MEMORANDUM

POST-COVID-19
THE PITFALLS OF VENTURE CAPITAL FUNDING

The lockdown caused by the Covid-19 crisis and the related economic slowdown have severely impacted a plethora of companies and, in particular, start-ups whose working capital is often less than that of long-established companies.

As a result, many promising companies are now "drying up" and urgently need to find sources of external funding.

This is obviously not the idyllic scenario to raise funds, however, the sustainability of these companies requires that new blood be injected.

Venture Capital ("VC") funds will certainly see investment opportunities. However, not under any conditions as the current crisis is an additional risk factor.

Among the many mechanisms available, we will discuss the so-called *Preferential Liquidation Mechanism* clause in more detail below.

1. What is a preferential liquidation clause?

This is a right that generally (i) applies to the class of preference shares issued to the VC, (ii) when there are funds to be distributed to shareholders in the event of a *Liquidity Event*, and (iii) allows the VC to receive funds before any other shareholder not pledged this prerogative.

In short, this clause applies the "*last in first out*" principle and allows the VC to recover the amount it has invested (or sometimes more if the VC has requested the application of a multiple or minimum return) in priority to any other shareholder. It is therefore intended to protect the VC against possible future poor results of the company to which it has committed funds.

However, this name is partly inaccurate and even misleading, as its scope is broader than its name suggests. Indeed, it applies both to so-called "classic" liquidations (i.e. a liquidation whether or not it is loss-making, voluntary or initiated by third parties), and to cases of "deemed liquidation", which usually includes a transfer of shares by shareholders or a sale of all or a substantial part of the company's assets. Whenever funds are available for distribution to shareholders, preferential liquidation applies. Therefore, a preferential liquidation clause is equivalent to an agreement between the shareholders and the VC on how the funds will be distributed in these two scenarios, the worst case (a deficit liquidation) or the best case (an exit in the form of a sale of shares to a third party).

2. What is the interest of such a preferential liquidation clause for the VC?

Investing in the capital of a company, particularly in start-ups or scale-ups, is undoubtedly a substantial risk. Moreover, these classic risks are exacerbated by the current crisis and uncertain future prospects.

It is obviously in the interest of a VC to have a stake in the capital. In the event of the company's success, this participation will enable them to participate in that success. In practice, however, the preferential liquidation mechanism has been developed, allowing VC's to be, in addition to their capacity as shareholders, creditors of the company, whose related priority undoubtedly represents a more enviable position than that of a mere shareholder. This change in practice has therefore enabled VC's to obtain a hybrid status combining certain advantages inherent in debt financing, while retaining the prerogatives of a capital investment. It thus allows VC's to participate in any *upside of the* company, while being (better) protected than other shareholders against any *downside*.

These clauses were also created by practice in order to correct a problem inherent in venture capital, namely the disparity in cost price which exists in particular between the founders who subscribed the shares at their nominal value and the VC's who had to pay a higher price per share since it was based on a theoretical valuation of the company.

3. Should a preferential liquidation be seen as an unfair clause?

First of all, it should be noted that this type of clause is by no means a panacea for VC's against the risks associated with a capital investment. In the event of insolvency, there is often nothing to distribute to shareholders. Preferential liquidation mechanisms give the VC a priority, sometimes in vain. Therefore, VC's will often justify the need for this type of clause by emphasizing the fact that they make significant investments in companies that are, for the most part, still controlled by their founders. A preferential liquidation mechanism is therefore often considered a *sine qua non* for access to the funds of a VC.

4. What about financial conditions?

Usually, preferential liquidation mechanisms have two key elements: (i) the amount of the preferential dividend/liquidation bonus and, (ii) the participation, if any, in the distributions of the balance remaining after the payment of the dividend/liquidation bonus. As noted above, the preferential liquidation mechanism is designed to give the VC the opportunity to recover the amount it has invested (or a multiple thereof or a minimum return) before any other shareholder in the event of a Liquidity Event.

5. Cumulative (*Participating*) vs. Non-Cumulative (*Non-Participating*)

(i) Non-cumulative

In the case of a non-cumulative preferential liquidation mechanism, the VC will not share in the balance of proceeds remaining after payment of its preferential share. With this type of mechanism, the maximum return of the VC is already known in advance, so that the VC may lose interest in the company once this result is established.

In order to further align the interests of the shareholders and the VC, the VC can be given the opportunity to convert its preference shares into ordinary shares that share in the full profit in proportion to the other shareholders. In this type of transaction, the VC will have the choice of either (i) exercising the preferential liquidation mechanism or, (ii) converting its preferential shares into equivalent common shares and thereby receiving a proportion of the proceeds of the sale *pro rata* to its "new common equity interest". The conversion rates for the preferred shares to common shares are generally 1 to 1, however, the terms and conditions of the various agreements should be read carefully to avoid unpleasant surprises at the time of conversion.

(ii) Cumulative

Contrary to the non-cumulative clauses, these will allow the VC, after having been reimbursed the amount of its investment in priority over the other investors or shareholders, to receive an additional distribution in the remaining proceeds, in proportion to its participation in the capital. Such a mechanism is sometimes called a "double dip" because the VC shares in the profits twice. When assessing the desirability of such a mechanism, the VC must take into account future capital rounds. If the company needs to raise more funding in the future, new investors will tend to request a similar mechanism which may cause the mechanism to lose its relevance.

6. What does this mean for your company?

Preferential liquidation mechanisms are usual in the context of investments by VC's. However, they are not required by all VC funds or in all transactions.

(i) From the perspective of the VC

It is essential to bear in mind that obtaining very or even too favourable liquidation conditions may *ultimately* prove to be a Pyrrhic victory, for two reasons. Firstly, if the clause is extremely advantageous for the VC, it can be a source of demotivation for the company's founders and employees. Indeed, if the common shares only participate when the company reaches an exceptionally high valuation, the founders and employees may not have sufficient economic motivation to continue to develop the company. In addition, if the company needs additional financing in the future, any new investor will likely want to have preferential liquidation terms at least equivalent to those of the original investor and will expect its liquidation rights to take precedence over those of the investor in the previous round.

(ii) From the point of view of the founders

It is essential to understand the drastic effects, in addition to the misalignment of interests between the different shareholders of the company, depending on their capacity (founders or investors) that this type of clause may have. A preferential liquidation (or the multiplication of these during various capital raising) can, in a scenario pushed to the extreme, reduce the value of the founders' shares in case of an exit. Particular care should be taken when a founder negotiates this type of clause with a VC.

For example, in 2018, when Paddy Power Betfair acquired the New York company FanDuel for around $465 million, the cumulative effect of the various preferential liquidation mechanisms to investors in different rounds of financing meant that the founders did not receive a single dollar from this sale.

It is therefore of crucial importance to be accompanied when drafting and negotiating the legal documentation relating to the entry into the capital of any scholarly investor.

Our Corporate/M&A team is at your disposal to accompany you in this decisive operation in the life of your company but also to watch over your interests.

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