



VALUING PRIVATE COMPANY CORPORATE STOCK IN LIGHT OF CODE SECTION 409A

This document addresses some of the common concerns surrounding the issue of how to value your company's stock and set the exercise price of your company's stock options for purposes of Internal Revenue Code Section 409A. Although not discussed specifically below, similar valuation rules apply when companies elect to issue stock appreciation rights.

This document is intended only as a general discussion of the issues involved in valuing private company stock for the purpose of issuing stock options and is not intended to be advice specific to your company.

What is Code Section 409A?

Section 409A is a tax code provision that was enacted in late 2004; final regulations interpreting Section 409A were issued in April 2007. Section 409A imposes taxes and penalties when a company grants "nonqualified deferred compensation" to a "service provider." Your employees, members of your Board of Directors, and any consultants who are not actively providing services to other, unrelated clients are "service providers." The definition of "nonqualified deferred compensation" is complex, but it includes items such as severance plans and employment agreements, bonus plans, and stock options that are issued with an exercise price that is less than the fair market value of the underlying stock. This document focuses on issues related to valuing corporate stock (or other equity interests in a private company) so as to ensure that the exercise price is not less than the fair market value of the stock for Section 409A purposes.

Why Does Section 409A Matter?

There are significant negative tax consequences if a company pays deferred compensation that does not comply with the requirements of Section 409A. First, the employee is subject to regular income tax on the value of vested deferred compensation even before the compensation is paid. This obviously can create significant economic hardship for an affected employee. For example, if you grant an employee an option that is not Section 409A compliant, he or she will have taxable income on the difference between the exercise price and the fair market value each time a portion of the option vests. The employee is also subject to tax every year thereafter on any additional increases in value while the option remains unexercised. Second, the tax imposed on this compensation is increased by an excise (penalty) tax that is equal to 20% of the amount of the deferred compensation. Finally, employees are potentially subject to interest on these taxes. While the taxes are imposed on the employee, they also affect the employer because the employer may have an obligation to withhold the taxes from the employee's cash compensation and is subject to penalties if this is not done. The employer also has an obligation to correctly report the income on the employee's Form W-2 and may be subject to penalties if this is not done. Some states, notably California, are adopting similar statutes.

Stock Options and Section 409A

Section 409A applies to any stock option or stock warrant granted to a service provider with an exercise price that is not at least equal to the fair market value of the underlying stock on the date of grant. Section 409A may also apply if an option that was priced at fair market value on the date of grant is later amended, unless at the time of the amendment the exercise price is reset to a price at least equal to the fair market value of the underlying stock at the time of the amendment. If Section 409A applies, the option must meet very strict requirements regarding when it may be exercised, what changes may be made to the option after the grant, whether or not vesting of the option may be accelerated, etc. These numerous restrictions make Section 409A-compliant options far less attractive as a compensation tool. These Section 409A requirements do not apply if the exercise price of the option is at least equal to fair market value at the time of grant and there are no deferral features built into the option other than the right to choose when to exercise it. In most cases, clients and their employees will prefer to have more flexible option instruments that are granted with a fair market value exercise price.

How is Fair Market Value Determined for Purposes of Section 409A?

In the private company context, the basic rule under Section 409A is that fair market value means “a value determined by the reasonable application of a reasonable valuation method.” There are certain requirements that a valuation method must meet in order to be deemed reasonable. These include:

The valuation must take into account ALL available information material to the valuation of a private company. Factors which the IRS has deemed important in this regard include:

- The value of the company’s tangible and intangible assets.
- The present value of anticipated future cash flows.
- The readily determinable fair market value of the stock or equity interests in similar companies engaged in substantially similar businesses.
- Recent arm’s length transactions involving the sale or transfer of stock or equity interests.
- Other relevant factors such as control premiums or discounts for lack of marketability.

