

## **D&G Legal Development Alert: Executive Compensation & Employee Benefits**

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### **PRIVATE COMPANY STOCK OPTIONS UNDER SECTION 409A**

Section 409A of the Internal Revenue Code was enacted on October 24, 2004 and sets forth rules that apply to deferred compensation plans. Because of its breadth, Section 409A applies to many arrangements that are not historically considered to provide deferred compensation – such as stock options.

Noncompliance with Section 409A results in very significant penalties to affected employees. As a result, companies need to understand how Section 409A impacts their future stock option grants and whether outstanding options must be modified to comply with Section 409A.

#### **Structuring Exempt Options**

When it comes to stock options, there are basically two approaches for avoiding penalties under Section 409A. The first is to find a specific exemption from Section 409A for the stock option. The second is to structure the stock option in a way that complies with Section 409A. Generally, it is far more preferable for a stock option to be exempt from Section 409A, because complying with Section 409A typically allows for considerably less flexibility. Unfortunately, the scope of the exemption is narrow and not always consistent with the business goals of the parties involved.

Companies must decide at the time of grant whether to structure their stock options to be exempt from, or comply with, Section 409A. Generally, stock options will be exempt from Section 409A if they

- (i) are issued by an eligible issuer (i.e., the option recipient's employer and certain affiliates of the employer),
- (ii) are exercisable for the issuer's common stock,
- (iii) do not have a deferral feature, and
- (iv) have an exercise price (sometimes referred to as a strike price) that is at least equal to the fair market value of the company's common stock on the date of grant. In addition, certain stock repurchase rights must be executed at fair market value for the option to be exempt from Section 409A.

## Determining Fair Market Value

Not surprisingly, the most significant issue for companies under Section 409A is whether the company's process for determining fair market value is sufficient to exempt stock option grants from Section 409A. On this issue, the Internal Revenue Service has provided the following guidance:

Stock Options Granted Prior to January 1, 2005. Stock options granted prior to January 1, 2005 that vest before January 1, 2005, generally will be exempt from Section 409A under grandfathering rules. Stock options granted prior to January 1, 2005 that vest on or after January 1, 2005, will be deemed to satisfy the FMV rules as long as the valuation standards set forth under Section 422 of the IRC have been met. Under these standards, a good faith attempt must be made to ascertain the FMV of the stock. If a good faith attempt is made, the option will be treated as granted at FMV even if the valuation produced by the good faith attempt is wrong. This is the least exacting standard for valuing stock.

Stock Options Granted On or After January 1, 2005 and Prior to January 1, 2009. Stock options will be deemed to satisfy the FMV rules as long as the company shows that their intent was not to grant a discounted option and that they applied a reasonable method for ascertaining the FMV of the stock. This is a more exacting standard for valuing stock than the "good faith" standard described above.

Stock Options Granted On or After January 1, 2009. Stock options will be deemed to satisfy the FMV rules as long as the company satisfies the requirements set forth under the Section 409A final regulations described below. This is the most exacting standard for valuing stock.

The final regulations issued under Section 409A provide that the FMV of private company stock must be determined by a reasonable valuation method that considers all facts and circumstances. Factors that must be taken into consideration when valuing company stock include the following, as applicable:

- Whether the valuation is consistent with valuations used for other corporate purposes;
- Discounts for lack of marketability;
- Control premiums;
- The present value of future cash flows;
- The value of tangible and intangible assets; and
- The market value of stock in similar publicly-traded corporations.

Certain valuation methods are presumptively reasonable. For example, a valuation performed by an independent valuation expert no more than 12 months before the option is granted will be presumed to result in a reasonable valuation. In addition, certain formula-based valuations are presumptively reasonable. Furthermore, in the case of a start-up company (i.e., a company that has been in business for less than 10 years), a written valuation made reasonably and in good faith by a person familiar with valuations will be presumptively reasonable.

### Practical Advice

What does all of this mean from a practical perspective?

Options Granted Prior to 2005. Stock options granted and vested prior to January 1, 2005 are exempt from Section 409A. Stock options that were granted before January 1, 2005, but vest on or after January 1, 2005, generally should be exempt from Section 409A if the board of directors of the issuing company made a good faith attempt to establish FMV of the stock underlying the option.

Options Granted after 2004 but before 2009. The FMV of the stock underlying these options must be based on any “reasonable valuation method.” This standard is higher than the “good faith” standard described above.

Consequently, the common practices of valuing common stock based on cursory evaluations or industry-standard discounts will not be sufficient to satisfy Section 409A. We recommend that boards prudently evaluate their valuations and confirm that such valuations would satisfy the “reasonable valuation method” standard. If the standard was not met, the transition rules under Section 409A allow companies to amend their stock options before the option is exercised and, in any event, before January 1, 2009.

Options Granted after 2008. The FMV of the stock underlying these options must be ascertained in accordance with the final regulations issued under Section 409A. The safest approach is to have an independent expert value the company’s stock. If this would be prohibitively expensive, and the other “safe harbor” valuation methods are not useful, the board might consider engaging an expert to provide a methodology for determining the company’s value, which the board could then use each time it grants stock options (although the methodology would need to be updated from time to time as the company develops and circumstances change). At a minimum, the board should rigorously assess the factors set forth in the final regulation, as well as other pertinent facts and circumstances, in order to establish the FMV of the their company’s stock. This analysis should be fully document and included in board minutes.

*For more information, contact Mark Bokert at (212) 468-4969 // mbokert@dglaw.com or the D&G attorney with whom you have regular contact.*