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EARLY-STAGE COMPANY VALUATION

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EARLY-STAGE COMPANY VALUATION

I. INTRODUCTION

The present discussion centers on legal and financial issues surrounding the valuation of "early stage"companies in the context of a marital dissolution.

A. Characteristics of Early Stage Companies

Early stage, or start up, companies have many unique characteristics. The principal characteristics, however, setting start up companies apart from more mature companies can be summarized in six major categories. First, these companies usually have new, often innovative, products or services. The familiar phrase of "building a better mousetrap" finds home in many of these young companies. More often than not, however, these products or services have not reached technical or economic feasibility and may still require additional research and development before they are ready to market. Along with these new products or services come potentially large markets that are needed to support the typical human and capital investments that many early stage companies require. Even then, most early stage management teams are unproven and, although strong in one or two skill sets such as technology, tend to lack a broad array of operational skills.

If technical or economic feasibility is achieved, it may still be years before the company reports its first revenue or profit. Complete marketing, sales, accounting and other administrative functions need to be fleshed out and in place before large-scale revenue generation can take place. Such a demand usually results in front-loaded costs, and therefore, losses. With a viable infrastructure in place, however, rapid growth can usually be achieved.

A final characteristic of many start-up companies is the absolute need to secure enough capital to achieve success. This is an ongoing challenge, so even though a company may have received some initial financing early in its development, risk of failure exists until the time the company is self-sustaining through the internal generation of cash flow.

Thus, early stage companies can be said to have a limited track record, little or no revenues, and no operating profits. *See*, Chris M. Mellen, *Measuring and Managing Value in High-Tech Startups*, p. 6, VALUATION STRATEGIES (September/October 2001). However, Mr. Mellen's article is deficient in many ways. The author didn't seem to have a solid understanding of very early stage companies as the article speaks mainly to "later stage" early stage companies.

Early stage companies most often take the form of a "close corporation." A "close corporation" has been defined as typified by (1) a small number of stockholders, (2) no ready market for the stock, and (3) and substantial majority stockholder participation in the management, direction and operation of the corporation. *See, e.g., Donahue v. Rodd Electrotype Co. of New England*, 328 N.E.2d 505, 511 (Mass. 1975).

Early stage companies can also be generally categorized into different stages of investment depending on how far along they are in their life cycles. Although there is significant overlap among stages, an understanding of the generic stages is helpful when comparing such companies for valuation purposes. The following paragraphs describe the generic stages in the life of a typical startup company.

The earliest stage of financing is normally referred to as the "seed" stage. The seed stage is characterized by a relatively small investment (typically below $250,000) that is made to explore the feasibility of a new idea or service. Seed capital is synonymous with "friends and family" financing, alluding to the traditional source of seed funding. A company in the seed stage may or may not have a formal business plan, and a complete management team is usually non-existent.

The next stage of financing is more formal, and is often referred to as first stage, or, in accounting terms, development stage. This stage is populated by companies that have proven the concept of their technology or service, usually through "alpha" or "beta" testing, and are poised to develop a management team and formal marketing and production efforts. Since the first stage is somewhat transitional, the source of funds can come from either "angel" investors (wealthy individuals) or from venture capitalists, and is usually dependent on the amount of capital needed, with angel financing normally ranging from $500,000 to $1,500,000. Larger investments usually fall to the venture capitalists who have much more capital at their disposal, but there are many instances where a venture capitalist will fund a much smaller need if the upside potential is high.

Second stage funding usually occurs when a company is to embark on, or has achieved, various sales and production milestones. Such funding is earmarked for working capital and capital expenditures needed to support anticipated sales and infrastructure growth. At this stage, the company has usually navigated the most uncertain part of its life cycle and is poised for capital formation and cash flow generation rather than pure expense. Unlike investors involved in a first stage financing, second-stage investors do not generally play an active role in the company since complete management teams are usually in place, although progress is monitored closely to assure agreed-upon milestones are met.

Once a company has completed its second stage of financing, subsequent financings depend upon capital needs, the state of the initial public offering (IPO) markets, and the exit strategies of the investors. Third and fourth round financings are not uncommon in more capital intensive or long lead-time industries such as biotechnology, whereas the presence of fifth and sixth rounds could signal problems internal or external to the company. Included in these later stages are bridge or mezzanine financings wherein investors will supply funds with the expectation that a liquidity event (either a sale or an IPO) is imminent.

Finally, the company has ramped up operations considerably and is ready for an IPO. At this point, investment bankers are usually brought in to set the per share value of the company that will be offered to the public. This is normally done by comparison to other "guideline" companies that are already trading in the public markets and by going on "road shows" that gauge investor interest at the determined price.

B. Common Context for Early Stage Company Valuation

The need for a valuation of an early stage company often arises in the context of a divorce involving a founder or significant shareholder. The shareholder spouse usually owns a significant amount of common stock that needs to be valued for the community. Typically, however, most previous sales of company stock have involved preferred stock (which, as will be discussed hereinbelow, normally possesses attributes that make it superior to common stock). Thus, while an overall determination of value can be made by a comparison to the sale of preferred stock, the common stock owned by the founder or significant shareholder is not necessarily comparable. Consideration needs to be given to preferred stock liquidity preferences (which tend to lower the value of the common stock), voting rights, board representation and participation rights. It is safe to say that most preferred stock rights come at the expense of the common stock, and therefore diminish the common stock's value. Additionally, if the company has a common stock option plan for its employees, Internal Revenue Service (IRS) regulations require that any common stock options granted under such plans be granted at fair market value. Accordingly, an efficient way to peg a value for a common stock-owning spouse is to reference the prices placed on grants of common stock options close to the period of valuation.

II. EFFECT OF "VENTURE CAPITAL INVESTMENT" ON EARLY STAGE COMPANIES

A. In General

Venture capital companies typically invest in unproven businesses that make traditional lenders, such as banks, nervous. *See,* Jerry Mahoney, *Venture Capital '99 Dot-com dollars pour in,* Austin American-Statesman, p. D-11(February 14, 2000). Venture capital is a primary means for early stage companies to obtain funding to start up and grow by developing and marketing new products, hiring new employees, and building a market position; venture capital funds are raised primarily from large institutional investors such as universities and pension funds. Often, venture capital is the only money available to such new and unproven businesses. Venture capital investment in 1999 and 2000 exceeded total venture capital investment over the previous ten years but has subsided in 2001 and thus far in 2002 following the bursting of the dot.com bubble. *See generally ,* Lori Hawkins, *Brother, Can You Spare a Billion?,* Austin American-Statesman, p. D-6 (March 18, 2002). In exchange for an infusion of capital, the venture capitalists normally take a sizable equity holding in the young companies. *See,* Lori Hawkins, *Austin Ventures has $825 million for startups,* Austin American-Statesman, p. D-6 (November 22, 1999).

Venture capitalists make money on their deals when the company in which they have invested sells its stock to the public (IPO), or is bought by another company. Profits are split between the institutional investors that put money into the venture capital "funds" managed by the venture capitalists. Normally, of the profits, 80% is returned to the institutional investors, and the remaining 20% is retained by the venture capital firm that assembled the particular fund from which the investments were made.

A venture capital firm should be distinguished from a relative newcomer to financial world, the "incubator." An "incubator" has become something of catch-all term to describe companies that offer hands-on, intensive support to a fledgling business. *See,* Renee Deger, *Incubators Nurture Urge to Go Public,* TEXAS LAWYER, p. 31 (April 10, 2000). The garden variety venture capital firm puts in more money than hands-on expertise, while an incubator often gives start-ups a home, office supplies, and executives. The number of incubators exploded in recent years, from some 12 known companies operating in 1980 to approximately 700 in 2000 (the highest concentration of which are located in California).

However, along with the demise of many dot.com companies after the April 2000 bubble burst, the number of incubators has diminished considerably. A couple of the more high profile incubators, such as CMGI and Internet Capital Group, have pared their investments and activities substantially. It is unlikely that these types of organizations will proliferate like they did before the bubble burst due to the structural problems they face in providing a full suite of operational services to early stage companies which historically possess less than a 50 percent chance of survival.

B. Initial Public Offerings

An "Initial Public Offering" (IPO) is the first public distribution of stock from a company that has not been publicly traded before. An IPO is synonymous with "going public."

The majority of firms go public because they need additional capital to execute long-range business plans, increase brand name recognition, and access funds for possible acquisitions. It should be noted than many people label a public offering as a marketing event, which it typically is; additionally, many of the people who have ownership interests in IPO companies get rich in the process.

At a public offering, after registration with the Securities and Exchange Commission, new securities are offered to the public at an offering price that has been agreed upon by the issuer and the lead underwriter. An underwriter is normally an investment banker who handles the offering of a new issue of securities. The underwriter buys all the securities from the issuer and distributes them to investors, making a profit on the underwriting "spread." The investment banker may be acting alone or as a member of an underwriting group or syndicate. (The public offering should be contrasted with a "private placement," which is a type of offering that allows the issuing company to avoid SEC registration requirements and save underwriting fees by offering shares directly to institutional and accredited investors.)

The IPO price depends largely on how well a company is received by institutional investors such as pension funds and insurance companies. *See,* Lori Hawkins, *Trying to get a piece of the IPO pie?,* Austin American-Statesman, p. A-1 (November 22, 1999). If institutional investors like a company, its initial price will be high, for example, $18-20 per share, whereas if the company is less well received, its offering price will be lower, perhaps $8-10 per share. *Id*.

Shares of initial public offerings are generally traded on the major stock exchanges. Seventy-five percent of IPOs trade on the Nasdaq, while the remainder either trade on the New York Stock Exchange or the American Stock Exchange.

In most cases, when an offering is labeled "hot," it is extremely difficult for an individual investor to obtain shares, because institutional "heavyweights" usually grab all the action. Thus, the only time most average investors can buy such stock is after it starts trading on the open market. In the case of hot high tech companies, the stock generally trades on the open market at a price well above the IPO price. *See, Id*.

In 1999, 541 companies across the country–more than 200 Internet related–raised more than $70 billion via the IPO process. *See,* Lori Hawkins, *IPOs Take Center Stage,* Austin American-Statesman, p. D-1 (December 27, 1999). Of course, since the bubble burst in April 2000, almost half of these companies have since gone bankrupt and out of business (see www.webmergers.com).

C. Effects of Venture Capital on Early Stage Companies

Benefits a company (or its people) obtains by going public include: (1) expansion of access to capital; (2) increased employee commitment and recruiting power; (3) enhanced product marketing; (4) expansion of business relationships; (5) enhanced merger and acquisition opportunities; and (6) enhanced flexibility in personal financial planning. However, prior to going public, an early stage company usually enters into a relationship with a venture capitalist in order to establish the company prior to attempting an IPO.

However, entrepreneurs often endure a love-hate relationship with venture capitalists, frequently having exchanged a controlling interest in their company for much needed cash. One result of such an interaction is that the venture capitalists obtain the power to recruit new leaders and thereby the power to change the direction of the company.

Venture capitalists tend to fund high-tech start-ups through two main types of investment: preferred stock or subordinated debt. *See,* David Wheat, *Threshold Tax Issues for High-Tech Startup Companies,* TEXAS LAWYER, p. 33 (March 20, 2000). However, preferred stock investments vastly outweighing subordinated debt.

Moreover, an infusion of venture capital brings with it numerous–and many times onerous–requirements demanded by the venture capital firm. For example, as a condition of financing, vesting schedules are almost invariably required for founder's stock or stock options issued to the company's employees. *See, e.g., In re Marriage of Jagannathan*, No. H011882, 1996 WL 1570260, *4 (Cal. Ct. App., March 4, 1996) (unpublished) (an expert testified that venture capitalists require vesting schedules for the following reasons: (1) to repurchase shares of stock from departing key employees for use in attracting replacement personnel; (2) to act as "golden handcuffs," encouraging managers to stay with the company; (3) to give the investors the ability to reacquire a portion of the shares in the event the invention, product or process being funded does not result in value; (4) to set a precedent on vesting schedules for future employees; and (5) to serve as a surrogate for a formal technology assignment by preventing the inventor from taking his or her idea elsewhere and competing without serious consequences).

In addition, the common shares and common stock options of the company are almost always restricted and are usually subject to a "lock-up" period. A lock-up period is a specified period of time during which the employees of the company are precluded from selling shares (although they can usually exercise their options). *See and cf., Pharm-Eco Laboratories, Inc. v. Immtech International, Inc.*, No. CIV.A. 18246, 2001 WL 220698, *3 (Del. Ch., February 26, 2001) (the parties' letter agreement provided that "[t]he persons receiving any Shares hereunder will agree to restrict the transfer of such Shares for any reasonable period required by the managing underwriter of the IPO ("the Lock-Up Period")").

D. Classes of Stock/Subordinated Debt

As already mentioned, in a large percentage of divorces involving an early stage company, one of the spouses will be a founder, or a ground level employee, who owns common stock in the company. Such stock will often represent the most valuable asset in the marriage. If venture capitalists are involved in the company, they will likely own preferred stock–as opposed to common stock–but such preferred stock will not usually be an issue in the divorce, unless, of course, the divorce involves the venture capitalist!

1. <u>Common Stock</u>

"Common stock" is the class of corporate stock representing residual ownership of the corporation, having voting powers, participating in profits by way of dividends (after payment to preferred stockholders), and sharing lastly in corporate property upon dissolution. *Indiana Wholesale Wine & Liquor Company, Inc. v. Indiana Alcoholic Beverage Commission*, 695 N.E.2d 99, 103-104 (Ind. 1998), *citing*, Black's Law Dictionary 278 (6th Ed. 1991). Traditionally, "common stock" means stock that "has a full voting right and unlimited proportionate right to share in the firm's residual earnings." *Indiana Wholesale Wine & Liquor Company, Inc.*, 695 N.E.2d at 104, *citing*, 11 William Meade Fletcher, et. al., *Fletcher Cyclopedia of the Law of Private Corporations*, §5086 (Perm. Ed. Rev. Vol. 1990).

