Common Stock Valuation and Option Pricing by Private Companies

10 Years of Valuations Under 409A

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It was the longstanding practice of privately held companies and their legal and accounting advisors to determine the fair market value of their common stock for purposes of setting option exercise prices by loosely estimating an appropriate discount from the price of recently issued preferred stock on the basis of the company's stage of development. This practice, previously accepted by the Internal Revenue Service (the "IRS" or the "Service") and the Securities and Exchange Commission (the "SEC"), was abruptly ended by the initial Internal Revenue Code Section 409A[1] guidance issued by the IRS in 2005. In contrast to past practice, the Section 409A regulations (the final version of which was issued by the IRS in 2007) contained detailed guidelines for determining the fair market value of the common stock of a privately held company by requiring a "reasonable application of a reasonable valuation method", including a few presumptively reasonable valuation methods or "Safe Harbors." These rules have reshaped private company common stock valuation and option pricing practices.

This article first briefly describes pre-Section 409A common stock valuation practices — the time-honored appropriate discount method. Next, it describes the valuation rules that were established by the Section 409A guidance issued by the IRS, including the Safe Harbors. It then describes the reactions of privately held companies of varying sizes and stages of maturity we have observed — what managements, their boards and their advisors are actually doing on the ground. Finally, it describes the best practices we have seen evolve thus far.

Note that this article is not intended to cover all of the issues under Section 409A. The sole focus of this article is the effect of Section 409A on the valuation of the common stock of privately held companies for purposes of setting nonqualified stock option ("NQO") exercise prices, so that such options are **exempt** from the application of Section 409A, and — for reasons we explain below – also for purposes of setting the exercise prices of incentive stock options ("ISOs") although ISOs are not subject to Section 409A. There are a number of significant issues relating to the effect of Section 409A on option terms and on nonqualified deferred compensation more generally that are beyond the scope of this article.[2]

Introduction

It has been almost 10 years since Section 409A of the Internal Revenue Code (the "Code") was enacted. This is an update of an article we wrote in 2008, a year after the final Section 409A regulations were issued by the IRS. In this article, we address, as we did previously, the application of Section 409A to the valuation of the common stock of privately held companies for purposes of setting the exercise prices for compensatory grants of ISOs and NQOs to employees[3] and we update the best practices we have observed, now over the last decade, in stock valuation and option pricing.

To appreciate the significance of Section 409A, it is important to understand the tax treatment of nonqualified stock options both before and after the adoption of Section 409A. Prior to the enactment of Section 409A, an optionee who was granted a NQO for services was not taxable at the time of grant.[4] Rather, the optionee was taxable on the "spread" between the exercise price and the underlying stock's fair market value at the time of option exercise.

Section 409A changed the income tax treatment of nonqualified stock options. Under Section 409A, an optionee who is granted a NQO in exchange for services may be subject to immediate income taxation on the "spread" between the exercise price and the fair market value at the end of the year in which the nonqualified stock option vests (and in subsequent years prior to exercise to the extent the underlying stock's value has increased) and a 20% tax penalty plus interest. A company that grants a NQO may also have adverse tax consequences if it fails to properly withhold income taxes and pay its share of employment taxes. Fortunately, a NQO granted with an exercise price which is not less than fair market value of the underlying stock on the date of grant is **exempt** from Section 409A and its potentially adverse tax consequences.[5]

While ISOs are not subject to Section 409A, if an option that was intended to be an ISO is later determined to not qualify as an ISO (for any of a number of reasons which are beyond the scope of this article, but importantly including being granted with an exercise price that is less than fair market value of the underlying common stock), it will be treated as a NQO from the date of grant. Under the rules applicable to ISOs, if an option would fail to be an ISO solely because the exercise price was less than the fair market value of the underlying stock as of the date of grant, generally the option is treated as an ISO if the company attempted in good faith to set the exercise price at fair market value.[6] There is risk that a company that fails to follow the valuation principles established by Section 409A may be considered not to have attempted in good faith to ascertain fair market value, with the result that the options would not be treated as an ISO and would be subject to all of the consequences of Section 409A for NQOs with an exercise price less than fair market value. Thus, setting ISO exercise prices at fair market value using Section 409A valuation principles has also become good practice.

