

Heller Ehrman Client Update, "Common Stock
Valuation Issues Raised by IRC Section 409A
for Private, Venture-Backed Companies"

November 8, 2005

Common Stock Valuation Issues Raised by
Internal Revenue Code Section 409A
for Private, Venture-Backed Companies

New Section 409A of the Internal Revenue Code (the "Code") tightens up the federal tax rules governing deferred compensation and imposes significant tax penalties upon noncompliant deferred compensation arrangements. It also raises important issues as to how private, venture-backed companies value their common stock.

Of particular importance is that Section 409A's expansive definition of deferred compensation includes "discounted" compensatory stock options and stock appreciation rights -- meaning, options and stock appreciation rights having an exercise price that is less than the fair market value ("FMV") of the underlying stock, measured as of the award grant date. This means that Section 409A penalties can apply to discounted stock awards, unless these awards are structured to comply with requirements contained in the statute as to the dates by which such awards must be exercised or expire. Discounted options conforming to historical practices, which vest on a four- or five-year vesting schedule and have a ten-year term, generally would not comply.

This development puts increased pressure on companies to be comfortable that any common stock valuation used with respect to options is thoughtfully determined by persons experienced in valuing early-stage companies and defensible should it later be challenged. The potential costs of a misstep are a 20% tax penalty applied to the employee recipient of a noncomplying award and potential exposure for the company (including under some circumstances its controlling persons) arising as a result of failure to withhold on or report timely income amounts deemed includable with respect to such an award.

Proposed Regulations issued under Section 409A on September 29, 2005 set forth reasonable valuation method presumptions for valuing stock not "readily tradable on an established securities market." These protective presumptions will influence the way in which private company stock valuations are conducted in order to best assure that companies are not inadvertently granting discounted stock awards. Although the Proposed Regulations are not expected to become final until January 2007, and may change before then, the presumptions they establish may (and should) be relied upon currently. They offer start-up companies with an opportunity to establish common stock valuations that will be presumed reasonable (and therefore easier to defend) should the IRS challenge them. At this point, a company disregards these presumptions at the peril of its and its employees' tax positions.

This memorandum summarizes the procedures and other steps that we believe private companies and their boards of directors should take to avail themselves of the new presumptions. We intend the suggestions contained in this memorandum to be practical advice for this interim period in which Section 409A is already effective but in which we have neither final Section 409A regulations on which to rely nor practice experience in interpreting the available Section 409A guidance.

Note that this memorandum does not address the concerns raised by currently outstanding options or stock appreciation rights that were granted with discounted exercise prices. These outstanding awards could be subject to Section 409A, and companies should be working with their tax advisors to determine whether and how to address these concerns. Certain actions that might be taken to resolve concerns raised by these awards must be taken by the end of 2005, so we urge immediate attention to this important issue.

Finally, we note that the concerns raised by Section 409A with respect to discounted equity awards apply specifically to stock options and stock appreciation rights. These same concerns generally do not apply to purchases of restricted stock governed by Code Section 83 (even if the applicable purchase price was at a discount to FMV measured as of the award's grant date). This may influence early-stage companies, particularly those with modest valuations, to prefer to compensate their early employees with restricted stock rather than options.

Valuation Presumptions

The Proposed Regulations provide that, in the case of stock not readily tradable on an established securities market, the FMV of the stock as of a valuation date means a value determined by "a reasonable application of a reasonable valuation method." The determination of reasonableness is made on a facts-and-circumstances basis, viewed from the valuation date.

The Proposed Regulations also provide that a valuation will be presumed reasonable if one of the following two methods¹ is consistently applied to compensatory equity awards issued by the company:

- A valuation by an independent appraiser meeting certain requirements (generally, those applicable to appraisals for charitable donation valuation purposes) that is performed within 12 months of the relevant date, assuming there are no subsequent material developments affecting the valuation since it was performed. We refer to this method as the "*Appraisal Presumption*" and we expect companies that anticipate or should reasonably anticipate that they are within 12 months of an initial public offering or of being acquired to rely almost exclusively on this presumption.
- A reasonable good-faith valuation of "illiquid stock of a start-up corporation" that is supported by a written report taking into account certain standard valuation factors (asset value, present value of future cash flow, market value of similar companies, and any other relevant factors). We expect this method, which we refer to as the "*Illiquid Stock Presumption*," to be relied upon by many early-stage private companies that are eligible to rely on it. To rely on this method, the following conditions must be satisfied:
 - The company does not have a class of equity securities that is traded on an established securities market,
 - The company has conducted a trade or business for less than 10 years,
 - The stock is not subject to any put or call right or obligation of the company or another person to purchase the stock other than a typical right of first refusal or unvested-share repurchase right,

¹ The Proposed Regulations provide for a third presumption, which requires a valuation determined by a formula based on book value, a reasonable multiple of earnings, or some combination, provided that this valuation method is used consistently for the stock for certain other purposes, including non-compensatory purposes like regulatory filings and third-party transactions. We do not believe at this time that this formula-based presumption will be that useful to earlier-stage venture-backed companies to the extent the book value and earning multiples information available with respect to similar companies generally do not provide meaningful data about them.

- The company does not reasonably anticipate that it will undergo a change in control or a public offering of its securities within 12 months following the relevant date to which the valuation applies,
- The valuation is set forth in a written report, and
- Those persons performing the valuation have “significant knowledge and experience or training in performing similar valuations.”

Although practice will continue to evolve on these matters beyond the date in early 2007 in which final Section 409A regulations are expected to be adopted, we anticipate that private companies will most likely proceed as follows with respect to availing themselves of the protection offered by these new presumptions:

Later-Stage Private Companies. Again, we anticipate that later-stage companies (those that reasonably should anticipate going public or being acquired within 12 months from the date for which the valuation determination is needed, or that have been in business for 10 years or more) will largely rely on the Appraisal Presumption and seek independent third-party appraisals conforming to the above requirements, notwithstanding that this will result in increased costs to such companies in administering their equity compensation programs. Companies may continue to rely on such an appraisal for 12 months following the valuation date; however, if the company experiences significant developments during this 12-month period (e.g., a financing, obtaining or losing a significant contract, becoming subject to or resolving significant litigation), we believe the appraisal should be updated.

Third-party appraisals range in cost, starting at around \$10,000 and increasing to the \$40,000 (or higher) range, depending upon the complexity of the company's business (whether it has multiple lines of business), its location (whether the company operates in a single location or globally), and other similar factors affecting the extent of diligence needed by the appraiser and the time required to analyze such diligence. To ensure that a company is relying upon an up-to-date valuation, we would expect companies to either pay for bring-down valuation reports or negotiate for periodic updates (perhaps quarterly) on an ongoing subscription-type basis with the appraisal firm that performs the original valuation.

Early-Stage Private Companies. At this time, we do not anticipate that early-stage start-ups, or other private companies whose boards of directors are reasonably certain will not be acquired or go public within the next year (and that have been in business for less than 10 years), will routinely seek independent third-party valuations, nor do we perceive a need for them to look to the Appraisal Presumption as their primary protection (although it is of course available to them). We do expect that they will seek the protection of the Illiquid Stock Presumption. This appears, in fact, to be the Treasury Department's intent in establishing this presumption. We emphasize, though, that early-stage companies are not required to satisfy the Illiquid Stock Presumption; there may be various ways in which such companies can support reasonable valuation decisions.

The requirements for the Illiquid Stock Presumption outlined above will likely result in increased focus on the procedures undertaken by even a very early-stage company and its board of directors to determine and document a valuation. Specifically, we suggest that early-stage companies approach their valuation procedures and practices as follows:

- Identify one or more members of the board of directors or management who have significant knowledge and experience, or training, in performing such valuations (such individual, a "Valuation Expert") and confirm that any individual tapped to perform this role is willing to act in this capacity and understands his or her responsibilities in doing so. Based on what is available to us in the Proposed Regulations, we believe that a venture capitalist or other investment and financing specialist on the company's board who has substantial experience valuing private companies should qualify as a Valuation Expert. Companies may also find that they have among their management team (e.g., someone in the finance department)

someone with sufficient experience or training on valuation matters to serve as the Valuation Expert.

