gelden dat de crediteuren die hierdoor getroffen worden voldoende beschermd worden en hun de mogelijkheid wordt geboden gehoord te worden. Wederom kan de identiteit van deze crediteuren informatie opleveren voor de rechter-commissaris over de toekomstperspectieven van de onderneming. Ook andere beslissingen van de curator die voor machtiging door de rechter-commissaris in aanmerking komen leveren momenten op waarop de rechter informatie kan krijgen over de toekomstperspectieven van de onderneming. Thans is reeds de machtiging van de rechter-commissaris vereist voor het voortzetten van de onderneming.[42] Hieraan kan een recht voor crediteuren gekoppeld worden om gehoord te worden en voor de rechter om ambtshalve crediteuren te kunnen horen. Hetzelfde zou ook moeten gelden voor het aangaan van een boedelkrediet, met name indien voor de nakoming door de curator zekerheid wordt gesteld. De rechter-commissaris zou curator en financier moeten horen omtrent hun beweegredenen.

Ook bij de aanvraag van een insolventieprocedure kunnen procedurele voorschriften ervoor zorgen dat de rechter zich actiever kan opstellen bij het inwinnen van informatie over de toekomstperspectieven van de onderneming. Het huidige art. 215 Fw bepaalt dat bij het verlenen van de voorlopige surseance de rechtbank beveelt dat naast de schuldenaar de bekende schuldeisers worden opgeroepen om, alvorens te beslissen over de definitieve verlening van de voorlopige surseance, te worden gehoord op het verzoekschrift tot surseance. In faillissement wordt slechts de mogelijkheid van oproeping van de schuldenaar geboden. Aannemende dat de toekomstige Insolventiewet zal kiezen voor één ingang tot verschillende procedures, is het te overwegen om de mogelijkheid op te nemen om de belangrijkste crediteuren op te roepen teneinde gehoord te worden over de aanvraag. Daartoe zou als vereiste gesteld kunnen worden dat, indien het gaat om een aanvraag van de debiteur zelf, deze bij zijn verzoekschrift een lijst met de belangrijkste crediteuren voegt. Voorts zou van de debiteur vereist kunnen worden bij zijn verzoek aan te geven of er sprake is geweest van een poging tot informele herstructurering en welke crediteuren daarbij betrokken zijn geweest. Op deze manier is de rechtbank snel op de hoogte van de identiteit van de bij een informele herstructurering betrokken crediteuren en kan zij deze, indien nodig, in een vroeg stadium horen.

Het verdient opmerking dat de hiervoor genoemde suggesties, die slechts geringe aanpassingen van de insolventieprocedure vereisen, vooral waarde zullen hebben in die gevallen waarin een informele herstructurering is mislukt en het verdere verloop van de insolventieprocedure vooralsnog onduidelijk is, maar er desalniettemin door de curator pogingen tot behoud van de onderneming worden ondernomen. Met name in deze gevallen speelt het risico dat ondernemingen nodeloos lang in faillissement worden voortgezet en is er behoefte aan mechanismen die bijdragen aan het tijdig staken van de onderneming. Door echter slechts mogelijkheden, en geen plichten, voor interventie van crediteuren en het horen van crediteuren in te bouwen, wordt er geen onnodige procedurele ballast gecreëerd in die zaken waarin reeds bij de aanvang van de procedure het verdere verloop duidelijk is. Bovendien zal het belang van interventiemogelijkheden voor crediteuren vooral afhangen van de wijze waarop in een toekomstige insolventiewet het moratorium in samenhang met mogelijkheden van gebruik, verbruik en vervreemding van goederen tijdens de procedure wordt uitgewerkt.

6. Tot slot

Concluderend kan gesteld worden dat er geen duidelijke noodzaak is voor het invoeren van een *debtor-oriented* insolventieprocedure ten aanzien van vennootschappen waarvan de kapitaalstructuur gekenmerkt wordt door geconcentreerd schuldkapitaal. Dit betekent dat in landen – zoals Nederland – waar het grootste deel van de vennootschappen dat gebruikmaakt van formele insolventieprocedures gerekend kan worden tot het prototype van de MKB-onderneming, wijzigingen van insolventiewetgevingen die beogen ondernemingen meer reorganisatiemogelijkheden te bieden niet ten koste moeten gaan van de positieve bijdrage die geconcentreerde kapitaalverschaffers aan de herstructurering van ondernemingen buiten faillissement kunnen leveren. Omgekeerd staat echter niet vast dat *debtor-oriented* systemen zonder meer negatief uitpakken voor kleinere ondernemingen. Een dergelijke conclusie sluit uit dat dergelijke procedures mogelijkheden voor interventie kunnen verschaffen aan partijen die essentiële informatie aan faillissementsrechters kunnen verschaffen over de toekomstperspectieven van de onderneming.

