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Chasing waterfalls: **understanding and negotiating liquidation preferences**

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Liquidation preferences are downside protection for investors. In the Time of Corona, expect to see investor-friendly preferences in venture capital term sheets. Here's how you negotiate.

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The pre-money value sets the price at which investors go in. The preference 'waterfall' determines who gets what at exit.

An 'exit' in this context means a share sale, a sale of all the assets, an IPO or a winding up.

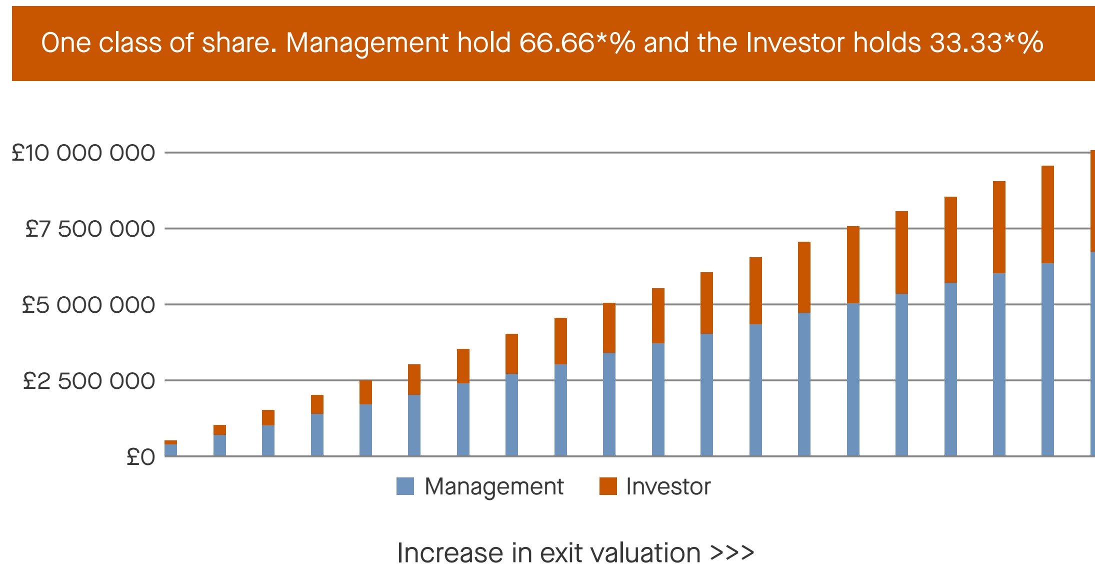
The easiest way to share the proceeds of an exit is pro rata and pari passu, which means proportionately to shareholdings and at the same price per share.

PRO RATA AND PARI PASSU PARTICIPATION

If at exit you have a two-founder team and an investor holding a single class of ordinary shares splitting proceeds of £1 million in equal thirds, then the shareholders take £333k each.

So, with the aggregate value of the exit proceeds increasing from left to right, that kind of arrangement could look like this at exit:

One class of share. Management hold 66.66*% and the Investor holds 33.33*%



Don't worry, it gets more complicated from here.

(Americans, by the way, call ordinary shares "common stock" and will be familiar with many of the principles discussed below.)

DOWNSIDE PROTECTION – THE PREFERENCE

But investors usually want down-side protection.

Consider if, in the pro rata and pari passu scenario above, the investor had invested £1m in the company. It would now be receiving only a third of that sum from the proceeds of exit. And the investor does not control the time of exit (and may be dragged into it by the other shareholders).

The investor's preference is often thought to balance against the founders' control of the company (and time of exit). Or, put another way, the founders can choose when to exit but the investor's funds invested (along with accrued but unpaid dividends) are protected by the preference.

(Americans call their preference shares "preferred stock" but will be familiar with many of the principles discussed below.)

A PREFERENCE OR PARTICIPATION

A simple way to cover the investor's downside is to build in a choice: the investment monies back (plus dividends) ahead of the founders or pro rata and pari passu participation.