As we've been advising clients over the past 10 years, establishing a supportable fair market value is critically important in the Section 409A environment.

How Exercise Prices for Common Stock Options Were Set Before Section 409A

Until the issuance of IRS guidance with respect to Section 409A, the time-honored practice of privately held companies in setting the exercise price of incentive stock options ("ISOs") for their common stock[7] was simple, easy and substantially free of worries that the IRS would have much to say about it.[8] For start-ups, the ISO exercise price could be comfortably set at the price the founders paid for their common stock, and often the objective was to get the upside equity opportunity into the hands of the key early employees as cheaply as possible. After subsequent investments, the exercise price was pegged at the price of any common stock that was sold to investors or at a discount from the price of the latest round of preferred stock sold to investors. For the sake of illustration, a company with a capable and complete management team, released products, revenue, and a closed C Round might have used a discount of 50 percent. It was all very unscientific. Rarely did a company buy an independent valuation for option pricing purposes, and, while the company's auditors were consulted — and their opinions carried weight, although not necessarily without some armwrestling — the conversation among them, management and the board was typically quite brief.

The Valuation Rules Under Section 409A[9]

The IRS guidance pertaining to Section 409A established a dramatically different environment in which private companies and their boards must operate in determining the valuation of their common stock and setting the exercise price of their options.

The General Rule. Section 409A guidance sets forth the rule (which we will call the "General Rule") that the fair market value of stock as of a valuation date is the "value determined by the reasonable application of a reasonable valuation method" based on all the facts and circumstances. A valuation method is "reasonably applied" if it takes into account all available information material to the value of the corporation and is applied consistently. A valuation method is a "reasonable valuation method" if it considers factors including, as applicable:

- 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 similar companies engaged in a similar business,
- recent arm's length transactions involving the sale or transfer of such stock or equity interests,
- control premiums or discounts for lack of marketability,
- whether the valuation method is used for other purposes that have a material economic effect on the company, its stockholders, or its creditors.

The General Rule provides that use of a valuation is not reasonable if (i) it fails to reflect information available after the date of calculation that may materially affect value (for example, completing a financing at a higher valuation, accomplishment of a significant milestone such as completion of development of a key product or issuance of a key patent, or closing a significant contract) or (ii) the value was calculated with respect to a date more than 12 months earlier than the date on which it is being used. A company's consistent use of a valuation method to determine value of its stock or assets for other purposes supports the reasonableness of a valuation method for Section 409A purposes.

If a company uses the General Rule to value its stock, the IRS may successfully challenge the fair market value by simply showing that the valuation method or its application was unreasonable. The burden of proving that the method was reasonable and reasonably applied lies with the company.

The Safe Harbor Valuation Methods. A valuation method will be considered presumptively reasonable if it comes within one of the three Safe Harbor valuation methods specifically described in Section 409A guidance. In contrast to a value established under the General Rule, the IRS may only successfully challenge the fair market value established by use of a Safe Harbor by proving that the valuation method or its application was grossly unreasonable.

The Safe Harbors include:

- *Valuation by Independent Appraisal.* A valuation done by a qualified independent appraiser (which we will call the "Independent Appraisal Method") will be presumed reasonable if the valuation date is no more than 12 months before the date of the option grant.
- *Reasonable Good Faith Written Valuation of a Start-Up.* A valuation of the stock of a private company that has no material trade or business that it has conducted for 10 years or more, if done reasonably and in good faith and evidenced by a written report (which we will call the "Start-Up Method"), will be presumed reasonable if the following requirements are satisfied:
    1. The valuation takes into account the valuation factors specified under the General Rule and events subsequent to the valuation that may render an earlier valuation inapplicable are taken into account.
    2. The valuation is performed by a person with significant knowledge, experience, education or training in performing similar valuations. "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 company operates.

3. 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 the employee's receipt of an offer to purchase by an unrelated third party or termination of service.

4. The company does not reasonably anticipate, as of the time the valuation is applied, that the company will undergo a change in control event within the 90 days following the grant or make a public offering of securities within the 180 days following the grant.