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42. Art. 98 Fw.

Mr. N. Christopoulos

Liquidation Preference in Private Equity

Or: 'Why simply driving a hard bargain doesn't necessarily mean getting the best deal'

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1. Introduction

1.1. Over the last few years, financial institutions have been more risk conscious when investing new money in start-up and emerging growth companies (such as technology, IT, telecom, life- or bio-sciences companies). As a consequence, many Venture Capital[1] funds have now accumulated large amounts of money, which are yet to be invested.

1. The terms Venture Capital and Private Equity are in practice often used to refer to identical situations, whereas formally, depending on the maturity of a company, a distinction should be made between venture capital and private equity investments. Venture Capital is generally used in connection with the financing of start-up or early stage companies, which generally have no track record yet. The risk involved with such an investment is very high, as it is highly uncertain whether the company will make any profits and consequently whether the investor will be able to make a (successful) return on his investment. Private Equity is used for any investment in private (i.e. non-listed) companies (typically mid-stage type companies) requiring new financing for further development or expansion of activities. Private Equity therefore includes venture capital. See: H.L. Kaemingk, 'Venture Capital en Private Equity – Financiering door participatiemaatschappijen', *O&F* 2002, nr. 50, p. 31-40. Where in this memorandum reference is made to Venture Capital, in most cases and *mutatis mutandis*, it can be extended to Private Equity situations as well.

At the same time, many companies that have survived the difficult last few years now require new (growth) financing. Where banks are (usually) reluctant to extend financing without receiving some (asset backed) security in return, Venture Capital investors are targeting opportunities that offer appropriate risk return profiles. Even though it would seem logical for an investor to negotiate the highest possible preferences in order to compensate for the risks involved in investing in such companies, this article will illustrate why merely stipulating a huge liquidation preference will not necessarily result in getting the highest return on investment.

1.2. In this article, I will first explain what a liquidation preference is (par. 2), followed by an overview of the main types of liquidation preference (par. 3 and 4), thus providing sufficient background to understand the various issues which may come into play when negotiating a liquidation preference: the overhang problem (par. 5) and the enforceability of a liquidation preference in combination with a drag-along right (par. 6). A quick reference to what is market practice is given in par. 7. Some practical tips for drafting a liquidation preference clause in the investment agreement are provided in par. 8. The relation between the articles of association and the investment agreement is discussed in par. 9. Finally, par. 10 contains the conclusion.

2. Definition

2.1. A liquidation preference is generally defined as the right of a holder of preferred stock[2] to receive a certain percentage or amount of the proceeds upon a 'liquidation' of the business of the company, in preference over the holders of common stock.[3] Typically, the main features of the arrangement will be reflected in the investment agreement and (to the extent possible (see par. 9)) in the company's articles of association.

2.2. A 'liquidation' within the context of a liquidation preference usually includes the following situations:

- a sale of (a substantial part or all) shares or assets of the company;
- a liquidation, dissolution or winding up of the company[4]; and
- a merger, reorganisation or other acquisition type transaction in which control of the company or control of (substantially) all of its assets is transferred.[5]

2.3. The liquidation preference will usually include actual bankruptcy situations. It should be noted, however, that if a suspension of payments (*surseance van betaling*) or a bankruptcy (*faillissement*) has been declared, the mandatory rules of (Dutch) bankruptcy law will apply and any distributions pursuant to the investment agreement will as a rule only be made after settlement of any creditor's claims in accordance with the prevailing priority rules. In general, there will not be much left to divide between the shareholders after such settlement.[6] A liquidation event is, therefore, usually intended to apply to situations in which there *are* (sufficient) funds to distribute, such as upon a profitable sale of all shares in the company. A 'liquidation' which generates sufficient proceeds is, therefore, sometimes also referred to as a 'deemed liquidation'.[7]

3. Different forms of liquidation preference; the liquidation multiple

3.1. Basically, there are two general types of liquidation preferences: (i) the non-participating preferred and (ii) the participating preferred liquidation preference.[8] They will be further discussed in par. 4.1 and par. 4.2 respectively.

3.2. Each of the above types of liquidation preferences makes use of the so-called liquidation 'multiple'. The liquidation multiple may range from '1X' or 'single liquidation preference' (upon liquidation, the investor receives an amount which is equal to the amount invested) up to as much as '5X' (the investor receives five times that amount). The existing shareholders and the company will prefer that the investor receives a low multiple (or none at all), while an investor is likely to seek a high multiple, although, as will be explained in par. 3.3 and par. 5 below, this is not always advisable.