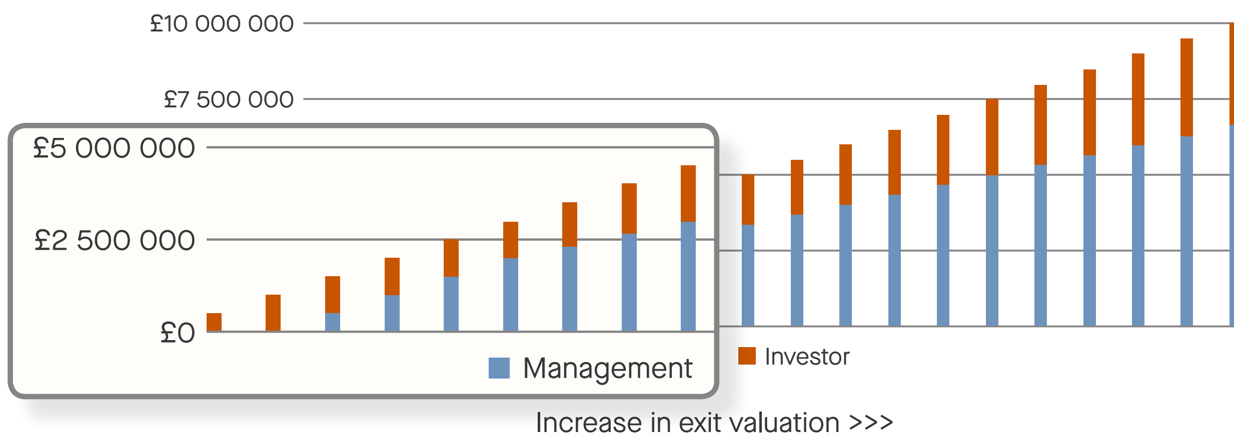
With our same example above, if the proceeds are less than £3 million, the rational investor would choose its preference and take (up to) the first £1 million from them; if proceeds were in excess of £3 million, then the investor would want to participate pro rata and pari passu.

CONVERTIBLE, NON-PARTICIPATING PREFERENCE

The classic way to facilitate that choice is for the investor to hold non-participating preferred shares (providing the preference) but which – at the election of the investor – convert into participating ordinary shares.

See that mapped out as follows with the aggregate value of the exit proceeds again increasing from left to right:

Two share classes, ordinary shares and convertible 1x non-participating preferred shares. Overall, Management hold 66.66*% of the shares and the Investor holds 33.33*%



'CATCH-UP' WATERFALLS

An alternative mechanism is for the investor to hold A ordinary shares and for the founders to hold ordinary shares.

At exit, the A Ords pay out first at the price per share at which they were acquired. The Ords then 'catch up' by paying out at the same price per share at which the A Ords have just been paid out. The A Ords and the Ords then participate pro rata and pari passu.

That order of distribution stops the moment you run out of proceeds to distribute. But if the proceeds get to the bottom of the waterfall, then the two share classes come out pro rata and pari passu overall. Neat.

PARTICIPATING PREFERRED – THE 'DOUBLE DIP'

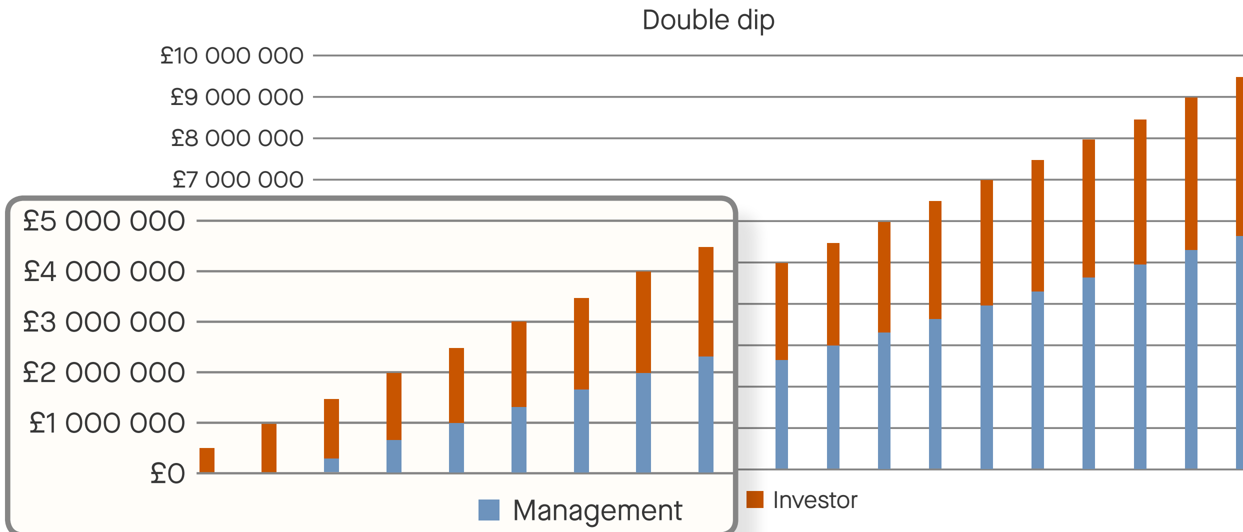
Prior to the coronavirus crisis, a participating preferred preference was very much viewed as a "term sheet nasty", up there on that list with perhaps only full ratchets.

