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My Company Sold for $100 Million And I Got Zilch. How Can That Be?

Heidi Roizen answers your questions

Heidi Roizen
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Dear Heidi:

I'm so raging mad right now my fingers can barely work the keyboard. Four years ago, I landed a VP of engineering job at a red-hot startup, for which I was granted options for 2% of the company. I've been toiling away all these years through the ups and downs, setbacks and growth, and multiple rounds of capital. The new capital that came in subsequent to my joining reduced my percentage ownership, but I still had 1% of all outstanding shares even after that. While it hasn't ended up becoming the unicorn I was hoping for, we recently were told that the company was being acquired for $100 million — so at least I thought I was walking away with a cool million bucks. But today, the transaction closed, and I was informed that my options are worth Bupkis! Nada! Zilch! My question, in addition to referring me to a good employment attorney, is, can you explain to me how this could possibly be true?

— Former Millionaire, Dogpatch, SF

Dear Former Millionaire:

I feel your pain. I really do. I've always thought it unfortunate that common practice is to tell employees share amounts and strike prices but not give them all the other numbers needed to help them evaluate what their options will end up being worth. For what it's worth, I encourage all the companies I work with to be more transparent. I guess yours wasn't.

There are probably multiple issues at play here, but I'm going to guess the biggest one is your preference overhang. Let me explain.

When venture capitalists buy equity, they typically do not buy the same shares employees get, which are common shares. They buy preferred shares. You can even guess from the name that these are somehow better. After all, if you were given the option of something *preferred* or something *common*, which would you take? There are all sorts of reasons this is so, including the obligation VCs have to protect the downside of investing the money they get from their Limited Partners — who are often entities like pension funds and school endowments. There are also some advantages to common shareholders by having two classes of stock — for example, this allows the company to price your common stock options at less than what the VCs pay because they have different attributes and, therefore, different values. (You can read more about preferred versus common here.)

The principal benefit of preferred shares for those who own them is that they get their money out first if the company is sold. While common practice is they get the same out that they put in, it is not unheard of for some of that money to carry a multiple, 2x or even more (meaning they might get two times or more their money out first), especially if the company had to raise money at a time when no one wanted to put any in without additional downside protection. Point is, this is the market, and it has been that way for a long time, and there is nothing inherently wrong with these terms. But if you don't know about it, it sucks.

Most employees think that, if they own 1% of a company sold for $100 million, they will get $1 million. But that's not the whole equation. What they will really get is the following:

Sales price minus legal fees minus carve-out minus banker fees minus preferred overhang, then that remainder is divvied up by percent of company-owned. (Whether the preferred stock is participating or not creates a further wrinkle, which you can read about here, but for now, this captures most of what you need.)

The "easiest" way for your 1% to be worth nothing is to have that preferred overhang be a lot of money since all the other things in the equation usually do not end up being more than about 15–20% of the total value being received in the sale.

And often that preferred overhang is a lot. If you raised multiple rounds (***regardless of the valuation of those rounds***) and if you raised more than your company is now being sold for, you will get nothing.

This might be easier to understand by example, so let me paint a hypothetical picture from what you've told me about your situation that would result in your goose egg payout.

Let's say your company raises a $2 million seed round, a $15 million Series A, and then a $50 million Series B. These have standard 1x preferences, meaning they will get their money out first in any sale of the company.

Then the company runs into problems, and no new investors are willing to come in. The board decides to start a sale process since the company is unprofitable and so cannot exist without new capital. But the company only has enough money to cover payroll for 60 days — not enough time to find a buyer and get a sale done. To increase the time they have to find a buyer, the existing investors offer an additional $10 million in a loan, or "bridge note" — but in exchange they will only put that in if they can get a 2x preference, in other words, they will get the first $20 million of any sale proceeds for doing this.

Four more months pass, and the company secures two competing bids to buy the company, the highest being $100 million. So they agree to sell for $100 million. The lawyers and bankers get paid $3 million for their work. Certain key employees were incentivized with a "carve-out " in order to stay through the transaction and make sure it would happen, and they get 10% of the deal, or $10 million. The seed, Series A, and Series B investors get their money back, or $67 million, and the bridge note would be paid $20 million. So, $3 plus $10 plus $67 plus $20 equals $100 million — ***and zero for all common shareholders, including you.***

Again, let me emphasize, this is not inherently unfair. When I raised capital as an entrepreneur about a million years ago, I sold preferred shares too. I even had the preferred overhang number on the wall in my office, to remind me how much money would have to go out the door before I or my team could make a single penny when the company finally got sold. The problem is most companies hide it.

In fact, one of my kids was recently interviewing at a startup and I told her to ask about the preferred overhang — she said the interviewer looked at her like she was asking about his sex life! She didn't get a callback.

Sadly, while I can explain to you why you have ended up in this predicament, I can't tell you how to fix it, at least not for this at-bat. However, I hope this explanation helps you go into your next endeavor with eyes open and hopefully with better data. You can actually find out the preference stack for many companies by simply Googling "how much money has company X raised?" While that won't give you any indication if the money was raised at other than a 1x, it will at least give you the ballpark preference overhang number. Even better, just ask what it is. But, be prepared for offended glares and raised eyebrows!

Wishing you better outcomes in your future,

— Heidi

Send me questions at HelpmeHeidi@threshold.vc