Example: in case of a 1X liquidation preference and a pre-money value[9] of EUR 10 million (which we assume to be the amount invested by the (common) shareholders), where the investment amount is EUR 5 million, and where we assume that the company is sold for EUR 15 million, then the proceeds of that sale are divided as follows: the investor receives 5 million (1X the amount invested), being 1/3 of the sale proceeds, and the common shareholders receive the remaining EUR 10 million, or 2/3 of the proceeds.

Example: in case of a 3X liquidation preference, using the same figures as above, the proceeds are divided as follows: the investor receives all of the 15 million (3 times the amount invested), and the common shareholders receive nothing.

3.3. The second example shows that the 3X liquidation preference benefits the investor only. With a 3X liquidation preference, for the common shareholders to receive a return equal to the EUR 10 million invested by them, the company should have been sold for EUR 25 million. For the common shareholders to receive 2/3 of all sale proceeds, the compa-

2. Venture capitalists and other investors in private companies typically receive preferred stock (= preferred shares) in return for their investment. Preferred stock has various preferences over common stock. These preferences can include *inter alia* liquidation preferences, dividend rights, redemption rights, conversion rights, anti-dilution rights and voting rights.
3. M. Zimmerman, D.N. Bernstein & B. Burditt, 'Venture capital: "Hello old friend" – closing a round with your existing investors', *TechNews* June 2002, Vol. 6, Issue 5 (Legal Eagle).
4. Please note that the English term 'liquidation' is sometimes mistakenly translated into the Dutch word '*liquidatie*'. In English, however, a liquidation can be either voluntary (then, the English words dissolution and winding-up (in Dutch: '*ontbinding, vereffening of liquidatie*') should be used) or involuntary (then, the English word bankruptcy (in Dutch: *faillissement*) should be used).
5. I merely note that upon an IPO, any outstanding preferred shares will (almost always) convert to common shares, thereby effectively eliminating any liquidation preference(s). An IPO is therefore generally not included as a liquidation event, but is dealt with in a separate provision of the investment agreement, which will contain a (specific) conversion ratio, protecting the investor's interests.
6. A liquidation outside of a bankruptcy situation (in Dutch: '*vereffening*') will also have to comply with the mandatory provisions of the Dutch Civil Code (see article 2:23b), containing virtually the same order of distribution: creditor's claims (preferred and regular) first, and if any proceeds remain, these may be distributed to the shareholders.
7. R. Marphatia, 'Negotiating the terms of a venture capital financing: key concepts for entrepreneurs', *Forum Focus*TM, Spring 2003.
8. M. Porter, '*Venture Capital Basics – Everything You Ever Wanted to Know About Venture Capital Financing Terms*', 12 April 2003: http://www.connect-utah.com/article.asp?r=221&page=3&iid=22&sid=1&bsc=.
9. Whereas the pre-money valuation is the valuation immediately *prior* to the investment having been made, the post-money valuation is the valuation immediately *after* the investment has been made. Generally, an investor will want the pre-money value of a potential investee company to be set as low as possible, since it will enable him to purchase a bigger percentage of the company for the same investment amount. By way of contrast, the founders and other existing shareholders of the company benefit from a higher pre-money valuation because they are then able to retain a greater percentage of the company.

ny would have to be sold for EUR 45 million. As a general rule, a high liquidation preference will push management (usually holding common shares) to strive for a high sale price. If, however, the multiple is set so high, that obtaining a sale price at which the common shareholders would receive anything has become highly unrealistic, then the high multiple will not secure the investors' return, but is more likely to induce the so-called overhang problem (see par. 5).

4. Non-participating and participating liquidation preference

4.1. As indicated in par. 3.1, two types of liquidation preference are generally distinguished: the non-participating and the participating liquidation preference. If an investor has a '*non-participating*' preference, then he will only receive his predetermined multiple upon liquidation and will not be entitled to receive any (part) of the remaining proceeds distributed to the common shareholders.

4.2. The limitation of the non-participating preference is exactly why an investor usually insists on receiving not only an initial return on his investment, but also a percentage of the then remaining proceeds equal to his pro-rata ownership of all of the shares which are entitled to participate in the distribution: a *participating* liquidation preference. This generally means that after the non-participating liquidation preference amount has been calculated, the preferred shares owned by the investor are treated (for financial entitlement purposes) as if they had been converted into common shares. Pro rata to the amount of 'common' shares they hold upon such conversion, the investor will then also share in the remaining proceeds (the so-called 'double dip').[10]

4.3. Within the framework of a participating liquidation preference, two types of shares can be distinguished: (i) *partially* participating preferred shares (where the remaining pro rata participation is limited (or 'capped') to e.g. two or three times the investment amount) and (ii) *fully* participating preferred shares (where the remaining pro rata participation is not limited). As will become apparent from the examples below, an investor will generally try to negotiate fully participating preference shares.

