Motivating Employees in the Face of Substantial Liquidation Preferences

The Overhang Problem

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Many venture-backed telecommunications companies have taken in substantial amounts of venture capital money and now find that the liquidation preference associated with this venture money exceeds any fair approximation of what the company is worth under any reasonable liquidity event scenario. As a result, the common stock (or options exercisable for common stock) held by employees is essentially worthless. This problem may be exacerbated in the event the company raises subsequent money in a down round because the lower valuation placed on the company in a down round (and, hence, the lower price paid per share by the investors in the down round) has the effect of severely diluting the ownership percentages of the employee common stockholders and option holders and often results in their stock and options being "underwater". These companies now face the challenge of how to motivate their employees in such a situation.

While in this down economy one might assume that cash salaries alone are sufficient, this approach may prove to be shortsighted. Employees that joined a startup or emerging telecommunications company likely did so in part because of the allure of equity, and the opportunity to be a part owner. Once these employees come to the realization that their ownership stake is worthless, the motivation derived from the equity component of their compensation may be eroded. Although few may leave immediately given the current economic climate, employees may nonetheless be on the lookout for more promising opportunities. As the economy improves, a more promising opportunity may be too good to pass up. If key personnel are lost, the value of the franchise, and the potential return to investors, can be negatively impacted.

In response to this problem, consideration should be given to ways in which employees can regain a meaningful equity stake in the company. While many of the methods for achieving this objective are relatively nascent in practice and still evolving in structure, there are several options that telecommunications and other similarly situated companies should consider with their advisors.

Example of such a Liquidation Preference

A simple example of how liquidation preferences work helps illustrate the problem. Assume Telco Inc. raised $80,000,000 in a series of venture capital financings through the sale of Series A, B, C and D preferred stock, and that these investors now own 80% of the Telco Inc., leaving the common stockholders with 20% in the aggregate. The preferred stock investors benefit from a liquidation preference that establishes a priority system for the distribution of proceeds from a sale of the business. In a typical case, this liquidation preference would provide that the investors as a group get their money back (or in some cases a multiple of their money back), often plus a dividend, before any money is paid to the common stockholders. The liquidation preference might also provide that, once the investors receive their original investment amount, they then share in the remaining proceeds with the common stockholders in proportion to their ownership percentages. Under this scenario, if Telco Inc. were sold for $100,000,000 in cash, assuming no dividend, the investors would pocket $96,000,000 (or $80,000,000 plus 80% of the remaining $20,000,000), and the common stockholders would receive $4,000,000 in the aggregate. As the size of the acquisition declines toward $80,000,000, the proceeds that would go to the common stockholders approaches zero, and at any number at or below $80,000,000, the investors would take the entire proceeds and the common stockholders would get nothing.

Range of Solutions

Grant of New Options. Following a down round of financing, the stock and options of employees may be rendered “underwater”. In other words, based on the valuation of the company in the down round, such stock or options are essentially worthless because the price paid or to be paid in the form of the exercise price of the options is well above the current value of such stock. In addition, the effect of a down round is often to severely dilute the percentage ownership of existing stockholders and option holders. A solution is to make new stock and option grants which, with a lower purchase or exercise price, provide the employees and management with greater potential for future value as well as increasing their ownership stake in the company. Expanding on the above hypothetical for purposes of illustration, option grants could be made to existing employees to increase ownership of the common stock from 20% to 25%.

Simply making new stock or option grants does not, of course, deal with the issue of a substantial liquidation preference overhang as all of the common stock (no matter how many shares there may be) is subject to this liquidation preference.

Modify the Liquidation Preference of the Preferred To Reduce the Overhang. A couple of approaches have emerged for dealing with the liquidation preference overhang problem. One often favored by new investors seeking to invest in a company that has already received venture funding is to require all existing preferred stock to convert to common stock prior to the new investment. This approach eliminates any and all liquidation preference other than that of the preferred stock sold in the new investment. Expanding on the above hypothetical for purposes of illustration, the Series D investors could have required as a condition precedent to their investment that the Series A, B and C preferred stockholders agree to convert to common stock. This conversion would eliminate the preference associated with the prior rounds of financing and position the common stockholders to participate at a much higher level in the proceeds from the sale. Often, this approach is coupled with the opportunity for the previous investors to participate in the new financing.

Variations of this approach include the requirement that the preferred stock of any previous investors who are not participating in the new financing (with participation usually meaning the purchase of an amount in the new financing at least equal to such investor’s pro rata share based on ownership in the company) be converted to common stock (with the preferred stock of any who do being allowed to remain as preferred stock) and a simple reduction of the liquidation preference of existing classes of preferred stock to an amount that is acceptable to the new investor.

Modify the Liquidation Preference so that Common Stockholders Participate Earlier in the Distribution of Proceeds. Another approach is to modify the existing liquidation preference so that holders of common stock participate earlier in the distribution of proceeds upon a sale of the company. While a standard liquidation preference provides for the preferred stockholders to be paid out in full before any proceeds go to the common stockholders, this is not the necessary outcome. Provision can be made so that proceeds are split between the preferred stockholders and common stockholders on some other basis. One alternative is to provide for the proceeds to be split on some percentage basis. Alternatively, provision can be made to layer into the liquidation preference a return to the common stockholders so that after the preferred stockholders have been paid out a certain portion of the proceeds, the common stockholders then share in the proceeds up to a certain amount, after which the proceeds might then revert to the preferred stockholders.

Create a Bonus Pool. Another approach is to leave the liquidation preference of the preferred stock as is but to establish a "bonus" or "carve-out" pool for distribution to management and employees in the event of the sale of the company. The size of such a pool and the circumstances in which it would operate (i.e., in any sale of the company or only a sale of the company in which the sale price is not sufficiently in excess of the liquidation preference of the preferred stock so as to provide the common stockholders with anything) are matters to be worked out by the company with its advisors. So are the rules regarding participation (i.e., do employees vest in such pool and, once vested, participate even if they are not with the company at the time of sale or is it available only to employees at the time of sale). The structure of such pools may range from a contractual or quasi-contractual commitment on the part of the company to its employees (perhaps in the form of a benefit plan) to a charter amendment establishing a new class of common stock which has participation in the liquidation preference scheme such that appropriate distribution would be made to the holders of such stock in the event of the sale of the company. The holders of such stock would of course be the company's employees who would receive it as either stock or option grants in much the same way as traditional option and stock grants are made.

Preferred Stock Option Plan. Another alternative is for the company to grant preferred stock options to employees. While this is by no means standard, companies are beginning to explore the benefits of this approach which would allow the recipient employees to participate alongside the investors in the proceeds upon the sale of the company. One drawback to preferred stock options is that the exercise price may need to be set at a price that is much higher than would be the case for common stock options, thereby undermining the desired effect and the perceived value to the recipient.

Complexity

All of the above solutions to the liquidation preference overhang problem can have significant implications for the company and its stockholders and can be complicated to correctly implement. None of them should be undertaken without the help of legal counsel and accountants experienced in such matters as potentially serious legal, tax and accounting issues are involved.

For more information on liquidation preferences and the overhang problem, please contact **Jonathan D. Gworek**.