2. Preferred Stock

Preferred stock has "preferential rights to dividends or to amounts distributable on liquidation, or to both, ahead of common shareholders." *Indiana Wholesale Wine & Liquor Company, Inc.*, 695 N.E.2d at 104, n. 9, *citing*, Black's Law Dictionary 1179 (6th Ed. 1991).

According to Gregory A. Barber, *Valuing Common Stock in Development-Stage Companies*, p. 39, VALUATION STRATEGIES (September/October 2000) (hereinafter referred to as "BARBER"), a typical preferred stock series will have the following features:

(a) convertibility (the preferred shares are convertible into common stock on a one for one basis, subject to anti-dilution protection, at the option of the holder, although an IPO of sufficient size often triggers an automatic conversion);

(b) voting and board seats (usually, preferred shares carry one vote for each share of common stock into which they are convertible; additionally, each round of preferred stock financing will have the right to elect one or two members to a five to ten member board of directors);

(c) dividend preference (preferred shares are given dividend preference over common shares, if and when dividends are declared);

(d) liquidation preference (preferred shareholders have priority to liquidation proceeds, typically equal to the offering price of the preferred shares); and

(e) marketability (preferred shares usually have no pre-IPO transfer restrictions).

3. Subordinated Debt

A debenture is a "[l]ong term unsecured debt instrument." *Becker v. North's Restaurants, Inc.*, 967 P.2d 1246, 1249 (Or. Ct. App. 1998), *citing*, *Black's Law Dictionary,* 278 (abridged 6th Ed. 1991). Debentures are otherwise known as "corporate bonds" and sometimes are referred to as "junk bonds" when issued for above-market interest rates by corporations with lower credit ratings. *Becker*, 967 P.2d at 1249, *citing*, 19 *Fletcher Cyclopedia of Corporations,* §3:98 at 226 (1995). Debentures are often preferred over stock issues as a method for obtaining start-up capital for corporations because the interest payments generally are deductible on the corporation's income taxes. *Id.* A "convertible" debenture allows the holder to convert the principal amount into stock of the corporation under specified circumstances–commonly, for example, if the corporation "goes public," or offers its stock for private sale. *Becker*, 967 P.2d at 1249*, citing*, *Black's Law Dictionary,* 231-32, 278 (abridged 6th Ed. 1991).

Often, debentures are subordinated debt, meaning that the debenture holders have agreed that one or more senior debts will be paid in full before "payment may be made on the subordinated debt and retained" by the subordinate debenture holder. *Becker*, 967 P.2d at 1249, *quoting*, Dee Martin Calligar, *Subordination Agreements,* 70 Yale LJ 376, 376 (1961). Because subordinated debentures usually are regarded by senior debt holders as equity capital, and not as debt, debentures are often used as a means of obtaining additional funding. *Id.* Subordination clauses vary in their terms, but they generally involve a common debtor indebted to two classes of creditors: junior creditors and senior creditors. *Becker*, 967 P.2d at 1249, *citing,* Peter F. Coogan, et. al., *The Outer Fringes of Article 9: Subordination Agreements, Security Interests in Money and Deposits, Negative Pledge Clauses, and Participation Agreements,* 79 Harv. L. Rev. 229, 233 (1965). Typically, the junior creditor accepts a note or debenture that, by its terms, provides that the junior creditor's right to repayment is subordinate, or junior, to payment of the senior debt; thus, the senior creditor obtains priority of payment. *Id.* Furthermore, in the event of the debtor's bankruptcy, the senior creditor often receives "'double dividends' out of the bankruptcy estate–the dividends paid on the senior debt and, by reason of the subordination agreement provisions requiring them to be turned over to the senior creditor, the dividends paid on the subordinated debt." *Becker*, 967 P.2d at 1249, *quoting*, Calligar, 70 Yale LJ at 376-77.

III. BASIC VALUATION TECHNIQUES

It has been recognized that the valuation of a closely held company is never an easy task. *Goodrich v. Goodrich*, 613 A.2d 203, 205 (Vt. 1992). As the New Jersey Supreme Court has also acknowledged:

> [t]here are probably few assets whose valuation imposes as difficult, intricate and sophisticated a task as interests in close corporations. They cannot be realistically evaluated by a simplistic approach which is based solely on book value, which fails to deal with the realities of the good will concept, which does not consider investment value of a business in terms of actual profit, and which does not deal with the question of discounting the value of a minority interest.

Dugan v. Dugan, 457 A.2d 1, 6 (N.J. 1983).

Although there is no perfect method for valuing early stage investments, a number of valuation approaches are available. The most prevalent approaches are the discounted cash flow (DCF) method, the market approach and the venture capital method. Later stage companies also utilize what is commonly referred to as the investment-banking model. As of late, one could also say that a new approach has been followed that is known as the "Greater Fool Approach." It should be noted that one commentator has stated that "traditional" valuation methodologies are often difficult to apply to developmental-stage companies. BARBER, at 38.

The venture capital method and the investment-banking model are discussed below under the heading "Innovative Valuation Techniques." Of the traditional valuation techniques, the discounted cash flow method and the market approach are typically most often utilized. There are, however, other traditional valuation techniques as well, although they are rarely applied to early stage companies.

Further, because the standard of value usually varies from state to state, the practitioner must make sure he or she is valuing the interest under the proper standard of value. According to the INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS (January 2000), the applicable "Standard of Value"is the identification of the type of value being used in a specific engagement, e.g., fair market value, fair value and investment value. The following are recognized "Standards of Value" taken from the INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS:

• Fair Market Value - the price, expressed in terms of cash equivalents, at which property would change hands between a hypothetical willing and able buyer and a hypothetical willing and able seller, acting at arms length in an open and unrestricted market, when neither is under compulsion to buy or sell and when both have reasonable knowledge of the relevant facts. *See also* Rev. Rul. 59-60 1959-1, C.B. 237;

• Forced Liquidation Value - liquidation value, at which the asset or assets are sold as quickly as possible, such as at an auction;

• Going Concern Value - the value of a business enterprise that is expected to continue to operate into the future. The intangible elements of Going

Concern Value result from factors such as having a trained work force, an operational plant, and the necessary licenses, systems, and procedures in place;

• Intrinsic Value - the value that an investor considers, on the basis of an evaluation or available facts, to be the "true" or "real" value that will become the market value when other investors reach the same conclusion. When the term applies to options, it is the difference between the exercise price or strike price of an option and the market value of the underlying security;

• Investment Value - the value to a particular investor based on individual investment requirements and expectations. In Canada, the term used is "Value to the Owner."

• Liquidation Value - the net amount that would be realized if the business is terminated and the assets are sold piecemeal. Liquidation can be either "orderly" or "forced"; and

• Orderly Liquidation Value - liquidation value at which the asset or assets are sold over a reasonable period of time to maximize proceeds received.

Other "value nomenclature" but not standards of value:

• Net Book Value - with respect to a business enterprise, the difference between total assets (net of accumulated depreciation, depletion, and amortization) and total liabilities as they appear on the balance sheet (synonymous with Shareholder's Equity). With respect to a specific asset, the capitalized cost less accumulated amortization or depreciation as it appears on the books of account of the business enterprise;

• Net Tangible Asset Value - the value of the business enterprise's tangible assets (excluding excess assets and non-operating assets) minus the value of its liabilities;

• Premise of Value - an assumption regarding the most likely set of transactional circumstances that may be applicable to the subject valuation; e.g. going concern, liquidation; and

• Residual Value or Terminal Value - the value as of the end of the discrete projection period in a discounted future earnings model.

A. Book Value/Adjusted Net Assets

1. Book Value

"Book value" is accounting terminology and represents the capitalized cost of an asset less accumulated depreciation, depletion or amortization, as it appears on the books of account of the enterprise. With respect to the enterprise, "book value" represents the difference between net assets and total liabilities as they appear on the company's balance sheet. The term "book value" does not represent the value of any items on a company's balance sheet, except by utter chance.

2. The Adjusted Net Assets Method of Valuation

Under the Adjusted Net Assets Method, a company's assets and liabilities are adjusted to appraised or fair market value in order the determine the value of the company's equity. The Adjusted Net Assets Method is commonly used if any of the following situations exist: the company has no established earnings history; a volatile earnings history; the continuation of the company as a going concern is questionable; or the company's goodwill is personal in nature. The Adjusted Net Assets Method is generally used in the valuation of a controlling interest since only a controlling interest usually has the ability to liquidate or sell specific company assets. If the Adjusted Net Assets Method is used to value a minority interest, discounts for lack of marketability and the minority interest generally should be applied. Shannon P. Pratt, BUSINESS VALUATION BODY OF KNOWLEDGE: EXAM REVIEW AND PROFESSIONAL REFERENCE, p. 87 (1998) [hereinafter referred to as "Pratt"]. Going concern value may be included in this method if the company is expected to continue operating and there exists intangible assets such as customer files, staff and procedures in place, or an established client base.

B. Income Methods

1. Definition

The income approach is a general way of determining a value indication of a business, business ownership interest, security, or intangible asset using one or more methods that convert anticipated economic benefits into a present single amount. THE INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS, p. 4 (2nd ed., July 2001). There are two primary approaches to estimate value based on the income approach: (1) capitalization of a single period of normalized earnings or cash flow; and (2) discounted future earnings or cash flow. Additionally, the excess earnings method is a hybrid income and asset based valuation methodology.

2. Capitalization of Earnings Method

The capitalization of earnings method is defined as a method within the income approach whereby economic benefits for a representative single period are converted to value through division by a capitalization rate. THE INTERNATIONAL GLOSSARY OF BUSINESS VALUATION TERMS, p. 3 (2nd edition, July 2001). The formula for applying the Capitalization of Earnings Method is next year's cash flow (or net earnings) divided by the capitalization rate equals estimated value (next year's cash flow should be representative of sustainable, long-term cash flow or earnings). A capitalization rate is simply an appropriate discount rate less long-term sustainable cash flow growth. The general steps in applying the method are as follows:

(a) obtain financial statements for a representative period of time (usually at least five years);

(b) adjust the financial statements for generally accepted accounting principles (GAAP) errors and for normalization adjustments;

(c) recompute federal and state tax liabilities on the normalized pretax income determined in Step (b);

(d) if the benefit stream to be capitalized is cash flow, adjust the net earnings in Step (c) to arrive at gross or net cash flow;

(e) determine the capitalization rate; and

(f) estimate the operating value of the company by dividing the net earnings in Step (c), or the cash flow in Step (d), by the capitalization rate obtained in Step (e).

GUIDE TO BUSINESS VALUATIONS, Vol. 1, p. 5-2 (Practitioners Publishing Company) [hereinafter referred to as "Guide"].

The capitalization method can be used for valuations of either control or minority interests. Adjustments to financial statements will dictate which type of interest is valued. The adjustments necessary to normalize the benefit stream should be consistent with the interest valued. If, for example, a minority interest is being valued, adjustments would not be made as to items which cannot be controlled by a minority ownership interest, such as owners' compensation.

The capitalization method should be considered when the following circumstances exist:

(a) earnings capacity contributes significantly to the company's worth;

(b) enough reliable data is available to reasonably estimate expected normal earnings;

(c) current earnings levels are expected to approximate future earnings;

(d) earnings for the subject company are significantly positive;

(e) expected growth rates are modest and predictable;

(f) owner benefits can be reasonably estimated; and

(g) the company has significant intangible asset value.

Id. at p. 2-42.

3. Discounted Future Returns Method

The discounted future returns method is based on the premise that a financial investment is worth the sum of all future benefits it will provide to the owner, each such benefit discounted to a present value at a discount rate that reflects the time value of money and the degree of risk (uncertainty) of receiving the benefits in the amounts expected. Pratt, at p. 105. The steps in estimating value pursuant to the Discounted Future Returns Method are as follows:

(a) create or obtain a financial forecast;

(b) adjust the financial forecast for any GAAP errors or normalization adjustments;

(c) recompute federal and state taxes if adjustments were made in Step (b);

(d) if net cash flow is the benefit stream to be discounted, additional adjustments should be made to arrive at forecasted net cash flow for each year;

(e) determine the discount rate;

(f) estimate the operating value of the company during the terminal year by use of an appropriate procedure such as a capitalization of terminal year cash flow; and

(g) estimate the current operating value of the company by discounting back all future operations (including the terminal value of the company in Step (f)) to present value using the present value conversion factors for the discount rate determined in Step (e).

Guide, at p. 5-42.

The Discounted Future Returns Method should be considered when the following circumstances exist:

(a) earnings or cash flow potentials contribute significantly to the company's worth;

(b) current cash flow levels are expected to differ significantly from long-term future cash flows;

(c) the company's future cash flows can be reasonably estimated;

(d) the company's net cash flow in the terminal year is expected to be significantly positive;

(e) the company's total net cash flow during the forecast period is not expected to be significantly negative;

(f) if valuing a controlling interest, owners' benefits can be reasonably estimated;

(g) the company is a start-up business; and/or

(h) the company is a potential acquisition target.

Guide, at p. 2-43.

In utilizing the DCF method for an early stage company, the starting point, as mentioned above, is the business plan and its accompanying financial projections. However, it should be noted that the vast majority of early stage company projections are optimistic, often requiring a "haircut," meaning that they need to be adjusted downward. Such necessary adjustment may also be accomplished by increasing the discount rate if resistance is met on adjusting the projections. Once the projections are more realistic, an appropriate discount rate can be selected. The selection of a discount rate is usually the most subjective aspect of the valuation using a DCF. Another unique item relating to start up companies when utilizing a DCF method is that the terminal value usually represents the vast majority of the company's overall value. As such, assumptions about the terminal value become critical. The terminal value is an estimate of the residual value of the company once the discreet cash flow period has ended, usually five years. Terminal values can be derived using multiples from the public market, or by relying on a capitalization of terminal year cash flow as discussed in the foregoing section. Caution should be used when utilizing multiples derived from the public market, however, as public multiple methodology falls under the market approach and is not a pure DCF.

In summary, although the DCF method is appropriate in many valuation contexts, its application to early stage companies is less than ideal. When a company has little or no operating history, an unfathomable market, an untested product, an unknown cost structure, unknown implementation timing, unknown market acceptance, an untested delivery vehicle, unknown competition, an unsophisticated management team, and often unrealistic expectations, the resulting valuation using a DCF is very often suspect.