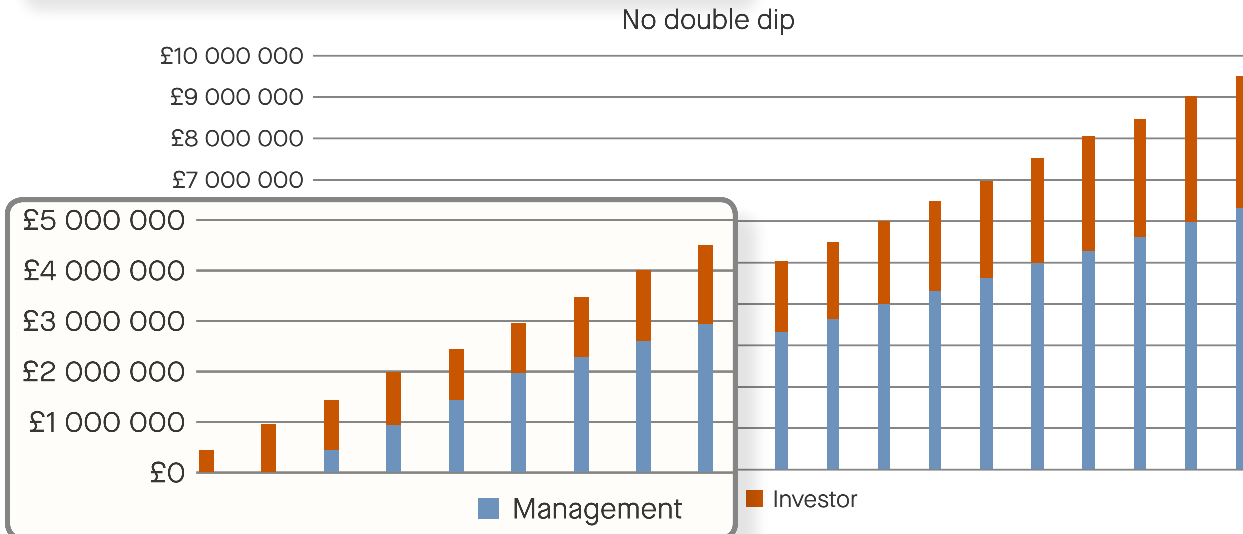
Occasionally, however, an investor would push for the double dip in a term sheet.

What participating preferred means though is a double dip – the return of the funds invested AND IN ADDITION a pro rata and pari passu distribution. In other words, those participating preferred shares get paid out twice, the investor *"gets her cake and eats it too"*.

Sometimes, poor drafting and confusion as to what is being asked for will cause a participating preferred preference to make its way into a term sheet by accident. And it can be quite hard to spot – the issue may not be immediately obvious if language has not been used precisely.

Here is how a double dip plays out compared to a convertible 1x non-participating preference (and keep your eye on the lower to middle valuations):





JUSTIFYING THE DOUBLE DIP?

If there is a commercial justification for the investor pressing for the inclusion of a participating preference, then it is probably limited to the argument that the founders are paid their salaries during the life of the business pre-exit; and that is a double dip for them at exit when they also see a return on their shares.