The valuation must be timely. There are two aspects to this:

- The valuation cannot be more than 12 months old.
- The valuation cannot be used if events have occurred since the initial valuation date which would “materially” affect the value of the company. For example, if the company entered into a major license agreement, significantly increased its customer base, or closed a financing round, it is likely that a new valuation determination would be needed.
- The method chosen should be used on a consistent basis, as this is a factor supporting the reasonableness of the valuation method. This means that, to the extent possible, the same method should be used for purposes unrelated to equity compensation grants.

It is worth noting that under these rules, certain valuation norms that have historically been used by start-up companies will not be acceptable for purposes of complying with Section 409A. Chief among these is valuing common stock at a set ratio to the most recent sale of preferred stock, as this valuation method does not take into account the other valuation factors described above.

It is also worth noting that technically these valuation rules do not apply when a company issues incentive stock options, where the standard remains one of a “good faith” attempt to set the exercise price at fair market value. However, if a company anticipates issuing both nonstatutory and incentive options it is effectively forced into the 409A valuation rules for all issuances given the need for consistency. In addition, using the 409A valuation rules when granting incentive stock options may be advisable in the event that the option later fails to qualify as an incentive stock option (for example, if the optionee is allowed to exercise the option more than 90 days after termination of employment) and thus becomes subject to Section 409A as of the time it was originally granted. Accordingly, we generally recommend that the Section 409A rules be followed in connection with all option grants.

Safe Harbor Rules

The IRS has also established certain “safe harbors” for testing the reasonableness of a private company’s valuation method. Using one of the safe harbor methods confers an enormous advantage. If a company does NOT use a safe harbor method, and the IRS later challenges the valuation, the burden is on the company to show that its valuation determination was reasonable. The company has a better chance of success in showing reasonableness if its valuation method incorporated the factors listed above, but there is still no assurance or guaranty that it will succeed. If the IRS proves that the valuation determination was not reasonable, then the option will be subject to Section 409A and the negative tax consequences described above would apply.

However, the IRS has established three presumptively safe valuation methods, described in more detail below. If a company uses one of these methods, then, in the event of an IRS challenge to its valuation, the burden shifts to the IRS to prove not only that the company’s valuation was too low, but also that the valuation method, as applied in the particular case, was “grossly unreasonable”. This is a high bar for the IRS to reach and if the IRS cannot meet this burden the company’s valuation determination will stand and the negative tax consequences of Section 409A will be avoided.

The First Safe Harbor: The Formula Valuation

The first safe harbor is if the company uses a “nonlapse restriction” for purposes of valuing its stock, and the stock received by the service provider is transferable only by means of this nonlapse restriction. In plain English, what this means that the employee may only sell or otherwise transfer the stock back to the company at a price determined by a fixed formula, such as book value or a multiple of earnings, and that the stock is otherwise nontransferable. Further, the company must use the same valuation formula for purposes of any nonlapse restriction applicable to the transfer of shares of stock either back to the issuer or to any person owning 10% or more of the issuer’s stock. This means that the same formula would have to be used in shareholders’ agreements governing the repurchase of founders’ shares and the like. Because of these limitations, the formula valuation method is quite restrictive and we do not expect it to be used by many companies.

The Second Safe Harbor: The Illiquid Start Up Valuation

A company that issues “illiquid stock of a start-up corporation” can elect to prepare a written valuation report following specific IRS guidelines in order to qualify for the second valuation safe harbor. Stock qualifies for this designation if it meets the following tests:

- The issuer has been in business for less than ten years (with the time in business of any predecessor corporation included in the calculation).
- The issuer is a private company that does not have any class of securities (debt or equity) traded on an established market.
- The issuer does not reasonably expect to undergo a change in control within 90 days of, or a public stock offering within 180 days of, the date that the valuation is performed.
- The stock is not subject to a put or call right or other obligation to purchase the stock, other than certain repurchase rights that lapse with the passage of time or occurrence of certain events, such as a right of first refusal or a right to repurchase unvested stock at its original cost.

