IF I SELL COMMON STOCK, DO I NEED A 409A VALUATION?

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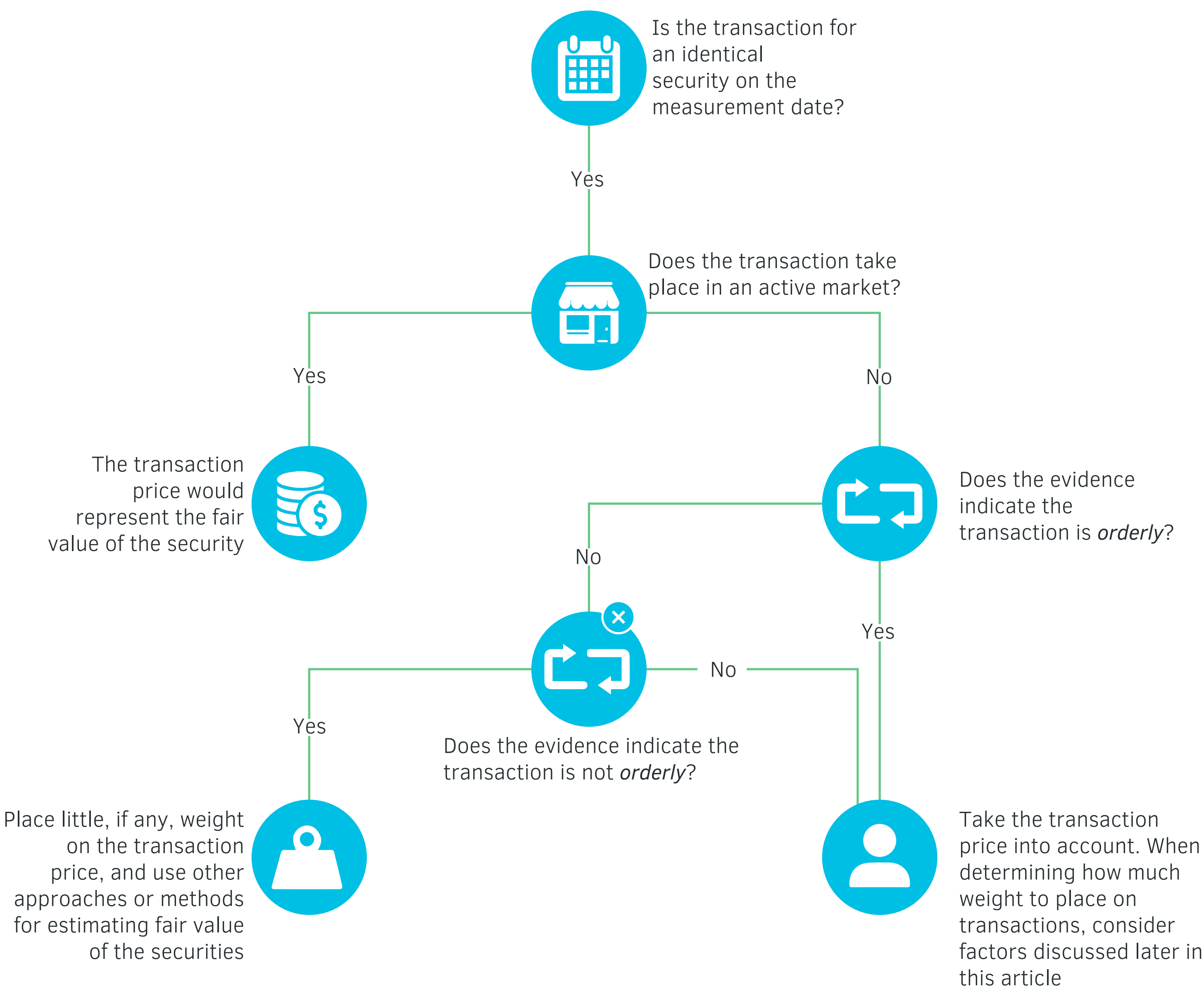
409A OVERVIEW

Section 409A of the IRS code regulates nonqualified deferred compensation. Typically, this type of compensation is issued in the form of stock options. Section 409A requires that the strike price of these options be set at or above the fair market value (FMV) of common stock. For private companies—within which shares are not actively traded on an open market—a third-party valuation firm is usually hired to determine the value of common stock.

