Priority shares and liquidation preference, the lowdown

By Rita Khoriaty on May 12, 2016

The number and type of shares a founder owns in a startup is a crucial point to think about in the context of venture capital transactions.

Joint stock companies (JSC), which are the most common form of startup companies in Lebanon, may issue two types of shares: common shares and priority (or preferred) shares.

Common shares are usually held by the founders (they are the common shareholders) and priority or preferred shares are held by venture capital investors (called the priority or preferred shareholders).

Priority of preferred shares are a class of shares that have higher claims on the company's assets and profits than do common shares. They enjoy a combination of features or privileges such as the right to receive dividends before common shares, and the right to receive the proceeds of the company's liquidation in priority to common shares.

In some foreign systems preferred shares do not have voting rights (which means the right to vote on decisions to be taken by the company). In Lebanon though, the only shares without voting rights are preferred shares issued by banks in accordance with the Law n.308/2001 relating to 'Bank share issuing and trading, bank bond issuing and bank ownership of real estate'.

Priority shares issued by JSCs are governed in Lebanese law by Article 110 of the Code of Commerce. This defines such shares as 'shares granting to their owners a certain anteriority [priority] either in relation to the receipt of dividends or to the reimbursement of allocated funds or in relation to both prerogatives, or any other material advantage'.

Priority vs preferred

It is worth noting that Article 110 does not use the expression 'preferred shares' but rather the expression 'priority shares'. The word preferred is used by the Lebanese legislator only in the context of Law n.308 in relation to preferred shares that are issued by Lebanese banks and that do not have any voting rights.

In light of the above it is preferable, in the context of venture capital transactions, to use the term adopted by the Code of Commerce [priority shares] rather than the one used by Law n.308 to avoid confusion with the 'preferred shares' issued by banks.

In practice

When it comes to venture capital transactions in Lebanon, the liquidation preference is essentially what makes a priority share privileged or preferred compared to a common share. Simply put, the term

‘liquidation’ means either the process of dissolution of a company, bringing it to an end and redistributing its assets and property to shareholders, or a merger or sale of the company.

The liquidation preference is one of the most important points to negotiate in a term sheet. It explains how the proceeds of a liquidation will actually be distributed among the priority shareholders and the common shareholders,when and if the company is actually liquidated.

The idea is that the priority shareholders will receive the liquidation proceeds before common shareholders.

In terms of liquidation preference rights, there are three categories of priority shares:

1. The straight or non-participating priority shares: in this case, the liquidation proceeds will be distributed to the priority shareholders before and in priority to the common shareholders. Thereafter, the balance of the proceeds (if any) will be distributed to the common shareholders proportionally between them. The priority shareholders will therefore not ‘participate’ with the common shareholders in the distribution of the proceeds’ balance.

2. The fully participating priority shares: in this case, the liquidation proceeds will be distributed to the priority shareholders before and in priority to the common shareholders. Thereafter, the balance of the proceeds (if any) will be distributed among both the priority shareholders and the common shareholders on pro-rata basis. The priority shareholders will therefore ‘participate’ with the common shareholders in the distribution of the proceeds’ balance.

3. The capped or partially participating priority shares: this category of priority shares represents an intermediary approach. The priority shareholders will have the same rights as those described above in relation to the fully participating priority shares. However, their aggregate return shall be capped to a certain amount. When they receive such capped amount, they stop ‘participating’ with the common shareholders in the distribution of the proceeds’ balance.

The first category of priority shares is the most advantageous to the founders. Fully participating priority shares should be avoided and founders should push hard for a non-participating liquidation preference, and eventually settle for a partially participating liquidation preference as a fallback position.

Also, venture capital investors usually negotiate certain multiples of the liquidation preference (for example, a two times multiple or three times multiple). This means that they are entitled to receive a multiple of their original investment (for example two times or three times their original investment) before the common shareholders get anything.

Founders should always try to offer no more than a one times liquidation preference.

To make it easy, let’s take a look at a concrete example: let’s say that you and your cofounder have incorporated a startup and a venture capital investor invests $10 million for one-third of your company, with a two times liquidation preference on a fully participating basis. If your company is sold at $50 million, then:

1. Before you and your cofounder get anything, the venture capital investor will receive two times his aggregate investment amount: 2x$10 million = $20 million.

2. Thereafter, the balance of the sale proceeds ($30 million) shall be distributed among you, your cofounder and the venture capital investor on a pro-rata basis, or proportionally to your respective ownership percentages in the share capital of the company. In other terms, the venture capital investor will 'participate' with you and your cofounder in the distribution of the sale proceeds' balance on pro-rata basis. Therefore:

- The venture capital investor who owns one third of your company will get one third of the sale proceeds' balance: 1/3 of $30 million = $10 million
- You and your cofounder will get two thirds of the sale proceeds' balance since you own two thirds of the company: 2/3 of $30 million = $20 million.

This means that the investor will receive in total $20 million + $10 million = $30 million out of the sale proceeds, although he only owns one third of the company, and you and your cofounder will end up receiving $20 million, despite the fact that you own two thirds of the company.

Had the above liquidation preference not been applied, and had the distribution of the sale proceeds been effected on the basis of the shareholders' respective ownership percentages in the share capital of the company, the venture capital investor would have only received one third of the sale proceeds - one third of $50 million = $16.67 million (instead of $30 million), and you and your cofounder would have received two thirds of the sale proceeds - two thirds of $50 million = $33.33 million (instead of $20 million).

Based on the above, and before you agree to any liquidation preference in a term sheet, it is of utmost importance that you get your venture capital investor to run demos and simulations showing you precisely how much you would receive based on various liquidation preferences/multiples/sale prices

scenarios.

RITA KHORIATY

Rita is a lawyer member of the Beirut Bar Association, specialized in civil law and corporate law. She advises several startups in venture capital transactions. Rita holds a Ph. D. in Law from Paris 2 Assas University and is also a lecturer of civil law at the Faculty of Law and Political Sciences of Saint Joseph University.