Liquidation Preferences In Start Up Investment Transactions

A liquidation preference determines how a company's assets are to be distributed upon the occurrence of a liquidation event. A liquidation preference is frequently used in venture capital investment agreements to specify which investors get paid first and how much of the company's assets they receive in the event of a liquidation event, such as the sale of the company. The use of specific liquidation preference dispositions is common when venture capital firms or angel investors invest in startup companies. Investors often make it a condition for their investment that they receive liquidation preference over other shareholders. This protects those investors from losing their money by making sure they receive at least their initial investment back before other parties receive a piece of the company's remaining assets to be distributed.

Below is a typical liquidation preference provision for an early stage investment agreement:

"Liquidation Preference: In the event of a liquidation event, as defined below, the holders of the Series A Preferred Shares shall be entitled to receive in preference to the holders of the Common Shares a per share amount equal to 1X the Original Purchase Price plus any declared but unpaid dividends."

It’s important that the investment agreement clearly defines what constitutes a “liquidation event". In spite of its negative connotation, a liquidation event is not necessarily an adverse event such as a bankruptcy or a winding down of the company. In the venture capital world a “liquidity event” can be a merger, an acquisition of the company's shares or substantially all of its assets, a change of control of the company, or any other similar event defined in the company's Articles of Association or the investment transaction documents.

Standard language defining a liquidation event may look like this:

"A Liquidation Even shall be either a merger, acquisition, sale of voting control or sale of substantially all of the assets of the Company in which the shareholders of the Company do not own a majority of the outstanding shares of the surviving corporation shall be deemed to be a liquidation event."

In cases such those in the above sample provision, there does not need to be an actual liquidation or bankruptcy of a company. In many venture capital investment agreements, a sale of the company is often deemed to be a liquidation event. If the company is sold at a profit, liquidation preference can also help venture capitalists be first in line to claim their portion of the profits. If the company is sold for a loss, a liquidation preference provides an investor with the right to receive a larger share of the sale revenue, even if it doesn't amount to a positive return on his investment (ROI).

There are **four primary features** of a liquidation preference:

1. The Multiple

The multiple determines the percentage of his investment that an investor must be paid back before the shareholders of common stock receive any remaining proceeds. A "1X" liquidation preference means that if the shareholder invested $6M into the company, he must be paid back $6M before any common shareholders are paid anything. If the company was sold for $15M, the investor would be guaranteed at least $6M of the proceeds, no matter what its equity ownership is. If the Company were to be sold for $900,000, the investor would be guaranteed the entire $900,000 proceeds, while other investors would receive nothing. This is because the $900,000 falls under the guaranteed $6M in liquidation preference. Using the example from above where the investor invested $6M and the Company is sold for $15M, if the investor were to have a 2X multiple, the investor would need to be paid back $12M (despite investing only $6M), before the common shareholders receive anything.

Multiples are typically 1X–2X, but depending on market conditions, a liquidation preference multiple of even 5X can be used. A company founder raising capital in a seed or early series investment round would want the investors to receive the lowest possible multiple and therefore the lowest possible proceeds obligated to them. On the other hand, an investor should seek a high multiple, in order to alleviate some of the risk in investing in an unproven startup company.

2. Participating vs. Non-Participating

Non-Participating Liquidation Preference: A *non-participating* liquidation preference grants the investor the option to **either**: (i) **exercise** his liquidation preference, or (ii) **convert** his preferred shares into common shares of the Company (according to a predetermined conversion rate of preferred to common shares) and be paid a proportion of the proceeds based on his equity ownership of the company. Typical preferred to common conversion rates are 1 to 1, however conversion rates granting more than 1 common share for every preferred share converted do exist (1.5X, 2X, etc.).

The following is an example of a **non-participating liquidation preference**:

An investor has invested $1M into a company with a 1X non-participating liquidation preference and a 1X conversion rate in exchange for preferred shares representing 20% ownership of the Company. The company is then sold for $2M. The investor now has two payout options:

1. He can exercise his liquidation preference to receive a guaranteed $1M back.

2. He can choose to convert his preferred shares into $400,000 worth of common shares (400K is equal to 20% of $2M).

The rational choice would be to obviously exercise the liquidation preference for the higher payout ($1M>$400,000). If the Company were to be sold for $6M, converting the investors preferred shares into common shares would result in him receiving $1.2M ($1.2M is 20% of the $6M sale price), which is more than the $1M liquidation preference alone. If the Company were to be sold for $5M, the investor would be indifferent between choosing to exercise ($1M) or convert ($1M, which is equal to 20% of the $5M exit price), since the same payout ($1M) would be achieved under both choices. This point of indifference is called the "conversion threshold". An exit value **below** the conversion threshold would lead an investor to exercise his liquidation preference. An exit value **above** the conversion threshold justifies conversion into common shares of the Company.

Participating Liquidation Preference: With a *participating* liquidation preference, after the investor has been paid back his liquidation preference, the investor will also receive additional **“**participation**”** in the remaining proceeds in proportion to his ownership, **without** the need to convert his preferred shares into common shares of the Company.

The following is an example of a participating liquidation preference:

An investor has invested $1M into a company with a 1X participating liquidation preference in exchange for preferred shares representing 20% ownership of the Company. If the company is sold for $2M, the investor would receive $1M according to his 1X liquidation preference, and then an additional 20% of the remaining $1M proceeds. 20% of the remaining $1M would equate to an additional $200,000 payout, generating a total payout of $1.2M ($1M + $200K).

The participation liquidation right is like double-dipping into the proceeds pool. Participating preferred holders will never convert into common shares because they will always have a higher value per share than common shareholders since they are adding their guaranteed liquidation preference value on top of their participation rights through their preferred shares. Generally speaking, founders should try to avoid participating liquidation preferences as this will always generate a larger exit value for the investor than non-participating liquidation preferences. For that reason, a participating liquidation preference is less common than a non-participating liquidation preference.

