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# The New Normal: A Primer on Liquidation Preference – Part II: The Investor Way

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In Part I of this three-part primer on liquidation preferences, we covered the why's and wherefores of the liquidation preference concept, and the ins and outs of the entrepreneur's choice in preferences, "non-participating" preferred (see here: The New Normal: A Primer on Liquidation Preferences - Part I: The Basics). In this Part II we'll look at the investor's choice in liquidation preferences, "participating" preferred. Participating preferred is likely where the venture market is heading as it cools, so while entrepreneurs may not like participating preferred, they should know about it, including ways to dial it back.

**Gotcha: Participating Preferred**

*The Participation Double-Dip.* To get a handle on participating preferred (and why entrepreneurs think of it as double-dipping), let's go back to Fact Pattern 1 from Part I, where VCI invested $1 million for 1/3 ownership stake with common holding the other 2/3s. As per the earlier analysis, in an exit where VCI holds non-participating preferred it can choose to receive either the first $1 million of the exit proceeds *or* 1/3 of the total exit proceeds. It gets one or the other payout – but not both. So, assuming exit proceeds of $3 million, either choice will give VCI $1 million of those proceeds, leaving $2 million for the holders of common stock. If the exit proceeds are above $3 million, VCI will always pass on its $1 million preference in favor of the 1/3 of the total proceeds option.

Now let's look at what happens if VCI holds straight participating preferred. On the same facts, VCI will receive the first $1 million of exit proceeds *plus* 1/3 of the remaining $2 million of exit proceeds. So, in the case of $3 million of exit proceeds, VCI will now get $1 million – it's preference share – plus $666,667 representing its pro rata share (1/3) of the $2 million remaining after it collects its $1 million preference. That leaves just $1,333,333 for the holders of common stock. Participation cost the common $666,667. Ouch.

*Participation: The Bark and the Bite.* The concept of participation – of investors double-dipping in the pot-of-gold at the end of the exit rainbow – riles most entrepreneurs. That's understandable, if not sensitive to the investor perspective. One key point, though: participation is not much of a factor in deals at either end of the startup success spectrum. In a busted deal (think say four of every 10 venture-backed startups), the exit proceeds generally don't cover the investors' base liquidation preference. In a home-run deal (think say one or two of every 10 venture-backed startups) the double-dip will make very little difference, in terms of what the entrepreneurs ultimately receive with and without participation.

Back to Fact Pattern 1. We saw that with exit proceeds of $3 million and non-participating preferred, VCI got $1 million and the common got $2 million. With participation, VCI gets $1,666,667 and the common got $1,333,333. So, participation netted VC1 $666,667, and cost the common $666,667. Now, the thing is, you can put in any number for the exit proceeds (well, any number above $1 million –below that VC1 gets it all in either case) and the dollar cost to the common of VCI having participating preferred is $666,667.

Now I am the last person to suggest that $666,667 is not real money, particularly in a "sideways" deal, where the exit proceeds are fair to middling, but well short of home run territory. Still, as the exit proceeds climb towards 10x territory, $666,667 will amount to more of a rounding error than an unjust double-dip. For example, at a $30 million exit – which generates roughly a 10x return for VCI – the common share of the proceeds with participation is $19,333,333, and without $20,000,000. Real money, but not likely to materially cramp entrepreneurial post-exit planning.

(A quick digression. While I think the double-dipping description of participating preferred is fair enough, putting myself in investor shoes I can make an argument for participation that passes the blush test. To wit, the idea is that if a deal works at all for the entrepreneur, in the sense of generating positive financial returns at the exit, it should generate some positive return, even if also modest, for the investors.)

**Recap**

It's been a few years since most entrepreneurs have had to think much about liquidation preferences. Non-participation has been market for some time now. In the post-pandemic world, though, you can be pretty confident we'll be seeing participating preferred making a comeback.

Next time we'll explore some of the nuances of participation preferences, including some compromises, a (fortunately very rare) double-down, and a subtle but important wrinkle.

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