



STRAIGHT TALK ABOUT CORPORATE/SECURITIES LAW

Private Company Stock Option Pricing in the 409A Era

Section 409A of the Internal Revenue Code, along with recent changes in financial accounting rules and practices, significantly and immediately raised the stakes regarding the way in which private companies set the exercise prices for their stock options and values for other stock-based compensation. Recently issued proposed IRS regulations provide some guidance regarding how private companies may determine the value of their stock for this purpose. 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.

Discounted Stock Options Under Section 409A

To avoid the adverse tax consequences associated with the application of Section 409A, any stock option which was issued after October 3, 2004 or first becomes vested after December 31, 2004 must have an exercise price equal to or greater than the fair market value of the underlying stock determined as of the option grant date. Options with an exercise price less than fair market value on the grant date constitute deferred compensation arrangements 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 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 penalty interest charge.

The granting company is required to withhold applicable income and employment taxes at the time of option vesting and could be required to withhold additional amounts as the underlying stock value increases over time.

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:

Any Reasonable Method Valuation. A company may choose to retain its existing option pricing practice if the company’s option exercise prices are intended to be equal to or greater

than the fair market value of the stock as determined by the reasonable application of a reasonable valuation method. The determination of whether a valuation method is reasonable or whether an application of a valuation methods is reasonable is based on all the facts and circumstances as of the valuation date. Factors which should be considered under a reasonable valuation method (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, including purposes unrelated to compensation of service providers
- whether all available information is taken into account in determining value

Whether or not some or all of the General Valuation Factors are used to determine value, the burden of proof will be on the Company to establish that the valuation method is reasonable. However, the consistent use of any of the followings method of valuation will be presumed reasonable unless the IRS can show that it was grossly unreasonable. We call these the “Presumptive Valuation Methods.”

Presumptive Valuation Methods

The regulations specify two methods that will be presumed reasonable if consistently used for all of an employer’s equity-based compensation arrangements, and a third method that may be applied to illiquid stock of a start-up corporation.

Independent Appraisal Method. 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) 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 had a material effect on the company’s stock value.

Binding Formula Method. A valuation based on a formula used consistently in a shareholder buy-sell agreement or similar binding agreement will be presumed reasonable if the formula price is also used consistently for all non-compensatory purposes requiring the valuation of the company’s stock, such as regulatory filings, loan covenants, and issuances to and repurchases of stock from third parties. This method does not apply with respect to stock subject to a stock right payable in stock, where the stock acquired pursuant to the exercise of the stock right is transferable other than through the buy-sell or other binding arrangement.

Illiquid Start-Up Method. A start-up corporation with no publicly traded stock that has conducted business for less than 10 years (an “illiquid start-up company”) may use a valuation, made reasonably and in good faith and evidenced by a written report that takes into account the General Valuation Factors described above, provided that:

1. The valuation is performed by a person with significant knowledge and experience or training in performing similar valuations;
2. 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
3. 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.

Like the Independent Appraisal Method, this valuation will not be considered reasonable if it is more than 12 months old or if significant events occurring 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.

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 with respect to employee stock issuances. 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.

Post-Founding to Expectation of IPO or Sale. We anticipate that many private technology and life sciences companies will now perform or obtain periodic appraisals of stock value, under either the Independent Appraisal Method or the Illiquid Start-up Method 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 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 an independent appraisal. However, here are some of the reasons that we expect to see many technology and life sciences companies obtaining independent appraisals of their stock value for purposes of pricing stock options:

- Relying upon this method 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. In addition, accounting firms (particularly Big Four) may 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, but sporadic (and often volatile) value-changing events (such as financing transactions, development milestones (or setbacks), customer wins (or losses), and changing market forces). 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 Method, or simply may forego any of the presumptive methods. The Illiquid Start-Up Method 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 an outside appraisal. However, if more and more companies begin to rely on the Independent Appraisal Method, 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 Method will be the clearest way to provide such assurances.

What About Outstanding 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 the “grandfather” dates. What should companies do about such option grants?

The response may depend on factors such as:

- the size of the prior grant;
- 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;
- which (if any) valuation method was used to price the prior option grants;
- the number of prior grants and optionees that may be affected;
- the potential tax exposure for the company and optionees if the options were determined to be underpriced; and
- whether the prior options were intended to be incentive stock options (ISOs).

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. **IRS transition rules permit discounted options to be remedied, but most of these remedies must be accomplished before January 1, 2006.**

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 non-complying option to fair market value as of the option grant date.
- Advise employees to exercise the option before **January 1, 2006**. Accelerate vesting if necessary.
- 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.

For More Information

For further information regarding the application of Section 409A and corrective action available to option issuers, please contact:

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