- *Formula-Based Valuation.* Another Safe Harbor (which we will call the "Formula Method") is available for companies that use a formula based on book value, a reasonable multiple of earnings, or a reasonable combination of the two to set option exercise prices. The Formula Method will not be available unless (a) the stock acquired is subject to a permanent restriction on transfer which requires the holder to sell or otherwise transfer the stock back to the company and (b) the formula is used consistently by the company for that (or any similar) class of stock for all (both compensatory and noncompensatory) transfers to the company or any person who possesses more than 10 percent of the of the total combined voting power of all classes of stock of the company, other than an arm's length sale of substantially all the outstanding stock of the company.

Choices for Companies' Valuation Practices

In the Section 409A valuation environment, companies may decide to take one of three courses of action:

- *Follow Pre-409A Practices.* A company could choose to follow pre-409A valuation practices. If, however, the option exercise prices are later challenged by the IRS, then the company will have to satisfy the burden of proving that its stock valuation method was reasonable and was reasonably applied, as required under the General Rule. The benchmark for that proof will be the rules, factors and procedures of the Section 409A guidance, and if the company's existing option pricing practices do not clearly reference and follow those rules, factors and procedures, it almost certainly will fail that burden and the adverse tax consequences of Section 409A will result.

- *Internal Valuation Exercise Following the Section 409A General Rule.* A company could choose to conduct an internal stock valuation following the General Rule. If the resulting option exercise prices are later challenged by the IRS, then the company again will have to satisfy the burden of proving that its stock valuation method was reasonable and was reasonably applied. Now, however, because the company can show that its valuation followed the Section 409A guidance, it is reasonable to think that its chances of satisfying this burden are significantly better, although there is no guarantee that it will prevail.

- *Follow One of the Safe Harbor Methods.* A company that wishes to minimize its risk can use one of the three Safe Harbors that will be presumed to result in a reasonable valuation. In order to challenge the value determined under a Safe Harbor, the IRS must show that either the valuation method or its application was grossly unreasonable.

Practical Solutions and Best Practices

When we wrote the first draft of this article in 2008, we suggested that the valuation patterns among private companies were falling along a continuum without sharp demarcations from start-up stage, to post-start-up to pre-expectation of liquidity event, to post-expectation of liquidity event. Since then it has become clear in our practice that the demarcation is between those who have enough capital to obtain an Independent Appraisal and those that do not.

Start-Up Stage Companies. At the earliest stage from a company's founding to the time when it begins to have significant assets and operations, many of the well-known valuation factors set forth in the IRS guidance may be difficult or impossible to apply. A company typically issues stock to founding shareholders, not options. Until a company begins to grant options to multiple employees, Section 409A will be of less concern.[10] Even after significant option grants commence, we are seeing companies balance the potentially significant dollar and other costs of achieving definitive protection from noncompliance with Section 409A against the often stringent financial circumstances of start-up stage companies.

In the early days of Section 409A, the cost of valuations by professional appraisal firms ranged from around $10,000 to $50,000 or more, depending on the age, revenue, complexity, number of locations, intellectual property and other factors that control the extent of the investigation required to determine a company's value. Now a number of established and new appraisal firms are competing specifically for Section 409A valuation business on the basis of price, many of them offering initial fees as low as $5,000 and some even as low as $3,000. Some valuation firms even offer a 'package deal' where subsequent quarterly valuations are priced at a discount when done as an update to an annual valuation. Even though the cost of the Independent Appraisal Method is now very low, many start-up stage companies are reluctant to undertake the Independent Appraisal Method due to the need to preserve capital for operations. Use of the Formula Method is also unattractive because of the restrictive conditions on its use and, for early stage start-ups, the Formula Method may be unavailable because they have neither book value nor earnings. Use of the Start-Up Method is also often not available due to the lack of in-house personnel with the "significant expertise" to conduct the valuation.