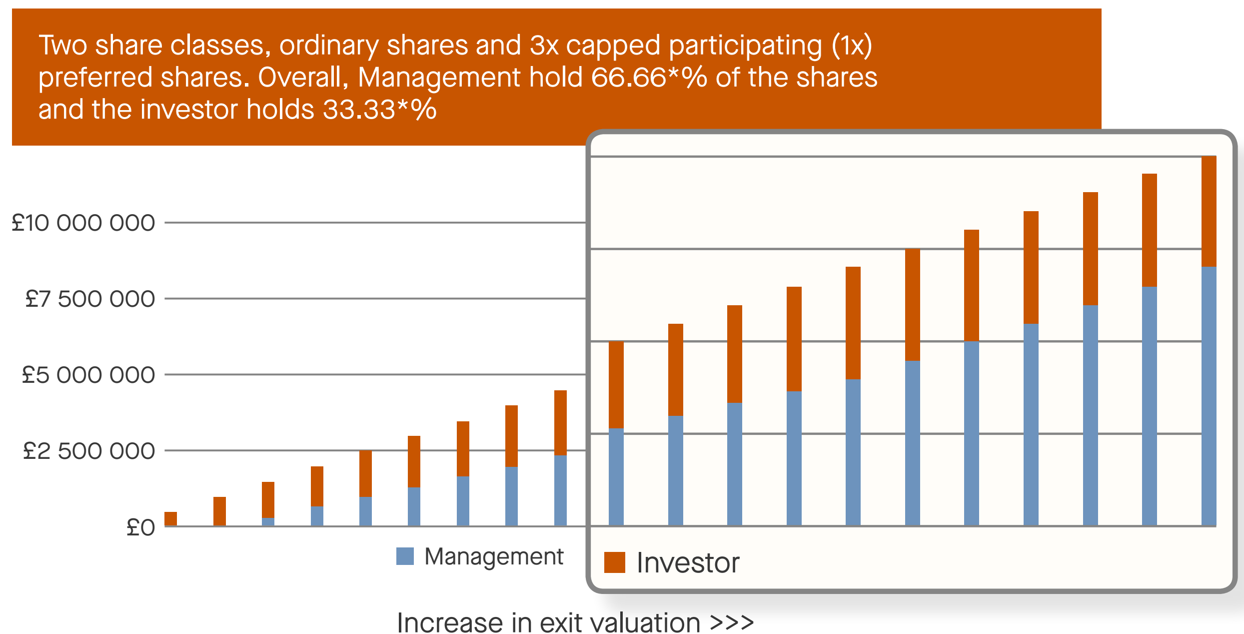
The strength of that argument is weakened if salaries are not at 'market' rate. Even if they are at market rate, the demands that founders place upon themselves and the pressures they are put under usually go well beyond what would otherwise be compensated for by salary.

The founders do not get their own liquidation preference on extra sweat put in over the years.

CAPPED, PARTICIPATING PREFERRED

If the investor really wants a preferred participating double dip, but the founders will not agree, then one compromise on both sides is to agree a capped participating preference. If agreed, the investor gets its 1x preferred return AND its pro rata and pari passu participation, but the participation is capped at an agreed level.

Here is a worked example showing what those numbers can look like:



Most VC funds will not be interested in that because they are not in the businesses of capping their upside.

But where you see it used is with mezzanine-type funders who are comfortable with less upside but want enhanced downside protection. Or some growth capital type funders who invest using a number of different share classes to seek to generate a blended risk and return profile across their share classes.

COUNT YOUR XS

The other compromise to steer away from a double dip is to look at "the X". So far, we have assumed that a preference means a return of the funds invested (plus dividends), a "1x". The founders can reasonably argue that a 1x return on day 1 after completion of the investment means the investor suffers no loss (ignoring the professional costs and management time incurred).

Return a 1x ten years later and the investor has a problem: it could have invested those funds elsewhere (or simply parked those funds in the bank and earned interest) to generate a return. At 1x, the investor is not benefitting from any risk premium. Other companies (or even the bank) might be a safer bet to house its investment funds.

And that may be the start of a line of argument that the 1x should be 1.5x or 2x. Or a formula could be included in the mechanics to factor in the investor's 'internal rate of return'.

