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Start-Ups, 409(A) Valuations, and Distributing the Unknown

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AAML Ohio Chapter Annual Symposium 2025
October 13, 2025

Learning Objectives

After completing this session, participants will be able to:

1. Understand the stages of a start-up business;
2. Understand concepts of capital raising and the potential impact to value;
3. Understand valuation issues related to start-up businesses and the types of valuations that are sometimes required for other purposes.
4. Potential strategies for resolving cases that include these types of interests.

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Start-Ups and Early Stage Businesses

Valuation of Early Stage Companies:

→What Are They?

- All “**Early Stage**” Companies Are Not Created Equal (a Non-Authoritative- But Helpful- Classification):
 - **Start-up stage** (i.e. pre-revenue, product prototype / pre-Phase I clinical trials compound created, entrepreneur(s)/family/friends- financed);
 - **Developmental stage** (i.e. may generate revenue, but have a significant cash burn; angel/ venture capital-backed);
 - **High growth stage** (i.e. generates revenue, but still burning cash due to capital investment; venture capital-backed; experienced in raising external capital.

Considerations with Capital Raises

Complex capital structures arise due to the need of the entity to raise capital

- Capital is infused in the entity based on multiple rounds of financing
- The source of these rounds occurs in stages:
 - Friends and Family: Individuals known to the owner who believe the idea is good and want to participate
 - Angel Investors: Individuals who offer capital to promising start-up companies in exchange for a piece of the business, usually in the form of hybrid equity. Can be professional investors who may or may not be accredited investors.
 - Venture Capital Funds: Funds in the business of providing capital to start-up business in exchange for a piece of the business and often a seat(s) on the board of directors

Sources of Capital

Capital Provider	Pros	Cons
Founders	▪ No dilution ▪ Credit card points	▪ High risk ▪ Lack of liquidity
Crowdsourcing	▪ No equity stake ▪ Market validation	▪ Public knowledge of ideas ▪ New/ potential fad?
Family & Friends	▪ Minimal equity stake ▪ “Easy” ask	▪ Mixing business & family ▪ Letting down “Uncle Fred”
Angel	▪ Minimal dilution ▪ Good contacts	▪ Growing sophistication ▪ Increasing expectations
Venture/ Private Equity	▪ Lots of capital chasing deals ▪ Invaluable contacts	▪ Limited timeline ▪ High expectations
Strategic/ Corporate Investors	▪ Brand name/ cache ▪ Access to channel/ customers	▪ Right can limit some exits ▪ Lack of strategic influence
Venture Debt/ Convertible Debt/ Bridge Loans	▪ Initially, does not dilute equity ▪ Provides additional runway	▪ High carrying costs

Considerations with Capital Raises

- Pre-Money:
 - Value of company prior to receiving investments such as external funding or financing
 - Used by venture capital firms to determine what their share will be based on how much they invest
- Post-Money:
 - Company's estimated worth after outside financing or capital injections are added
 - Pre-money value PLUS new equity received from investors
- Example:
 - Pre-Money \$300 million
 - Investment \$30 million
 - Post-Money \$330 million

Considerations with Capital Raises

- Typical rounds of financing include:
 - Series A preferred stock equal to the investment with the right to convert to common stock
 - Series B preferred with the same characteristics but subordinate to Series A in terms of liquidation preference but buy in at a higher price
 - Series C returns, which have the same features as Series B but at a higher price
 - Common stock, which can continually be diluted after each series

Rights and Characteristics

Equity components in complex capital structures

- Preferred, common, share-based awards
- Value of certain preferred not captured in models:
 - Control rights
 - Dividends
 - Redemption
 - Conversion rights
 - Liquidation preference
- Non-voting
- Non-convertible
- Right of first refusal
- Anti-dilution
- Drag along/tag along rights

Enter the 409A Valuation



Why

409A refers to the IRS code Section 409A enacted in 2004.

It regulates the taxation of nonqualified deferred compensation plans, ensuring they comply with certain rules to avoid adverse tax consequences for participants.



Methodologies

Traditional valuation methodologies:

Market Approaches
Income Approaches
Asset Approaches



Assumptions ^{xxx}

Heavily reliant on projections and expectations

Was there a management interview?

Were management claims vetted?

Any circular reasoning?



Provider Issues ^{xxx}

Who certifies the report?

Can someone testify?

Did they test assumptions?

Are there other services?

The 409A valuation is a way to determine the fair market value of a private company's stock, especially for tax purposes, like when offering stock options to employees.

For private company stock, investment rounds are often used as data points for 409A valuations. It is believed that these rounds provide insights into how investors value the company. Valuation experts consider factors like amount raised, the valuation at each round, and any special terms or conditions attached to the investments.

What's wrong with that?