Example: *partially participating*: if the investment amount is EUR 5 million and we assume that the company is sold for EUR 25 million, where the investor has negotiated a 1X liquidation preference with a maximum pro rata participating factor of 2X (the 'partial' character of this participation is created by the pro rata 'cap' or 'ceiling'), then the proceeds of that sale are divided as follows: the investor receives EUR 5 million for his 1X liquidation preference. Because he owns 5 million of the 15 million combined common and preferred shares, the investor is furthermore entitled to receive 1/3 of the remaining EUR 20 million, until he has received another EUR 5 million pursuant to his partial (maximised) pro rata participation. The investor receives 10 million (40% of the proceeds) and the common shareholders receive 15 million (60% of the proceeds).

Example: *fully participating*: the same facts as above, except that the investor has a fully participating liquidation preference. Then the proceeds are divided as follows: the investor receives his 1X liquidation preference (EUR 5 million), and participates for 1/3 in the remaining EUR 20 million (i.e. EUR 6.67 million). The investor receives a total of EUR 11.67 million (being 46.7% of the proceeds) and the common shareholders receive EUR 13.33 million (or 53.3% of the proceeds).

4.4. The second example clearly shows that fully participating liquidation rights (in this scenario) add EUR 1.67 million to the investor's proceeds as compared to a situation where the investor has (only) a partially participating liquidation right. Since any (full) participation right for the investor will always cause the common shareholders to receive less, the founders and other large common shareholders may negotiate – as a condition for granting (full) participation rights to the investor – the right to receive a portion of the proceeds equal to the amount received by the investor either on a per share or on an aggregate basis (e.g. a 1X liquidation amount) before the investor participates in the distribution of any remaining proceeds. This is the so-called 'catch-up right' or 'out of turn payment' (see also par. 5.2-ii).

5. The overhang problem

5.1. A liquidation preference should be carefully considered. If the liquidation preference exceeds a fair approximation of what the company is worth, the common stock (or any options exercisable for common stock) – usually held by employees and management – becomes worthless upon the occurrence of a liquidation event. As a result, the employees and management holding shares in the company may lose their motivation and drive to increase the value of the business, which is exactly what an investor will want to avoid, since they are the ones who are in a front position to make the company a successful investment. This is sometimes referred to as the 'overhang problem'.[11] In a situation where the company has to raise subsequent money in a down round[12], this problem may even be exacerbated as the lower valuation, inherent to down rounds, will cause the common shareholders to be severely diluted.[13]

5.2. In order to retain effective incentives for both management and other employees, the overhang problem may be solved as follows:

(i) before entering into a new financing: by converting all existing preferred stock into common stock, thereby effectively eliminating the preference associated with previous financing rounds and giving all shareholders equal rights before the new financing round is entered into. Each shareholder should at least be given the opportunity to participate in the new round; sometimes, shareholders who do

10. The common shareholders and the company may try to negotiate that the double dip will fall away when the exit value exceeds a certain predetermined level.
11. J. Gworek & J. Steele, *Motivating Employees in the Face of Substantial Liquidation Preferences: The Overhang Problem*, see: http://www.mitforumcambridge.org/archive/r_may03.html#sponsor, K. Laws, '*Snidely Whiplash And The Liquidation Preference*', 12 September 2003, see: http://www.ventureblog.com/articles/indiv/2003/000185.html, and Brad Feld, *Term Sheet: Liquidation Preference*, dated 4 January 2005; see: http://www.feld.com/blog/archives/2005/01/term_sheet_liqu.html.
12. In a down round, the company is valued lower than in the previous financing round, and as a consequence the price paid per share is also lower. In a 'flat round', the company is valued the same as in the previous round and hence the price per share is identical.
13. A company will often require several rounds of financing, involving multiple investors, to achieve profitability. Each new equity financing dilutes the ownership of earlier investors (especially in down rounds). An anti-dilution provision aims to minimise or prevent altogether the dilutive effect of a new issue of shares for a specific investor or class of (preferred) shares. See: M. Porter, *loco citato* (footnote 8).

not participate are contractually obliged to convert their preferred stock into common stock[14];

(ii) by modifying the existing liquidation preference so that the holders of common stock participate earlier in the distribution of proceeds upon the sale of the company, e.g. by splitting any proceeds on a fixed percentage basis, or by putting in a separate new layer in the liquidation preference (cf. par. 4.4 on the 'catch-up right'), causing the common shareholders and the preferred shareholders to share a part of the proceeds on an equal or other reasonable basis, before the remainder of the proceeds is paid out pursuant to the existing liquidation preference;

