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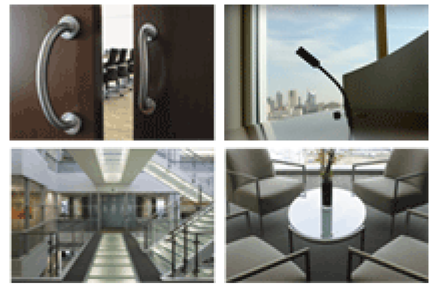

Are Your Nonqualified Stock Options Properly Valued?

The Valuation of Private Company Stock Options Under 409A

by B. David Joffe

Until recently, private companies issuing stock options had little guidance and not much reason to be concerned with the determination of the fair market value ("FMV") of nonqualified stock options issued to employees. However, since the addition of Section 409A ("Section 409A") to the Internal Revenue Code (the "Code") regarding the taxation of nonqualified deferred compensation plans, the determination of FMV has become very important, and private companies now need to be concerned—***and to take necessary action by December 31, 2008***—with respect to the pricing of employee stock options.

Section 409A is broadly written to encompass nonqualified stock options as a type of nonqualified deferred compensation plan. Despite the fact that stock options may not intuitively seem to be deferred compensation, if the option is issued at an exercise price below fair market value and the option holder can delay the exercise of the option until a later tax year, this effectively results in the deferral of taxation on the discount. In order to comply with Section 409A, options have to be exercisable **only** upon one of the permitted specified events under Section 409A (separation from service, death, disability, specified time, change in control, or hardship), which eliminates the flexibility for the employee to determine when to exercise the option. In limited cases, some companies may choose to issue options exercisable only upon a change in control. Otherwise, though, the practical impact of Section 409 will be the immediate taxation of discounted, vested options.

Assuming options are not structured to comply with Section 409A, to avoid the immediate taxation (as well as a 20% additional tax, interest, and withholding requirements), the options need to fall within a particular exception. Under the final regulations to Section 409A, there are three requirements for the exception:

- the exercise price may never be less than the FMV of the underlying stock on the date the option is granted;
- the number of shares subject to the option must be fixed on the original date of grant; and
- the option may not include any additional feature for the deferral of compensation.

Perhaps the most problematic requirement under the final regulations is determining FMV. For a public company, the rules are fairly straightforward: FMV is basically determined by the closing price, arithmetic mean of the high and low prices, or similar methods. For a private company, the valuation method must be "reasonable."

Reasonable Valuation Method

Under the regulations to Section 409A, whether a valuation method is reasonable is determined based on "facts and circumstances" considering a number of specified factors:

- the value of tangible and intangible assets of the corporation;
- the present value of anticipated future cash-flows;
- the market value of stock or equity interests of similar businesses, provided the value can be readily determined through nondiscretionary, objective means (such as through trading prices on an established securities market or an amount paid in an arm's length private transaction);
- recent arm's length transactions involving the sale or transfer of stock or equity interests; and
- other relevant factors such as control premiums or discounts for lack of marketability and whether the valuation method is used for other purposes that have a material economic effect on the company, its stockholders, or its creditors.

The use of a valuation method is not reasonable if it does not take into consideration all available material information. Similarly, the use of a previous value is not reasonable if it fails to reflect material information (for example, the resolution of material litigation or the issuance of a patent) *or* the value was calculated more than 12 months ago. The company's consistent use of a valuation method to determine the value of its stock or assets for other purposes, including for purposes unrelated to compensation of employees, is also a factor supporting the reasonableness of such valuation method.

While the company may use any reasonable method, if the IRS audits the company, the company will have the burden of establishing that the method was reasonable, considering the factors noted above.