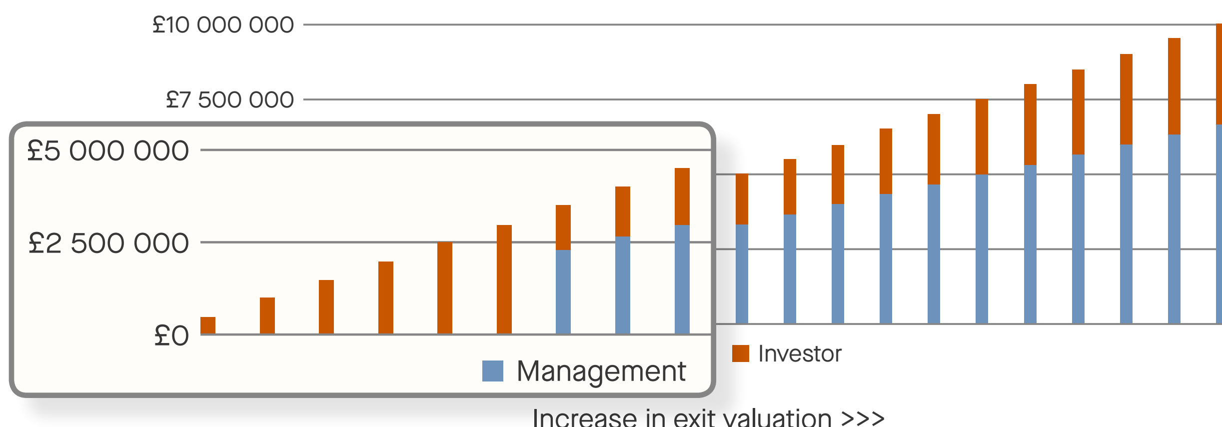
Much less common in the years prior to the coronavirus crisis were preferences at many multiples. With the world economies as they are at time of writing, we are now seeing instances of "high x" preferences in term sheets.

It is worth remembering that in the years immediately following the dot.com crisis of the early noughties you might sometimes have seen preferences go up to 10x even in extreme cases. In the Time of Corona expect to see instances of that kind of approach as a means of pricing the risk.

Ultimately, agreeing what the x is should be centred on a discussion on the risk premium the investor should benefit from. Careful thought should be given to that x because it may set a benchmark for subsequent investment rounds and it will have a fundamental influence on what kind of price the shareholders are willing to exit at.

Here is another worked example, this time showing returns on convertible 3x non-participating preference:

Management holding ordinary shares, Investor holding convertible
3x non-participating preferred shares. Overall % split, 66.66*% and 33.33*% again



LAYERED PREFERENCES

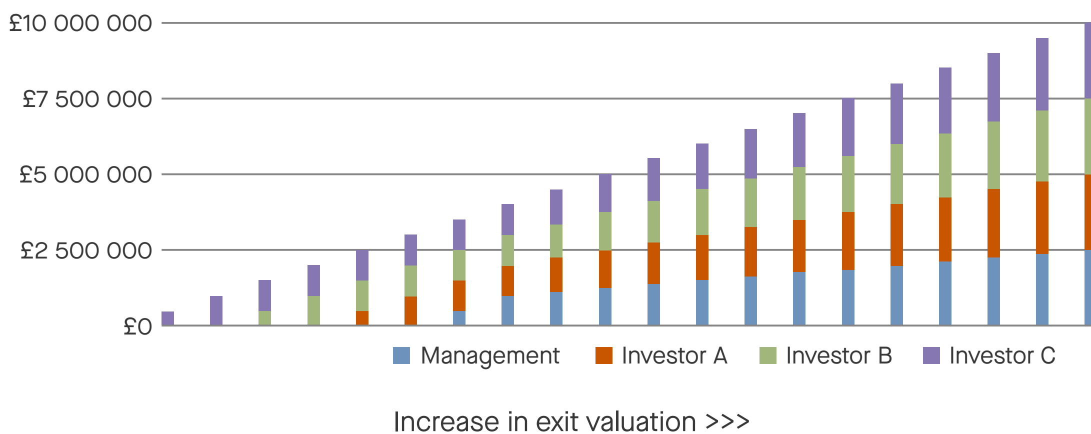
In the worked examples so far, we have talked about investor singular. On most venture-capital type deals, the investor at series A gets its preference but then on each subsequent significant funding round – series B, series C, series D, etc – the investor on that round gets a new preference that sits on top of the existing preference(s).

