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Series A Term Sheet
Liquidation Preference: Downside Protection or Boost Returns

This is the second article in our Series A Term Sheet series, where we walk through the National Venture Capital Association's ("NVCA") model term sheet, explain key terms and highlight what matters most for founders. Today, we focus on liquidation preference, a critical provision that determines who gets paid first and how much when a company is acquired or shutdown.

What is a Liquidation Preference?

A liquidation preference is a right attached to preferred stock that dictates how proceeds are distributed in a merger and acquisition ("M&A") exit or company shutdown. This provision, in all its different forms, ensures that investors recoup their investment before common stockholders (typically the founders and team) receive any proceeds.

This provides some "downside protection" for investors when there is an unfavorable exit or shut down by ensuring that investors are paid first. Thus, if investors purchase $1 million of preferred stock at a post-money valuation of $10 million and the company is later sold for only $1 million, the liquidation preference ensures that all those proceeds are paid to the preferred stockholders, and none to the common stockholders.

Founders and investors debate, however, whether the liquidation preference should also "boost returns" for investors when there is a favorable exit, meaning when the exit valuation is higher (sometimes much higher) than the valuation at the time of the investment. This choice between downside protection and boosting returns lies behind the three different types of liquidation preference with one providing only downside protection (non-participating preferred), one providing downside protection and boosting returns (participating preferred), and the third a compromise between the first two (capped participating preferred).

Types of Liquidation Preference

Below we list the three primary types of liquidation preferences:

1. **Non-Participating Preferred (Founder-Friendly)**: The investor receives the greater of (a) an amount equal to their original investment (or some multiple thereof) and (b) an amount equal to their prorata portion of the proceeds together with common stockholders.

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2. **Participating Preferred (Investor-Friendly)**: The investor (a) first receives an amount equal to their original investment (or some multiple thereof), and (b) then receives their prorata portion of the remaining proceeds together common stockholders.

3. **Capped Participating Preferred (Hybrid Approach)**: The investor (a) first receives an amount equal to their original investment (or some multiple thereof), and (b) then receives their pro rata portion of the remaining proceeds, but only until a total return cap is reached (e.g., 2x–3x of the original investment). The investor may always convert to common to receive their full pro rata share if it exceeds the capped return.

Liquidation Preference Clause from the NVCA Term Sheet

Here is what the three different liquidation preference options look like in the NVCA model term sheet:

In the event of any liquidation, dissolution or winding up of the Company, the proceeds shall be paid as follows:

[**Alternative 1 (non-participating Preferred Stock)**: First pay [__ times] the Original Purchase Price [plus [accrued and] declared and unpaid dividends] on each share of Series A Preferred (or, if greater, the amount that the Series A Preferred would receive on an as-converted basis). The balance of any proceeds shall be distributed pro rata to holders of Common Stock.]

[**Alternative 2 (full participating Preferred Stock):** First pay [___ times] the Original Purchase Price [plus accrued and declared and unpaid dividends] on each share of Series A Preferred. Thereafter, the Series A Preferred participates with the Common Stock pro rata on an as-converted basis.]

[**Alternative 3 (cap on Preferred Stock participation rights)**: First pay [___ times] the Original Purchase Price [plus accrued and declared and unpaid dividends] on each share of Series A Preferred. Thereafter, Series A Preferred participates with Common Stock pro rata on an as-converted basis until the holders of Series A Preferred receive an aggregate of [_____] times the Original Purchase Price (including the amount paid pursuant to the preceding sentence).]

Example: Liquidation Preference in Action

Assume a startup raises $1 million in a Series A round at a post-money valuation of $10 million. The investor owns 10% of the company, and the founders and team collectively own the other 90%. The company is later acquired for $15 million.

Here's how different liquidation preferences would distribute the proceeds:

1x Non-Participating Preferred (Founder-Friendly)

- Investor converts to common and receives $1.5 million (10% of $15 million)

- Founders and team receive $13.5 million

1x Participating Preferred (Investor-Friendly)

- Investor receives $1 million return of capital + $1.4 million (10% of remaining $14 million) = $2.4 million
- Founders and team receive $12.6 million

2x Capped Participating Preferred (Hybrid)

- Investor receives $1 million return of capital + $1 million (pro rata share up to 2x cap) = $2 million
- Founders and team receive $13 million

Summary Table: Liquidation Preference Outcomes

Liquidation Preference Type	Investor Receives	Founders and Team Receive
1x Non-Participating (Founder-Friendly)	$1.5M	$13.5M
1x Participating (Investor-Friendly)	$2.4M	$12.6M
2x Capped Participating (Hybrid)	$2.0M	$13.0M

The Liquidation Preference Stack

Liquidation preferences are renegotiated at each financing round. The two most common stack structures are:

- **Last Money In, First Money Out**: Later-round investors are paid first.
- **Pari Passu Sharing**: All preferred shareholders share proceeds pro rata regardless of investment round.

Carta Data and Market Practice

According to Carta data (as of 2023), the most common liquidation preference in Series A financings is **1x non-participating preferred**. This structure was used in approximately 70% of all Carta-tracked deals and is generally viewed as founder-friendly. Participating preferred and capped participating preferred appear less frequently and are more common in investor-favorable environments or later-stage rounds.

Key Takeaways

- **1x non-participating preferred** is most common and founder-friendly.
- **Participating Preferred** allows investors to "double dip" by receiving both a return of capital and a share of common proceeds.
- **Capped Participation** offers a compromise by limiting the investor's total return.
- **Liquidation stacks** vary by deal but can materially affect founder and team outcomes.

Founders and team should advocate for 1x non-participating preferred and be thoughtful about how liquidation preferences evolve in later rounds.

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