GUNDERSON DETTMER CLIENT ALERT

PRIVATE COMPANY STOCK VALUATION AND OPTION PRICING MATTERS

April 2011

We wanted to take the opportunity provided by the AICPA's recent release of the exposure draft Practice Aid to share with our clients and friends some observations and best practice suggestions on this topic. We refer to the accompanying article by Cogent Valuation titled *Cheap Stock Valuation – Allocation Methods* for more information on the AICPA Practice Aid and the significance of its release.

Federal tax rules governing deferred compensation (Internal Revenue Code Section 409A) have changed the landscape of private company valuation practices since 2005. The Section 409A regulations impose a "reasonableness" requirement on the determination of the fair market value of the stock underlying employee stock options, with dire consequences for options with strike prices below the grant date fair market value. Because these regulations offer a presumption of reasonableness if the stock value is based upon an independent appraisal that meets certain requirements (we refer to this presumption as the "independent valuation safe harbor"), many private technology and biotechnology companies now routinely obtain third-party valuations to support their option pricing decisions.

Although many of the private companies we work with now routinely obtain independent valuations of their stock, questions continue to arise. The AICPA Practice Aid will certainly draw renewed attention to these issues, and perhaps bring greater clarity. From our vantage point, though, the Practice Aid release is just one of several developments related to private company stock valuation matters that merit attention. These include:

- Increased IRS focus on private company valuation matters, including in the context of ongoing 409A audits of larger public companies that acquire private companies,
- Public companies' increased reluctance to take on risk arising from the valuation practices of the private companies they acquire, and
- Secondary sales of private company stock at prices that vary from a company's 409A valuation.

We attach to this Alert some "Further Observations" on private company valuation matters in which we discuss these developments in more depth.

In addition, we encounter valuation practices that present concerns in certain contexts, including:

- Meaningful delays between the "as of" date of a third-party valuation report and the issuance date of the same report to the company, such that events occurring after the "as of" date make the report's conclusion obsolete before the company can even use it,
- Obtaining a valuation after the fact to support the pricing used for already-granted options, where the valuation obtained reflects a grant date fair market value that is higher than the exercise price,
- Obtaining board approval of option grants prior to obtaining the valuation report on which the option pricing will be based,
- Continuing to rely on an independent valuation for 12 months (the maximum period permitted under the safe harbor), without considering whether any material events made the valuation obsolete, and
- An absence of any process or back-up for stock valuations by early-stage companies.

As we continue to watch these developments, we wanted to offer these best practice suggestions:

- Even early stage private companies that do not obtain an independent valuation should establish thoughtful valuation practices that include consideration of the factors identified in the Section 409A regulations and should document the steps taken to determine the values used for option pricing purposes. Such practices would optimally include a "memo to file" that discusses the relevant factors and circumstances that existed each time options are granted, as well as a board record that reflects the board of director's consideration of these same factors and circumstances.
- The Section 409A regulations offer a second safe harbor for early-stage private companies that have access to a "valuation expert," such as a venture capitalist or someone else with at least five years' appropriate experience valuing companies, provided that the process is documented in a written report. Companies not obtaining an independent valuation should try to avail themselves of this safe harbor, when practicable.
- Private companies that obtain independent valuations should recognize that:
    - "You get what you pay for" – Saving a few thousand dollars now might be important, but it needs to be weighed against the trouble that could follow if, a few years hence when the company's stock value has risen considerably, the auditors, an acquirer or the IRS reject the valuation, e.g., on the basis that the valuation firm did not use appropriate methodology.
    - "Garbage in/garbage out" – The valuation firm needs to have all relevant information affecting the company's stock value when they prepare their valuation report. If in proximity to the valuation report the company has, for example, received an acquisition offer or experienced significant secondary sales, we expect that on audit or in diligence it would be very helpful to see the valuation report specifically reference these events, even if only to dismiss them as not influencing entity or stock value.
- Private companies working with an appraisal firm should determine an appropriate valuation update cycle. While the independent appraisal safe harbor provides that the appraisal *may* be relied upon for as long as 12 months, our view is that the permitted reliance period ends when an event occurs that materially affects the valuation.
    - A board of directors should consider whether the business environment in which the company operates requires either a more frequent valuation cycle or a less frequent option grant cycle.
    - Valuation firms will work with clients to help them determine whether an updated appraisal is appropriate and many offer a fixed annual rate that includes quarterly or semi-annual valuation updates.
    - Companies whose circumstances are changing rapidly, in particular those entering the registration process or likely to receive acquisition bids, should work with the valuation firm to compress the time between delivery of the valuation report and its "as of" date.