If the company is lucky enough to get to, say, series E then it may be that there are preferred share classes A to E and each has its preference stacked on top of the share class below, starting with E on top and going down to A and the ordinary shares below it.

The descriptor 'waterfall' imagines that the proceeds – the water – are poured out and filter through the preferences working their way to the bottom (if they are able to get there without being exhausted).

Modelling a waterfall with preferences E to A can get famously complicated, but here is a simple worked example:

Investors A, B and then C each invest £1 million at series A, B and then C.
A new class of share is issued each time with a convertible 1x non-participating preference. By number, the A, B, C and then management's ordinary shares each make up 25%



Layered preferences are perhaps easy to visualise, but the (often conflicting) interests of each group of investors need to be considered at each funding round and the waterfall is usually a key battleground in negotiations.

EIS AND VCT RELIEFS

Special care must be taken where an investment is intended to benefit from EIS or VCT relief, e.g. where the investors include an EIS or VCT fund or individuals who are UK tax-payers and have agreed to invest on the understanding that EIS relief would be available in respect of their investments.

Where a company has several funding rounds, any EIS and VCT investors who participated in an earlier round will expect that any subsequent rounds (in the case of EIS, to the extent occurring in the relevant EIS qualifying period) are structured so that the availability of their EIS or VCT relief is not prejudiced.

A preference waterfall could potentially result in the loss of EIS relief for EIS investors or in the loss of a VCT fund's qualifying status, owing to the EIS and VCT codes prohibiting EIS and VCT shares from carrying "any present or future preferential rights to a company's assets on a winding up".

The rationale behind this is that EIS and VCT investments are meant to be 'risk capital investments', where the investment is genuinely at risk, and thus should not be 'protected' by a preference in a winding up situation.

One way of dealing with this is to distinguish between different types of exit, such as a winding up and a sale.

The EIS and VCT codes do not prohibit a preference on sale (where the exit proceeds come from a third party rather than the company), so it would be possible to use a preference waterfall to apply on a sale, but have a simple pro rata and pari passu participation in the event of a return of capital on winding up or liquidation.

Investors may be uneasy though about the lack of protection in a winding up situation, which has prompted the market to take a closer look at published HMRC guidance and existing case law. On that basis, it seems that HMRC's current practice is to consider the priority in which assets are received, as opposed to the amount of assets received by holders of EIS or VCT shares on a winding up.

PRIORITIES

This suggests that a preference waterfall applicable on a winding-up could still comply with EIS and VCT rules, provided that each class of shares participates at each stage of the waterfall (however small such participation).

Using the example of a 'catch-up' waterfall, the A Ords would pay out first at the price per share at which they were acquired. Provided that the Ords would also have a small participation at that stage of the waterfall, neither class would have a priority.

For instance, the A Ords could receive 99.999% of the available proceeds up to the amount previously invested (less dividends previously received in respect of the A Ords) with the Ordinary Shares also receiving 0.001% of such proceeds at the same time. The opposite would then be the case when the Ords 'catch up'.