In the event a company cannot find a qualified (or willing) Valuation Expert internally, it should consider obtaining the ongoing services of an independent valuation expert or firm to assist the company with valuations. Presumably valuation firms will make their expertise available to such companies on a consulting-fee type basis without requiring the issuance of a full-blown valuation report. Also, we would expect that the cost of having an independent valuation firm prepare a written valuation report designed to satisfy the Illiquid Stock Presumption would be less expensive than a full-blown appraisal report.

- Identify the factors relevant to the company's business that should be taken into account in making a valuation determination. Review and update such factors on a periodic basis as the company's business and market conditions change.

The factors applicable to a particular company as of a particular valuation date should be the ones identified in the written valuation report. We would expect that, for a newly-incorporated company, most standard valuation factors would provide little meaningful data on which to base a valuation. Over time, as the company and its business matures, we would expect that more and more of the valuation factors, both financial data (ratios and multiples) as well as assessments of the company's business prospects, would become relevant and should be considered in making a valuation determination. We would expect that the length of, and the extent of analysis contained in, written valuation reports would expand (and perhaps even contract) as the company moves through this developmental process.

Attached to this memorandum is an additional memorandum provided to us by Cogent Valuation suggesting factors relevant to valuing venture-backed companies operating in a number of industry segments.

- Identify the individual or firm who will prepare the written report required to evidence the valuation determination. Although in some instances, the Valuation Expert might prepare the written report, we would expect the written reports more typically to be prepared by company personnel or outside advisors to the company, with appropriate input and review from the company's Valuation Expert. Ultimately, the Valuation Expert will endorse the written report, so his or her involvement in the report preparation process is important.

The Proposed Regulations do not require that such written reports take any particular form, or detail any specific steps that must be taken to perform the valuation. Currently, we anticipate that these reports will be set forth in a stand-alone document, although we anticipate that in some cases companies may set forth the substance of such a report in its board resolutions. We suggest that boards of directors adopt in connection with their granting employee stock options the valuation conclusions of the written report, either by reference to the report or by having the report itself attached to the board minutes.

We anticipate that the "best practice" that will evolve under this new presumption will entail the preparation of a stand-alone written report, endorsement of the report by the Valuation Expert (e.g., by signing the report), adoption of the report by the board of directors through board resolution, and attachment of the report to the board minutes.

Attached to this memorandum is a sample written valuation report of the sort that might be prepared by the company's Valuation Expert.

- Keep the company's outside accountants informed about valuation determinations. Companies will want to avoid having their accountants take contemporaneous valuation

positions for financial statement purposes that conflict with the determinations adopted by the board of directors in connection with stock option grants.

Intermediate-Stage Private Companies. Ahh, the awkward teenage years.... The Illiquid Stock Presumption is not available for companies that "reasonably anticipate" (or should reasonably anticipate) going public or being acquired within 12 months. Consequently, companies will face uncertainty as to the exact point in time at which they should cease relying on the Illiquid Stock Presumption and begin relying on the Appraisal Presumption.

The following are factors that suggest a company has transitioned to a stage of corporate development at which it should begin meeting the Appraisal Presumption requirements (if it has not already done so) and obtaining an independent valuation with respect to its common stock:

- The company is meeting with, receiving, or seeking bids from a potential acquiror.
- The company is meeting or scheduling meetings with potential underwriters or investment bankers.
- The company has or is considering putting in place bonus or other compensatory arrangements designed to incent management to complete an acquisition or public offering of the company.
- The company is executing or about to execute strategies suggesting that it is seeking, or may soon engage in, a public offering or an acquisition transaction -- e.g., hiring a CFO or other company personnel for the purpose of readying the company to go public or be acquired.
- The record established by presentations to the board of directors reflect that the strategic initiatives being considered and adopted by the board of directors presuppose a near-term public offering or acquisition.
- The company (or its accountants) has begun a program to ensure the company's compliance with Sarbanes-Oxley.

Of course, private companies that have been conducting business for 10 years or more, or that have capital structures involving put and call rights, will want to rely upon the Appraisal Presumption whether or not they anticipate engaging in such a transaction within 12 months.