But what if I sell common stock? Doesn't that transaction establish the value of the shares and therefore remove the need for a 409A valuation? It depends on the facts and circumstances of the transaction.

One challenge with relying upon a transaction of private shares is determining whether the transaction is an indication of FMV. Chapter 8 of the AICPA cheap stock guide, Inferring Value from Transactions in a Private Company's Securities, provides the following flow chart for guidance in evaluating private company stock transactions.



1. Note: Much of the information in this article relies upon Chapter 8 of the AICPA Valuation of Privately-Held-Company Equity Securities Issued as Compensation - Accounting and Valuation Guide.

As you can see, there are three essential questions in determining how secondaries should be used as an indication of value.

01

Is the transaction for an identical security?

In our hypothetical, common was sold, and we need the value of common shares.

02

Does the transaction take place in an active market?

With few exceptions—such as a broad tender offer in which employee stock is traded on a repeated basis—private common shares are not traded in an active market.

03

Does the evidence indicate the transaction is *orderly*?

This final question is often where most of the analysis will take place.

WHAT IS AN ORDERLY TRANSACTION?

FASB ASC 820 defines an orderly transaction as

> *A transaction that assumes exposure to the market for a period prior to the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities; it is not a forced transaction (for example, a forced liquidation or distress sale).*[2]

In private company financing situations, this definition is often satisfied, but that is not the case with secondary transactions. Circumstances that indicate the transaction was not orderly include:

- The transaction was a "fire sale," meaning it wasn't open for a long enough time to allow for negotiation and other customary transaction activities
- The offer was open for an adequate amount of time for negotiation, but it was only extended to a single market participant rather than a broad/open market
- The transaction resulted in a price that was significantly different from other recent transactions of the same security
- The offer was open for an adequate amount of time for negotiation, but it was only extended to a single market participant rather than a broad/open market
- The seller was forced to sell to meet legal requirements.

Each of these circumstances focuses on situations in which the seller would usually be pressured to accept a price below FMV, but equally important is the need to assess whether the buyer had pressure to buy at a price higher than FMV. For example, perhaps an eager investor offered a premium over current FMV without a thorough analysis in order to gain early entry into a fast-growing start-up. Circumstances such as these should be determined not to exist before applying any weight to the transaction.

In determining whether a transaction is orderly, a good rule of thumb is to assume it is orderly until proven not orderly.

If the transaction of common stock under question doesn't have enough evidence to prove it was not orderly, then it can and should be taken into consideration when determining the FMV of the company's common stock. After getting to this point, there is just one more hurdle. The final task is determining how much weight to apply to the transaction versus other indications of value.

2. Statement of Financial Accounting Standards No. 157 Fair Value Measurements, Financial Accounting Standards Board, 8.

WEIGHING THE TRANSACTION

Applying weight requires additional judgement. Industry trends suggest secondary transactions of private stock are less reliable when compared with other market indications of value and therefore should usually have little weight applied to them. This is due to the many hurdles discussed in this article. When weight should be applied, the AICPA provides several factors to help determine how much:

Timing of transaction data. How close to the valuation date did the transaction take place? The more time that passes, the less relevant the transaction becomes.

Sufficient sophisticated bidders. For private company shares, the pool of investors is often limited. The smaller and less sophisticated the investor pool, the less reliable the transaction.

Sufficient information to value the investment and make an investment decision. Private companies are less regulated, and therefore, investors may have a limited amount of information going into a transaction. Always consider how much knowledge the investor had of relevant facts.

Pattern of trades. How many shares are being transacted upon? How often do these transactions occur? Are they repeated investors? The higher the volume of shares, frequency of transactions, and diversity of investors, the more reliable the recent transaction becomes.

Other biases or costs of holding, hedging, or trading the securities. Be sure to consider any other irregularities that could be taking place in the transaction.

CONCLUSION

Section 409A of the IRS code has significant tax implications for companies issuing (and employees receiving) deferred stock compensation. A 409A valuation can help avoid unnecessary tax penalties. Determining whether a common stock transaction can be used in place of a 409A valuation may require significant judgment. Even when the transaction can be used as an indication of value, in most cases, other market indicators will need to be considered in tandem. When in doubt, the best decision is to enlist a reputable valuation firm to provide a 409A valuation. With that in hand, you and your auditors will be more confident the determined common share price is equal to fair market value.