The Liquidation Preference of Non-Participating Preferred

What's "The Deal" with NVCA Escrow Provision?

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Background

Recently introduced drafting options in the form model charter prepared by the drafting committee of the National Venture Capital Association (the "NVCA") have triggered a vibrant discussion among legal practitioners and venture capitalists.[1] The discussion centers around one very fundamental question. What does a liquidation preference entitle non-participating preferred stockholders to receive in a liquidity event?

As discussed below, the election of different drafting options pertaining to escrow and other contingent payments can result in a very different allocation of proceeds in certain liquidity events. The specific type of liquidity event for which these drafting options are relevant is that in which the consideration paid to all stockholders at the time of closing does not exceed the amount at which preferred stockholders would choose to participate on an as-converted to common stock basis (such amount hereafter referred to as the "conversion threshold"), but in which there is an escrow or other contingency payment that if subsequently released would result in total consideration to the stockholders that would exceed the conversion threshold.

In this scenario, at the time of the closing the preferred stockholders are not sure whether they would be better off receiving their original investment back as a priority payment, or being treated like holders of common stock and participating in the proceeds, including all contingent payments, alongside the common stockholders. The specific NVCA drafting option at issue eliminates the need for the preferred stockholders to make a choice at the time of the closing between these two options and ensures that in the end they will receive the greater of the two amounts.

This article explores in detail the mechanics and economic impact of this drafting option and concludes that while there is nothing inherently unfair or unreasonable about the impact it may have from a business perspective, given that it represents a relatively novel approach with significant implications, parties should consider raising the issue at the term sheet stage of the venture transaction.

Discussion

Upon a liquidity event, the holders of non-participating preferred stock are entitled, on a per share basis, to the greater of two amounts: (1) the original price per share paid for the preferred stock, plus any accrued but unpaid dividends (hereinafter referred to as the "liquidation preference"), or (2) the amount the holder would receive if the holder's shares of preferred stock were converted into common stock. Upon the occurrence of most liquidity events, this decision is reasonably straightforward: If the total consideration to be paid to all stockholders is above a certain amount, the preferred stockholders will be better off being treated as though they had converted to common stock because on an "as converted" basis the investors will always get more than their liquidation preference. Conversely, if the total consideration to be paid to all stockholders is below a certain amount, the preferred stockholders will be better off taking their liquidation preference.

A simple example illustrates the two options facing the holders of non-participating preferred stock. Assume that a venture capital firm purchases 5 million shares of Series A preferred stock for $5 million dollars, representing 50% of the total capital stock of the company on an as-converted basis in exchange for this investment. Further assume that there is no dividend on this preferred stock. If the company is subsequently sold for total consideration in excess of $10 million, the holders of preferred stock will be better off being treated as though they converted to common stock because they would receive 50% of an amount in excess of $10 million which will be more than the $5 million they originally invested. In this example, $10 million is the venture capital firm's "conversion threshold." If the company is subsequently sold for less than $10 million, the holders of preferred stock will be better off taking their liquidation preference because 50% of an amount that is less than $10 million will be less than the $5 million they originally invested.[2]

While the above scenarios are reasonably straightforward, the decision becomes more complicated for the holders of Series A preferred stock if the total consideration payable is greater than the conversion threshold of $10 million, but some portion of it is contingent and payable in the future pursuant to an escrow arrangement, earn out or other holdback such that less than the $10 million conversion threshold is paid out at the time of the closing. The preferred stockholders will not know at the time of the closing, when the initial payment is made, whether they will be better off taking their liquidation preference, or being treated as though they converted to common stock, because it will not be until the contingent payment is paid (or not) that they will know whether the total consideration exceeds the conversion threshold.

