What you need to know about liquidation preferences

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In the world of investment, the term "liquidation preference" (or sometimes known as the waterfall) holds significant importance for both investors and founders as ultimately it sets out an order of priority about who gets a "return" back first.

When it comes to the distribution of proceeds during events like liquidation, winding up, or the sale of a company, class(es) of shares held by investors often enjoy a preferred right over ordinary shares. This preferred right is commonly known as "liquidation preference" meaning the preferred shares get a first bite of the cherry.

Preferred shares, held by investors are entitled to receive a certain multiple of their initial investment before any other class of shares can participate in the distribution of available proceeds. Typically, this multiple is set at one times the investors initial investment, but in some cases, it may be set at two times or even higher, depending on the circumstances (for example down round scenarios or where the company has underperformed and failed to raise its next round). After the preferred shares have received their initial investment back, they may or may not have further rights to participate in the remaining proceeds alongside other classes of shares. If they do have such rights, they are referred to as "participating" shares, and if not, they are termed "non-participating" shares.

For example, let's say a company raises £10 million in a Series A round of funding. The investors negotiate a 1x non-participating liquidation preference, which means that in the event of a liquidation or sale of the company, the investors will be paid back their original investment of £10 million before any other shareholders receive any proceeds. If there is any money left over after the investors are paid back, the remaining proceeds will be distributed to the holders of the other shares.

For founders (and the other existing shareholders), it is more favourable if investors' shares are "non-participating" as this is purely downside protection. This is because investors will need to convert (or be deemed to have converted) their preferred shares into ordinary shares, to receive more than their investment amount in an upside scenario. By holding "non-participating" investor shares, investors have downside protection, ensuring that they will at least recover their initial investment if the company's value upon exit is lower than the value at the time of their investment.

However, if the company's value increases over time, investors can exercise their conversion rights (or be deemed to have done so), converting their preferred shares into ordinary shares and participating proportionally in the sale proceeds in accordance with their percentage shareholding instead. Sometimes, this concept is implemented without the need for a formal conversion right. (Please note however that conversion rights are not always compatible with certain tax incentives etc such as EIS).

It is worth noting that where the most senior preferred shares hold a non-participating preference, other less senior preferred shareholders might receive "catch-up rights" so that by the end of the distributions all preferred shareholders have all received their investment back and, potentially, then also caught up the highest price paid per share in the company. As such there is always value in seeing and understanding the liquidation waterfall and asking your investors to model this for you, so you can see how it will work at different exit values.

A non-participating preference means that in our example above, the investors would not participate in the "leftover" amount above their £10m investment unless they instead converted into ordinary shares and effectively collapsed the waterfall.

On the other hand, "participating" investor shares guarantee investors a baseline return, as they receive their initial investment back before any other distribution. Following this, they also get to share in any additional value, participating alongside other shareholders. This "double-dip" mechanism can have a significant financial impact and can will reward investors if the company experiences substantial growth (meaning they get the first bite of the cherry and then more of the punnet!).

Going back to our example above, if the investors negotiated a 1x participating preference, this would mean that the investors would be entitled to receive their original investment amount before any other shareholders receive any proceeds and would then get to participate equally in any upside. In this scenario, the investors would receive £10 million before any other shareholders receive any money from the liquidation event as well as the upside.

It is important for founders to remember that terms agreed in earlier stage investments (i.e., seed and series A) can set a precedent for future investment rounds, so care needs to be taken to ensure all parties appreciate the impact of certain terms (i.e. setting the precedent for a participating preference) as if it is likely future investment rounds will take place into a new class of share that is layered as the top of the existing waterfall.

The choice between "participating" and "non-participating" liquidation preferences is a crucial consideration during negotiations between investors and founders. It directly impacts the distribution of proceeds and influences the alignment of interests between the various shareholders at exit.

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