4. Excess Earnings Method

The Excess Earnings Method mentioned earlier is rarely, if ever, applicable in the valuation of an early stage enterprise for the simple reason that most early stage companies don't even have earnings let alone "excess" earnings. Accordingly, it is the opinion of these authors that an excess earnings method be shunned in favor of more appropriate valuation methodologies.

5. Criticism of Income Approaches.

It has been argued also that, when valuing early stage companies, the income approach at times produces results that are very sensitive to small changes in assumptions. BARBER at 38. Such sensitivity usually arises because of the significant leverage in the capital structure of the company, the high applicable discount rate, and the long period of anticipated negative cash flows. *Id.*

Further, a valuation of an early stage company is based almost invariably on projections of income, not a historical income stream. Thus, as discussed, valuation methodologies such as excess earnings are not usually employed for such valuations.

C. Market Approaches

Under market approaches, the value of a business is based on comparable business sales transactions, guideline companies, or prior transactions in the subject company's stock.

1. <u>The Guideline Company Method</u>

This method estimates value by comparing guideline companies' valuation multiples to the subject company. Revenue Ruling 59-60 strongly advocates the Guideline Company Method.

Guideline companies should be similar to the subject company. The term "similar" allows for wide latitude in the selection of guideline companies. The object is to find companies that experience similar risk characteristics, such as markets served, type of products, geographical territory, size and comparability of financial history. Pratt, at p. 128; *see also,* Robert L. Brown, Ed., VALUING PROFESSIONAL PRACTICES AND LICENSES: A GUIDE FOR THE MATRIMONIAL PRACTITIONER, §7.02[b][2] (1997 Supp. 2nd Edition) (if comparable sales data is utilized, the translations used to postulate value should be comparable in terms of (1) size of practice (volume); (2) location (urban vs. suburban vs. rural); and (3) time of the transaction). For instance, it is common in the U.S. Tax Court to compare companies that have similar consumer brand recognition and distribution, even though the products of such companies may be very different. Shannon Pratt, *Business Valuation Body of Knowledge*, p. 127 (John Wiley 1998).

The Guideline Company Method is based on valuation multiples derived from guideline companies applied to the subject company, such as price to earnings ratios.

Notwithstanding that income approaches are used extensively in valuing going concerns, the preferred method of valuing a startup company is indeed by comparison to the values of other similarly situated companies. For example, if the subject company provides Internet infrastructure, one could analyze the prices investors are currently paying for Internap Network Services or F5 Labs. If investors are valuing these companies at 5 times next year's revenue, then such a comparison could be a benchmark for the valuation of the subject company. Many venture capital firms also maintain databases on the valuations other venture capital firms have placed on similar companies at a similar stage of development. These databases are especially useful for very early stage companies that may not be ready for the public markets for years.

2. <u>Comparable Sales/Prior Transactions Methods</u>

These methods are based upon a comparison of the subject company to sales of comparable companies or prior transactions within the subject company. The comparable sales method is similar to the guideline company method, since appropriate multiples are applied in estimating value.

Value is estimated based on the prior transactions method by examining sales transactions relating to the subject company. These transactions may provide some of the best evidence of value, provided they are arms-length transactions within a reasonable proximity in time to the valuation date. In closely-held corporations, prior transactions may not have been arms-length, since the founders, for example, may have dictated (and not negotiated) the terms of such transactions to junior participants in the company.

When using comparative company data, the presence of significant value-creating events occurring between the investment date and the valuation date need to be considered to determine the resulting impact on the present value. Examples of such value-creating events include hiring a new chief executive officer, landing a new customer, or completing a new product. Also, interim investments often are in the form of preferred stock, whereas the subject of a divorce valuation will usually be common stock. Potential areas of difference between preferred and common stock that need to be considered include, as noted earlier, redemption rights, conversion features, dividend and liquidation preferences, and control attributes. When utilizing preferred stock investments as the benchmark for the valuation of minority common stock interests, especially incentive stock options, consideration should be given to the investment round, the investor, differences in marketability, and board representation and influence.

3. <u>Applicability of Market Approaches</u>

The market approach should be considered when the following circumstances exist:

(a) there is an adequate number of guideline companies and/or transactions to determine a value multiple;

(b) if guideline companies will be used, there is adequate data on the guideline companies to allow the consultant to make appropriate analyses and adjustments;

(c) the valuation is for federal income tax purposes; and/or

(d) the company being valued is considering a public offering in the near future.

Guide, at p. 2-43.

D. Discounts and Premiums

There are two "discounts" commonly encountered in the valuation of a closely-held or early stage business: (1) the lack of marketability discount; and (2) the minority interest discount. Additionally, a "control premium" sometimes arises in such valuations.

1. <u>Lack of Marketability Discount</u>

The concept of marketability deals with the liquidity of an interest, *i.e.,* how quickly and how certainly the interest can be converted to cash at the owner's discretion. Shannon P. Pratt, Robert F. Reilly, and Robert P. Schweihs, VALUING A SMALL BUSINESS: THE ANALYSIS AND APPRAISAL OF CLOSELY HELD COMPANIES, p. 528 (3rd Ed. Irwin 1996). The "lack of marketability" discount measures the diminution in value attributable to the lack of a ready market for a particular interest in property. *See, e.g., Ward v. Commissioner,* 87 T.C. 78, 106-107 (1986). The rationale underlying the lack of marketability discount is simple: any interest in a closely held business, subject to infrequent trading and therefore a lack of marketability, is less attractive to the average investor than a similar interest which is traded publicly and to which the public has ready access. *See, Central Trust Co. v. United States,* 305 F.2d 292 (Ct. Cl. 1962). Essentially, the lack of marketability discount "equalizes" an interest in a closely held business with an interest in a publically traded business.

Despite the absence of a specific regulation or ruling, the Internal Revenue Service has conceded the propriety of the lack of marketability discount in many valuation cases. *See, e.g., Estate of O'Connell v. Commissioner*, 37 T.C.M. 822 (CCH 1978). Consequently, the fair market value of a closely held business is calculated according to established valuation criteria, and then discounted for its lack of marketability.

The lack of marketability discount may be simply a flat percentage of fair market value. *See, Id.* Alternatively, the discount may represent how much it would cost to create the missing marketability for the closely held business being evaluated. *Wallace v. United States,* 556 F. Supp. 904 (D. Mass. 1981).

There is no general rule regarding the size of the discount for lack of marketability, but generally it has ranged from 20% to 35%. *See, e.g., Estate of O'Connell v. Commissioner* (30%); *Wallace v. United States* (35%).

As will be discussed hereinbelow, in the context of an early stage company, by restricting or nullifying transferability, stock transfer restrictions almost invariably affect the value of a company's shares.

2. Minority Discount

By definition, a minority interest represents control of less than 50% of the shares of a corporation; in a partnership, it means less than 50% of the partnership interest. Courts have long recognized that the shares of stock of a corporation that represent a minority interest are usually worth less than a proportionate share of the value of the assets of the corporation. *See, e.g., Estate of Newhouse v. Commissioner*, 94 T.C. 103, 249 (1990); *Ward,* 87 T.C. at 106; *see also*, *Goodrich*, 613 A.2d at 205 (when the wife's stock represented a minority interest in the corporation, such factor supported a discount because the shares were not readily marketable and could not convey a controlling interest in the company; a purchaser of the wife's interest would not receive guarantees of future dividends, and the record did not reflect any special rights or powers attending the minority interest). The minority discount reflects a minority interest's lack of control over corporate policy and inability to direct the payment of dividends or compel the liquidation of the corporate assets. *Harwood v. Commissioner,* 82 T.C. 239, 267 (1984), *aff'd without published opinion,* 786 F.2d 1174 (9th Cir. 1986).

As one commentator has said about the "dilemma" of the minority stockholder whose interests are not being served by the majority:

> [h]e can sell the stock to another outsider, in which event the price is likely to reflect a substantial discount by reason of the "captive" position of the investment in the corporation, or he can sell to the insiders. While there may be buyers at a favorable price if the insiders regard it as desirable to eliminate outside participation in the affairs of the corporation, the insider market is normally restricted. On balance it is fair to conclude that the price obtainable by the outsider for the minority shares normally will be substantially less than the pro rata asset and income values.

Goodrich, 613 A.2d at 205-206, *quoting*, Feld, *The Implications of Minority Interest and Stock Restrictions in Valuing Closely-Held Shares,* 122 U.Pa.L.Rev. 934, 936-37 (1974).

There is no general rule concerning the size of the allowable minority discount. The courts have consistently allowed a 20% to 35% discount for minority ownership. *Ward*, 87 T.C. 78 (33 1/3%); *Northern Trust Co. v. Commissioner*, 87 T.C. 349 (1986) (25%); *Henry J. Knott v. Commissioner,* 55 T.C.M. 424 (CCH 1988) (30% discount appropriate to reflect the illiquidity and lack of control inherent in the 50% limited partnership interest); *Moore,* 62 T.C. M. 1128 (35% discount from the underlying net asset value for a minority general partnership interest with certain restrictions on selling, withdrawing or assigning the partnership interest).

Although there is some overlap between the discount for a minority interest and the discount for lack of marketability, the discounts are conceptually distinct. *Estate of Newhouse,* 94 T.C. at 249; *Harwood,* 82 T.C. at 267. Nonetheless, courts have varied in their actual applications of the discounts to particular fact situations. Some courts combine the two "conceptually distinct" discounts into a single discount. For example, in *Estate of Newhouse,* 94 T.C. at 252, the Tax Court held that an estate acted properly in discounting a 44% interest in a closely held corporation 35% to reflect both lack of marketability and minority ownership.

However, it has been argued that such discounts are usually taken *consecutively*. *See,* Shannon Pratt, *Shannon Pratt's Business Valuation Update,* Vol. 3, No. 1, p. 2 (January 1997) [hereinafter referred to as "Pratt's Update"]. Consecutive application of the discounts occurs as follows:

Net Asset Value:	$100
Minority Interest Discount - 30%:	-30
Publically Tradable Minority Value:	70
Marketability Discount - 40%:	-28
Net Minority Nonmarketable Value:	$42

See, Id.

A third approach taken by the courts is to add the discounts together. In *Barudin v. Commissioner,* No. 7156-94 (U.S. Tax Ct., August 26, 1996), the court added a 19% minority discount and a 26% marketability discount for a total discount of 45%. *See, Pratt's Update,* at p. 2; *see also, Whittemore v. Fitzpatrick*, 127 F.Supp. 710, 721-722 (D. Conn 1954) (combined a 50% lack of marketability discount with a 32% minority discount); *Lefrak v. Commissioner,* 66 T.C.M. 1297 (CCH 1993) (20% minority discount added to 10% lack of marketability discount).

3. Control Premium

If the value of owning a minority interest must be discounted due to a lack of control, it makes sense that the value of owning a controlling interest also may cause an adjustment to overall value, due to the presence of control. In fact, ownership of a controlling interest, *i.e.*, more than 50 percent of the voting stock, may be worth a "premium." As stated in Rev.Rul. 59-60 §4.02(g), 1959-1 C.B. 237:

> [t]he size of the block of stock itself is a relevant factor to be considered....[a]lthough it is true that a minority interest in an unlisted corporation's stock is more difficult to sell than a similar block of listed stock, it is equally true that control of a corporation, either actual or in effect, representing as it does an added element of value, may justify a higher value for a specific block of stock.

In *Estate of Salsbury v. Commissioner*, 34, T.C.M. 1441, 1451 (1975), the Tax Court stated:

> [t]he payment of a premium for control is based on the principle that the per share value of a minority interest is less than the per share value of a controlling interest.....[a] premium for control is generally expressed as the percentage by which the amount paid for a controlling block of stock exceeds the amount which would have otherwise been paid for the stock if sold as minority interests and is not based on a percentage of value of stock held by all or a particular class of minority stockholders.

The concept of the control premium was further clarified in *Estate of Chenoweth v. Commissioner,* 88 T.C. 1577, 1581 (1987), when the Tax Court stated:

> [w]e would tend to agree that the sum of the parts cannot equal more than the whole, that is, the majority block together with the control premium, when added to the minority block of the company's stock with an appropriate discount for minority interest, should not equal more than the total 100 percent interest....

IV. INNOVATIVE VALUATION TECHNIQUES

A. Real Options Application in Marital Dissolutions

"Real options" is the frequently used term for a branch of finance known as contingent claims analysis. In essence, real options are analogous to, and valued in the same way as, financial options. Most practitioners, for example, are quite familiar with one major category of financial option -- the employee stock option ("ESO"). A financial option such as an ESO provides the holder the right, but not the obligation, to purchase a share of stock in the issuing company. The following terms are specified in an ESO:

• Exercise price -- the price per share that the option holder may purchase the underlying stock
• Maturity -- the expiration date of the option
• Number of options
• Vesting schedule

For example, suppose an option has an exercise price of $20, and a one-year maturity. If the underlying stock price is above $20 per share at maturity, the holder will exercise, by paying $20 and receiving the higher-valued stock. If, however, the underlying stock falls below $20 at maturity, the holder of the option will allow it to expire unexercised; after all, the holder could purchase shares on the open market for less than the $20 exercise price. An option gives the holder an opportunity to either make a profit (if the stock price is above the exercise price) or break even (if the stock price is below the exercise price). This is quite different from owning the stock itself; if the stock price rises, the holder makes a profit, but *if it falls, the holder suffers a loss that the option holder avoids*.

