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Private company stock option pricing in the 409A era

We expect recently-issued proposed regulations under Section 409A of the Internal Revenue Code, along with recent changes in financial accounting rules and practices, to significantly and immediately affect the way in which private companies set the exercise prices for their stock options and values for other stock-based compensation. This *Alert* summarizes the option pricing rules for private companies in the proposed regulations and their expected impact on stock option grant practices. (The same rules apply for purposes of setting stock appreciation right base prices.) Although these are "proposed regulations," they can be relied on currently, and we expect that most companies and tax advisors will treat them as applicable immediately, particularly with respect to stock options.[1] Click on the following links for *Cooley Alerts* describing the background and enactment of Section 409A, initial guidance from the IRS and Treasury, and other aspects of the new proposed regulations.

- **Enactment of Section 409A** www.cooley.com/news/alerts.aspx?ID=000038715520
- **Initial guidance under Section 409A** www.cooley.com/news/alerts.aspx?ID=000038783320 www.cooley.com/news/alerts.aspx?ID=000038824620
- **Initial Alert on the Section 409A proposed regulations** www.cooley.com/news/alerts.aspx?ID=000039067020
- **Pricing public company stock options and SARs in the 409A era** www.cooley.com/news/alerts.aspx?ID=39093120

Check www.cooley.com periodically for new Alerts on the proposed regulations, including an upcoming *Alert* on how the proposed regulations affect other aspects of equity compensation.

Discounted stock options under Section 409A

Under Section 409A, any stock option having an exercise price less than the fair market value of the underlying stock determined as of the option grant date constitutes a deferred compensation arrangement that typically will result in adverse tax consequences for the option recipient and tax withholding responsibility for the granting company. (We will refer to such stock options as "discounted options.") These adverse tax consequences are described in more detail in our prior Alerts on Section 409A. They include taxation at the time of option *vesting* rather than the date of exercise (or later), a 20% additional tax on the optionee in addition to regular income and employment taxes, and a potential interest charge. The granting company is required to withhold applicable income and employment taxes at the time of option vesting, and possibly additional amounts as the underlying stock value increases over time.[2]

Stock valuation and option pricing alternatives

As described in detail below, the proposed regulations provide guidance on valuation for purposes of setting option exercise prices. Companies may respond to the proposed regulations in any of the following ways:

Status Quo. A company may choose to retain its existing option pricing practice. If the company's option exercise prices in fact equal or exceed the fair market value of the underlying stock, Section 409A generally will not apply to such options. *This is true whether or not the company applies any of the rules or factors set forth in the proposed regulations.* IF, on the other hand, the company's option exercise prices are later found to be below fair market value (for example, on audit by the IRS), then the burden will be on the company to prove

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that its stock valuation method was reasonable by reference to the standards and rules found in the proposed regulations. If the company's current valuation practice makes no reference to the factors and methods set forth in the proposed regulations (or if it uses no valuation method at all), it will fail to satisfy this burden and the adverse consequences of Section 409A will apply.

Informal Valuations Using Specified Factors. A company may choose to perform its own internal stock valuation based on specified factors set forth in the proposed regulations. (See the reference to ***"General Valuation Factors,"*** below.) If the company's option exercise prices are later found to be below fair market value, then the burden will be on the company to prove that its stock valuation method was reasonable. However, the company improves (but does not guarantee) its chances of satisfying this burden if it employs the factors specified in the regulations.

Adopt One of the New "Presumptive" Methods. A company may choose to adopt one of the "presumptive" stock valuation methods set forth in the proposed regulations, thereby putting the *burden on the IRS* to prove that BOTH (i) the company's stock option prices are below fair market value, AND (ii) the company's application of the presumptive method was "grossly unreasonable." These presumptive methods are described below. They involve either a written valuation by an appraiser or other person with knowledge and experience in stock valuation or a binding formula.

The attached "flow chart" is helpful in illustrating the foregoing alternatives and their potential advantages and disadvantages.

Presumptive valuation methods

The regulations specify three methods that will be presumed reasonable if consistently used for all of an employer's equity-based compensation arrangements. The valuation resulting from any of these presumptive methods will be considered to be fair market value and may only be rebutted by the Internal Revenue Service if the company's application of the method is found to be "grossly unreasonable." The three presumptive methods are:

Independent Appraisal Presumption. A valuation performed by a qualified independent appraiser using traditional appraisal methodologies (as would be applicable to an appraisal for an employee stock ownership plan (ESOP)) will be presumed reasonable if it values the stock as of a date that is no more than 12 months before the applicable stock option grant date. However, this presumption would not apply if events subsequent to the appraisal date have a material effect on the company's stock value.