3. **The Cap**

While liquidation preferences were designed to protect investors, participating liquidation preferences can create unfair scenarios for the founders and existing shareholders. Caps on the amount of committed capital were introduced for this reason. Payout caps are typically around 3X the investment amount. An investor committing $1M with a 1X participating liquidation preference on a 3X cap can receive up to $3M in total proceeds ($1M liquidation preference + $2M in participation) if he does not convert. In order to receive any payout higher than its cap, an investor must choose to fully convert his preferred shares to common shares of the Company.

4. Seniority Structures

Liquidation preferences are usually easy to understand and assess when dealing with a solitary investor. They can become much more complicated to understand as a company matures and sells additional series of equity. Understanding how liquidation preferences work between different investors is often mathematically and structurally challenging. Typical payout structures are more complicated due to numerous investors with liquidation preferences and different seniority. It is particularly important for an early stage investor to understand seniority structures to determine where he falls in the payout order, also known as the "waterfall".

Standard Seniority: In this structure, liquidation preference payouts are done in order from latest round to earliest round. This means that in the event of a liquidation, Series B investors will be paid back their full liquidation preference before Series A investors receive anything. The majority of startups follow this seniority format. Raising capital is tough for most startup companies. Therefore, later stage investors are able to demand priority seniority because earlier investors depend on them to fund the company's survival.

For example, an imaginary company named "Palo Alto Benjamins Ltd." has received both Series A and Series B investment rounds of $1M each with 1X liquidation preference. Unfortunately, Palo Alto Dollars Ltd. is sold for only $900K. Series B investors will receive the full $900K exit proceeds, while Series A investors will receive nothing.

In another example, Palo Alto Dollars Ltd. has received both Series A and Series B investment rounds of $2M each with 1X liquidation preference. Palo Alto Dollars Ltd. is then sold for $3M. In this event, Series B investors will receive $2M, then Series A investors will receive only the remaining $1M.

Pari Passu: For this structure, all preferred shareholders, regardless of their class of preferred shares (A, B, or C), across all stages, have the same seniority status. This means that every investor will receive a piece, not necessarily equal however, of the proceeds. For example, an imaginary Company named "Start Up Nation Ltd." has completed three financing rounds (Series A, Series B, and Series C), each with liquidation preference and pari passu seniority. Each and every investor from Series A, Series B, and Series C has equal priority when receiving exit proceeds.

For a pari passu payout, investors share proceeds pro rata to capital committed in the event that there is not enough proceeds to fully cover all investors.

For example, "Start Up Nation Ltd." has raised $77 Million in total with 1X *non-participating* liquidation preferences. The Founders have invested $2M, which is 2.6% of total funds raised. The Series A investors have invested $5M, which is 6.5% of total funds raised. The Series B investors have invested $30M, which is 39% of total funds raised. The Series C investors have invested $40M, which is 51.9% of total funds raised. If the company was ever sold for 250, the Founders would receive $6.5M (2.6% of the exit proceeds), the Series A investors would receive $16.25M (6.56% of exit proceeds), Series B investors would receive $97.5M (39% of exit proceeds), and the Series C investors would receive $129.75M (51.9% of the exit proceeds).

The pari passu structure is commonly found in privately held companies with high valuations (known as unicorn companies), especially those started by prominent founders. Top startups do not have a shortage of funding so later stage investors have no leverage to demand any seniority. In addition, many prominent founders are early stage investors in their own company and would reject any liquidation seniority that was above them.

Tiered: In some cases, investors from different rounds can be grouped up into tiered seniority levels. For example, a theoretical company named Spacebox Hyper Drive Ltd. has raised about $1.5B through five investment rounds. Their Series E and D investors share the highest level of seniority. Their Series C and B investors share the middle tier, while their Series A investors share the lowest tier among preferred shareholders. Within each tier, investors follow the *pari passu* payout. This is a type of hybrid between the standard seniority and the pari passu design.

Why Is A Liquidation Preference Important

For investors that provide capital for companies, whether high tech startups or existing companies, liquidation preference is an important tool. It offers security on the risk investors make in giving a large amount of capital to finance a company or business. The liquidation preference is an investor's ticket in claiming what he has invested if the Company is sold for a loss, or if the company declares bankruptcy. Liquidation preference also provides companies or businesses an ease on prioritizing who gets paid first and how much when a company achieves its dreams of making a successful exit.

Most experienced investors will not want to engage with a company with excessive liquidation preferences. The greater the liquidation preference ahead of management and employees, the lower the potential value of the management's and employee's equity. A situation such as this can negatively affect the Company's staff's motivation for success. There’s a fine balance here and each case is situation specific, but a skillful investor will want a combination of “the best investment terms” while insuring “maximum motivation” of management and employees. Obviously what happens in the end is a negotiation and depends on the stage of the company, bargaining strength, and existing capital structure, but in general most companies and their investors will reach a reasonable compromise regarding these provisions. Note that investors receive either the liquidation preference and participation amounts (if any) or what they would get on a fully converted common holding, at their election. They do not receive both, although in the fully participating case, the participation amount is equal to the fully converted common holding amount.

While this article breaks down fundamental features of a liquidation preference and provides common seniority arrangements covered by many startups investment rounds, it is important to remember that liquidation preferences are dispositive and can be legally structured in any way. Some companies have exotic variations of the typical setups described above. Therefore, it is important to read the legal language carefully, at first on a term sheet and afterwards in the full investment documentation to have a clear understanding of where you will stand *vis*-à-*vis* the other shareholders of the Company.

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