Presumptive Methods

For the company that does not want to rely on the "facts and circumstances" approach, there are three methods to determine FMV that are presumed to be reasonable. The presumption can be rebutted by the IRS Commission if the application is "grossly unreasonable." In most cases, therefore, a company would be well-advised to consider using a presumptive method. These methods are as follows:

- An Independent Appraisal. A valuation of a class of stock determined by an independent appraisal that is no more than 12 months before the relevant transaction to which the valuation is applied (for example, the date of grant of a stock option). This method is the clearest of the available options. However, start-up companies may be unwilling to spend the time and money necessary to obtain and update an independent appraisal.
- A Formula. A valuation based upon a formula, provided that the stock is valued in the same manner for purposes of any transfer of shares to the company or any person that owns stock 10% or more of the voting stock of the company (other than an arm's length transaction involving the sale of all or substantially all of the outstanding stock of the issuer). An example might be a multiple of sales or earnings, or book value. It is important to note that the valuation must be consistently applied to all valuations of stock. Therefore, it appears that the same value would have to be used for issuances to and repurchases by the company from third parties and nonemployees, for regulatory filings, and for loan covenants. As such, this method may be too restrictive for most companies.
- A Valuation Report for an Illiquid Start-Up Company. There are a number of requirements for this method:
  - The valuation method must be made reasonably and in good faith and be evidenced by a *written* report that takes into account the specified factors noted above;
  - The company (and its predecessors) cannot have been in the active conduct of a business for ten years of more;
  - The company cannot be public (that is, it cannot have any securities hat are readily traded on an established securities market);
  - There must not be any permanent put or call on the stock or any permanent requirement that the company or any other person purchase the stock (a right of first refusal or a repurchase right for unvested, restricted stock awards is permitted);
  - At the time of the valuation, it cannot be reasonably anticipated that the company will undergo a change in control within the 90 days following the action to which the valuation is applied, or make a public offering of securities within 180 days following the action to

which the valuation is applied; and

- The person performing the valuation must be qualified to perform such a valuation such that a reasonable individual, apprised of such knowledge, experience, education, and training, would reasonably rely on the advice of such person with respect to valuation in deciding whether to accept an offer to purchase or sell the stock being valued. For this purpose, significant experience generally means at least five years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry in which the service recipient operates.

This last method may be attractive to start-up companies because it avoids the expense of an independent appraisal, both with respect to the initial appraisal and updates. However, the company has to be careful that the requirements are met, particularly noting the qualifications of the person performing the valuation. For this method, it would be advisable to have a written report that clearly sets forth an evaluation of the factors as well as the required knowledge, experience, education, and training of the person performing the valuation.

Related Issues

The regulations contain provisions regarding the modifications and extensions of stock options, which should be taken into account if the company proposes to make changes to its existing options. Generally, a modification is treated as a new stock right that may or may not result in the deferral of compensation depending on how it is structured; an extension is treated as a deferral of compensation. It should also be noted that the requirements for stock options under Section 409A apply similarly to stock appreciation rights. In addition, Section 409A generally applies with respect to restricted stock units and phantom stock arrangements. However, it does not apply with respect to grants of restricted stock.

Action Plan

If an employer has issued stock options that are below FMV, the employer needs to take action depending on when the option was issued. Stock options that vested before January 1, 2005, are not subject to these rules if they are not materially modified after October 3, 2004. There are several ways to address options that do not qualify for the exemption:

- By December 31, 2008, cancel the option.
- By December 31, 2008, raise the exercise price to FMV as of the option grant date. (The lost discount could be made up with cash, restricted stock, or other property).
- By December 31, 2008, exchange the option for stock having a value equal to the spread or for cash.

There are other methods if the stock option is structured to comply with Section 409A. There is also an exception if the options are structured to be exercised within 2 ½ months after the year in which they vest.

Also, for older grants, the company may want to obtain an after-the-fact valuation to bolster the argument that the exercise price reflected FMV. As a related matter, companies that have incentive (qualified) stock options may want to consider the factors set forth in the regulations as a method of establishing good faith for the valuation of such options.

Companies should evaluate existing options and take necessary action by December 31, 2008.

If you have any questions regarding this article or Section 409A, please contact one of the Employee Benefits and Executive Compensation attorneys at Boult, Cummings, Conners & Berry PLC:

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