Other Things to Expect

We anticipate that the greater focus on valuation procedures may cause companies to make option grants on a more regimented basis than they have done in the past (e.g., granting options at regular meetings of the board of directors rather than from time to time between board meetings by unanimous written consent of the board or an authorized board committee).

We also anticipate that some companies will want to establish a relationship with a valuation firm with whom the company, the board of directors and the company's Valuation Expert may from time to time consult.

Individuals who are identified or volunteer to act as a company's Valuation Expert may want to receive some more formal valuation training from time to time (e.g., by attending valuation training session offered by a valuation firm). Venture capital firms may also want to have a valuation firm provide periodic valuation training to their general partners and associates.

A company may anticipate that its Valuation Expert will want information on potential liability he or she may face in performing this new role. Provided actions taken by the Valuation Expert are taken in good faith and with thoughtful observance of reasonable procedures designed to conform valuation determinations to the presumptions described above, we do not anticipate that a Valuation Expert will

face any greater exposure to liability than that faced by any person having a fiduciary obligation to the company.

Conclusion

The availability of these new presumptions should offer venture-backed companies (and their employees) reasonable comfort and protection in light of the changes brought about by Section 409A. These changes will, though, necessitate thoughtful application of company procedures (of the sort suggested above) affecting valuation practices and in some cases may affect the valuation conclusions themselves.

Attached to this Client Alert is a memorandum prepared by Cogent Valuation, a firm that specializes in independent valuations and financial opinions, detailing valuation factors that may apply to early-stage, venture-backed companies. The Cogent Valuation memorandum should help private companies identify factors that may apply to valuing their common stock in connection with preparing written valuation reports for purposes of the Illiquid Stock Presumption. Reliance on the expertise and training offered by firms such as Cogent Valuation should help a company support the conclusion that its Valuation Expert and its board of directors operated in good faith in reaching a reasonable valuation conclusion. Cogent Valuation's contact information is included in their materials. In addition, the Heller Ehrman attorney with whom you regularly work will be able to provide you with referrals to additional valuation experts.

Template Written Valuation Report for Purposes of the Illiquid Stock Presumption

[This template is intended to be useful to companies as they prepare written valuation reports designed to satisfy the protective presumption set forth in Prop. Treas. Reg. § 1.409A-1(b)(5)(iv)(B)(2)(iii) (the "Illiquid Stock Presumption" described further in the Heller Ehrman Client Alert, "Common Stock Valuation Issues Raised by IRC Section 409A for Private, Venture-Backed Companies," dated November 2005). No guidance is available as of November 2005 that specifies the form or substance required of a written report designed to satisfy the presumption; rather, a reasonable and good faith effort to comply with the general principles set forth in the proposed regulations is required. This template is designed to assist companies in supporting such reasonable and good faith effort to comply.]

ABC Company Common Stock Valuation Report

This summary sets forth an analysis of the fair market value of the Common Stock of ABC Company (the "Company") at the nonmarketable, minority level of value as of November __, 2005 (the "Date of Valuation"). The undersigned, with the assistance of the Company's management and other Company personnel, [independent valuation consultants with whom the undersigned conferred,] [the Company's accountants,] [members of the Company's Board of Directors (the "Board") and personnel of the firms with which certain of those directors are affiliated] and [identify any other persons consulted], believes that the valuation set forth below appropriately reflects the current fair market value of the Company's Common Stock and understands that this Report will be used by the Board (and authorized Board committees) for general purposes when issues of the valuation of the Common Stock arise, including in connection with the granting of options exercisable for Common Stock to employees and other service providers of the Company.

Business and Industry Description

The Company [creates and manufactures/is developing/provides services and support to] _____. The Company's business is properly classified in the [software and IT services/semiconductors/ hardware and equipment/consumer [electronics/high-tech] products/biotechnology and pharmaceuticals/healthcare services/medical devices] industry. As of the Date of Valuation, the Company's product was _____ [describe stage: in development/in Phase I clinical trials/in beta test with prospective customers/being shipped for revenue to its initial customers/was generating quarterly revenue for the most recent fiscal quarter of \$_____].

