

Understanding Liquidation Preferences In Venture Capital Financings

by

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With the collapse of the IPO market in late 2000, the most likely exit in a venture capital-backed company is a sale rather than IPO. Therefore, investors' are focusing on the liquidation preference on their preferred stock to provide greater returns, because the sale of a venture capital-backed company will be "deemed" to be a liquidation under the company's charter. Therefore, the liquidation preference will have significant economic impact on the returns to investors and the management and employees.

At a minimum, the investors and the company's management should expect the investors will have their capital returned "off the top" in a liquidation (sale) of the company before any sale proceeds can be shared with employees and management. The preference matters most when the liquidation value of a company is low. For example, if the investors have invested \$10MM in a company, in any sale up to that dollar amount, the investors will receive 100% of the sale proceeds. Only when the sale exceeds \$10MM will management and employees enjoy any up side from the ownership of their stock.

The liquidation preference in a venture capital financing is usually not limited to a mere return of capital of the investors, however. In order to maximize their returns over and above a return of capital to achieve higher IRRs, the investors will normally require one (or more) of the following features in the liquidation preference:

- a greater "up front" or "off the top" preference (more than just a return of capital),
- cumulative dividends, or
- that the preferred stock "participate" with the common stock.

Understanding these elements of a liquidation preference is critical in the negotiation process. Although a venture capital transaction is a "partnering" of entrepreneurs (the founders of the company who own common stock) with professional management (the venture capital investors who will own the preferred stock), there is a "zero sum" aspect to liquidation preferences. When the company is sold, the amount of sale proceeds will be fixed. How those proceeds are divided is significantly impacted by the liquidation preference. If the investors negotiate a higher liquidation preference, more of the sale proceeds will be allocated to them—at the expense of management and employees.

The "Off the Top" Preference

Preferred stock terms in 2001 and 2002 often provided investors with two, three, or more times their original investment prior to distributions to the common stockholders. The impact of such a provision is self evident. Building on the example earlier, if the investors have invested \$10MM and negotiated a three times capital (3X) up front liquidation preference, the sale value of the company must now reach \$30MM before management and the employees receive any sale proceeds.

Cumulative Dividends

A dividend preference for the preferred stock may appear insignificant — after all, start-up (and even mature) technology companies do not pay dividends. However, the liquidation preference may provide the investor its invested capital (or more if negotiated) “plus declared or accrued but unpaid dividends prior to and in preference to any payment to the holders of common stock.” It is unlikely dividends will be “declared” by the company’s Board of Directors, but cumulative dividends will “accrue” like interest and become payable upon the sale of the company. Cumulative dividends are a subtle way to increase the return to the investors (at the expense of management and employees).

Participating Preferred Stock

Participating preferred stock means that after the payment of the preference “off the top,” the investors will share the remaining sales proceeds with the common stock on an as-converted basis. Participating preferred stock may or may not be capped (*i.e.*, pro rata participation until some upper limit is reached, usually measured as a multiple of the amount invested). For example, the preferred stock terms may provide the investors will receive their investment off the top, then participate with the common stockholders pro rata until the investors have received a total of three times (3X) their original investment. Assume the investors have invested \$10MM, have 3X participating preferred, and own 50% of the shares of the company. After payment of the first \$10MM in sale proceeds to the investors, the investors and holders of common stock would split the next \$40MM in sale proceeds 50/50. If participation is unlimited, the investors and common stockholders would continue to split the sale proceeds no matter how high the sale value of the company. The end result is the investors receive more than 50% of the sale proceeds.

As mentioned above, the elements of the liquidation preference are not mutually exclusive. Investors can (and do) negotiate for greater up front preferences, cumulative dividends *and* participation rights on the preferred stock. These elements together will ensure that even greater percentages of the sale proceeds will be allocated to the investors when the company is sold.

The investors and the company’s management should be mindful that there needs to be a balance in the terms of the liquidation preference. If the preference favors the investors too much, the proposed sale of the company may not provide employees and management an incentive to consummate the sale transaction or vote in favor of the proposed transaction when a vote is put to the stockholders.

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