(iii) by creating a so-called 'bonus pool' or 'carve-out pool'. This arrangement leaves in place the liquidation preference but forces the company to reserve a certain part of the company's share capital for distribution (of options on the reserved shares) to management and employees. General negotiation items are: the size of the pool (usually a percentage of the total number of outstanding shares, which may generally vary from 2% to 20%) and the conditions under which it will operate (e.g. that the pool will only be used when a certain minimum sale price is not reached as a consequence whereof the common shareholders would receive nothing after the preferred shareholders have received their liquidation preference);

(iv) by granting *preferred* stock options to employees. Although not standard, this approach enables employees to participate alongside the investors in any proceeds upon the sale of the company. One drawback to preferred stock options is that the strike (= exercise) price may have to be set at a price much higher than would have been the case for the common stock options (since the preferred stock options are worth more due to their preference), thus undermining the desired effect and the perceived value to the option holder;

(v) by offering management (and employees) a predetermined transaction bonus: if the company is sold (for a certain price), the – cash[15] – transaction bonus aims to make up for the fact that the shares held by management (and employees) will be (almost) worthless after the investor's preference has been paid out. A similar solution is setting up a valuation hurdle at which the preference of the investor will fall away. In setting (and formulating) the hurdle, it is then advisable not to use a single hurdle, such as 'If the company is sold for more than EUR 100 million, the preference will fall away', because if then the company is sold for only EUR 95 million, the objective to sell high (i.e. over EUR 100 million) has in fact almost (but not entirely) been reached, but management (and employees) will still not benefit at all. As with offering a cash transaction bonus, this (undesired) side-effect can be prevented by using sliding scales (e.g. sale price between EUR 90 and 100 million) with corresponding (sliding) preference reductions.[16]

6. Combining the liquidation preference with a drag-along

6.1. The liquidation preference is usually combined with a drag along right. The drag along right gives the investor the right to force all or a substantial part of the other shareholders to (vote in favour of a decision to) sell their shares along with the investor.[17]

6.2. Pursuant to Dutch law, under certain circumstances, the exercise by an investor of the rights granted in a drag along clause may not always be permitted.[18] Let's assume that the proceeds of a specific sale are exactly equal to the contractually agreed liquidation preference of the investor. This will leave nothing to distribute between the other (common) shareholders. An exercise of the drag along right under these circumstances would mean that the investor who is dragging the other shareholders can in fact force them to accept a zero return on their shares. If, furthermore, one may reasonably argue that another purchaser (who may be willing to pay a higher purchase price) can possibly be found if some extra time is taken, it may become difficult for an investor to refuse to wait any longer (e.g. because of a close of his investment fund), and a court may very well find such use of a drag along right to be contrary to the principles of reasonableness and fairness that shareholders have to uphold amongst themselves (*'redelijkheid en billijkheid binnen de vennootschap', article 2:8 Dutch Civil Code*)[19] or even deem this to be an abuse of power (*'misbruik van bevoegdheid', article 3:13 Dutch Civil Code*). Obviously, as with any situation, the circumstances may very well justify the enforcement by an investor of a drag-along clause, but he should realise that – as with the overhang problem – this is yet another incentive to negotiate a realistic and (reasonably) fair liquidation preference.

6.3. At present, there is no relevant Dutch case law regarding the issue of enforceability of a liquidation preference. This could mean that the exercise of any liquidation preference is treated with sufficient care by private equity investors already and hence the court is never called upon to render a judgment on this issue, but it could also mean that in situations where an investment has 'gone bad', and the enforcement of a liquidation preference may turn out to be unreasonable on the other parties involved, the investor simply does not enforce his rights following from the liquidation preference, but merely uses his preferred position as a bargaining tool. If an investment has been successful, obviously, the enforcement of a liquidation preference is unlikely to be(come) an issue.

6.4. Possible ways to contractually prevent the unreasonable effects which may arise from the use of a liquidation preference (in combination with a drag-along) may be:

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14. This is the so-called 'pay-to-play', sometimes also referred to as the 'put up or shut up' principle. In short, it means that if an existing shareholder is not willing to participate in a new round, he not only risks being severely diluted due to the issue of new (preferred) shares or even have his preferred shares converted, but may also – as a consequence of such conversion – (be caused to) lose several contractually agreed important arrangements, such as board seats, approval rights, anti-dilution protection, pre-emptive rights and even (portions of) the liquidation preference. The use of the pay-to-play principle will therefore usually sufficiently incentivise most investors to participate in a new round. The Fish & Richardson surveys (§ 7 of this article) show that the pay-to play provisions have become increasingly popular.
15. The bonus should be in cash and not in (new options on) shares, since after the investor's preference will have been paid, there will be not much left in certain scenario's; see: Colin Blaydon & Michael Horvath, 'Liquidation Preferences: What You May Not Know', *Venture Capital Journal*, March 2002.
16. See: Colin Blaydon & Michael Horvath, *loco citato* (see footnote 15).
17. The drag along right may also apply to a decision to sell all or a substantial part of the *assets* of the company. A drag along right will enable the investor to exercise greater control over the timing of a liquidation event (and consequently of his exit strategy). The drag along right is granted either by signing a voting agreement (i.e. to vote in favour of a sale when such a sale is triggered by one or more shareholder(s)) or by granting an irrevocable proxy to the relevant investor(s) to vote on their shares in favour of a liquidity event.
18. P.E. Wateler, 'Venture-capitalcontracten', *AA* 2002, 51, p. 131.
19. Some authors refer to article 6:2 jo. article 6:248 of the Dutch Civil Code in connection herewith. See: M.A.F.J. Schoolmeesters, 'Actieve bemoeienis door een participatiemaatschappij: mogelijkheden en risico's', *V&O* 2004, p. 54-55. Article 2:8, however, is a *lex specialis* of article 6:2 (jo. article 6:248) of the Dutch Civil Code, and deals specifically with the principles of reasonableness and fairness within the context of a corporate entity.

(i) to create a catch-up right (as explained in par. 4.4 above) so that the common shareholders will also receive a (reasonable) fixed minimum return,

(ii) to expressly subject the exercise of the drag along right to the prior consent of the managing board or supervisory board of the company, or

(iii) to limit the right of an investor to invoke a drag along right (in combination with a liquidation event) to scenarios in which the liquidation event generates an amount which is at least equal to or exceeds a certain predetermined minimum sale price.

7. Market Survey results: recent developments

7.1. Pursuant to (recent) market (venture capital) surveys[20], practically all financings (in which the most recent round is at least *pari passu* with the previous rounds) contain a liquidation preference arrangement. As to the liquidation multiples, between 80% and 90% (of all transactions reviewed) contain a 1X liquidation preference, around 10% a 1X up to 2X liquidation preference and only a very small percentage of all transactions show an even higher liquidation preference. Furthermore, around 75% of all deals contain a *participating* liquidation preference.[21]

7.2. The major conclusion of the Fish & Richardson survey is that the so-called single or 1X liquidation preference seems to (have) be(come) the new standard. The Fish & Richardson researchers note a continued dominance of 'company-friendly' terms. One could say that the relative demise of multiple liquidation preferences (as compared to several years ago) is reflective of the more upbeat investment climate for venture capital. Furthermore, it is likely that the increased competition for deals has also resulted in the (further) loosening of terms as compared to the last few years.

8. Drafting the investment agreement

8.1. Obviously, a liquidation preference arrangement contained in any investment agreement will be different and to a large extent depend on the factual circumstances. There are, however, several basic elements which should always be carefully considered:

(i) *the definition of Liquidity Events*: when does the liquidation preference have to apply? Only in case of a sale of shares or in case of a sale of assets as well? Upon the transfer of what percentage of shares/voting rights/assets does it need to apply? Explicitly state the events that should qualify as a Liquidation or Liquidity Event;

(ii) when reference is made to any *purchase price*, make sure that it is clear what the purchase price is (i.e. state the amount) or how exactly it can be calculated. The same applies to dividends. If a calculation formula is included (which is advisable), make sure to also include one or several examples which clearly (and comprehensibly) illustrate how this formula works[22];

(iii) if the preferred shareholders are granted the right to (partially/fully) participate[23] in any remaining proceeds on an as-if converted basis, the *method of conversion* (together with the conversion ratio, i.e. the ratio at which preferred shares are converted into common shares, which usually is 1:1) should be made clear, and should be included either in the liquidation preference clause itself or in a separate conversion clause[24];

(iv) any *other deal-specific elements* that are negotiated between the parties (e.g. any catch-up rights, limitations to the extent of participation after the initial preference, specific language added to solve any overhang problems, etc.).

