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# Stock Option Pricing Issues for Private Companies: Our Recommendations in Light of Section 409A and Recent AICPA Guidance

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1. Private companies have, to a great extent, avoided the direct impact of the far-reaching regulatory changes of the last few years that have significantly affected public companies. However, a number of recent tax and accounting changes inspired by "public company issues" will dramatically alter the way private companies grant stock options to employees. In short, the common private company practice of valuing stock option grants based on rule of thumb discounts and cursory board resolutions stating that "the Board has determined that the fair market value of the common stock is $X" will no longer suffice.

**Overview of Developments**

**Section 409A**

***General.*** Section 409A imposes strict operational and documentary requirements for all nonqualified deferred compensation plans and agreements entered into, or vesting after, January 1, 2005. The definition of nonqualified deferred compensation is extremely broad and reaches many arrangements not historically considered deferred compensation, including some stock options. If an arrangement is not compliant with, or exempt from, Section 409A, the employee or independent contractor will be subject to current income inclusion and a 20% penalty tax, and the company may have withholding obligations.

***Exemption for Some Stock Options.*** Stock options with an exercise price that is at least equal to the fair market value of the company's common stock on the date of grant (and that do not otherwise have a deferral feature) are exempt from Section 409A. Recently proposed IRS regulations provide that the fair market value of stock that is not publicly traded must be determined by the reasonable and consistent application of a reasonable valuation method that considers all relevant facts and circumstances on the valuation date. The regulations set forth a list of factors that should be considered under a reasonable valuation method, including, as applicable, the value of tangible and intangible assets, the present value of future cash-flows, the market value of stock or other equity interests in similar companies, and other relevant factors such as control premiums, discounts for lack of marketability, and whether the valuation method is used for other purposes that have a material economic effect on the company and its stockholders. Valuations that are more than 12 months old, or that do not reflect the most current available information with respect to the company, are not considered reasonable.

***Valuation Safe Harbors.*** In order to provide private companies with more certainty that their valuation methods will be considered reasonable, the Section 409A regulations provide two safe harbors. First, an independent appraisal undertaken no more than 12 months before the option grant date will be presumed to result in a reasonable valuation. Second, for a company that is less than 10 years old, a valuation will be presumed reasonable if it is (i) made reasonably and in good faith, (ii) evidenced by a written report that takes into account the factors listed above, and (iii) made by person(s) with significant knowledge and experience in performing similar valuations. However, the second safe harbor does not apply to a valuation if the company may reasonably anticipate at the time of the valuation that it will undergo a change in control or a public offering within 12 months.

***Modifications.*** Certain modifications of exempt stock options, including any change that has the effect of reducing the exercise price below the fair market value of the stock on the option grant date, or an extension or renewal, or any addition of a deferral feature, will trigger the application of Section 409A unless an exemption applies. These types of changes, particularly extensions of the exercise period, have historically been quite common and have not had significant tax consequences. Because of the drastic effect of Section 409A, however, companies should carefully consider the consequences of any such modifications.

***Immediate Action May Be Required.*** Stock options that were not vested before December 31, 2004, and that have an exercise price below the fair market value of the stock on the option grant date will be subject to Section 409A unless remedial action is taken to exempt the options from 409A. To make the options exempt from Section 409A, companies must increase the exercise price to the fair market value of the stock on the option grant date. The IRS regulations allow until December 31, 2006, to make the necessary change to the options. However, any payments made after 2005 to compensate employees for the lost discount will be subject to Section 409A. Accordingly, it is recommended that companies review their option grants before December 31, 2005, to determine if any of those options will need to be amended to avoid the application of Section 409A.

In addition, companies that have modified otherwise exempt options during 2005--e.g., by extending the exercise period of the options--may have inadvertently caused those options to be subject to Section 409A. Companies may be able to take remedial action in 2005, and possibly in 2006, to avoid adverse consequences.

**AICPA Practice Aid**

Companies seeking to go public often encounter scrutiny by the SEC of the "fair value" of pre-IPO compensatory equity awards. Companies are required to recognize additional compensation expense if it is determined that they issued "cheap stock" as a result of underestimating the fair value of the company's common stock in accounting for compensatory stock and option grants. In past years, the SEC typically allowed a company to make this determination based on a "rule of thumb" discount from the IPO price range.

In 2005, the SEC modified its practice for reviewing cheap stock issues and began to apply the recommendations contained in an AICPA Practice Aid--*Valuation of Privately-Held-Company Equity Securities Issued as Compensation*--initially issued in mid-2004. The Practice Aid identifies three acceptable valuation methodologies: market-based, income-based (such as discounted cash flow) and asset-based. In addition, the Practice Aid establishes a hierarchy of valuation methodologies. The preferred method involves a valuation at the time of issuance by an unrelated valuation specialist. If a contemporaneous valuation is not possible, the Practice Aid recommends a retrospective valuation by an unrelated valuation specialist. The final, and least favored, alternative is a valuation established by a so-called "related-party valuation specialist," such as the IPO company's board of directors.

The Practice Aid goes into significant detail as to best practices for how private companies should value equity-based compensation, and the SEC requires relatively extensive prospectus MD&A disclosure of the process by which IPO companies comply with the Practice Aid. As a result, private companies considering an IPO should consult with their accountants and attorneys in order to evaluate how to comply with the Practice Aid.

To date, the best practices contained in the Practice Aid have been implemented primarily in the context of IPOs-specifically, with respect to the 12-month period prior to the initial filing of a company's registration statement. In the future, practices may emerge that require a private company to apply the Practice Aid either (i) under GAAP, in connection with all compensatory equity grants, regardless of whether an IPO is pending, or (ii) under Section 409A, in order to establish the availability of an exemption.

**Recommendations**

1. The safest choice is to use an appraisal firm, business valuation specialist or similar third party to determine the fair value of a private company's common stock contemporaneously with each compensatory grant of stock or options. For practical reasons, this may require that a company limit the number of times its board of directors approves compensatory equity grants each year.

2. If recurring third-party valuations would be prohibitively expensive, the board might engage a third party to value the common stock as of a specific date, and then use the third party's valuation methodology to determine the fair value of common stock each time the company subsequently grants compensatory equity awards. This approach will be considered more subjective and less desirable, however, since a related party--the board--will be required to determine whether each of the factors and assumptions underlying the baseline valuation continues to be appropriate as of each valuation date.

3. If a private company does not use a third-party appraiser, the board's determination of fair value should be reasoned and consistent. The board should consider the applicability of the methods contemplated by the Practice Aid, as well as the 409A factors listed above. Moreover, the board's analysis should be fully documented in board minutes and other corporate records.

For more information on Section 409A compliance, please see the Section 409A Checklist and Compliance Timeline and presentation slides, or contact:

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