The valuation must be made reasonably, in good faith, and be supported by a written valuation report that takes into account the factors described in paragraph 4, above. The issuer must reasonably determine that the person who performs the valuation is qualified to perform such a valuation based on the person’s “significant knowledge, experience, education or training,” which generally means at least 5 years of relevant experience in business valuation or appraisal, financial accounting, investment banking, private equity, secured lending or other comparable experience. Individuals who could qualify to prepare the report include Board members who represent venture capital funds and have valuation experience, CFOs and controllers with the requisite experience, etc. The advantage of this method is that there is little or no out-of-pocket cost involved if an employee or Board member performs the valuation. The downsides are that a company may not have an employee or Board member with the requisite valuation experience and, even if a Board member has the right experience, he or she may not be willing to incur the liability risk of preparing a valuation report for these purposes.

The Third Safe Harbor: The Independent Appraisal

The third safe harbor is the use of a recent appraisal made by a qualified independent appraiser. An appraisal is recent if it is less than 12 months old, although, as discussed above, the occurrence of a material event (such as a major licensing transaction or the closing of a finance round) may make the appraisal stale in less than 12 months. Accordingly, we recommend that clients who use the appraisal method obtain an annual appraisal but consider having it updated on an as-needed basis if there are significant events which may change the value of the company. It is important to use an independent, qualified appraiser for this purpose; he or she must be a third party, possess the relevant professional qualifications and designations, and have experience in valuing corporate stock. There are some downsides to using an appraisal – obtaining them can be expensive and time consuming, and once obtained it is difficult for a company to argue that the appraised value is inaccurate, even if the value is markedly different from what the company expected. That said, in many cases obtaining an appraisal will be the best option even for those companies that are qualified to use the illiquid start-up method. Although not foolproof – because the IRS can still attempt to prove that a particular appraisal was grossly unreasonable – the appraisal method provides the highest level of certainty available. In addition, we would expect boards of directors to feel more comfortable that they have fulfilled their fiduciary duties if they rely on an appraisal to set the value of the company’s stock rather than the more uncertain illiquid start-up method. Our experience so far is that almost all private companies backed by venture funds are using the independent appraisal safe harbor.

What We Expect Most Companies Will Do

We expect that companies in the true founding stage may elect to forego using the safe harbors. Obtaining an appraisal is likely to be cost-prohibitive for such companies, and many will not have an employee or Board member

who is qualified under the IRS guidelines to prepare a written valuation report. Once a company is past the true founding stage – for example, is earning revenues, or has completed an angel or venture capital financing round – we expect that companies will use either the illiquid start up method (if the particular company qualifies) or the independent appraisal method. In general, we recommend the use of the independent appraisal method, despite its greater costs, because it provides the most certainty and because we anticipate that obtaining independent appraisals will become the industry norm.

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Hutchison Law Group

FIRMS OFFERING VALUATION SERVICES

Below is a list of firms with whom we or our clients have worked which offer valuation services for purposes of Section 409A.

Business Development Associates, Inc.

6200 Falls of Neuse Road
Suite 200
Raleigh, NC 27609
Contact: Jim Meese
Phone: (919) 871-9980

CapVal, LLC

7812 Brookdale Drive
Raleigh, NC 27616
Contact: James B. Lurie
Phone: (919) 266-7592
Fax: (919) 266-6270
E-mail: jlurie@capval-LLC.com

Grant Thornton

201 South College Street, Suite 2500
Charlotte, NC 28244
Contact: Mark Edwards
Phone: (704) 632-6926
Fax: (704) 334-7701
E-mail: mark.edwards@gt.com

Paramax Corporation

111 Corning Road, Suite 185
Cary, NC 27511
Contact: Bill Morgenstern
Phone: (919) 852-0712

Pisgah Financial, LLC

P.O. Box 2216
Asheville, NC 28802
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Fax: (828) 678-7856
E-mail: ghwall@pisgahfinancial.com

Willamette Management Associates

1355 Peachtree Street, N.E., Suite 1470
Atlanta, GA 30309
Contact: Mark Zyla
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ZTR Enterprises LLC

310 North Front Street, Suite 4 #177
Wilmington, NC 28401
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Phone: (404) 915-4474
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