For example, if the total consideration is $15 million, but only $5 million is payable at the closing with the $10 million balance payable pursuant to an earn out, the holders of preferred stock have a dilemma. If they opt to take their liquidation preference, they will receive all $5 million payable at the time of the closing, but not share at all in up to the additional $10 million payable pursuant to the earn out. If the full earn out is eventually paid, the preferred stockholders would end up with $5 million out of a total of $15 million paid out, or one-third of the total consideration. The holders of common stock would receive $10 million. On the other hand, if the preferred stockholders chose to be treated as though they converted to common stock, they would receive 50% of the initial payout of $5 million, or $2.5 million, and then 50% of the $10 million earn out, or $5 million, for a total of $7.5 million. In this second scenario the holders of common stock would also as a group receive $2.5 million at the initial closing and $5 million when the earn out is paid. Which "horse" the holders of preferred stock pick in this example-their liquidation preference or that which they would be paid if converted to common-results in a large, $2.5 million differential.[3]

A recent drafting option in the NVCA documents takes the holders of Series A preferred stock out of this predicament. This option provides for the preferred stockholders to receive their initial $5 million as if they opted to take their liquidation preference, and then, when the earn out is paid, for the preferred stockholders to receive another $2.5 million. As a result they end up in the same place they would have been in had they opted at the closing to be treated as though they had converted to common stock. This option in effect allows the preferred stockholders to "ride two horses" until the escrow breaks, being treated like a preferred stockholder initially, and then switching over to receive the consideration payable to the common stockholders if that turns out to be the better result for them once the contingent payments are made. In effect, applying this mechanism, the preferred stock retains features of both common stock and preferred stock until the contingent payment is made. In this way the drafting option transforms the preferred stock into a security that is a "hybrid" of preferred stock and common stock.

A summary table below illustrates how the proceeds would be allocated under the three methods described above. The table reflects the distribution of proceeds in the event of a sale of a company that is owned 50% by the preferred stockholders and 50% by the common stockholders under two different scenarios in which the total consideration payable is $15 million. Scenario 1 assumes that $5 million is paid out at the time of the closing with $10 million contingent, and Scenario 2 assumes $8 million is paid out at closing with $7 million contingent. The row labeled "LP" shows how payments would be made if the preferred stockholders elected their liquidation preference; the row labeled "Convert" shows how payments would be made if the preferred stockholders were treated as though they converted to common stock; and the row labeled "Hybrid" shows how payments would be made if the preferred stockholders received the benefit of the hybrid approach reflected in the NVCA drafting option described above. In both cases the assumption is that the full amount of the contingent payments is ultimately paid out. The table shows that under both Scenarios 1 and 2, the worst outcome for the holders of preferred stock is what they would receive if they opted to take their liquidation preference. The best outcome for the preferred stockholders is the hybrid approach because they get the same total share of the proceeds as they would if they converted to common stock, but they get paid out more at the time of the closing than they would if they had converted to common stock.[4] In addition, and more importantly in certain scenarios, the preferred stockholders have much less at risk in the contingent payment.[5]

Summary Table: Allocation of Proceeds

	Scenario 1				Scenario 2			
Timing	Initial Payment		Contingent Payment		Initial Payment		Contingent Payment	
Amount	$5M		$10M		$8M		$7M	
Payable On	PS	CS	PS	CS	PS	CS	PS	CS
LP	$5M	$0M	$0M	$10M	$5M	$3M	$0M	$7M
Convert	$2.5M	$2.5M	$5M	$5M	$4M	$4M	$3.5M	$3.5M
Hybrid	$5M	$0M	$2.5M	$7.5M	$5M	$3M	$2.5M	$4.5M

The introduction of this drafting option has caused practitioners to focus during document drafting on the question of which of these approaches results in the correct outcome for the preferred and common stockholders.[6] Reasonable people can and do disagree as to which is the correct outcome. Naturally, if acting in their own self-interest, the investors would be inclined to argue in favor of the "hybrid" approach, whereas the common stockholders would be of the view that the preferred stockholders should have to choose at the time of the initial closing whether they want to take their liquidation preference, and nothing else, or be treated like common stockholders and share equally in both the initial payment and escrow risk. In trying to shed light on this discussion, the commentary to the NVCA documents indicates that the "most common" approach in practice is to require the preferred stockholders to choose one or the other.[7]

This result also seems consistent with the history of how the mechanics of the liquidation preference provision have evolved. The original (and until not very long ago more common approach) drafting approach left little in doubt on this point. Under this earlier approach, the holders of preferred stock had to actually convert their preferred stock into common stock prior to the closing of the sale of the company if they wanted to participate like a common stockholder. If they did not so convert, they remained preferred stockholders as of the closing and as such were entitled only to their liquidation preference. If the holders of preferred stock converted to common stock prior to a liquidity event they would in fact be common stockholders and be paid out as such, participating fully in any escrow risk.