Since the payoffs from holding an option are significantly different than holding stock, the valuation methods are also different. Financial options are typically valued by the use of the Black-Scholes Model, which requires the following five inputs:

• Current price of underlying stock
• Exercise price (discussed above)
• Time to maturity
• Risk-free rate of interest
• Volatility of stock (degree to which it rises or falls in a given time period)

Real options tools emerged when corporations and academics noted that many projects, such as new product development activities or new plant construction, evidenced the same type of payoffs, that is, a new product might be launched if the market develops favorably, or it can be abandoned (expire worthless) if the market for the product fails to develop. Practitioners found that, by employing financial option concepts, they could arrive at more relevant estimates of value for their projects. To evaluate a possible plant expansion, for example, an option pricing framework such as the following would be used:

• Current value of the opportunity to expand (current price of underlying asset)
• Cost of the new plant (exercise price)
• Time when final decision must be made (maturity of option)
• Risk-free rate of interest
• Volatility of project

The key reason that an option pricing model is superior in this example is because the company has the luxury of *waiting and learning* more about the value of building a new plant. This is just like the holder of a stock option, who has the ability to *wait and learn* what happens to the price of the underlying stock.

Therefore, the most frequent applications of real options in a marital dissolution setting will be in the valuation of assets that contain options to *wait and learn*, such as:

• Emerging technology companies
• Venture capital investments
• Intellectual property (patents, trade secrets)

Such assets can be thought of, and modeled as, learning options. For example, a start-up company that is developing a new, high-technology product often holds a series, or sequence, of real options (some investors think of them as milestones):

• Concept stage -- funds invested to demonstrate technological feasibility
• Prototype stage -- funds invested in a working version of the product
• "Beta" test -- funds invested in an actual customer setting
• Infrastructure -- funds invested to staff management team and build company infrastructure
• Rollout -- funds invested in manufacturing facility

At each of these stages, the owner has the right, *but not the obligation*, to invest in the next stage if the milestone is successfully passed. To take a simple example, assume we are valuing an ownership interest in a start-up that has achieved the first three milestones above, but the infrastructure (which is expected to cost $850,000 and take one year) is not yet in place. The following parameters are assumed:

Estimated current value of opportunity	$2,400,000
Expected cost of manufacturing facility	$1,600,000
Maturity of option to roll out	1 year
Risk-free rate of interest	5%
Volatility of opportunity	40% per year

Notice that a simplified (non-option) analysis would indicate that the company is worthless, i.e., the value of the opportunity ($2.4 million less the $1.6 million rollout cost) is only $800,000, but the infrastructure will cost $850,000, for a negative present value of ($50,000). However, the fact that the owner has an "option" to wait one year before rollout means there is a chance that the project will be more valuable at "expiry" of the real option. Applying the standard Black-Scholes Model to this set of facts, we find that the value of this option to roll out the product is $926,000. Therefore, we find that the company should spend the $850,000 on the infrastructure, because the net value is positive ($926,000 - $850,000).

A final note -- real options methods do not automatically produce a higher value than traditional methods such as the income and market approaches. This is primarily because *these traditional methods are poorly suited to the task of valuing assets containing embedded options, and thus the they are often misapplied to produce unsupportably high values*. Real options methods, on the other hand, are useful at "getting under the hood" and facilitating a critical evaluation of the key value drivers in many otherwise hard-to-value marital assets. For more details on this method and its potential applications, please refer to the accompanying article, "Real Options: Extending Project Finance Techniques to Valuation of High-Growth Enterprises."

B. Venture Capital Method

The "Venture Capital" method of valuing early stage companies is a variant of the DCF, although in a much simplified fashion. The steps of the venture capital method are as follows:

(1) Assume no cash distributions until a liquidity event is achieved, either an IPO or sale of the company;

(2) Estimate the exit value of the company usually by reference to valuation multiples of public companies in a similar industry as the subject company;

(3) Discount the expected exit value at an appropriate discount rate, usually ranging from 35 percent to 55 percent, but it would not be uncommon to see discount rates up to 80 percent or higher for very early stage, or highly risky, companies.

The practitioner must remember though, that less than 5 percent of all business plans get any funding at all and less than one percent receive venture funding.

C. Investment Banking Method

The "Investment Banking" method is a variant of the market approach, but again, in a simplified form. When an investment gets involved in a valuation, it usually means that an IPO for the company is imminent. As such, much of the uncertainty that is normally present in early stage companies has been overcome and the company is well on its way to becoming an established member of the corporate world. Under these circumstances, investment banks attempt to select guideline companies similar to the subject company. A cursory comparison with these guideline companies is performed to establish a "starting point" for setting the per share price, but then the real work begins.

After setting the initial price range (which is usually incorporated into a document known as a "red herring"), company management embarks on a "road show" where the company's "story" is related to institutional investors and other investment banks. Based on the feedback received during these road shows, a final price is selected, at the high range if the road show was successful, or at the bottom of the range if it was not.

However, just because a company files an S-1 Registration to go public doesn't guarantee that it will go public. Over the past two years, over 30 percent of the companies that have filed to go public have pulled their registration statements (see www.ipo.com). Again, the practitioner should be aware of this phenomenon and incorporate this information into the valuation as needed.

V. STOCK RESTRICTIONS

A. In General

Start-up companies, almost always closely-held corporations, will typically have bylaws or other agreements that restrict transferability of shares or interests. Many such companies also have buy-out agreements. According to the Nebraska Supreme Court,

> ...stock restrictions are devices often employed to insure that the management and control of the business remains with the same group of investors or with people well known to them. Such restrictions may be embodied in the articles of the corporation, in the bylaws, or in shareholder agreements, and generally provide that upon the withdrawal or death of a stockholder, his shares will be sold or transferred only to the remaining stockholders or to the corporation, or at least will be offered to them before being sold to any outsider. Such agreements make it possible for shareholders to choose future associates and prevent unwanted outsiders from entering the business if their integrity or business acumen is in doubt.

F.H.T., Inc. v. Feuerhelm, 320 N.W.2d 772, 776 (Neb. 1982). Venture capital companies frequently require stock transfer agreements before they will infuse funds into a target company. *See, e.g., In re Marriage of Quay*, 22 Cal. Rptr. 2d 537, 539 (Cal. Ct. App. 1993) (a venture capital company required the key man of the business to enter into a stock restriction agreement, by which the company acquired the right to buy back some of the key man's already vested shares).

Typically, a stock transfer restriction is enforceable if it is "reasonable." For example, in Texas, article 2.22 of the Texas Business Corporation Act provides that stock transfer restrictions are enforceable against the holder of the restricted security, or any successor or transferee of the holder, if such restrictions are reasonable and are conspicuously noted on the stock certificate.

In *Dixie Pipe Sales, Inc. v. Perry*, 834 S.W.2d 491, 492 (Tex.App.–Houston [14th Dist.] 1992, writ denied), upon the death of a shareholder, the corporation refused to transfer the stock to the beneficiaries under the will and opted instead to pay them the book value of the stock pursuant to a right of first refusal contained in the corporation's bylaws. The parties agreed that, under article 2.22 of the Texas Business Corporation Act, the restriction was valid, and thus the question was whether the corporation was entitled to the right of first refusal when the transfer was made by the will. *Id*. at 493.

The Texas intermediate appellate court stated that restrictions on the power of a corporate shareholder to transfer his or her shares of stock may validly be imposed in the charter or the bylaws of a corporation, provided such restraints are reasonable and not contrary to public policy. *Id.* According to the Texas appellate court, the reasonableness of such a restriction is ordinarily to be determined by applying the test of whether the provision is sufficiently necessary to the particular corporate enterprise to justify overruling the usual policy of the law in opposition to restraints on the alienability of personal property. *Id*.

The Texas appellate court also noted that article 2.22 specifically provided that a transfer restriction could be enforced against any successor or transferee of the holder. *Id*. Thus, the transfer restriction applied to a beneficiary under the will. *Id*. at 494.

In discussing whether the restriction was reasonable, the Texas appellate court stated:

> [t]he provision in [the corporation's] bylaws is not unreasonable, but is calculated instead to advance legitimate objectives of both the corporation and its individual stockholders, that is, to keep the stock in the family.

> Such a restriction is inherently more "reasonable" when applied to the stock of a corporation having only a few shareholders who are active in the business and members of the same family, than when imposed on the stock of a corporation that has many shareholders who are not only unrelated to one another, but who, ordinarily, do not participate actively in the day-to-day management of the corporation.

Id.; *see also, Ling and Company v. Trinity Savings and Loan Ass'n,* 482 S.W.2d 841, 844 (1972) (there was nothing "unusual or oppressive" in requiring a selling shareholder to notify and give an option to buy to more than twenty other shareholders); *Shindler v. Harris,* 673 S.W.2d 600, 609 (Tex.App.–Houston [1st Dist.] 1984, writ ref.'d n.r.e.) ("clear and unequivocal" forfeiture provision appearing in a written joint venture agreement upheld).

In Massachussetts, on the other hand, corporate restrictions on stock transfer are enforceable unless such restrictions are "palpably unreasonable." *See, Durkee v. Durkee-Mower*, 428 N.E.2d 139, 141 (Mass. 1981).

B. Applicability to Spouse

In the context of a divorce, an issue of immediate significance is whether transfer restrictions will be applicable to the non-employee spouse.

The majority position among the various states appears to be that, generally, in a divorce, a transfer restriction will not be enforced against the spouse unless the restriction specifically addresses the issue of divorce. The Texas case of *Earthman's, Inc. v. Earthman*, 526 S.W.2d 192 (Tex.Civ.App.–Houston [1st Dist.] 1975, no writ) affords a good example of the majority position.

In *Earthman's*, the wife was awarded, in the divorce, a 21% ownership of the closely-held corporation owned and controlled by the husband and his sons. *Id*. at 196. When the wife sought to have the shares transferred into her name, the corporation took the position that share transfer restrictions which gave the corporation or other shareholders a first right purchase the shares became effective upon the transfer incident to the divorce. *Id*. at 198. Not surprisingly, the wife sued. *Id*.

On appeal, the Texas appellate court noted that a provision which restricts a stockholder's right to sell or transfer his stock, particularly one which affords a prior right of purchase to the corporation or to another stockholder, is not looked upon with favor and is strictly construed. *Id*. at 202. The Texas appellate court further noted that it had generally been held that such a restriction is inapplicable to a transfer occurring as a result of an involuntary sale, or by operation of law, unless by specific provision in the restriction it is made applicable. *Id*.

The Texas appellate court also cited the Louisiana case of *Messersmith v. Messersmith*, 86 So.2d 169 (La. 1956), in which it was argued that certain community owned stock should not be divided in kind, as decreed by the divorce court, and that the husband should be permitted to retain the stock and to pay his wife one-half its book value in accordance with a restrictive clause in the corporate charter requiring a stockholder, who wished to sell his stock, to first offer it to the other stockholders or officers of the corporation. *See,* 526 S.W.2d at 202. In *Messersmith*, the Louisiana Supreme Court determined that the restrictive provision of the charter could not prevent the recognition of the wife's share of ownership in the corporation, held that she was entitled to have delivered to her in kind the interest awarded to her under the divorce decree, and stated:

> [t]he restriction in the charter cannot affect the status of the stock purchased during the existence of the community or the rights the wife may assert thereunder. Such a restriction cannot negative the wife's present interest as a co-owner, and as a co-owner in community she is clearly entitled to be recognized as such and obtain the exclusive management and control of her vested interest.

Earthman's, 526 S.W.2d at 202, *quoting, Messersmith*, 86 So.2d at 173.

Accordingly, the Texas appellate court in *Earthman's Inc*. held that the restrictive provision should not be construed so as to preclude the wife's right to have her shares of ownership reflected on the books of the corporation and to have the stock certificates evidencing her ownership issued to her. 526 S.W.2d at 202.

The rationale of *Earthman's* and *Messersmith* also appears in the reported decisions of a number of other state courts. *See, e.g., In re Marriage of Devick*, 735 N.E.2d 153, 162 (Ill. Ct. App. 2000) (transfer restriction was applicable only to voluntary transfers, and not to transfers by operation of law, such as by court order; further, the restriction did not apply to any subsequent transfers by the wife because the language of the agreements did not specifically include such a provision, and because the wife had neither joined in the agreements nor waived her interest in the stock); *Allied Creditor Service, Inc. v. Swanson*, No. CIV.A. 98-03362D, 1998 WL 448920, *2 (Mass. Super., July 24, 1998) (the word "transfer" in the restriction was not sufficiently specific to include the equitable distribution of assets by operation of law, pursuant to a divorce decree); *Bryan-Barber Realty, Inc. v. Fryar*, 461 S.E.2d 29, 31-32 (N.C. Ct. App. 1995) (the agreement contained no express provision regarding the interspousal transfer of shares incident to equitable distribution, and the spouse had neither joined in the agreement nor waived her interest in the stock); *Durkee*, 428 N.E.2d at 141 (the restriction did not specifically apply to the "transfer" of shares pursuant to divorce); *Castonguay v. Castonguay,* 306 N.W.2d 143, 145 (Minn. 1981) (a transfer of stock ordered by a court in a marriage dissolution proceeding was an involuntary transfer not prohibited under a corporation's general restriction against transfers, unless the restriction expressly prohibited involuntary transfers).

Furthermore, even when a transfer restriction explicitly addressed the issue of divorce, at least one state court managed to avoid enforcing such restriction against a spouse. In *Wilke v. Wilke*, 569 N.W.2d 296, 298 (Wis. Ct. App. 1997), the applicable transfer restriction contained an independent provision entitled "Effect of Divorce," which granted the stockholder (husband) the right to purchase from the spouse (wife) any shares subject to the restriction and awarded to the wife in a subsequent divorce. However, in a marital property agreement, the husband and wife had each agreed to "give up" all rights in property awarded to the other in the divorce. 569 N.W.2d at 298. As a result, held the Wisconsin appellate court, the husband waived his right to repurchase the restricted stock. 569 N.W.2d at 299.

C. Analogy: Buy-Sell Agreements

In today's increasingly complex economic climate, closely held corporations frequently have buy-sell agreements in place between partners and shareholders. Normally intended for the mutual protection of the partners or shareholders, and to promote the continuous, harmonious and successful management of the business (by allowing the surviving or remaining parties to maintain ownership and control of the business), a buy-sell agreement typically contains mutual covenants to buy and sell a shareholder's or partner's interest at death, or if a shareholder wished to make an inter vivos sale of his or her interest in the business. *See, e.g., Little v. X-Pert Corp*., 867 S.W.2d 15, 16 (Tex. 1993). Buy-sell agreements also typically require the interest or stock to be purchased at a particular price, often "fair market value," and provide a mechanism for determining such value.

