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Liquidation preference: Get your basics right

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THE progressive liberalisation of the foreign investment regime has provided a major boost to private equity and venture capital investments in Indian companies. With the advent of more sophisticated players in the private equity and venture capital arena, the deal terms also tend to get more complicated and sophisticated.

Many of the terms that are commonly employed in deals by these private equity players in other jurisdictions, may pose significant challenges in the Indian regulatory environment. In the context of deal terms and documentation, investor rights, and particularly provision for liquidation preference has always been an area of much debate and negotiation.

So what is liquidation preference? Liquidation preference is typically defined as the right of the investor (usually holding preference shares), to receive its investment amount plus certain agreed percentage of the proceeds in the event of a 'liquidation' of the company, in preference over the other shareholders. Contrary to a common perception equating 'liquidation' to 'winding up', 'liquidation event' is typically defined to include not only winding up of the company but also any 'liquidity event', which could include a sale of shares or substantial assets, an acquisition or merger of the company or in some cases even a 'non-qualified' IPO.

However, since the returns are typically expected to be higher in case of a 'liquidity event', as compared to a winding up of the company, in certain deals, 'liquidation event' and 'liquidity event' are dealt with separately. In this article, reference to 'liquidation' of a company includes a liquidity event.

Liquidation preference entitles the investor to a certain agreed return upon occurrence of a liquidation event, which is usually computed as a 'multiple' of the amount invested. For instance, the liquidation preference can range from '1x' (that is an amount equal to the investment amount) to '3x' (that is an amount equal to three times the investment amount) or in certain instances even more. During negotiations, many a times this becomes a hotly negotiated issue since while the promoters and existing shareholders would want the investor's liquidation preference with a low multiple, the investor who is generally coming in at a higher valuation than others would ask for a higher multiple.

Broadly, there are two types of liquidation preference (i) non participating liquidation preference and (ii) participating liquidation preference. Under non-participating liquidation preference, the preference holder will be entitled to receive his predetermined returns (as discussed above), but shall not be entitled to receive any portion of the surplus proceeds to be distributed to the equity shareholders. On the other hand, under participating liquidation preference, the investor, after receiving his pre-determined returns, shall also be entitled to participate (whether fully or to a limited extent) along with the equity shareholders in the distribution of the surplus proceeds. With respect to enforceability of such liquidation preference right, under Section 85 of the Companies Act, 1956, preference shares are entitled to preference upon liquidation of the company. However, equity shareholders have not been specifically provided with such rights under the Act. The general view is that in private companies, a liquidation preference waterfall can be created amongst the equity shareholders, as the specific provisions under the Act which deal with different types of share capital are not applicable to private companies.

This would amount to creation of a class of equity shares with differential rights, and should be enforceable if the provisions are incorporated in the Articles of Association of the company. However, in cases of public companies, creation of a differential class of equity shares would require compliance with Companies (Issue of Share Capital with Differential

Voting Rights) Rules, 2001, and may not be feasible.

Also, the law is unclear as to whether the liquidation preference in case of preference shares, can have a participating right as highlighted above, over and above the preference capital in the company. One view is that as long as the shareholders of a company agree to such preferred distribution and the same is captured in the terms of the preference shares and in the articles of the Company, then such provisions should be binding on the Company and its shareholders. However, the provisions of the Act does not specifically state whether the liquidator would be bound to respect such right inter se between the shareholders at the time of winding up of the company.

Apart from compliance with the Act and applicable foreign exchange laws, when structuring a liquidation preference clause, it is important to ensure that the investment document sets out the liquidation preference clause in an un-ambiguous manner, particularly in the context of seniority of different classes of shares. Albeit, legally speaking, enforceability of such provisions under law remains untested in Indian courts and hence the investors should look at adequately securing other forms of exits and protections for their investments through put options, drag and tag along rights, etc. over and above the liquidation preference.