- Investments are typically made based on future expectations, not current results.
- An entity may have no revenue (and lots of expenses) but have value to investors looking at a long horizon.
- Investors may be paying a premium based on the prior record of the PE or VC firm.
- Appropriate expenses vs. perquisites
- Owner compensation
- Market factors
- Does the valuation become a self-fulfilling prophecy?

409A Regulations

409A regulations only require that valuation be by “reasonable application of a reasonable valuation method” – facts and circumstances matter, with leeway as to how a value is determined

409A regulations provide guidance as to the factors to be considered when applying a valuation method:

- The value of tangible and intangible assets of the company
- The present value of anticipated future cash flows of the company
- The market value of stock or equity interests in substantially similar corporations and other entities the value of which can be readily determined through nondiscretionary, objective means (e.g., because it is tradable on an established market or was recently sold in an arm’s length transaction);
- Recent arm’s length transactions;
- Control premiums; and
- Discounts for lack of marketability. [Treas. Reg. 1.409A-1(b)(5)(iv)(B)(1)]

409A Assumptions

“Values lies in the eyes of the beholder.”

Who is the beholder?

Assumptions are the key to every valuation and should be your first stop when analyzing a valuation report for litigation.

- Growth
- Management ability
- What is known or knowable as of the valuation date
- Profit margins
- Appropriate expenses vs. perquisites
- Owner compensation
- Market factors

Other Issues

- Date of Valuation – Known and knowable
- Historical (to actual) 409A valuations
- Marketing and advertising vs historical financial statements
- Exactly *how long* are you a startup?

In summary:

- Know the 409A assumptions and their *implication* on the valuation.
- What is the payback period for *any* value conclusion?
- Is someone available to testify?
- Trust but verify.
- Understand the valuation models.
- Use common sense.

The “Backsolve” Method

Backsolve is an analysis used to infer an entity’s total equity value.

- Calculations used to solve for equity value that returns a price equal to the most recent transaction value of a security in the capital structure.
- Typically relied upon when:
 - Most recent transaction of entity’s stock occurred within 12 months of the valuation date;
 - No significant events or entity milestones have occurred since the transaction; and
 - Transaction involved arms-length parties.
- For example, in a recent arms-length, orderly transaction involving an entity’s equity securities, the backsolve method based on the recent transaction price can be used to imply the values of the other securities using relatively few assumptions.
- Solves for total equity rather than individual security. (Can add a waterfall analysis assuming a monetization event at the determined equity value).

Strategies for resolving cases that include these types of interests

- Value and distribute
- Value, distribute and add a tag-along with a set percentage
- Value, distribute and add a tac-along with a declining percentage
- Distribute if, as and when income/proceeds received based on a fixed percentage
- Distribute if, as and when income/proceeds received based on a declining percentage
- Distribute in-kind
- Move interests into a “hold-co”

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Q & A

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Kenneth J. Pia, Jr. is a Lead Managing Director at CBIZ. With more than 30 years of professional business valuation and litigation support experience, Mr. Pia has developed a national reputation working on a wide range of complex valuation engagements. He has performed valuations of businesses and partial business interests for a variety of purposes including, but not limited to, family law matters, employee stock ownership plans, business damages, buy-sell agreements, shareholder litigation, estate and gift tax matters, and buying and selling businesses.

Mr. Pia is heavily involved with the American Society of Appraisers (ASA). He is the immediate past-chairperson of the ASA's Business Valuation Committee, is a member of the National Business Valuation Education Committee, and teaches nationally for the ASA's accreditation program. Mr. Pia is also a Co-Chair of the American Academy of Matrimonial Lawyers Foundation's Forensic & Business Valuation Division and has been named to the American Academy for Certified Financial Litigators Advisory Board for New York and Connecticut.

Mr. Pia is a frequent speaker on business valuation topics on the national and local levels for numerous professional organizations, including the American Bar Association, American Institute of Certified Public Accountants, American Academy of Matrimonial Lawyers, and National Center for Employee Ownership. In addition to teaching for the ASA's accreditation program, he previously instructed for the American Institute of Certified Public Accountants' Certificate of Educational Achievement (CEA) program in business valuation. He is also an Adjunct Professor at Quinnipiac University. Mr. Pia has technically reviewed publications on divorce finance and taxation for the American Bar Association, as well as several books on business valuation. In 2007, he was appointed as one of two appraisers to the State of Connecticut's Eminent Domain Task Force, established to determine the methodologies to be used in the calculating lost intangible economic value of businesses due to the state exercising domain rights.

Mr. Pia has been qualified as an expert witness in Federal District Court and the State Courts of Connecticut, Commonwealth of Massachusetts, New York, Virginia, and California, as well as various arbitration proceedings. He has also rendered extensive services relating to court testimony. Mr. Pia is on the State of New York Courts' list to receive court appointments in the following counties: New York, Kings, Richmond, Queens, Nassau, Suffolk, and Westchester. He has received court appointments in New York and Connecticut.



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