If, for example, a buy-sell agreement provides that, upon the involved spouse's divorce, the business has a right to buy back that spouse's interest in the business at a specified price, and if the buy-sell agreement is enforceable against the non-involved spouse, then the issues concerning the valuation of the interest (for purposes of divorce) have become decidedly simplified. Thus, the binding effect of buy-sell agreements is an important issue for both parties and their attorneys.

In some states, Texas, for instance, the issue is unresolved, perhaps surprisingly so. There appear to be only two reported cases in Texas that, in the context a of divorce, specifically address the issue of the effect of a partnership agreement on the valuation of a partner's interest, *Finn v. Finn*, 658 S.W.2d 735 (Tex.App.–Dallas 1983, writ ref'd n.r.e.) and *Keith v. Keith,* 763 S.W.2d 950 (Tex.App.–Fort Worth 1989, no writ). Naturally, the two cases are at odds with each other.

In *Finn*, under the terms of the law firm's partnership agreement, if the husband died or withdrew, he was entitled only to (1) the amount contained in his capital account, (2) any earned income which had not been distributed, and (3) his interest in the firm's reserve account, less ten percent of his proportionate share in the accounts receivable for clients' disbursement. By a vote of three fourths of the senior partners, the husband could have been required to withdraw, and in that event he was entitled to the same compensation for his interest as provided for under the voluntary withdrawal provisions. The partnership agreement did not provide any compensation for accrued goodwill to a partner who ceased to practice law with the firm, nor did it provide any mechanism to realize the value of the firm's goodwill. 658 S.W.2d at 741-742. It is interesting to note that the opinion of the Dallas Court of Appeals in *Finn* does not mention that the partnership agreement contained buy-out provisions upon divorce, or that the wife signed the agreement. It is probably safe to assume–but this is just an assumption–that the partnership agreement contained no such provisions and that the wife did not sign it.

The Dallas appellate court majority held that the community estate was not entitled to a greater interest than that to which the husband was entitled in the firm's goodwill, and that the extent of the husband's interest was governed by the partnership agreement. *Id*. at 741. It should be noted that the *Finn* opinion was the result of an *en banc* rehearing (11 Justices sitting) with 4 of the Justices joining the majority, 2 concurring, and 5 joining in the dissent.

In a well-reasoned concurring opinion, Justice Annette Stewart strongly disagreed with the *Finn* majority opinion:

> [t]he partnership agreement does not control the value of the individual partnership interests. The asset being divided is the husband's interest in the partnership as a going business, not his contractual death benefits or withdrawal rights. The formula in the partnership agreement may represent the present value of the husband's interest, but it should not preclude a consideration of other facts. The value of the husband's interest should be based on the present value of the partnership entity as a going business, which would include consideration of partnership goodwill, if any.

Id. at 749 (Citations omitted).

The Texas Supreme Court's refusal to find reversible error in the *Finn* decision may ***not*** have been an implicit approval of the opinion of the Dallas Court of Appeals on partnership goodwill. The Court of Appeals reversed the trial court, but on grounds unrelated to the question of partnership goodwill. Thus, it is at least arguable that the *Finn* opinion on partnership goodwill was *dicta*.

In *Keith,* the (non-professional) husband asserted on appeal that trial court erred by failing to find the market value of a partnership, of which he was a partner, by applying the formula set forth in the partnership agreement, since his wife had signed the agreement, thereby approving the agreement, accepting its provisions, and agreeing to be bound by it. 763 S.W.2d at 953. The partnership agreement provided a method for determining the value of the business in the event it was terminated due to the withdrawal, other act, or death of one of the partners. *Id*. The Fort Worth appellate court stated that it agreed with the concurring opinion of Justice Stewart in *Finn, i.e.,* that the formula set forth in the partnership agreement with respect to death or withdrawal of the partner was not necessarily determinative of the value of a spouse's interest in the ongoing partnership as of the time of divorce. *Id*.

The conflict in Texas regarding the binding effect of buy-sell agreements is reflected throughout the country. According to one Tennessee appellate court, a "small minority" of courts hold that, in a divorce, the non-shareholder spouse is bound by a shareholder valuation agreement entered into by the shareholder spouse. *Harmon v. Harmon*, No. W1988-00841-COA-R3-CV, 2000 WL 286718, *7 (Tenn. Ct. App., March 2, 2000), *citing, Hertz v. Hertz*, 657 P.2d 1169, 1174 (N.M. 1983) (the wife was bound by a provision in a stock agreement of the husband's law firm which set the value of goodwill and other intangible assets at $1.00 in the event of sale of the stock, reasoning that, if the shareholder husband terminated his employment with the law firm, he could not realize the value of the firm's goodwill, and that the non-shareholder spouse should not "receive a greater value than that of the shareholder"...).

It should be noted that the Tennessee court in *Harmon* added that later New Mexico cases limited *Hertz* to its facts. *Harmon*, 2000 WL 286718 at*7-*8, *citing, Cox v. Cox*, 775 P.2d 1315, 1318 (N.M. Ct. App.1989) ("[i]t would be equally inequitable and disturbing to permit the shareholder spouse to retain the entire community interest in the goodwill by simply entering into a restrictive shareholders' agreement and then later realizing the value upon resale of the professional association, change in the agreement, or otherwise).

Moreover, the "small minority" noted in *Harmon* has been otherwise characterized as a "substantial number of jurisdictions" by one state supreme court chief justice. *See, Huff v. Huff*, 834 P.2d 244, 259 (Colo. 1992) (Rovira., C.J., concurring in part and dissenting in part) ("[i]n a substantial number of jurisdictions, the courts rely on an existing partnership agreement in valuing a partner's interest), *citing*, *Peddycord v. Peddycord,* 479 N.E.2d 615 (Ind. Ct. App. 1985); *Weaver v. Weaver*, 324 S.E.2d 915 (N.C. Ct. App. 1985); *Hertz*, 657 P.2d 1169; *Finn,* 658 S.W.2d 735; and *Holbrook v. Holbrook*, 309 N.W.2d 343 (Wis. Ct. App. 1981).

To be included as well in the "substantial small minority" of cases holding that an applicable shareholder or partnership agreement controls valuation are *McDiarmid v. McDiarmid,* 649 A.2d 810, 815 (D.C. Ct. App.1994) (when the partnership agreement provided husband could not recoup the value of the goodwill in law firm, the wife was bound), *Mocnik v. Mocnik,* 838 P.2d 500, 505 (Okla. 1992) (the goodwill of a medical practice was not divisible marital property when under the express language of a stockholder's agreement, the husband could not recoup goodwill value); and *McCabe v. McCabe*, 575 A.2d 87, 89-90 (Pa. 1990) (the husband's partnership interest in his law partnership was to be valued pursuant to the partnership agreement,which was the "preeminent factor" in valuing his interest); *Mitchell v. Mitchell,* 732 P.2d 208, 214 (Ariz. 1987) (partnership agreement prohibited husband from realizing any goodwill from his partnership).

The rationale for the "minority position" is aptly summarized in *Holbrook*:

> [t]here is a disturbing inequity in compelling a professional practitioner to pay a spouse a share of intangible assets at a judicially determined value that could not be realized by a sale or another method of liquidating value.

Holbrook, 309 N.W.2d at 355 (footnote omitted); *see also*, *McDiarmid,* 649 A.2d at 816, n. 2 ("when presented with an agreement to which the professional spouse is bound, it is inequitable to disregard the terms of that agreement and award the nonprofessional spouse an interest in the law firm beyond that enjoyed by the professional spouse").

Another minority position holds that a shareholder's agreement can establish a "presumptive value" for the divorcing spouse's shares. *See Stern v. Stern*, 331 A.2d 257, 261 (N.J. 1975) (if a partnership agreement exists, then there is a presumption that the agreement controls the value of aa spouse's interest). According to the Tennessee court in *Harmon*, the holding in *Stern* has been limited somewhat by *Bowen v. Bowen,* 473 A.2d 73, 78 (N.J. 1984), which emphasized that the value fixed in the partnership agreement is only to be considered the presumptive value in certain situations, such as in *Stern,* when the books are well-kept, the proper factors are considered, and the value is periodically and carefully reviewed. *Harmon*, 2000 WL 286718 at *8.

On the other hand, again according to the Tennessee appellate court in *Harmon,* the clear majority of courts holds that the value established in a buy-sell agreement of a closely-held corporation, not signed by the non-shareholder spouse, is not binding on the nonshareholder spouse, but is considered, along with other factors, in valuing the interest of the shareholder spouse. *Harmon*, 2000 WL 286718 at *8, *citing Bettinger v. Bettinger,* 396 S.E.2d 709, 714 (W. Va. 1990) (a majority of courts which have considered a buy-sell agreement in a closely held corporation setting the stock value for equitable distribution purposes has determined that such an agreement should not be considered as binding, but rather should be weighed along with other factors in making a determination as to the value of such stock); *see also, Money v. Money,* 852 P.2d 1158, 1161 (Alaska 1993) ("[w]e hold that a trial court is not bound by a buy-sell agreement valuation, but may consider such a valuation when valuing marital property, especially when that valuation is supported by other valuation methods); *Huff,* 834 P.2d at 257, n. 17 ("[b]y our decision today, we join those jurisdictions which recognize that a trial court may consider various valuation methods, including a partnership agreement); *Bosserman v. Bosserman*, 384 S.E.2d 104, 108 (Va. Ct. App.1989) (in a majority of jurisdictions, the price set by a buy-out provision does not control the determination of value when the other spouse did not consent or was not otherwise bound by its terms, even though the agreement was executed after the marriage, because the value set by the buy-out provisions does not necessarily represent the intrinsic worth of the stock to the parties; when stock is subject to a restrictive transfer agreement or by-law, the price fixed by such provisions will not control its value, but the restriction on transfer is a factor which affects the value of the stock for purposes of equitable distribution*); Amodio v. Amodio*, 509 N.E.2d 936, 937 (N.Y. 1987) (if transfer of the stock of a closely held corporation is restricted by a bona fide buy-sell agreement which predates the marital discord, the price fixed by the agreement, although not conclusive, is a factor which should be considered); *In re Marriage of Hall*, 692 P.2d 175, 179-80 (Wash. 1984) (trial court may consider various methods for valuing the goodwill of a spouse participating in a partnership, including the formula in the partnership agreement); *see also, In re Marriage of Melnick,* 468 N.E.2d 490 (Ill. Ct. App. 1984); *Bowen,* 473 A.2d 73; *Arneson v. Arneson*, 355 N.W.2d 16 (Wis. Ct. App.1984); *In the Matter of the Marriage of Belt*, 672 P.2d 1205 (Or. Ct. App. 1983); *Rogers v. Rogers,* 296 N.W.2d 849 (Minn. 1980); *In re Marriage of Moffatt,* 279 N.W.2d 15 (Iowa 1979).

As might be expected, the Tennessee appellate court in *Harmon* sided with the "majority" position. *Harmon*, 2000 WL 286718 at *10 ("...we adopt the majority view on the weight given to such agreements, holding that they may be considered along with any other relevant evidence on valuation, but are not controlling").

D. Effect of Transfer Restrictions on Value

"It cannot be questioned that the stock restriction agreements are a valid and relevant circumstance in respect to the fair cash value of the stock of the two corporations." *Erwin v. Erwin*, No 87-315-II, 1988 WL 27249, *6 (Tenn. Ct. App. March 22, 1988). As "a valid and relevant circumstance" affecting value, stock restrictions generally represent a significant factor in appraising the market value of stock, but not an absolutely limiting one. *Fechtor v. Fechtor*, 534 N.E.2d 1, 5 (Mass. App. Ct. 1989) (stock was subject to a transfer restriction which gave the corporation a first option to buy at book value the shares of a stockholder who desired to sell), *citing*, *Mailloux v. Commissioner,* 320 F.2d 60, 62 (5th Cir.1963) and *United States v. Parker,* 376 F.2d 402, 409-410 (5th Cir.1967).

In the words of one court:

> ...the limitation created by the restrictive agreement necessarily affects the actual marketability of the stock, and thus its value. Therefore, a bona fide provision or agreement must be considered when a trial court determines the value of stock for purposes of equitable distribution. When stock is subject to a restrictive transfer agreement or by-law the price fixed by such provisions will not control its value, but the restriction on transfer is a factor which affects the value of the stock for purposes of equitable distribution.

Bosserman, 384 S.E.2d at 108. Another court has stated that, although there will be debate about the size of the discount to be applied to recognize the transfer restriction, "the important thing" is that the restriction "be taken into account adequately after suitable analysis." *Fechtor v. Fechtor*, 534 N.E.2d 1, 5 (Mass. App. Ct. 1989), rev. denied, 537 N.E.2d 157 (Mass. 1989); *see also Hansel v. Holyfield*, 779 So.2d 939, 949 (La.Ct.App. 2000), *writ denied*, 789 So.2d 591(La. April 12, 2001), *reconsideration denied*, 792 So.2d 747 (La. May 25, 2001) (the trial court did not error by applying a 23% discount to restricted stock owned by the parties, rather than the lesser discount of 10% argued by the wife).

A trial court's refusal to apply a discount for lack of marketability due to a transfer restriction may well be error. In *Rogers v. Rogers,* 296 N.W.2d 849, 852-853 (Minn. 1980), for example, the trial court erred in relying upon an opinion of value which recognized no discount at all by reason of a stockholder's agreement which restricted transfer.

As with a transfer restriction, a buy-sell agreement may affect the value of the pertinent ownership interest. *See*, *Harmon*, 2000 WL 286718 at *11, *citing*, *Bosserman*, 384 S.E.2d at 108; *see also,* Rev.Rul. 59-60, §8, 1959-1 C.B. 237.

VI. DEFERRED COMPENSATION

A. Founder's Stock

Founder's stock is usually awarded to individuals who initially organize a company. Common stock, normally with only a nominal face value, is transferred to these individuals in return for their services and efforts in establishing the company. Strictly speaking, there is no "technical" definition of founder's stock. *In re Marriage of Jagannathan*, 1996 WL 1570260, *4 (Cal. Ct.App. 1996) (unpublished).

