



## ***New Tools for Valuing Private Company Interests In Family Law Matters***

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### **Introduction**

Valuing private company equity interests can be challenging even in the best of circumstances. The problems compound if the company is young, a technology firm, or if the valuation is required in a divorce setting. Typically private company interests can include direct ownership interests (shares, member or partnership interests) in private companies, stock options and warrants, carried interests, or diversified investments through venture funds. Because the prices (or values) of such interests cannot readily be obtained from quotes or active trading, estimating their value at the relevant date requires other tools. Fortunately, such tools continue to develop in other areas and can be applied in family law settings.

Relatively recent developments in federal tax law have brought increased focus on the valuation of such interests--and provide a potential new source of information for hard-to-value privately held assets in divorce proceedings. The IRS issued regulations under IRC 409(A) in late 2005 that result in unfavorable income tax treatment for employee stock options under certain circumstances. To avoid adverse tax consequences under 409(A), most private companies that use stock options as an element of compensation routinely have their common stock interests appraised independently on roughly an annual cycle. Many private companies began obtaining "409(A) valuations as early as 2006. More recently,

changes in GAAP<sup>1</sup> accounting for stock option expense (SFAS 123 (R)) have created an additional reason for private companies to obtain independent appraisals of their common stock.

### **Valuing Stock Options in Divorce**

A significant body of case law exists regarding the treatment of employee stock options<sup>2</sup> in divorce proceedings in California. Specific rules have been developed to determine, in the case of unvested options, the portion of a stock option that is community property and divisible between the parties.<sup>3</sup> Depending on the specific

<sup>1</sup> Generally Accepted Accounting Principles is the required basis for SEC registrants. Most companies of even modest size comply with GAAP as it is a fairly universal accounting "language".

<sup>2</sup> Options are typically granted to an employee subject to vesting and other requirements. Grants are most frequently made upon commencement of employment and a single grant may cover a large number of shares.

<sup>3</sup> California law typically views vested options as marital property and uses a time rule, such as from *Marriage of Nelson*, which computes the number of shares of unvested options that are considered marital property as the ratio of the share of the vesting period that occurred before the separation date. (For example, if an option vests over four years and the separation occurs three years into vesting, 75% of remaining unvested shares would be considered marital property in divorce. *In re Marriage of Nelson* 177 Cal. App. Ed 150, 222 Cal. Rptr. 790 (1986). See Donald A. Glenn, "Valuation and Division of Marital Property," *Litigation Services Handbook*, 4<sup>th</sup> Ed., Weil, Frank Hughes, and Wagner, eds. (2007), Chapter 32.

facts, a court may take into consideration whether the option was intended to incent future performance or to reward past performance, but these rules focus on what *portion* of the shares subject to the option are marital property, *not* the fair market value of those shares as part of the community assets.

One method of avoiding the complexity of valuing private company stock options owned by the community is to divide the rights to the financial benefits arising from stock options between the parties, in which case no valuation of the options or the underlying stock is required. While this may solve the immediate need to value the property, it may simply postpone conflicts when the options are exercised or other events force a pricing of the asset. Particularly in the case of private company stock options, the non-employee spouse normally is not in a position to unilaterally exercise options granted to the employed ex-spouse. More importantly, the employee spouse typically is better informed about the company status and prospects and is therefore in a superior position to decide when it is the right time to exercise the options.

Even more problematic is the case involving executive options. Such options typically are offered as an incentive for the executive to create significant value for the firm. By reducing the future financial benefits accruing to him/her, theoretically the executive has reduced incentives to perform. Additionally, the ex-spouse may unfairly continue to benefit from the performance of the executive long after the separation occurs. Moreover, in the case where options are converted to voting stock, the ex-spouse could end up with a potentially inappropriate continuing voice in the operation of the company.