9. Relation with the articles of association

9.1. Under Dutch law, the articles of association generally do not contain the entire liquidation preference clauses which are included in the investment agreement, since that is not always possible (e.g. due to mandatory law) or desirable (e.g. if the investor does not want his liquidation preference to be publicly known).[25] The articles of association normally only contain arrangements for a 'strict' liquidation scenario (i.e. bankruptcy or winding-up). For the 'strict' liquidation scenario, several 'steps' are usually included pursuant to which any proceeds remaining (after distribution to creditors) shall be distributed to the (preferred) shareholders.[26] As indicated, in a winding-up or bankruptcy scenario, there will probably not be much left to distribute to shareholders. That is why sometimes the articles of association also contain a clause stating that in case of a 'liquidity event', the proceeds will be distributed in the same manner as in case of a 'strict' liquidation scenario as stated in the articles of association.[27] In any scenario, the investor should insist that the articles of association contain a provision indicating who is entitled to receive any (remaining) proceeds. I note

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20. The US-based law firm Fish & Richardson publishes a quarterly Multimarket Venture Capital Survey which is based on a review of publicly reported venture capital financings that have taken place in five regions of the USA (Mid-Atlantic, NY Metro, New England, Southwest and Southern California regions of the US). The latest survey relates to financings that took place during the first quarter of 2005. See: http://www.fr.com/news/articledetail.cfm?articleid=462. Similar numbers appear from other surveys, e.g. the Fenwick & West LLP/Shiboleth survey for the Israel region: http://www.fenwick.com/docstore/VCSurvey/Israel_VC_Survey_H2_2004.pdf.
21. Of which around one-third is capped, which cap then ranges anywhere from 2 to 7 times the original issue price.
22. This is especially in the interest of the Company, since it will generally not have the time to wait for the shareholders to agree upon the interpretation of an unclear formula, when it is in dire need of new capital. But it can also be in the interest of any non-preferred or minor shareholders, who generally will not be in a position to force their interpretation of the liquidation formula on any major (preferred) shareholders.
23. For some samples of such specific language, I refer to the article from Brad Feld, *loco citato* (see footnote 11). Other, more detailed examples of Investment Agreement provisions can be found on various places on the internet, e.g. on: http://vls.law.villanova.edu/prof/cohen/web/BusinessAcquisitions/BusAcq-F03/Preferred-LiquidationPref-10-09.doc en http://vls.law.villanova.edu/prof/cohen/web/BusinessAcquisitions/BusAcq-F05/Preferred-CumulativeDivandLiquid-10-28.doc.
24. The articles of association have to explicitly allow or provide for a conversion (*Asser-Maeijer 2-III*, nr. 194 and R.W.Th. Norbruis, *Conversie van aandelen in andersoortige aandelen*, Monografieën Van der Heijden Instituut, nr. 43, p. 147, Deventer: Kluwer 1993). If the common shares and the preferred shares do not have the same nominal value, maintaining a 1:1 conversion ratio will trigger an obligatory amendment of the articles of association and (in case of a capital reduction) the creditor's protection procedure of article 2:209 of the Dutch Civil Code (see: R.W.Th. Norbruis, *loco citato*, p. 153).
25. Cf. R.W.Th. Norbruis, *loco citato*, p. 156 (see footnote 24).
26. E.g. first, any unpaid preferred (cumulative) dividends are paid on the preferred shares. Then, from the balance remaining and insofar as possible, each preferred shareholder shall receive an amount equal to the nominal value increased with any share premium on those shares. Finally, the balance then remaining shall be distributed pro rata to all shareholders. Obviously, this is merely an example. Many other 'steps' can be included for different classes of shares.
27. The 'liquidity event' in the articles of association, is then defined to have substantially the same meaning as the definition of liquidity event contained in the investment agreement, i.e. also including a regular sale scenario. The enforceability of such a provision from the articles will be restricted by the rules of mandatory law (see par. 2.3). As for the enforceability of these provisions when contained in the investment agreement, see par. 9.2).

that it is not allowed to subject the entitlement to any proceeds to a decision of the managing board, a specific class of shareholders or any other party for that matter.[28]

9.2. Obviously, in the investment agreement, the full liquidation preference is set forth. In addition, the investment agreement generally contains a provision that states that in case of any conflict between the terms of the articles of association and the investment agreement, the provisions of the investment agreement will prevail. Some investors, however, prefer to (try to) include the full liquidation preference in the articles of association, since they feel that these may take preference over the terms of the investment agreement.[29] Apart from the fact that – as indicated – this is not always possible or even desirable, it can be argued that it is not even necessary: the parties will clearly always have (had) the intention to effectuate the liquidation preference in conformity with the provisions of the investment agreement. The contractual confirmation of the parties that they explicitly intend the investment agreement to prevail over the articles of association, should generally be sufficient to secure any investor's (liquidation preference) interests.

10. Conclusion

'Merely driving a hard bargain does not necessarily mean getting the best deal'.

As we have seen, when negotiating a liquidation preference, it is not always advisable for an investor to try to negotiate the maximum liquidation preference. In his negotiations, the investor should also pay due attention to the interests of the other stakeholders involved, such as management and employees. Denying the fact that they have to be kept stimulated to perform, may in practice leave the investor with no return on investment, while based on the terms of the investment agreement, he would have expected to receive the maximum liquidation preference. When contemplating exercising his rights under the investment agreement, the investor should finally respect the (reasonable) rights of other stakeholders, even though the investment agreement does not force him to, because it may very well be that dragging one's co-shareholders to a zero return will not be allowed by the court.