Founder's stock consists of actual "issued" shares of common stock while stock "options" grant only the right to purchase a set number of shares in the future. Founders "own" the stock outright from the beginning; option holders have to "exercise" the option and pay exercise price in order to receive the specified shares of stock. Capital gains treatment applies to both founder's shares and stock options as long as the base stock is held over 12 months before sale.

In some circumstances, founder's stock also differs from stock options with respect to vesting. Founder's stock may be considered fully "vested" upon receipt of the original shares, whereas stock options normally vest over a period of years. However, even though founder's stock may be fully "vested," it is also normally subject to severe transfer restrictions, which, in and of themselves, constitute a sort of "vesting." Consequently, the holder of Founder's stock must remain with the company, typically for three to five years, in order to realize any value from the stock they own. For example, almost invariably, an individual who receives Founder's stock must sell the stock back to the company for the original price if he or she does not remain with the company for the required period of time. *See and cf., Id.* (the husband's unvested founder's stock could be repurchased by the company for what he paid for them, but his vested shares were only subject to a restriction that gave the company the right of first refusal to purchased such shares at fair market value). In essence, the company has a "call option" on the founder's shares which it does not have in relation to traditional common stock options.

In other words, Founders stock is subject to reverse vesting in terms of value. The shareholder owns the stock, but its value cannot be realized until time restrictions are met.

B. Stock Options

1. <u>In General</u>

A "stock option" is the right to buy a designated stock (termed a "call" option), or to sell a stock (termed a "put" option), at anytime within a specified period at a determinable price, if the holder of the option so chooses. *See, In re Marriage of Short*, 859 P.2d 636, 641 (Wash. Ct. App. 1993), *aff'd in part, rev'd in part on other grounds,* 890 P.2d 12 (Wash. 1995); *see also*, Internal Revenue Code §1234(a) (an employee stock option is a contractual right to purchase stock on or before a specified date at a predetermined price). There are two classifications of options: (1) statutory or qualified options, those granted under and governed by specific Internal Revenue Code sections; and (2) nonstatutory or nonqualified options, those governed under the more general I.R.C. principles of compensation and recognition of income. *Wendt v. Wendt*, No. FA96 0149562 S, 1998 WL 161165, *116 (Conn. Super., March 31, 1998), *aff'd*, 757 A.2d 1225, 1230 (Conn. App. Ct. 2000); *but cf.,* Tracy A. Thomas, *The New Marital Property of Employee Stock Options*, FAMILY LAW QUARTERLY, Vol. 35, No. 3, p. 502 (Fall 2001) ("[c]ourts sometimes discuss employee options in terms of qualified and nonqualified, but these are simply designations used by the Internal Revenue Service...to determine the point in time at which the option will be taxed as income") (footnote omitted) [hereinafter referred to as "Thomas"].

Stock options are a form of compensation commonly used by start-up companies, technology companies in particular. *See, In re Marriage of Robinson*, 35 P.3d 89, 93 (Ariz. Ct. App. 2001). Indeed, stock options often represent a significant part of an employee's compensation plan. *Id.* It has been estimated that between ten and twelve million private sector employees in the United States have employee stock options, a ten-fold increase in the last ten years. Thomas, at p. 498.

When the option holder has the absolute right to exercise the purchase right at any time by paying the purchase price, the option is "vested and matured." *See, e.g., Everett v. Everett*, 489 N.W.2d 111, 113 (Mich. Ct. App. 1992). If the option cannot be exercised until some future date, the ability to exercise being contingent upon a future event, such as the employee remaining an employee, the option is "unvested." *See, Id.*; *see also*, *In re Marriage of Robinson*, 35 P.3d at 93, *quoting*, Kristy Watson, *Acting in the Best Interests of the Child: A Solution to the Problem of Characterizing Stock Options as Income,* 69 Fordham L.Rev. 1523, 1538 (2001), *quoting* Note, *Stock Options–Classification and Valuation,* 15 Equitable Distribution J. 77, 77 (1998) (a stock option may be vested and matured, vested and unmatured, or unvested: the option is vested and matured if the employee has an absolute right to exercise the option immediately; the option is vested and unmatured if the employee cannot exercise the option yet but has an absolute right to do so at some future date; the option is unvested if it cannot yet be exercised and if future vesting is based upon the occurrence of a certain contingency); *cf.,* Thomas, at p. 503 (the label "mature" connotes the same operative period as "excercisable"; both are when the employee can access the option to buy corporate stock) (footnote omitted).

Whether the options are granted to provide compensation for past or present services, or whether they are used to provide incentive for continued employment, such options usually expire upon termination of employment.

To the Internal Revenue Service, an employee stock option is a form of "deferred compensation." *See*, *Short*, 859 P.2d at 641-642. In effect, the employee accepts the employer's promise to pay in the future, rather than a current cash payment, and, if the employer's stock option plan has been carefully drawn so that it is accepted as a "non-qualified" plan by I.R.S., the employer need not fund the plan, as would otherwise ordinarily be required by ERISA. *Id.*

Typically, stock options vest over time, for example, 20% per year, in which case the employee must remain with the company for 5 years to vest 100% of the options. The grant of a stock option does not equate to ownership of stock, which is acquired at the time the options "vest" and are exercised. The employee's cost of the stock options is set by the company in the form of a stated exercise price. The employee pays for the stock at the time the stock options are exercised. Generally, as mentioned, if an employee leaves the company prior to the stock options vesting, the unvested stock options are lost.

In the ordinary employment context, the value of stock options is the difference between the employee's cost of the stock options and the price the stock can be sold. Therefore, if the value of the company's stock does not increase, the stock received pursuant to exercising the vested stock options may have little or no value. There is no guarantee that stock options will have value or that the employee will actually exercise vested stock. As stated in *Rice v. Montgomery*, 663 N.E.2d 389, 392 (Ohio Ct. App. 1995):

> ...the true value of the stock option to its owner is the potential for appreciation in stock price without investment risk. If the stock price were to drop, the owner of the option simply would not exercise it, because he could instead buy the stock more cheaply on the market. As stated by Treas. Reg. 1.83-7(b)(3), the value of this type of stock option is risk-free appreciation.

Ultimately, according to one Arizona appellate court, the value of an option depends directly on the terms of the option. *In re Marriage of Robinson*, 35 P.23d at 93, *quoting*, Michael J. Mard & Jorge M. Cestero, *Stock Options in Divorce: Assets or Income?,* 74 Fla. B.J. 62, 62 (May 2000).

With regard to legal issues surrounding employee stock options, one commentator has argued that the law "has failed to keep up with this modern form of employee compensation and indeed has struggled to understand this new form of property in the context of dividing and distributing marital property. Thomas, at. p. 497. In particular, according to such commentator:

> [t]he law has been slow to address the new property of the ESO [employee stock option] and instead has tried to conform the option to the existing legal parameters of pensions, deferred compensation, fringe benefits, or publically traded stocks. However, these analogies all fail to adequately address the relevant legal questions simply because ESOs do not fit the characteristics of these other forms of property. The resulting law is thus contradictory and disjointed as it tries to fit the square peg of an ESO into existing round holes.

Id. at p. 500 (footnotes omitted).

It is very important to note that the Nebraska Supreme Court has held that a lower appellate court erred by concluding, as a matter of law, that a lawyer was not negligent for failing to advise his client of the unsettled nature of the law regarding whether unvested stock options were part of the marital estate (inlcuding out of state decisions favorable to the client), and whether the marital estate's unvested stock options should have been valued without deducting potential capital gains tax. *Wood v. McGrath, North, Mullin & Kratz*, 589 N.W.2d 103, 108 (Neb. 1999).

2. <u>Valuation</u>

Courts across the country have used a variety of methods to value employee stock options. *Davidson*, 578 N.W.2d at 858; *In re Marriage of Robinson*, 35 P.3d at 94 (various methods have been proposed by courts and commentators for valuing employee stock options, whether for purposes of dividing marital assets or calculating child support). One state appellate court has summed up the difficulties in valuing stock options as follows:

> [q]uantifying the value of a stock option at the time of its grant is a complex task, subject to the vagaries of market forecast and compounded by the fact that no ready market can exist for nontransferable stock options.

Rice, 663 N.E.2d at 392. Moreover, the Supreme Court of Pennsylvania recently stated:

> [w]e agree with [the lower courts] that it is impossible to ascribe a meaningful value to the unvested stock options, primarily because it is absolutely impossible to predict with reliability what any stock will be worth on any future date. Ascription of a value to a stock option before it vests is impermissibly speculative.

Fisher, 769 A.2d at 1169; *see also*, Thomas, at. p. 517 ("...the problem with valuing an ESO is that it does not have an ascertainable market value because it is unassignable and because its value is dependent upon certain future contingencies") (footnote omitted).

In the same vein, it has been opined that estimates of option values are a species of "soft information" that is derived from sources such as the specific terms of a plan (including when and for how long options are exercisable), historical information concerning the volatility of the securities that will be authorized to be optioned, and debatable assumptions about the future. *See, Lewis v. Vogelstein*, 699 A.2d 327, 336 (Del. Ch. 1997).

Although the valuation issue is difficult, and although there are a number of methodologies by which values can be assigned to options, three general approaches stand out, and a fourth is sometimes possible. *See and cf., e.g., In re the Marriage of Harrington*, 929 P2d 1159, 1168-1169 (Wash. Ct. App. 1997) (although contingencies surrounding a stock purchase agreement (which the court found analogous to a stock option) might be relevant in valuing the purchase right, the court declined to impose any particular valuation formula upon the trial court). According to one state appellate court, at least in the context of child support, the appropriateness of the valuation method will depend on such factors as the nature of the stock options, market conditions, tax consequences, ease of application, and other facts and circumstances peculiar to each case. *In re Marriage of Robinson*, 35 P.3d at 95.

It should noted, as well, that some courts have rejected any valuation method as inappropriate to a non-marketable, contingent stock option interest, and have instead deferred the valuation (and distribution) decisions until the option is actually exercised. Thomas, at pp. 517-518.

a. Intrinsic Value

An option's intrinsic value is obtained by subtracting the exercise price from current market price of publicly traded stock and multiplying that by the number of shares of the stock option. *Wendt*, 1998 WL 161165 at *192; *Murray v. Murray*, 716 N.E.2d 288, 298 (Ohio Ct. App. 1999) (for purposes of determining child support, the court valued each vested stock option "according to the stock price on the most recent date on which an option could be exercised [*i.e.*, the maturity date,] minus the [strike] price on the day that option was granted); *see also*, G. Daniel Jones and Melvyn Frumkes, *Dividing Stock Options*, p. 4, AMERICAN ACADEMY OF MATRIMONIAL LAWYERS MARCH MEETING (2001) [hereinafter "Jones and Frumkes"] (intrinsic value represents the difference between the current stock price and its strike, or exercise, price). However, according to Judge Tierney in *Wendt*, the intrinsic valuation method does not take into account two factors: (1) risk of investment, and (2) volatility of the stock price. 1998 WL 161165 at *192; *cf.*, Thomas, at p. 518 (the intrinsic method fails to discount for any of an options contingencies, such as required future employment and stock price volatility) (footnote omitted). To illustrate such weakness in the intrinsic value method, Judge Tierney proposed the following scenario in *Wendt*:

> [i]f a stock option grant was given at a $50 per share rate on December 1, 1995, and the stock price on October 1, 1997 was $50, that stock would have zero intrinsic value. Inherent in stock options is the right to be able to acquire that stock at sometime in the future, presumably when its price had increased. If that same stock had an ability to grow and it was exercisable on December 1, 1999, no doubt that stock option would have some market value on October 1, 1997 even though it had no intrinsic value as of October 1, 1997.

Id. As a result, Judge Tierney concluded that intrinsic value is an inadequate method of evaluating stock options in a marital context. *Id*.; *see also*, Jones and Frumkes, p. 4 (intrinsic value is "[n]ot generally accepted"); *Fisher,* 769 A.2d at 1171 (Newman, J., concurring) ("[t]he majority appears to believe that the intrinsic value method is too speculative, and I agree").

Despite his articulated reservations–"[i]t appears that...the intrinsic value...is [not] useful to obtain a value of employment issued unvested stock options in a marital setting, *Wendt*, 1998 WL 161165 at *199–Judge Tierney nevertheless used intrinsic value in *Wendt*. *See, Wendt,* 757 A.2d at 1232, n. 3. Moreover, intrinsic value has been used by other state courts in divorce settings. *See*, Geoffrey S. Poll, *Tax Traps/Tax Tricks and the Complex Property Case*,4, NEW FRONTIERS IN MARITAL PROPERTY LAW (State Bar of Texas 2000), *citing*, *Richardson v. Richardson*, 659 S.W.2d 510 (Ark. 1983) (awarding amounts to the spouse with respect to unexercised stocks options based on their intrinsic value); *see also*, *Fountain v. Fountain*, No. COA01-14, 2002 WL 171303, *5 (N.C. Ct. App., Feb. 5, 2002) (the trial court did not err by using the intrinsic value method, as opposed to the Black-Scholes Method, since intrinsic value was a sound valuation method, the court's determination was based on competent evidence, and the North Carolina appellate court had never expressly adopted any particular approach for valuing stock options).

b. Discount to Present Value

Another possible valuation methodology for options is termed "discount to present value." *See, Wendt*, 1998 WL 161165 at *192. In the discount to present value method, the intrinsic value of the option is determined, then various discounts, *i.e.*, risk of forfeiture, lack of marketability, and tax consequences, are applied to the intrinsic value in order to obtain the present value. *See, Id*. at *193.

