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Legal & investment issues facing startups and emerging tech companies

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What Happened to the 1x Liquidation Preference?

In a presentation at the MIT Enterprises Forum Venture Lab at One Union Square in Seattle last month, titled "Financing a Start-up in a Downturn," Andy Sack of the Founder's Co-op and Michelle Goldberg of Ignition tracked trends in startup financing, and how first round deal terms have changed over the past year.

In addition to compression in valuation ranges and toughening of anti-dilution ratchets, Sack and Goldberg reported that the typical first round liquidation preference had moved now to 3x, from the 1x of a year ago and what would normally be typical. Moreover, preferred is now typically participating.

Similar trends (not first round specific) are logged in a Fenwick & West report on trends in VC financings in the San Francisco Bay Area.

The simple explanation for multiple liquidation preferences, I suppose, is that the economic depression gives funds the upper hand when negotiating investment terms with startups. (I won't suggest that the compressions in valuation come from the same place; presumably it makes sense to not overpay when we may have seen the end of the ponzi valuation era and it may not be possible to flip companies in the same way. For more in that vein, see my "What, No Exit" post.)

But is it really in anyone's interest, investor or insider, fund or founder, to run up the liquidation preference multiples?

Fred Wilson argues strongly, and persuasively, that multiple x liquidation preferences and participation are destructive in early round financings (and, by implication, that companies simply shouldn't accept investments on such terms).

I found Fred's thoughts in his recent post, "The Three Terms You Must Have In A Venture Investment." Although he believes a liquidation preference is one of the three essential investment terms, in a fascinating thread of comments and replies, Fred expresses serious concerns with abuses of the liquidation preference concept. Here's a brief excerpt from his replies to the stream of comments:

> "The multiple liquidation preference is particularly damaging to the capital structure and should only be used in the late stages of a deal when a transaction is imminent . . . The participating preferred . . . is also something that isn't ideal either and should only be used when the valuation is ahead of where the company is at the time of investment. And participating preferreds should be capped."

For the record, my clients who have closed preferred stock deals this year have, so far, not given more than 1x liquidation preferences, but a few have given participation rights where one supposes they may not have a year ago. Then again, most of my clients are doing inside rounds right now. Many are planning to get through this year by generating as much revenue as possible, putting off additional financings, even at the expense of sacrificing some opportunity to scale more quickly.

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