Background on Company; Standard Valuation Considerations

The undersigned considered the following standard valuation factors in reaching the conclusion below:

Asset Value

The Company's assets as of the [Date of Valuation *[use if significant change in assets since most recent balance sheet]*/date of its most recent balance sheet (dated as of _____, 200__)] consist of:

Intellectual property consisting of: _____ [in development/_____], having a value of approximately: \$_____

Cash on hand: \$_____

Accounts receivable: \$_____

[List other assets; characterize status or provide estimated value]

The Company estimates that the total value of its assets as of the [Date of Valuation *[use if significant change in assets since most recent balance sheet]*/date of most recent balance sheet (dated as of _____, 200__)] equals: \$_____.

To ensure compliance with requirements imposed by the IRS, any tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of avoiding any tax penalty or of promoting, marketing or recommending to another party any transaction or matter addressed herein.

Net Worth

The Company's most recent balance sheet (dated as of _____) reflects the following:

Total Assets: \$ _____

Total Liabilities: \$ _____

Net Value: \$ _____

Present Value of Future Cash Flow

[The Company currently _____ *[describe situation with respect to cash-flow matters]*, and [anticipates that the present value of its future cash flow, on an annualized basis, is \$ _____; [however, realization of this level of cash flow is not expected to occur until 20__].]

[The Company currently _____ *[describe situation with respect to cash-flow matters]*, and cannot anticipate with any certainty its future cash flow position.]

Capitalization

The Company's current capital structure is as follows:

<u>Class of Stock</u>	<u>Number of Shares Authorized</u>	<u>Number of Shares Outstanding</u>	<u>Number of Shares Subject to Options and Warrants</u>	<u>Aggregate Liquidation Preference Applicable to Series</u>	<u>Other Comments and Notes</u>
Common Stock	5,000,000	1,200,000	800,000	N/A	
Series A Convertible Preferred Stock	2,000,000	2,000,000	None	\$12,000,000	Series A [does/does not] have participation rights with the Common Stock
Total	7,000,000	3,200,000	800,000	\$12,000,000	

Valuation of Comparable Companies

[Insert any available data]

Acquisition Potential

[In the absence of a third-party offer to buy the Company and its business, it is impossible to value the Company for acquisition purposes, however, it is reasonable to assume that the potential acquisition value of the Company does not exceed \$ _____ *[provide description: e.g., that it would be no more than X% of cash-on-hand; that it is less than aggregate liquidation preference; that the amount reflects value to be distributed to shareholders if the Company were to be liquidated as of the Date of Valuation.]*

[The Company engaged in discussions with a potential acquiror during the period _____ regarding a possible acquisition of the Company by this part. Based upon these discussions, the undersigned believes that it is reasonable to assume that, were the Company to be acquired as of the Date of Valuation, the aggregate value to be received by the Common Stock, as a class, would not exceed \$_____. Those discussions terminated on _____[date], and the Company does not anticipate, and is not aware of any reason why it should anticipate, that it will be acquired during the next 12 months.] *[May be beneficial to explain why the discussions terminated, particularly if the termination was due to price.]*

[The undersigned is aware that in [month/year], _____, a company [engaged in the same business as the Company] [and at approximately the same stage of development] was acquired by _____ for an aggregate value of approximately \$_____.]

Summary of Standard Valuation Factors

[The above factors suggest that the Common Stock, as a class, has in aggregate [at most, a nominal value, consistent with that of an early-stage start-up company] [a value of no more than \$_____] [a potentially significant value, consistent with that of a latter-stage start-up company].

[The above factors do not provide a sufficient basis for fully valuing the Common Stock.]

Additional Factors Considered

[As the Company's sole product remains in an early stage of development, no other factors were considered, as no such factors provide meaningful additional data in reaching the conclusion set forth below.]

[In addition to the above, the undersigned considered also the following factors, which he/she considered relevant in reaching a final conclusion as to valuation:

[See attached Exhibit A for a sample discussions of certain factors as might be included in a written valuation report. Exhibit A is not an exhaustive list of such factors and is attached solely to suggest a way of memorializing the analysis that might be undertaken in preparing a written valuation report. It draws on the more comprehensive list of factors set forth in the Cogent Valuation memo dated November 8, 2005, which detail potentially applicable factors by industry.