Judge Tierney's opinion in *Wendt* recites that the discount to present value method was used in an unpublished New York decision, *Evans v. Synder*, 207 N.Y.L.J. 21, April 15, 1992 (N.Y. Sup.Ct. 1st Dept 1992), which was affirmed without opinion, 603 N.Y.S.2d 740 (N.Y. App. Div. 1993). Judge Tierney also states that, although the trial court in *Evans* set forth in detail the discount to present value calculations (which had reduced the stock's intrinsic value of $3,837,500.00 to a present value of $1,654,730.00), the trial court did not actually compute and divide the present value of the restricted stock issue, but rather awarded the wife "a portion of the stock at the time a transfer is possible." *Wendt*, 1998 WL 161165 at *193. Judge Tierney ultimately concluded that "[t]he present value/discount method appears to be a viable method of valuing unvested stock options and/or restricted stocks if there is sufficient supporting data to justify the use of the various discounts." *Id*. at *199 (although, as already mentioned, in *Wendt* Judge Tierney himself employed the intrinsic value method).

In *Hansel*, 779 So.2d at 948-949, the trial court did not error by finding that the discount to present value method advocated by the husband more fairly and accurately established a present value of unvested stock options than did the Black-Scholes model [discussed immediately below] advocated by a the wife.

c. Black-Scholes Option Pricing Model

There are several sophisticated methods which can be used to determine the exact value of a particular stock option. *Wendt*, 1998 WL 161165 at *193. The most generally accepted mathematical (theoretical) model used to value options is termed the "Black-Scholes Model," named after its creators, who first published the methodology in 1973 (thereby winning the Nobel Prize in economics). Jones and Frumkes, p. 3; *see also*, Thomas, at p. 518 (the most common alternative valuation method seen in divorce cases is the Black-Scholes Method) (footnote omitted). The model is "complicated," and its "imposing algebra" requires six inputs of data, most often done by computer. Jones and Frumkes, p. 3. In fact, of the Black-Scholes Model, Judge Tierney comments:

> [i]t appears to a layman to be one of the most complicated formulas ever devised by mankind. It is hardly useful for a court to consider with a simple calculator on the bench. It would require expert computation.

Wendt, 1998 WL 161165 at *195; *but cf.,* Thomas, at p. 519 (the Black-Scholes Method is well known, generally accepted, and commercially accessible through user-friendly computer software programs).

The Black-Scholes Model relates the value of an option to six factors: (1) exercise or strike price; (2) current stock price; (3) the dividend yield for the particular stock; (4) the time to expiration; (4) the current risk free market rate of return; and (6) the future volatility (standard deviation) of the particular stock. Jones and Frumkes, p. 3; *see also*, *Wendt*, 757 A.2d at 1223, n. 4, *citing*, *Snyder v. Commissioner,* 93 T.C. 529, 540, 1989 WL 129656 (1989) (the Black-Scholes method of valuation "is a complex formula which reflects the interrelationship of the fair market value of the stock to be purchased, the exercise price of the option, the amount of dividends to be paid on the stock over the life of the option, the 'risk-free' rate of return at the time the option is granted, the volatility of the stock to be purchased, and the term of the option").

The Black-Scholes model makes a number of assumptions, however, that are not relevant to placing a value on nonvested stock options in a marital setting: (1) the value of the option has nothing to do with expectancies about the future price of the underlying stock (a purchaser of an option would not buy the option merely because of a belief that the price of the stock will rise), (2) there must be a known market for the asset, and (3) there must be prior history of the trading price for both the underlying stock and the option being evaluated. *Wendt*, 1998 WL 161165 at *196. In *Wendt*, Judge Tierney concluded: "[t]he Black-Scholes model is not an appropriate method of evaluating employment issued unvested stock options in a marital setting." *Id*. at *197; *see also*, *In re Robinson*, 35 P.3d at 95, *quoting*, Andrew C. Littman, *Valuation and Division of Employee Stock Options in Divorce,* 29 Colo. Law. 61, 62 (May 2000) ("these models generally were designed to value marketable options," which employee stock options typically are not); *Lousiana State Employees' Retirement System v. Citrix Systems, Inc.*, No. CIV.A. 18298, 2001 WL 1131364, *7 (Del. Ch., September 9, 2001) (the defendant's expert testified that, while the Black-Scholes method may be appropriate for valuing freely tradeable options, the model overstates the value of employee options which are not liquid, freely tradeable options); *In re Coleman Company, Inc. Shareholders Litig.*, 750 A.2d 1202, 1208, n. 13 (Del. Ch. 1999) (the existence of variables, *i.e.*, the risk free rate, volatility of the underlying stock, expiration date of the option, etc., may cause the model to have less reliability in certain circumstances).

Further, the Black-Scholes Method was developed for European-style options, which are exercisable only at their expiration date with no vesting and transferability restrictions, whereas almost all U.S. employee stock options can be exercised at any time after vesting (usually by year seven or eight) and are rarely transferable. Warren Cole and Brenda Keen Schwartz, *Tophats, Handshakes and Handcuffs*: *Identifying and Dividing the Different Executive Compensation Plans*, p. 28, 27th ANNUAL ADVANCED FAMILY LAW COURSE (2001). In addition, employee stock options can almost never be sold or traded, unlike publicly traded options. *Id*. Finally, and most importantly, the Black-Scholes model attempts to predict future price volatility based on the stock's past performance over a specified period. *Id*.

The inherent difficulties presented by the Black-Scholes Method prompted one trial court to state:

> [t]he court finds that the Black-Scholes method was created in 1973 for the purpose of evaluating stock options traded on the public market. The Black-Scholes method involves various components. Involved in the formula are the analysis of dividends, the volatility of stock and the lack of a known market for these "contingent resources." The Black-Scholes method also has a number of variations. No one Black-Scholes formula exists. The Black-Scholes method does not appear to be an accurate method for evaluating employment issued stock options in a marital context.

Chammah v. Chammah, No. FA 95145944S, 1997 WL 414404 at *6 (Conn. Super., July 11, 1997).

Nevertheless, Judge Tierney's (and the others') observations notwithstanding, the Black-Scholes Model has indeed been applied in divorce cases. In *Davidson*, 578 N.W.2d at 858, the Supreme Court of Nebraska held that the trial court did not abuse its discretion by applying the Black-Scholes Model to value the husband's employee stock options, when the husband's own accountants used the method, the wife's expert used the method, and the company used the method for it proxy statement.

Thus, the Black-Scholes Method does appear to provide an possible alternative valuation methodology. As explained by one state court justice:

> I have discussed discounting to present value and the Black Scholes model simply to illustrate that there are alternatives to the unacceptably speculative intrinsic value method employed by [the wife's] expert in this case....I reiterate that if parties provide the trial court with expert testimony that cogently sets forth how a present value can be assigned to stock options, it is within the court's discretion to accept that testimony and order immediate distribution of the marital assets.

Fisher, 769 A.2d at 1172 (Newman, J., concurring).

d. Market Value

Options to purchase or sell shares of major public corporations are freely traded on public stock markets, but, in the case of most divorces, nontransferable stock options generally will be involved, which only the owner or the owner's estate can exercise.

However, even options from smaller companies are sometimes traded on an established market. As a result, the "market comparable approach," as one court has termed it, bases the value of stock options on their worth in a secondary market; such options, known as warrants, are publicly traded and bring a price distinct from the value of the underlying stock. *Banning v. Banning*, No. 95 CA 79, 1996 WL 354930, at *6 (Ohio App., June 28, 1996). The market comparable approach uses the price of publicly traded stock options from the same company as of the date of the trial or divorce, but although the market approach is a good measure of the value, the necessary information is rarely available and, therefore, such method is not often used. *Id*.

C. Stock-Based Compensation Plans

1. Incentive Stock Option Plan

Under an incentive stock option plan (ISO), a company grants a right to an employee to buy the company's stock during a stated period of time at a price equal to its fair market value at the time of issuance. Such a plan can be designed to restrict the stock purchased so that the employee receiving the stock can only sell it to the company, and only upon his or her termination of employment – at a price equal to the fair market value of such stock at the time of the sale.

If the employee exercises an ISO at a time when the value of the stock exceeds the purchase price, he or she will receive an immediate benefit in the form of a bargain purchase. If the stock's value continues to rise, he or she will receive further benefit – since, if the stock is restricted, the employee can sell the stock to the company upon the termination of employment at a price that takes into account the further increased value.

In order for an option to qualify as an ISO, the option must satisfy a number of requirements set forth in Section 422 of the Internal Revenue Code. Each ISO must be granted in connection with the optionee's employment, under a plan that details both (1) the aggregate number of shares that may be issued upon the exercise of the ISO and (2) the employees (or class of employees) who are eligible to receive the ISO. In addition, an ISO may only be granted with an exercise term of 10 years or less, and the exercise price may not be less than the fair market value.

When these requirements are satisfied, the ISO issuance constitutes a nontaxable event for federal income tax purposes. The company granting the ISO receives no deduction either on the date the ISO is granted or on the date the ISO is exercised. Similarly, no amount is generally included in taxable income by the optionee on either date.

However, the potential for income recognition exists on the date of exercise for an ISO. This is because the difference between the value of the stock received on the exercise of the option and the option price constitutes an item of tax preference for purposes of the alternative minimum tax.

Absent income recognition by the optionee under applicable alternative minimum tax rules, gain or loss will be recognized by the employee receiving an ISO only upon his or her sale of the stock. The amount of gain or loss will equal the difference between (1) the sum realized on the sale of the stock and (2) the sum of any amount paid for the option (presumably zero), plus the amount paid for the stock upon the exercise of the option.

An ISO must be granted pursuant to a plan that is approved by the sponsoring company's shareholders within 12 months before or after the adoption of the plan. The approval by the shareholders of a stock option plan must comply with all applicable provisions of the corporate charter, bylaws, and the laws of the state of incorporation.

2. Nonqualified Stock Option Plan

Like ISOs, nonqualified stock options (NSOs) are contractual rights to buy stock from the issuer at a specified price. Unlike ISOs, though, an NSO grant is not restricted to employees and they are not required to meet specific tax requirements.

Accordingly, a good deal of flexibility is available in designing NSOs. For example, the price of NSOs need not bear any relationship to the price of the stock being optioned, nor must NSOs be exercised within any particular time frame.

Whether the granting of an NSO constitutes a taxable event depends principally on whether the NSO has a "readily ascertainable fair market value" at the time it is granted. Because NSOs are normally nontransferable and are not immediately exercisable in full, they generally do not have an ascertainable fair market value. For this reason, the exercise of an NSO will generally constitute a taxable event.

The amount that will be included in income by the NSO recipient will be the excess of (l) the fair market value of the stock over (2) the sum of any amount paid for the NSO (presumably zero), plus the amount paid for stock. The amount taken into income by the individual will be characterized as ordinary income. The company granting the NSO will generally be entitled to a tax-deduction equal to the amount that is included in the individual's income.

If the optionee continues to hold the stock after exercise, and he or she eventually sells the stock for a gain, the additional tax due on the gain will be taxed at the capital gains rate. It will be applied to the difference in value from the date of exercise to the date of sale.

3. Restricted Stock Plan

Under a restricted stock plan, an employee is generally granted shares of stock that are subject to: (1) a substantial risk of forfeiture, and (2) transfer restrictions that lapse only if he or she remains in the employ of the company for a specified period. If the employee terminates employment prior to the expiration of the restriction period, then he or she forfeits the shares to the company.

If the employee remains employed by the company until the end of the restriction period, then the forfeiture provision will lapse and the employee will own the stock. A restricted stock plan may also provide that the employee (1) can only sell the stock to the company, and (2) will have to sell the stock to the company when his or her employment terminates.

Internal Revenue Code §83(a) provides that an employee receiving stock under such a plan will realize no income for federal income tax purposes at the time of the grant (unless he or she files an election pursuant to Section §83(b)). Rather, the employee will realize income when the restriction or forfeiture provision lapses in an amount equal to the then value per share multiplied by the applicable number of shares. The company issuing the shares will be entitled to a deduction equal to the amount taken into income by the employee (to the extent that the amount constitutes reasonable compensation). Upon the employee's sale of the shares to the company, the employee will also realize income or loss.

4. Stock Appreciation Rights Plan

A stock appreciation rights plan (SAR) is another method of management compensation. *See, e.g.*, *Chamison v. Healthtrust Inc.*, 735 A.2d 912, 915 (Del. Ch. 1999), *aff'd*, 748 A.2d 407 (Del. 2000) (at the time of its formation, the company had awarded stock appreciation rights to certain key officers as incentive bonuses for their efforts on behalf of the company; such rights are a form of employee compensation awarded to executives, operating much like phantom stock plans; *Pogostin v. Rice*, Civil Action No. 6235, 1983 WL 19985, *4 (Del. Ch., August 12, 1983) (it is well settled that stock appreciation rights are reasonably related to the legitimate purpose of retaining qualified personnel). Distributions from an employee's SAR account are based only on the increase, if any, in the value per share between the date of the award and the date of distribution. While some SAR plans use a maturity date as an automatic time for distribution, others allow an employee to choose – within a prescribed period – the timing of the distributions from his or her account.

5. Stock Bonus Plan

Under a stock bonus plan, an employee bonus is contingent upon the issuing company's earnings exceeding a stated level for a specified period. Bonuses under the plan may be contingent on the financial or earnings performance of the company. A stock bonus plan allows a company great flexibility in compensating key employees. For instance, such a plan can provide that if earnings rise above a certain minimum level, the bonus amounts will also increase, thus providing the company employees an incentive to maximize earnings.

The bonuses may be paid in the form of the company's stock or cash, or both. A stock bonus plan can provide that the stock received under the plan can only be sold to the company, and/or must be sold to the company when employment terminates, at a price equal to the value per share at the time of transfer.

An employee receiving shares under a stock bonus plan realizes no taxable income at the time he or she is awarded bonus credits. When the amount of the stock bonus is paid, then the employee will realize ordinary income in an amount equal to the value per share multiplied by the number of shares he or she receives, plus the amount of any cash received.

The company awarding the bonus credits is entitled to a deduction equal to such amount (to the extent it constitutes reasonable compensation). When the employee sells the stock to the company, he or she rea1izes income or loss, as the case may be.

D. Phantom Stock

Under a "phantom stock" plan, hypothetical shares of a company's stock are allocated by book entry to the account of an employee. No actual cash or shares of stock are set aside by the company to fund future distributions.