Illiquid Start-Up Presumption. A special presumption is provided for "illiquid stock of a start-up corporation." A start-up corporation is a corporation with no publicly traded stock that has conducted business for less than 10 years. A valuation of illiquid start-up stock will be considered reasonable if five requirements are satisfied:

1. The valuation is evidenced by a written report;
2. The valuation takes into account the General Valuation Factors described below. As indicated below, events subsequent to the valuation must be taken into account and may render an earlier valuation inapplicable;
3. The valuation is performed by a person with significant knowledge and experience or training in performing similar valuations;
4. The stock being valued is not subject to any put or call right, other than the company's right of first refusal or right to repurchase stock of an employee (or other service provider) upon termination of service; and
5. The company does not reasonably anticipate an IPO, sale or change in control of the company within 12 months following the equity grant to which the valuation applies.

The valuation factors specified in the proposed regulations (which we refer to as the ***"General Valuation Factors")*** are:

- the value of tangible and intangible assets of the company
- the present value of future cash flows
- the public trading price or private sale price of comparable companies
- control premiums and discounts for lack of marketability
- whether the method is used for other purposes
- whether all available information is taken into account in determining value

Even if a valuation applies these factors, it will not be considered reasonable if it is more than 12 months old. In addition, significant events occurring even before the 12-month anniversary will require the valuation to be updated. Such events would include, for example, the possibility of (or plans for) a future investment in the company by an outside investor, an initial public offering or sale of the company, resolution of material litigation, or the issuance of a patent.

Binding Formula Presumption. A valuation based on a formula used in a shareholder buy-sell agreement or similar binding agreement will be presumed reasonable if the formula price is used for all noncompensatory purposes requiring the valuation of the company's stock, such as regulatory filings, loan covenants, and sales of stock to third parties. This method will not be available if the stock may be transferred other than through operation of the buy-sell or similar arrangement to which the formula price applies. Because of the restrictive conditions on use of this presumption, we do not expect it to be widely utilized by private technology and life sciences companies.

Practical implications for private companies

We expect the proposed regulations to affect private company valuation and option grant practices differently at three different stages in the private company lifecycle.

Founding Stage. During the very early stage of a typical technology or life sciences company, in particular from the time of founding to the time when the company begins to have assets (whether tangible or intangible) and operations and begins to make option grants to multiple employees, we generally do not expect to see formal appraisals or written stock valuations. Companies at this stage typically issue stock (rather than stock options) to their initial founding shareholders, and Section 409A generally does not apply to employee stock issuances. Thus, the concern noted above about issuing discounted stock options is often not present at this stage. It is still necessary to value the new company's stock to determine whether the company must report taxable income to the founders on their stock purchases. (This would generally be the case if the amount paid by the founders for their stock is less than its fair market value.) However, at this stage, performing a meaningful valuation using the General Valuation Factors is often impossible due to the company's lack of assets and financial history or projections.[3]

Post-Founding to Expectation of IPO or Sale. We anticipate that many private technology and life sciences companies will now obtain periodic, independent appraisals of stock value for purposes of setting the exercise price on their stock options, once they have assets (whether tangible or intangible) and operations and begin to make option grants to multiple employees. There is no clear line demarcating when a company has entered this stage, and in some cases, the company's first venture capital or "angel" financing will mark the company's entry into this stage. This would be particularly true in cases where the first financing occurs soon after the founding. In other cases, the company will enter this stage long before its first financing, perhaps because the company develops assets and operations without financing and these assets and operations can be valued using the General Valuation Factors. The company's board of directors will need to rely on its judgment and consultations with counsel to determine when it makes sense to begin obtaining independent stock valuations.

As noted above, the proposed regulations do not *require* that a company obtain a formal appraisal. Why, then, do we expect to see technology and life sciences companies obtaining independent appraisals of their stock value for purposes of pricing stock options? Here are some of the reasons:

- The Independent Appraisal Presumption is the clearest presumption available under the proposed regulations. Relying upon this presumption provides the best protection against the adverse consequences of Section 409A.
- Many boards of directors will be concerned about possible liability for both the company (unpaid withholding taxes due upon option vesting) and optionees (the 20% additional tax and interest charge) under Section 409A if discounted options are granted inadvertently. Thus, we expect many boards will wish to rely on outside experts for their valuations to minimize such exposure.
- For financial accounting purposes, auditors have long pressed private companies to be more rigorous about their stock valuations. We expect to see this pressure increase as the new option expensing rules under FAS 123R go into effect on January 1, 2006. [See our *Cooley Alert* on FAS 123R www.cooley.com/news/alerts.aspx?ID=000038783920]. In addition, we have even seen accounting firms refuse to accept new audit engagements with private companies unless the company agrees to obtain regular independent appraisals of its stock.

