required in the governing statute and the company's articles of incorporation. An additional benefit of a USA is that it is often far easier to amend and supplement than a company's articles of incorporation, which generally requires shareholder approval and corporate registry filings.

USAs generally set out rights and obligations of the shareholders in their management of the company (i.e. composition of the board of the directors), as well how shareholders may liquidate their shareholdings in the company (i.e. prohibitions on transfer, which may include rights of first refusal, pre-emptive rights, tag along rights and drag along rights). Such rights generally allow shareholders to restrict dilution of their shareholdings and maintain control over who is able to become a shareholder of the company. Given the obvious overlap between the three agreement approach and a USA, it's common to choose one model or the other, though there may be situations in which a USA underlies the CVCA model documents where those other agreements are not being signed by all shareholders.

When not to use CVCA model documents

As noted above, the CVCA model documents serve many positive purposes, such as building uniformity within the venture capital industry, creating roadmaps on commonly negotiated terms, and providing comfort through familiarity to U.S. investors.

However, the model documents are *very* comprehensive and not appropriate for every company at every stage in every financing. All users of the documentation should consider the length of documentation, how the documents are organized (with key terms sprinkled through three to six different documents), and whether these documents are even appropriate for the particular deal. If you are looking to raise a pre-Seed or Seed round of anywhere under \$1 million, the cost to process a full CVCA model transaction (both internally, as well as through external advisors) may be inordinately high.

Practically speaking, where there is a mismatch in the size/stage of the company with the style of transaction being undertaken, deal fatigue often arises. This can lead to early stage founders simply accepting terms, or making representations and warranties in the stock purchase agreement, in a bid to get the deal done, without necessarily understanding the implication or consequence of the dense drafting. It is often a burden on these very early stage companies, which tend to already be run on tight budgets, to commit time and resources to the sort of deep due diligence and document review demanded by a more senior sized investment transaction, and neither the company nor the investors are served well in this way.

Conclusion

The CVCA model documents can provide cost-effective options for venture capital-stage investments in early stage companies. As long as documents are selected with care, and the transaction structure takes into account the size, stage and resources of the parties, the CVCA model documents can be an excellent resource which promotes consistency in terms not only across Canada, but across the border into the United States, which is particularly helpful when dealing with investors on both sides of the border.

That being said, the CVCA provides the model documents for informational purposes only, and specifically states that the documents only serve as a starting point in any transaction. Given that the documents are drafted so comprehensively, it is strongly advised that they be considered carefully, and potentially narrowed down from their starting breadth to accommodate the circumstances of the particular parties for the particular transaction. It is important that the parties engage legal counsel to aid the parties in tailoring these documents to meet the business realities and specifications of the parties involved. As with the availability of most form documents, one size rarely fits all, and an ounce of forethought can save a pound of pain down the road.

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