In considering and evaluating any of these additional factors, note that these lists contain general factors that may or may not be applicable to any particular company at any particular stage of its development and so may or may not actually affect the Common Stock valuation. The person preparing this written report, and the Board of Directors in adopting it, should identify and give consideration only to those factors that provide meaningful information in reaching a valuation determination. We would expect a written report prepared for a company at a later-stage of development to include a discussion of relatively more factors than a written report prepared for an earlier-stage company.]

Conclusion

Based upon the above, as well as upon the experience of the undersigned in valuing other companies [in the same industry/at the same developmental stage], the undersigned is of the view that as of the Date of Valuation the aggregate value of the outstanding shares of the Company's Common Stock, as a class, is \$_____, and that the per share value of the Common Stock is \$_____.

Executed by: _____

Title: _____

Date: _____

EXHIBIT A

The following are examples of how the person preparing a written valuation report with respect to a private company for purposes of the Illiquid Stock Presumption might memorialize his or her analysis of applicable business factors. These items would be included in the "Additional Factors Considered" section of the template written valuation report to which this Exhibit A is attached.

See also the Cogent Valuation Memorandum, "Factors to Consider in Valuing Early-Stage Companies," dated November 2005, which lists additional factors that may be relevant, including factors that may be relevant to particular industry segments.

- The venture capital funding prospects of the Company: [The Company is not currently in discussions with prospective investors but anticipates that it will seek additional financing in ___ months.] [The Company believes that it will require additional financing within the next six months, and is currently in preliminary discussions with two venture capital firms related to a prospective financing. No financing has been obtained as of the Valuation.]
- The funding prospects and valuations applicable to similar companies: [Companies in the Company's industry with products at a similar stage of development have generally been able to obtain financing over the past 12 months/have been facing difficulty in obtaining financing and cannot be certain to receive needed financing within a ___-month period.]
- Growth prospects for the _____ industry: For public companies in this industry, the _____ [financial metrics] are generally [positive/negative/improving].
- Innovativeness/Evaluation of the Company's product: [The Company anticipates that it will begin shipping its product in approximately ___ months.] [The Company anticipates that its product will continue in development stage for approximately another ___ months.] [The Company has encountered difficulties in completing the final stage of development but anticipates that it will be able to resolve such issues within ___ months.]
- The existence, ability to protect and licensing rights applicable to the Company's intellectual property: [The Company has no significant concerns about its ability to protect its intellectual property and is not aware of any pending or threatened claims by third parties (including current or former service providers to the Company) against the Company's intellectual property.] [The Company is currently attempting to resolve a patent infringement claim involving the Company's Patent No. _____.]
- Expected product adoption rates and hurdles in the marketplace to release and acceptance of the product: [The Company's product is unique and the Company is not currently aware of potentially competitive products being offered or developed by other companies.] [The Company has become aware that Big Software Co. is developing/considering acquiring _____, which may result in significant market competition.]
- The Company's partnership and alliance opportunities with major industry players: [The Company has been approached by Big Pharma Co. with an offer of corporate financing, which it has not yet accepted.] [The Company unsuccessfully tried to complete a joint venture with _____ during _____ and has not sought/ identified other potential joint venture partners.]
- Ability of the management team: [The Company's management team has significant experience in managing companies through similar stages of product development.] [The Company's [CEO/management team] has not previously managed a similar-stage company.] [The Company is seeking a VP Sales. Filling such position with a qualified candidate is critical to the Company's transition into the next phase of its business and strategic plans.]
- Access to financing (other than venture-capital financing): [The Company sought project financing in connection with _____ in _____, 20___. The Company did not successfully

obtain such financing./The Company secured financing from _____ in _____, 20__ in the aggregate amount of \$_____ and *[list other material terms of arrangement]*.

- The Company's current and projected cash burn rate: [The Company's current burn rate, which it anticipates continuing for approximately the next 12 months, is \$_____ per month.] [The Company's current burn rate, which it anticipates increasing at a rate of approximately ___% per quarter over the next 12 months, is \$_____ per month.]