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28. *Asser-Maeijer 2-III*, nr. 566.
29. This is an entire discussion in itself, but as a general rule, one can say that it is not so that the articles of association will always prevail over the terms of a shareholders agreement (such as the investment agreement). Especially where the agreement is sufficiently detailed and provided that it contains a voting arrangement stating that the parties intend to let the agreement prevail over the articles of association, a court will generally be inclined to follow the provisions of the agreement, unless e.g. the result thereof would be unreasonably burdensome on one or more parties.

Actualiteiten

Besluit actuele waarde

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Vooruitlopend op de Wet van 16 juli 2005 (*Stb.* 2005, 377) waarmee titel 9 Boek 2 BW is aangepast, is het Besluit actuele waarde van 14 juni 2005 (*Stb.* 2005, 321) bekend gemaakt. Dit Besluit is de opvolger van het Besluit waardering activa. Het Besluit actuele waarde is van toepassing op boekjaren die na 31 december 2004 zijn aangevangen en geldt voor rechtspersonen die de jaarrekeningregels van titel 9 Boek 2 BW toepassen.

Waarderingsbegrippen

Het Besluit actuele waarde dat alleen geldt als tegen actuele waarde wordt gewaardeerd, hanteert als waarderingsbegrippen *vervangingswaarde* (kort weergegeven: het bedrag dat nodig is om een vervangend actief met een in economisch opzicht gelijke betekenis te verkrijgen of te vervaardigen), *bedrijfswaarde* (contante waarde van de aan een actief of groep activa toe te rekenen geschatte toekomstige kasstromen bij de bedrijfsuitoefening), *opbrengstwaarde* (het bedrag waartegen een actief maximaal kan worden verkocht, onder aftrek van nog te maken kosten) en *marktwaarde* (het bedrag waartegen actief kan worden verhandeld of een passief kan worden afgewikkeld tussen terzake goed geïnformeerde tot een transactie bereid zijnde partijen die onafhankelijk van elkaar zijn).

Toepassingsystematiek

De systematiek in de toepassing van deze begrippen is als volgt:

- materiële vaste activa, niet zijnde beleggingen, worden tegen vervangingswaarde gewaardeerd dan wel indien lager, de bedrijfswaarde. Bij een besluit tot voorgenomen verkoop geldt de opbrengstwaarde;
- onder bezwarende titel verkregen immateriële vaste activa die bij verkrijging geactiveerd zijn tegen kostprijs en waarvoor een liquide markt bestaat, worden tegen vervangingswaarde gewaardeerd dan wel indien lager, de bedrijfswaarde. Bij een besluit tot voorgenomen verkoop geldt de opbrengstwaarde. Zelfvervaardigde immateriële vaste activa en om niet verkregen immateriële vaste activa worden niet geactiveerd en dus ook niet gewaardeerd;
- voorraden, niet zijnde agrarisch, worden gewaardeerd tegen vervangingswaarde dan wel indien lager de opbrengstwaarde;
- agrarische voorraden worden gewaardeerd tegen opbrengstwaarde;
- activa, zijnde niet financiële instrumenten, die opbrengsten kunnen opleveren als belegging, worden gewaardeerd tegen marktwaarde;
- financiële instrumenten voorzover in het Besluit niet uitgezonderd, worden gewaardeerd tegen marktwaarde, mits deze betrouwbaar kan worden vastgesteld;
- passiva worden tegen marktwaarde gewaardeerd mits zij (i) financiële instrumenten zijn en deel uitmaken van de handelsportefeuille, (ii) derivaten zijn, of (iii) verzekeringsverplichtingen dan wel pensioenverplichtingen betreffen;
- activa en passiva waarvan de risico's afgedekt zijn of zijn geweest, kunnen met inbegrip van de waardeveranderingen op de afgedekte posities worden gewaardeerd.

Met derivaten (afgeleide financiële instrumenten) worden gelijk gesteld grondstofcontracten die elk der partijen recht geven op afwikkeling in contanten of ander financieel instrument tenzij het contract werd aangegaan en duurzaam dient ten behoeve van de verwachte inkoop-, verkoop- of gebruiksbehoeften, bij het aangaan van het contract voor dit doel werd bestemd, en aangenomen mag worden dat de afwikkeling door levering zal plaatsvinden.

De financiële instrumenten die niet tegen actuele waarde mogen worden gewaardeerd, betreffen onder meer financiële instrumenten, niet zijnde derivaten[1], die tot het

1. Derivaten maken deel uit van de handelsportefeuille.