If the stock options are not simply divided numerically between the parties, then it becomes necessary to determine their dollar value in order to allocate the proper value to each party in the overall property settlement. In the case of publicly traded options, one approach taken by some courts has been to determine the intrinsic value of the options at the date of separation, i.e., the difference between the current price and the strike price of the option. Another approach is to compute the value of the option as of the date of separation using an option pricing model, such as a Black-Scholes model, or to use option prices quoted in the market when available. From a valuation perspective, the option pricing approach provides a more realistic estimate of the value of the option at the time of separation.<sup>4</sup>

In the case of private companies, it seldom is possible to find contemporaneous, market prices for either stock options or the underlying stock. Consequently, the methods commonly applied to estimate the value of public company stock options are not applicable. However, independent stock valuations prepared for private companies in response to IRC Section 409(A) and SFAS 123 (R) may represent a valuable source of information to the parties and their counsel to assist them in valuing private company stock and options in connection with marital dissolution and other family law matters.

### **Background on Using 409(A) Valuations**

In 2005, the IRS published regulations under IRC 409(A) in which employee stock options were declared to be a form of deferred

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<sup>4</sup> The value of an option can be expressed as the sum of the “intrinsic” value, which is the difference between the current price and the strike price, and the “time” value, which is the potential future value of the option derived by considering future possible values of the stock.

compensation. The regulations established some significantly adverse tax consequences for the recipients of stock options if the options are granted with exercise prices lower than the fair market value of the underlying stock at the time of grant. This is a problem for a private company since there is no readily available source for determining the value of its' stock at a given point in time. As a result, most private companies have gradually established a practice of obtaining independent valuations of their common stock to support the exercise prices in their employee stock options. These 409(A) valuations typically are performed on an annual basis (more frequently in some cases) and provide a basis for setting stock option exercise prices at or above the stock's fair market value. These valuations provide an independent opinion of a company's total value which is then allocated to different equity claims, including common stock. The 409(A) valuation report typically provides a substantial amount of information about the company, its expected future prospects, and the fair market value of its common stock. This information can be useful in valuing private company equity interests in connection with a marital property settlement.

Assuming a 409(A) valuation report can be obtained<sup>5</sup>, it is likely to contain most, if not all, of the information a valuation expert would need to estimate the fair market value of private equity holdings owned by the community. The reports contain the assumptions used by the company's independent appraiser, and may provide a foundation for estimating the value as of a date pertinent to the divorce proceedings. The

409(A) valuation reports offer evidence from a third party and provide a low-cost starting point for a valuation professional estimate the value of the marital interests.

### **Other Private Equity Assets**

Valuation reports prepared for 409(A) purposes also may provide a good starting point for estimating the value of other private company equity interests such as restricted stock and preferred stock.

Beyond valuing an equity interest in a single private company, the contents of 409 (A) valuation reports can contribute information needed to estimate the value of the portfolio assets held in venture capital funds and other private equity firms that own a portfolios that consist primarily of private company equity securities

### **Conclusions**

When equity interests in private companies represent a potentially significant portion of a community's assets, the parties and the court now have another tool to aid in determining the value of those interests. Access to 409(A) valuation reports is not likely to eliminate the need to engage a valuation expert, since other factors, such as controlling or non-controlling interests and illiquidity still must be addressed. However, it has the potential to provide information regarding the private company that is not otherwise available and therefore should reduce the time and cost required by the valuation expert to reach a conclusion about the value of the private company equity interests.

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<sup>5</sup> Because of the sensitivity of some of the information contained in a valuation report, the company is not likely to be enthusiastic sharing it outside its inner circle. Therefore, it is likely that a subpoena will be required to obtain the valuation report.

**About the authors:**

Bruce Pollock is CEO of Enterprise Valuations, Inc. Ronald Schmidt is a Principal of Finance Scholars Group and a Senior Valuation Expert for Enterprise Valuations. Through Enterprise Valuations, they have performed hundreds of valuations of early stage and venture financed companies for tax compliance (IRC Section 409(A)) and GAAP compliance (SFAS 123(R)). They have extensive experience in valuing complex private equity holdings of companies, investors, and owners. Mr. Pollock holds MBA and JD degrees from U.C. Berkeley and is a member of the California Bar. Dr. Schmidt earned a Ph.D. in economics from the University of Wisconsin, is an Accredited Valuation Analyst, and has served as an expert witness in state, federal, and bankruptcy courts on valuation and damages issues.

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