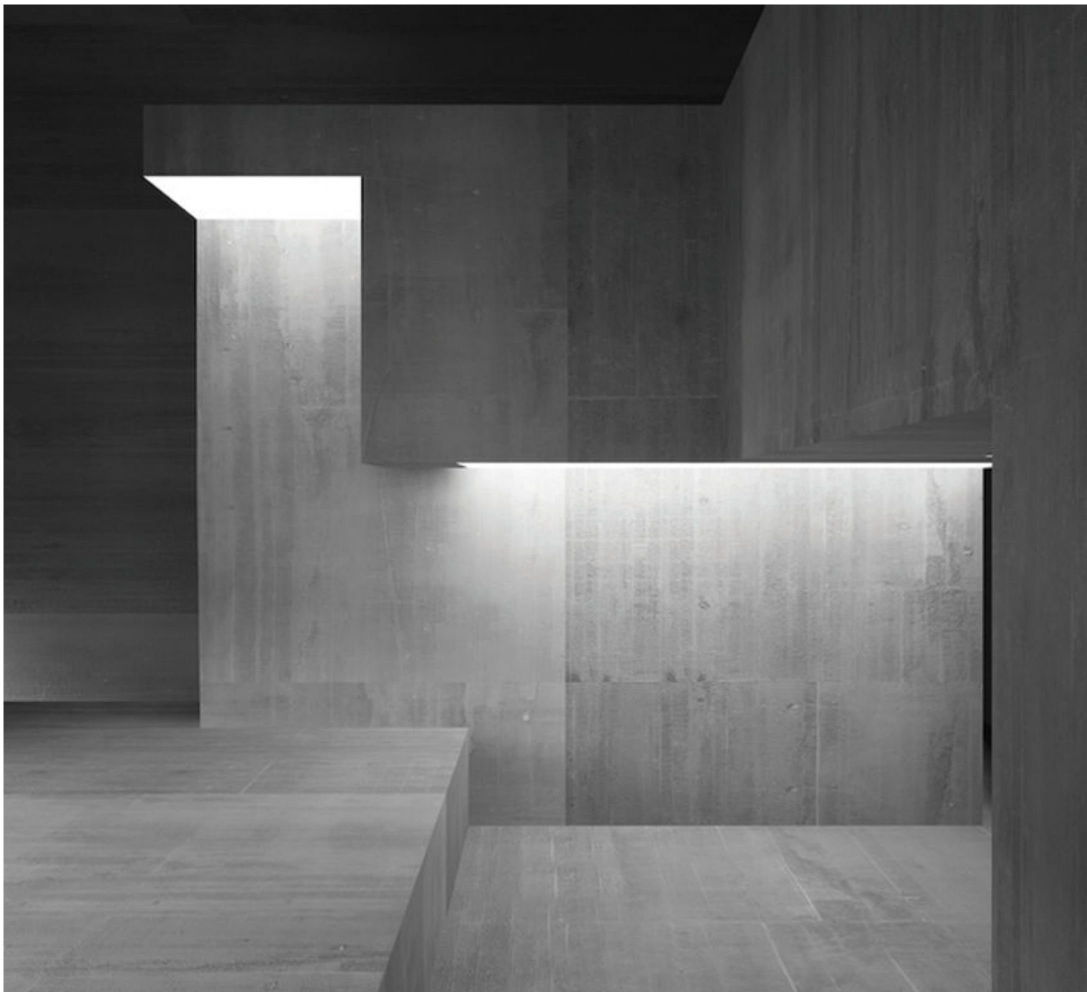
SEE WHAT HAPPENED? NO PRIORITY

It is generally understood that HMRC has accepted this practice to date and has not so far challenged it.

Where EIS relief is intended to be claimed, the document into which the preference waterfall is built (normally the company's articles of association) is required to be submitted to HMRC (either with an EIS advance assurance application or an EIS compliance statement).

It can therefore be assumed that HMRC are aware of this type of provision. At time of writing, however, we are not aware of any formal statement on the matter from HMRC.

There can be no guarantee that HMRC will not challenge this practice in the future. The drafting of the legislation would seem to be broad enough to allow such a challenge – and whether a 0.001% participation is a meaningful participation at all may be debatable.



ENTREPRENEUR'S RELIEF – BE CAREFUL

A sale of shares at exit will usually result in a liability for capital gains tax (“**CGT**”) purposes. Currently, CGT is charged at marginal rates of up to 20% although, for some, entrepreneurs' relief may be available up to the recently substantially-reduced lifetime limit of £1 million.

This relief brings down the effective rate of CGT to 10% for up to £1 million worth of gains; essentially up to £100,000 relief is available.

Entrepreneurs' relief is only available if certain conditions are met. In particular, a seller can only access the relief if the company is a ‘personal company’ which meets the requirements for at least two years prior to the sale.