Most technology and life sciences companies experience frequent value-changing events (such as financing transactions, development milestones and customer wins). Accordingly, we anticipate that companies choosing to rely on independent appraisals will choose to obtain annual appraisals with quarterly or semi-annual updates to their valuation—presumably from the same appraiser that performs the annual valuation—in order to ensure that they have a valuation that takes all available information into account when setting the exercise price for stock options granted during a given year. Grant dates for such companies likely will cluster around appraisal dates (or the dates of appraisal updates) to ensure that options are priced appropriately.

Of course, many companies at the post-founding/pre-expectation of IPO or sale stage may choose to rely instead on the Illiquid Start-Up Presumption, or simply may forego any of the presumptive methods. Although the proposed regulations are unclear on this point, it is possible that the Illiquid Start-Up Presumption may be satisfied by a written report produced by one of the company's internal financial personnel or a board member who has experience or training in stock valuation. This would obviously be less expensive and perhaps more timely than a formal outside appraisal. However, if more and more companies begin to rely on the Independent Appraisal Presumption, and if auditors continue to pressure companies to obtain outside valuations, we expect that fewer boards of directors will choose to rely on alternative methods. Moreover, we expect that appraisal firms, over time, will develop more cost-effective and timely appraisal procedures for private company stock to meet the demands triggered by these new regulatory pressures.

After Expectation of IPO or Sale. Once a company reasonably anticipates that it will undergo a change in control event or an IPO within the next 12 months, the company no longer may rely on the Illiquid Start-Up Presumption. We expect most companies at this stage (whether on track for an IPO or sale) effectively will be required to use the Independent Appraisal Presumption.

- For those companies planning an IPO, their auditors and SEC rules will likely require formal appraisals of their stock for financial accounting purposes.

- For those companies planning a sale, the buyer now will be concerned about the company's compliance with Section 409A and will want some assurances that the company has not granted discounted options. Complying with the Independent Appraisal Presumption will be the clearest way to provide such assurances.

What to do about previous option grants

Many private companies have outstanding options that either were granted intentionally with a discounted exercise price, or were priced without reference to the valuation factors and methodologies described in the proposed regulations. Some of these stock options are subject to Section 409A because they were granted or vested after certain "grandfather" dates. (See the attached chart and our prior Alerts for those dates.) What should companies do about such option grants?

The response may depend on factors such as: (i) the size of the prior grant; (ii) the extent to which—in the board's (or management's) judgment—the exercise price of the prior grant may be less than the grant date fair market value; (iii) which (if any) valuation method was used to price the prior option grants; (iv) the number of prior grants and optionees that may be affected; and (v) the potential tax exposure for the company and optionees if the options were determined to be underpriced. If the option in question is an "incentive stock option" intended to qualify under Section 422 of the Internal Revenue Code (commonly referred to as an "ISO"), the board also may wish to discuss with counsel whether the option is protected against the application of Section 409A because the board's prior determination as to fair market value was made in good faith. The board may choose to obtain an after-the-fact valuation (whether formal or informal) to support the prior grant price or at least ascertain whether there is a discount on prior options.

If the board determines that action is needed to avoid the application of Section 409A to prior option grants, there are several available alternatives. The proposed regulations and IRS Notice 2005-1 allow companies time to "fix" discounted stock options and other deferred compensation arrangements that do not comply with Section 409A. The chart accompanying this *Alert* describes various option grant permutations, whether Section 409A is applicable, whether a correction is appropriate, and the applicable deadline.