If the employee remains with the company until the end of the restriction period, then the phantom shares are converted into actual shares or cash, or both. Again, the company may use a restriction period to prevent any employee leaving within a set period of years from receiving any stock or cash.

For example, in *In re Marriage of Leisner*, 579 N.E.2d 1091 (Ill. Ct. App. 1991), the husband received over $400,000.00 pursuant to a phantom stock agreement with his employer executed during marriage. The agreement stated that the employer found it "desirable to encourage and reward [the husband] in a manner that will stimulate his active interest in the development and financial success of the Company and strengthen his desire to remain with the Company." *Id*. at 1092. The agreement further provided that if employer-business was not sold by a particular date, the husband was to receive a promissory note from it for an amount equal to the value of 20 shares of its common stock (hence the term "phantom stock agreement"), plus "a sum...equal to the amount of cash which the husband would have received on account of [any cash dividends upon the common stock of the company which would have been declared and paid prior to the date of sale of the company]...had he been the owner of...[such 20 shares]." *Id*. Ultimately, the trial court found that since the agreement had been executed during marriage, all proceeds thereof were marital property, a decision upheld by the appellate court on appeal. *Id*. at 1095.

To the extent that phantom shares are distributed in cash, they are valued using the existing value per share of the company's stock. Shares distributed to an employee also may be restricted so that they may be sold only to the company, and/or must be sold to the company upon termination of employment.

In *Liesner*, the husband argued that the trial court, in determining that all the proceeds from the phantom stock plan were marital property, failed to consider that he had already paid $105,000.00 in taxes on the proceeds and still owed another $20,000.00. *Id*. at 1099. The appellate court noted that, under Illinois law, the trial court was not obligated, when ***valuing*** an asset, to deduct from that value the amount of taxes which were paid on it; rather, the trial court was required to consider the tax consequences of the property ***division***. *Id*.

An employee receiving a phantom stock grant realizes no taxable income at the time of the award. The employee is taxed at ordinary income tax rates when distributions are made from the phantom stock account. If shares are later sold to the company, the employee will realize income or loss, as the case may be, with capital gains tax being payable on any income so realized.

E. Golden Handcuffs

Essentially, "golden handcuffs" are a benefit package, often involving stock options, designed to ensure that an employee remains with the employer. *See*, *e.g.*, *In re Marriage of Harrison*, 225 Cal.Rptr. 234, 240 (Cal. Ct. App. 1986) (the court was satisfied that the options represented "golden handcuffs" to assure the husband would stay with the company); *cf.*, *Wendt*, 757 A.2d at 1235 (where the trial court found that unvested shares were granted partially for present, but largely for future services, the options could not be categorized solely as "golden handcuffs").

As stated by the trial court in *Wendt*, 1998 WL 161165 at *158:

> [s][tock options for future compensation can include: specific language to that effect in the grant documents, long term retention of key executives, increasing the executive's incentives and efforts, providing security for the executive and "golden handcuffs."
>
> This type of option for future compensation is granted to insure the employee's continued employment and future productivity. The valued employee is offered an incentive to remain with the company because if he is no longer with the company the "golden handcuff" option terminates with no payment to the employee. These incentive stock options, awarded now, but for labor to be expended in the future, beyond the date of dissolution are not divisible. Evidence of the future nature of the option is usually found in the language of the option grant or employment agreement.

The Texas case of *Charriere v. Charriere*, 7 S.W.3d 217 (Tex.App.–Dallas 1999, no pet.) deals with classic "golden handcuffs," *i.e.,* options that are presently "vested," but the underlying subject stock of which is onerously restricted. In *Charriere*, the option agreement provided that the options granted to the wife were exercisable any time after the grant date and before the "option termination date," and thus were exercisable during the marriage. *Id*. at 220. The Dallas appellate court necessarily rejected the wife's argument that classifying the options as community property was improper because the options had no value apart from her post-divorce personal services (due to the "admittedly"onerous transfer restrictions). *Id.* 221. Thus, all of the options belonged to the community estate. *Id*. at 218.

Charriere should be contrasted with the California case of *Harrison*. In *Harrsion*, the husband was awarded, during the marriage, nonqualified options to acquire company stock, fully exercisable on the day of the grant. 225 Cal.Rptr. at 238. However, any stock issued was subject to restrictions providing for forfeiture to the corporation if the employee were terminated for cause or were to leave voluntarily without corporate consent. Such forfeiture provisions lapsed in 20% increments, starting two years after the stock was issued, and did not apply if the employee died, was terminated without cause, or left corporate employment voluntarily with corporate consent. *Id*. The trial court applied a "*Hug*" time apportionment formula referring to the time the options were granted until the time the restrictions to the subject stock lapsed. *Id*. at 237.

On appeal, the California appellate court noted that since the stock was subject to restrictions, it was not "vested," but that the options, on the other hand, were vested. *Id*. at 238. For this reason, according to the California appellate court, the trial court's formula referring to the vesting dates of the options was wrong, although harmlessly wrong, since the formula could be–and was–modified to refer to the date upon which the restrictions on the stock issued pursuant to the options were removed. *Id*. After such modification, the California appellate court found that the options were indeed "golden handcuffs," and specifically noting that there was no evidence to indicate the stock options were a factor in initially attracting the husband to the company, or that they were granted as deferred compensation for past services. *Id*. at 240. Rather, based on the record, the California appellate court concluded that the stock options reflected the husband's time, skill and effort beginning on the date the options were granted. *Id*. Ultimately, the use of the time frame regarding the lapsing of the stock restrictions diluted the wife's share of the property to account for the post-divorce efforts of the husband. *See*, J. Lindsey Short, Scott T. Cook, Milton Frankfort, Kenneth D. Fuller, and Brenda Keen Schwartz, *Complex Executive Compensation Plans*, p. 12, NEW FRONTIERS IN MARITAL PROPERTY LAW (State Bar of Texas 1997).

The result in *Harrison* should next be compared to that in *Miller*, 915 P.2d 1314. In *Miller*, the husband's employer granted the husband 2,500 shares of restricted stock, which was to vest over five years. *Id*. at 1315. During the restriction period, the husband could not transfer or pledge his interest in the stock shares, but retained all other rights associated with ownership of the stock shares, including the rights to vote the stock and to receive cash dividends; further, the restrictions affected his right to retain all or portions of the restricted stock shares in the event of the termination of his employment prior to the expiration of the restriction period, his retirement, total and permanent disability, or death. *Id*.

With respect to such restricted shares, the Colorado Supreme Court noted that the employer could not unilaterally repudiate the husband's right to retain the stock, and that he had indeed received the shares, not simply a conditional right to receive the shares. *Id*. at 1319. Because the husband had already earned the right to receive the restricted shares, they represented a form of deferred compensation, and thus constituted marital property. *Id*. at 1319-1320. According to the Colorado Supreme Court, that the husband's full enjoyment of the benefit was conditioned on his remaining an employee affected the present value of the restricted stock shares, not their marital nature. *Id*. at 1320.

In contrast to *Miller*, the Supreme Court of Nebraska held, in *Davidson*, 578 N.W.2d at 856, that restricted "retention shares" should be treated like stock options, and subject to a time-apportionment rule (acknowledging but disagreeing with *Miller*).

Interestingly, or "inexplicably," in the words of the California appellate court in *Harrison*, the wife presented no evidence on the value of the options themselves; rather, she focused on the value of the stock controlled by the husband. 225 Cal.Rptr. at 239. The appellate court noted that options are regularly bought and sold on listed exchanges, and conjectured that some day there would be a case in which one spouse would emphasize the value of the vested option while the other spouse would argue the value of the restricted stock issued pursuant to that option, thereby highlighting the element of post-separation efforts. *Id*. at n. 2.

Further, according the California appellate court in *Harrison*, the trial court properly applied the time apportionment formula to "the gain on the stock option plan after the costs of the purchase of the stock by [the husband] and any taxes paid thereon are repaid to [the husband]." *Id*. at 237, n. 1. In doing so, the trial court used an effective tax rate of 61% to determine the federal and state income tax impact on the net gain apportioned between the parties, which was also upheld by the appellate court. *Id*. at 240.

F. Tax Trap Regarding Stock Options

Generally, the spouse holding the stock options does not have property or funds which would allow a "buy out" of the non-employee spouse's interest in the stock options. Therefore, it is typical for the vested and nonvested options to be split between the parties. This division of stock options may now be more difficult as a result of Internal Revenue Service Field Service Advice No. 200005006, which concluded that stock options exchanged for the release of marital rights or property was an arm's length transaction and subject to Internal Revenue Code §83 (stock options are taxable when transferred). According to the IRS, therefore, the employee spouse will be taxed on the transfer of the stock options, based on the fair market value of the options at the date of the transfer.

The position of the IRS is that Internal Revenue Code §1041 prevents only capital gains from being taxed on the transfer of property to a spouse; since the transfer of stock options represents a transfer of income, such transfer is excluded from §1041 treatment.

The inherent problem with Field Service Advice No. 200005006 is that it fails to take into account whether the divorce occurs in a community property state. The division of employee stock options in a community property state is not actually a transfer. It is actually a court-ordered partition of the community estate. A partition of the community estate pursuant to a valid court order should not constitute a transfer subject to taxation. Whether or not the analysis applied in Field Service Advice No. 200005006 is adopted and applied in community property states remains to be seen. Because a Field Service Advice is not binding and is not to be cited as precedent, the issue remains unresolved.

The value of vested stock options is easily determined based on the current price of the company's stock and the exercise price. In order to transfer vested stock options, the employee spouse would exercise the number of vested shares to be transferred and transfer that stock to the spouse pursuant to Internal Revenue Code §1041.

Unvested stock options have some value, but that value should reflect discounts addressing the fact that the options are not exercisable and the realization of value may be speculative.

Few appellate courts have addressed a trial court's ruling on the tax effects associated with stock options. In *Everett*, 489 N.W.2d at 113, the trial court failed to consider the tax effects of exercising options as part of its valuation analysis, and the appellate court held that such failure constituted error. The Michigan appellate court recounted the testimony of the husband's expert that, even though the options were not subject to immediate taxation, they would be taxed when they were exercised because they were a form of employment compensation. *Id*. A thorough discussion of the tax effects related to stock options is well beyond the scope of the present paper, but the prudent practitioner should keep the issue well in mind.

VI. TAX CONSIDERATIONS

Generally, the marital issues which must be addressed when one spouse is involved in an early-stage company is the value or division of founder's stock and stock options. During a company's development stage through the initial public offering, the employee's stock and stock options are usually encumbered by transfer and/or lock-out restrictions, venture capital investments in the form of preferred stock and no market in which the stock can be sold. In this context, the stock is either valued and such value is included in the marital estate or the stock is split in some manner.

Internal Revenue Code §1041 provides that the transfer of capital assets, incident to divorce, is not subject to recognition of capital gain or loss at the time of transfer. Therefore, the transfer of stock in an early-stage company will not result in a taxable transaction and the basis of the stock will carry over to the receiving spouse. In addition, if stock held by the employee spouse is transferred to the non-employee spouse, the company will generally require the recipient spouse be bound by the various restrictions addressed above.

If the stock is valued, there will generally be a note from one spouse to the other to equalize the division of property if sufficient assets do not exist to offset the value of the stock. A primary issue relating to a property settlement note is whether to apply a stated interest rate. Internal Revenue Code §163(h)(1) provides that no deduction is allowed for personal interest; therefore, the receiving spouse would have interest income while the paying spouse would have no deduction for interest paid. If the property settlement note is properly structured by tracing and allocating the note to specific property which qualifies as an "investment," interest could possibly be deductible as investment interest. Investment interest is deductible to the extent of investment income. To achieve this result, the property settlement note should be traced to an asset which would qualify as an investment asset or a passive asset and such interest would be deductible as investment interest or passive interest subject the limitations prescribed in the I.R.S. code. Property settlement notes are not required to have a stated interest rate as reflected in P.L.R. 8645082 (Aug. 14, 1986). The Internal Revenue Service held in this Private Letter Ruling that the imputed interest rules under Internal Revenue Code §§ 483, 1272, 1273, 1274 and 7872 will not apply to installment obligations in exchange for property in a transaction in which Internal Revenue Code §1041 applies. Based on this Private Letter Ruling and Treasury Regulation §1.1274-1(b)(3)(iii), an obligation arising from the division of marital property will not be subject to imputed interest if the note is silent as to interest.

Employee stock option plans are commonly associated with early-stage companies. These stock options are generally non-qualified options which are subject to Internal Revenue Code §83 which deals with compensation and income recognition. Pursuant to Internal Revenue Code §83(e)(3), no taxable event occurs at the time of the grant when the stock does not have a readily ascertainable fair market value as of the grant date. The taxable transaction occurs when the grant is exercised. Employees may exercise the grant by either selling the stock at the time of exercise with federal taxes withheld at the time of the sale or by holding the stock and paying the company the exercise price and related federal taxes. Non-qualified stock options are generally not transferrable to the non-employee spouse. One method of dealing with the division of stock options is for the employee spouse to act as a constructive trustee for the non-employee spouse. The employee spouse would pay the net proceeds to the non-employee spouse at the time the grant is exercised and the stock is sold. This transaction is taxable to the employee spouse, therefore, the divorce decree should address the tax consequences to the employee spouse. Another method is to value the stock options and compensate the non-employee spouse with other marital property or a property settlement note.

VII. CONCLUSION

The valuation of an early stage company is not a purely scientific endeavor; rather, it is also and decidedly an art, based on how certain elements, like the management team, product development, and marketing channels, eventually come together. While financial calculations, like a DCF, do have merit, they are by no means the end of the story. With regard to early stage company valuations, financial analysis serves more as a point of reference, and not the definitive conclusion. In the end, it's all about how much risk there is in getting the product to market, the length of time it will take to get to market, and how much revenue, and ultimately cash flow, the concept will generate in the long run. Disagreements will undoubtedly arise, but the foregoing discussion can at least provide a window into the procedures available to narrow the inevitable differences which will arise in early stage company valuations in the context of divorce.