A more recent approach, which is followed in the NVCA model forms, eliminates the need for the holders of preferred stock to actually convert to common stock, allowing them instead to be treated as though they had converted. This so-called "deemed" conversion was introduced in part to simplify closing mechanics by eliminating the need to actually effect the conversion of preferred stock to common stock. This mechanical approach was not, however, intended to change the economics of the payout upon a sale of the company by allowing the holders of preferred stock to benefit from the "hybrid" approach described above.

Conclusion

Regardless of the history, both the more conventional and "hybrid" allocation models are defensible in theory. The author submits that the question is not whether one or the other is correct. There is no correct answer. In other words, the real question is: What have the parties agreed to as the business deal? The problem, and the source of much confusion, is that even though it has far reaching implications, this subtle allocation point is typically not addressed in the term sheet. Given that practitioners generally agree that the conventional approach is the more common and accepted meaning of the words "non-participating preferred stock", it would seem sensible for those negotiating venture capital term sheets to be explicit when the parties have agreed upon and intend the holders of preferred stock to get the benefit of "hybrid" non-participating preferred stock. Addressing this explicitly in the term sheet would pre-empt a lot of unnecessary negotiation around this point during the document drafting phase of the transaction, and save all parties involved both time and money. In the absence of explicit language in the term sheet on this point, non-participating preferred should be construed to have its conventional meaning.

For more information on liquidation preference, please contact **Jonathan D. Gworek**.

Footnotes:

1. See Article Fourth, Part B, Section 2.3.4 of the NVCA model Venture Capital Financing Document, last updated May 2006.

2. Investors are indifferent with respect to any sales price between $5 million and $10 million as they will always get just their original investment, or $5 million back. The range of prices over which the seller is indifferent is sometimes referred to as the investor's "range of indifference".

3. It is worth emphasizing that the dilemma described above exists only when the sale of the company meets a very specific set of parameters-(1) the total consideration payable including all amounts subject to contingencies exceed the conversion threshold, and (2) the total consideration paid out at the time of the initial closing does not exceed the conversion threshold. This set of parameters is likely to apply in only a very narrow set of circumstances, most likely in a disappointing, "fire sale" scenario. Of course, the more money that has been invested in a company, the higher the conversion threshold. In addition, the larger the contingent payment is as a percentage of the total consideration payable, the more money is at stake.

4. The result of this "timing" is that even if the contingent payments are paid out entirely so that the escrow risk does not negatively impact the common stockholders, the preferred stockholders still make out better than the common stockholders because they get paid out earlier and benefit from the time value of that "early" payment. Provision can be made in the charter so that the preferred stockholders pay the common stockholders an interest rate on this early payment which interest gets deducted out of the final payment to the preferred stockholders so that the preferred stockholders do not end up better off than the common stockholders.

5. More specifically, while the full contingent payments in the scenarios represented in the table were paid out resulting in only the timing disparity described in footnote 4, this is of course not always the case. If the full amount of the contingent payments were not paid out, the preferred stockholders would do considerably better under the hybrid approach than the conversion approach because they would receive more than their pro-rata share on an as-converted to

common stock basis.

6. The relevant provision of the NVCA documents reads: “In the event of a Deemed Liquidation Event pursuant to Subsection 2.3.1(a)(i), if any portion of the consideration payable to the stockholders of the Corporation is placed into escrow and/or is payable to the stockholders of the Corporation subject to contingencies, the Merger Agreement shall provide that (a) the portion of such consideration that is not placed in escrow and not subject to any contingencies (the “Initial Consideration”) shall be allocated among the holders of capital stock of the Corporation in accordance with Subsections 2.1 and 2.2 as if the Initial Consideration were the only consideration payable in connection with such Deemed Liquidation Event and (b) any additional consideration which becomes payable to the stockholders of the Corporation upon release from escrow or satisfaction of contingencies shall be allocated among the holders of capital stock of the Corporation in accordance with Subsections 2.1 and 2.2 after taking into account the previous payment of the Initial Consideration as part of the same transaction.”

7. The specific language in the commentary reads: “This section includes two alternative escrow provisions – one that allocates an acquisition escrow pro rata among all stockholders and one that allocates the escrow in a manner that ensures that the Preferred Stock holders always receive their liquidation preference, even if some or all of the escrow is forfeited. We believe the former alternative is the most common way of handling this issue in a merger agreement.”