For existing discounted stock options, one of the following correction methods may be used in order to avoid the adverse consequences of Section 409A:

- Before January 1, 2007, raise the strike price of the noncomplying option to fair market value as of the option grant date. In addition, it is permissible for the company to pay the optionee a cash or stock bonus (which will be taxable) to compensate for any lost economic benefit. If the company "ties" the cash or stock bonus to the increase in the option price (i.e., as a means of obtaining optionee consent), the cash or stock bonus must be paid before January 1, 2006 (notwithstanding that the increase in the exercise price need not occur until January 1, 2007). Alternatively, the cash or stock bonus may be made subject to a vesting schedule and/or delivered in the future as part of a deferral arrangement. If the cash or stock is to be paid or delivered in the future, such arrangement would need to comply with the requirements of Section 409A, unless payment or delivery is made within a short period of time after vesting pursuant to the short-term deferral exception (2½ months after the taxable year of vesting).
- Exercise the option before January 1, 2006.
- Before January 1, 2006, exchange the discounted option for stock having a value equal to the difference between the fair market value and the exercise price (i.e., the "spread" on the option).
- Before January 1, 2006, exchange the discounted option for cash equal to the spread on the option. Alternatively, the cash may be made subject to a vesting schedule and paid at a future date; such an arrangement would need to comply with the requirements of Section 409A, unless payment is made within a short period of time after vesting pursuant to the short-term deferral exception.

Note that any corrective action, other than merely raising the exercise price of the option, may result in immediate or deferred application of income and employment taxes, but if properly structured would avoid the application of the additional taxes imposed by Section 409A. Corrective action usually will require board approval and optionee consent as well. In certain cases, corrective action may have financial accounting consequences.

Conclusion

We expect that the proposed regulations, along with recent changes in the financial accounting rules and practices, will usher in a new era of stock option pricing and compensatory stock valuation among private companies. Boards of directors should be consulting with counsel now to determine how best to address these changes. Please feel free to call any member of the Cooley Godward Compensation & Benefits Group or Tax Group with questions about Section 409A and the proposed regulations.

Circular 230 Disclosure

The following disclosure is provided in accordance with the Internal Revenue Service's Circular 230 (21 CFR Part 10). Any tax advice contained in this *Alert* is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.

Decision Matrix for Previously-Granted Discounted Options

Description of Option	Status under 409A	Corrective Action Needed?
At-the-money (nondiscounted) stock option granted at any time	Exempt from 409A by virtue of the general rule exempting at-the-money option grants	None needed—make sure no material modifications are made that will result in loss of exemption
Discounted stock option granted prior to 10/4/04 and earned and vested by 12/31/04	Exempt from 409A by virtue of the grandfather provisions.	None needed—make sure no material modifications are made that will result in loss of grandfather status
Discounted stock option granted after 10/3/04 and before 12/31/04 and earned and vested by 12/31/04. (Option not yet exercised.)	Potentially subject to 409A unless it can be shown to be part of a pattern and practice	Determine if a pattern and practice of granting discounted options in the relevant time period can be established. If yes, see above. If no, see below.
Discounted stock option granted prior to 12/31/04 but not earned and vested by 12/31/04. (Option not yet exercised.)	Subject to 409A since it qualifies for neither the general exemption nor the grandfather exemption, but eligible for transition relief	See list of correction alternatives in text of Alert and discuss with counsel.
Discounted stock option granted after 12/31/04 and prior to 12/31/05	Subject to 409A, but eligible for transition relief	See list of correction alternatives in text of Alert and discuss with counsel.
Option (whether or not discounted) that is with respect to stock other than common stock and was not earned and vested on 12/31/04. An option of this type may be part of a "carve out plan" for a privately held company.	Does not qualify for the at-the-money exemption, but arguably can rely on Notice 2005-1 until 1/1/07. Can still qualify for the ISO exclusion.	Corrective action may be required. Discuss with counsel.
Option having a "feature for the deferral of compensation" (other than vesting)	Apparently subject to 409A	Corrective action required. Discuss with counsel.

Notes

1 Although the proposed regulations are not yet technically effective, IRS Notice 2005-1 (guidance under Section 409A that is currently effective) requires taxpayers to comply with Section 409A in "good faith" during this transition period. Compliance with the proposed regulations will be considered good faith for this purpose. Because the proposed regulations contain the only rules on numerous issues under Section 409A, the IRS is likely to apply the principles described in the proposed regulations even before they become effective, and many companies likely will wish to utilize those principles to ensure good faith compliance during this transition period.

2 Although the IRS has informally indicated that the 20% additional tax is not a withholding tax, no formal guidance to this effect has been issued.

3 In some cases, newly founded companies obtain venture capital or "angel" financing simultaneously with (or soon after) the founders' stock issuances. In such cases, it has been and will continue to be necessary to take into account the effect of the financing on the company's prospects and assets for purposes of determining the tax implications of the founders' stock issuances. It is, of course, also permissible to take into account differences in the stock purchased by the investors (typically preferred stock with liquidation preferences and special voting rights) and the stock issued to the founders (typically common stock).

Private Company Option Pricing Flow Chart