Private company valuation matters are likely to see continued focus and developments over the next few years. For companies that have not reviewed their valuation practices recently, the issuance of the AICPA Practice Aid might serve as a useful wake-up call that now would be a good time to undertake such a review.

Gunderson Dettmer's lawyers are available to assist in addressing questions you may have regarding the issues discussed in this Alert. Please contact the Gunderson Dettmer attorney with whom you regularly work. Contact information for our attorneys can be found at www.gunder.com.

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FURTHER OBSERVATIONS ON DEVELOPMENTS INVOLVING PRIVATE COMPANY STOCK VALUATION

April 2011

We wanted to share in greater detail some observations we have related to the valuation issues we discuss in our Client Alert, *Private Company Stock Valuation and Option Pricing Matters*. Our comments on the topics below are merely that – observations drawn from our practice and our ongoing work with over one thousand private companies:

Increased IRS focus on private company valuation matters. In the course of its practice of nearly continual audits of large U.S. public corporations, the IRS has issued multi-page information document requests that include Section 409A requests. These IDRs include requests for detailed information relating to private companies acquired by the public company under audit, and we understand that in the course of these audits the Service is looking closely at the private target company's valuation practices.

"Cheap stock" charges taken for financial statement purposes at the time of an initial public offering on the basis of after-the-fact (as opposed to contemporaneous) valuations is itself nothing new. However, many clients express concern about the possibility that the IRS might use a later-obtained valuation developed for this non-tax purpose to undermine the reasonableness of the valuation used when the company granted options so as to conclude that the affected options are subject to – and violate – Section 409A.

In addition, the IRS has increased its audits of smaller companies. We expect that recently-public companies with relatively high valuations would be a primary target of such audits.

Secondary sales of private company stock at prices that vary from the company's 409A valuation. With high-valuation private companies seeing a dramatic increase in sales of their stock by existing stockholders, including through SecondMarket, SharesPost and in a variety of other types of transactions, we currently have more questions than answers about the effect of such sales on 409A valuations. This issue, which the AICPA Practice Aid may ultimately help clarify, bears close attention.

To date, our experience has generally been that limited secondary sales of a company's stock, especially if the sales are to company affiliates or to parties who have access to little financial information about the company, have not had much influence on the company's 409A valuation on the basis that sales under such circumstances are not thought to be a good indication of actual value. The valuation analysis in this context, however, depends on the specific facts and circumstances, and companies experiencing secondary sales will face increasing pressure to consider the need to update their 409A valuation if they want to continue operating within the independent appraisal safe harbor.

Clients should also note that in some circumstances insiders who sell stock to the company or to company affiliates at a premium to the sale date fair market value of the stock can be deemed to have compensation income on some or all of the sales proceeds above fair market value. In certain fact-specific contexts, the company can also have withholding obligations on this income, notwithstanding that the company may not have been a direct party to the sale transaction. Companies should seek advice on these matters early in the course of the transaction. We note this issue to highlight that successfully distinguishing the secondary sales values from the company's 409A valuation can in some circumstances result in transactions that feel capital in nature being re-characterized as compensatory transactions.

Public company acquirers exhibiting increasing reluctance to take on risk arising from the valuation practices of the private companies they acquire. We now see fewer acquisitions in which public company acquirers assume private company stock options and suspect that this change in deal structure relates in part to the acquirers' reluctance to assume along with the options themselves the tax and employee relations risk that might accompany the options if the historic stock values seem unreasonable.

In addition, options granted in the weeks preceding an acquisition with strike prices at a discount to the deal price receive a high level of scrutiny. The results of this scrutiny are unpredictable and are likely influenced by the parties' risk profiles. In some deals, the parties have concluded that options granted in the weeks prior to the transaction must be "up-priced" under existing IRS corrections procedures (if these procedures are available in the specific circumstances). In other contexts, parties have obtained a "retroactive" independent valuation concluding that the actual fair market value was not only substantially less than the deal price but less even than the value the target company used for purposes of setting the exercise price!

Further, and while we would not suggest this is a trend, we have encountered acquirers that, when faced with what they view as inadequate process supporting the exercise prices that apply to the target company's options, are inclined to simply concede that pre-acquisition options violate Section 409A (and require that they be reported as such, a matter which the acquirer controls once the deal closes) without waiting for that point to be raised in an audit. Should this extremely conservative approach develop into a trend, it seems that Section 409A would have the effect of imposing a potentially substantial premium on the cost of acquiring private companies.

For all of these reasons, it is in our view well worth it for even an early-stage company to develop and keep current on thoughtful valuation practices and to continue to pay attention to further developments on these issues.

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