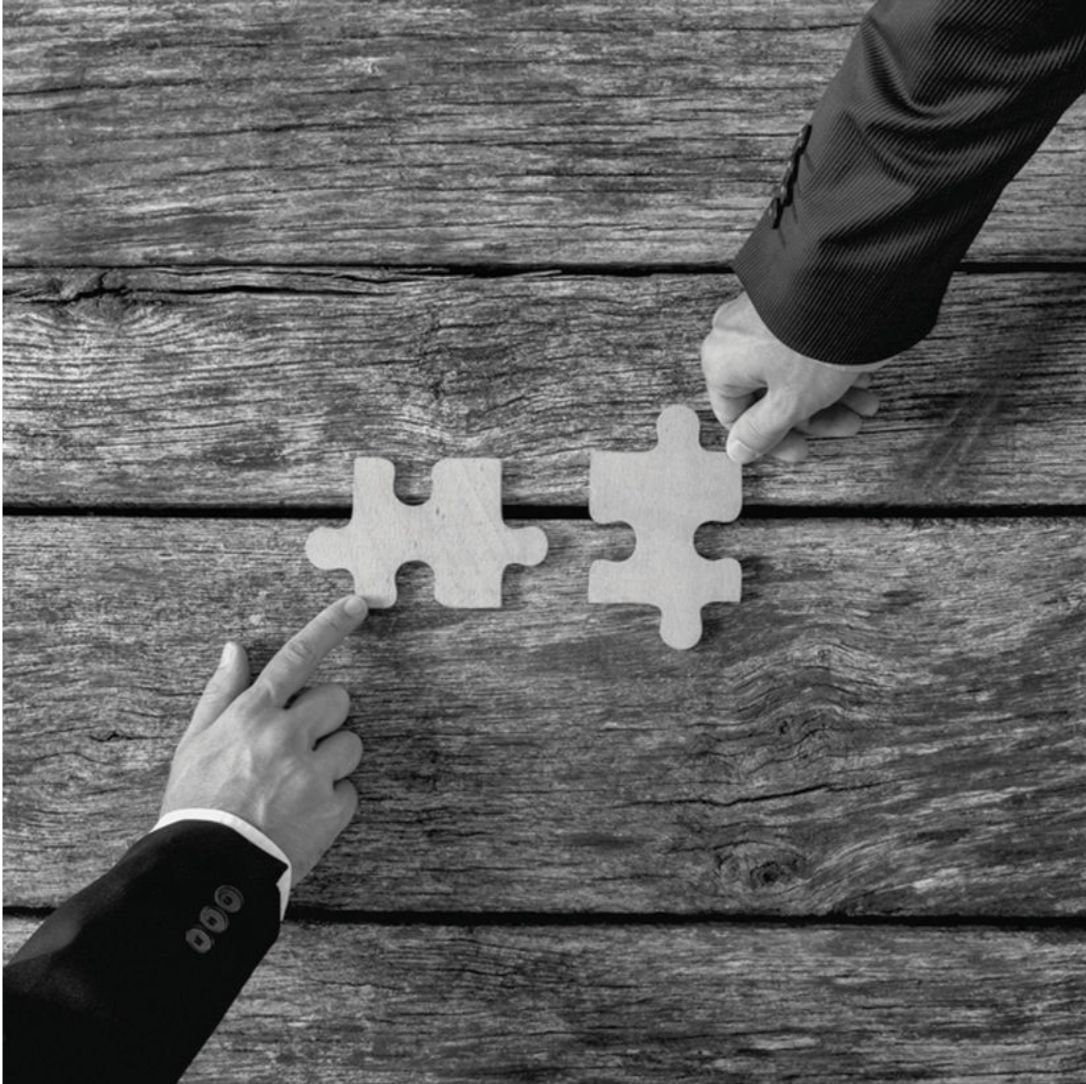
This generally means that the shareholder must have held at least 5% of the ‘ordinary share capital’ for those two years. For these purposes, it is likely that preference shares held by investors will constitute part of the ordinary share capital so the investors' shares need to be taken into account when making the 5% calculation.

Since 2018, this means that – for relief to be available – not just 5% of the votes of ordinary shares but also 5% of dividends and 5% of assets available on a winding up must be held by the relevant shareholder for the two-year period.

With a waterfall, it is likely that, taking into account preferences detailed above, the investors' subscriptions will swamp the balance sheet for some time so that ordinary shareholders (i.e. management) may be ineligible for entrepreneurs' relief.

As the company's balance sheet grows, the shareholders' shareholding may return gradually to qualifying status; but, remember, the two-year rule will need to be complied with for relief to be available.

Note also that a shareholder with exactly 5% pre-investment will never qualify post-investment.



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This piece was researched and prepared by Henry Humphreys, Annette Beresford and Jeremy Glover. If you have questions about how liquidation preferences work, how to negotiate them or what their tax implications are then do please speak to our expert team.

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