Our Recommendations:

- The general recommendation is no different for start-up companies than for companies at any stage of development: opt for the maximum certainty that they can reasonably afford, and, if necessary, be willing to take some risk if they are cash-constrained.
- Because reasonably priced valuation services tailored specifically for the needs created by Section 409A are now being offered in the market, even some early stage companies may consider that the cost of an Independent Appraisal is justified by the benefits afforded.
- If the start-up cannot afford the Independent Appraisal Method and the Formula Method is too restrictive or inappropriate, the remaining options include the Start-Up Method and the General Method. In both cases, companies that intend to rely on these methods will need to focus on their valuation procedures and processes to ensure compliance. Developing best practices include the following:
    1. The company should identify a person (e.g., a director or a member of management) who has "significant knowledge, experience, education or training in performing similar valuations", if such a person exists within the company in order to take advantage of the Start-Up Method. If such a person is not available, the company should identify a person who has the most relevant skills to undertake the appraisal and consider whether it may be feasible to augment that person's qualifications with additional education or training.
    2. The company's board of directors, with the input of the person identified to perform the appraisal (the "Internal Appraiser"), should determine the factors relevant to its valuation, given the company's business and stage of development, including at least the valuation factors specified under the General Rule.
    3. The company's Internal Appraiser should prepare, or direct and control the preparation of, a written report determining the valuation of the company's common stock. The report should set forth the qualifications of the appraiser, it should discuss all valuation factors (even if simply to note a factor is irrelevant and why), and it should come to a definitive conclusion (a range of value is unhelpful) as to fair market value and provide a discussion as to how the valuation factors were weighted and why.

4. The company's valuation procedure described above should be performed in cooperation and consultation with its accounting firm in order to ensure that the company does not determine a valuation that the accountants will refuse to support in its financial statements.
5. The company's board of directors should carefully review and expressly adopt the final written report and the valuation established in it, and should expressly refer to the valuation established by the report in connection with grants of stock options.
6. If additional options are granted later, the board should expressly determine that the valuation factors and facts relied upon in preparing the written report have not materially changed. If there have been material changes, or if more than 12 months have passed since the date of the report, the report should be updated and adopted anew.

Intermediate-Stage Private Companies. Once a company is beyond the start-up stage but does not yet reasonably anticipate a liquidity event, its board of directors will have to apply its judgment in consultation with the company's legal counsel and accountants to determine whether it should obtain an independent appraisal. There is no bright line test for when a company should do so, but in many cases the company will have reached this stage when it takes its first significant investment from outside investors. An 'angel' round could be significant enough to trigger this concern. Boards that gain truly independent outside directors as a result of the investment transaction will be more likely to conclude that an independent appraisal is advisable. Indeed, venture capital investors typically require the companies they invest in to obtain an outside appraisal.

Our Recommendations:

- The general recommendation for companies in this intermediate stage of growth is again the same: opt for the maximum certainty that they can reasonably afford, and, if necessary, be willing to take some risk if they are cash-constrained.
- Companies that have either begun to generate significant revenues or that have completed a significant financing will both be more capable of bearing the cost of the Independent Appraisal Method and be more concerned about possible liability for the company and for optionees if their valuation is subsequently determined to have been too low. Because reasonably priced valuation services tailored specifically for the needs created by Section 409A are being offered in the market, intermediate-stage companies are likely to determine that the cost is justified by the benefits afforded.
- Companies that foresee a liquidity event in their future are more likely to use, if not a Big 4 accounting firm, then one of the larger and relatively sophisticated regional firms in order to assure that their accounting and financial affairs are in order for an IPO or acquisition. Many such firms require that their clients obtain independent valuations of their stock for purposes of option grants, and we've heard reports of accounting firms that are refusing to take on new audit accounts unless the company agrees to do so, especially in light of the option expensing rules under FAS 123R.
- A common practice that has developed in implementing the Independent Appraisal Method is to have an initial appraisal performed (or annual appraisals), and then to have that appraisal updated quarterly (or perhaps semi-annually, depending on the company's circumstances), and to plan option grants to occur soon after an update. The only caveat is that if, as is the case with many technology companies, a company has experienced a value-changing event since the most recent appraisal, the company must be sure to advise its appraiser of such events in order to be sure that the appraisal incorporates all relevant information.
- If a company at this stage, after careful consideration, determines that the Independent Appraisal Method is not feasible, the next best option is to apply the Start-Up Method if all the

requirements for relying on this method are met or, if the Start-Up Method is not available, apply the General Rule. In both cases, the company should consult with its accounting and law firms to determine a reasonable methodology of valuation for the company based on its facts and circumstances and, at a minimum, undertake the appraisal as we described above for Start-Up Stage Companies.

Later Stage Private Companies. Companies that anticipate — or reasonably should anticipate — going public within 180 days or being acquired within 90 days, or that have a line of business that has continued for at least 10 years, cannot rely on the Start-Up Method and, while such companies may rely upon the General Rule, many will, and should, rely predominantly on the Independent Appraisal Method.

Our Recommendations:

- Companies contemplating an IPO will be required – initially by their auditors and later by the SEC's rules – to establish the value of their stock for financial accounting purposes using the Independent Appraisal Method.
- Companies planning to be acquired will be advised that prospective buyers will be concerned about compliance with Section 409A and will require evidence of defensible option pricing, typically the Independent Appraisal Method, as part of their due diligence.

Other Observations

Finally, for NQO grants, companies that cannot take advantage of a Safe Harbor and that determine reliance on the General Rule leaves more risk than the company and the optionees are willing to take on may also consider limiting Section 409A exposure by making the options **compliant** with (rather than **exempt** from) Section 409A. A NQO may be "409A-compliant" if its exercise is limited to events permitted under Section 409A guidance (for example, upon (or upon the first to occur of) a change of control, separation from service, death, disability, and/or a certain time or schedule, as defined in Section 409A guidance). However, while many optionees whose options are not restricted in this manner in fact do not exercise their options until such events occur, applying these restrictions may in subtle ways change the economic deal, or the optionee's perception of it, and thus may have an effect on incentivizing service providers. Considering the application of such restrictions from both the tax and business perspectives is imperative.

Please feel free to contact any member of our Tax or Corporate practice groups for assistance and advice in considering your company's choices of valuation practices under Section 409A. While we are not competent to perform business valuations, we have counseled many clients in these matters.

Footnotes.

1. The tax law regulating nonqualified deferred compensation plans, including nonqualified stock options, which was enacted on October 22, 2004 and became effective on January 1, 2005.

2. These issues are addressed in more detail in other Morse Tax Alerts.

3. Unless an exemption applies, Section 409A covers all "service providers," not just "employees". For purposes of this article, we use the term "employee" to indicate a "service provider" as that term is defined in Section 409A.

4. This treatment applied so long as the option did not have a "readily ascertainable fair market value" as defined under Section 83 of the Code and related Treasury regulations.

5. To be exempt from Section 409A, a nonqualified stock option must also not contain an additional right, other than the right to receive cash or stock on the date of exercise, which would allow compensation to be deferred beyond the date of exercise and the option must be issued with respect to “service recipient stock” as defined in the final regulations.

6. See section 422(c)(1).

7. ISOs only. Until Section 409A there was no requirement that NQOs be priced at fair market value.

8. The SEC was not a concern unless the company was likely to file for its IPO in less than a year or so, giving rise to cheap stock accounting concerns that could require a restatement of the company’s financial statements. This has not changed as a result of Section 409A, although there have been changes recently in the valuation methodologies that the SEC sanctions, which seems to point to a substantial convergence in valuation methodologies for all purposes.

9. The IRS issued guidance which adopted differing valuation standards depending upon whether options were granted before January 1, 2005, on or after January 1, 2005 but before April 17, 2007, or on or after April 17, 2007. Options granted before January 1, 2005 are treated as granted at an exercise price not less than fair market value if the company made an attempt in good faith to set the exercise price at not less than the stock’s fair market value on the date of grant. For options granted in 2005, 2006 and up to April 17, 2007 (the effective date of the final Section 409A regulations), the IRS guidance expressly provides that where a company can demonstrate that the exercise price is intended to be not less than fair market value of the stock at the date of grant and that the value of the stock was determined using reasonable valuation methods, then that valuation will meet the requirements of Section 409A. The company may also rely on the General Rule or the Safe Harbors. Options granted beginning on and after April 17, 2007 must comply with the General Rule or the Safe Harbors.

10. Although Section 409A does not technically apply to outright stock grants, care must be taken when establishing the value of stock grants issued proximate to the grant of options. For example, a grant of stock with a reported value for tax purposes of $0.10/share may be questioned when a subsequent grant of NQOs at a fair market value strike price of $0.15/share established using a Section 409A valuation method is made close in time.