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Granting Stock Options At Fair Market Value

by Alison E. Wright

The stakes have gotten much higher with respect to early stage companies pricing stock options. The general rule is that the exercise price of the stock option cannot be less than the fair market value of the stock underlying the option determined on the date of grant. If an option is granted with a discounted exercise price, the tax consequences for the employee or advisor receiving the option can be severe. In order for an incentive stock option ("ISO") to qualify as an ISO, the exercise price of the stock option cannot be less than the fair market value of the stock underlying the option determined on the date of grant. An ISO granted at a discount is automatically re-characterized as Nonstatutory Stock Option ("NSO"). An NSO granted at a discount is in violation of Internal Revenue Code Section 409A. A violation of Code Section 409A results in the employee or advisor being taxed in the year the option is vested (instead of when the option is exercised) and the employee is subject to a 20% penalty tax on top of income tax. The company is required to report the income and the penalty to the IRS in the year the option is vested. Code Section 409A compliance is a hot topic for the IRS, and also for investor's counsel, acquirer's counsel and underwriter's counsel (in the event of a company IPO).

So with those negative tax consequences as a backdrop, it is important that emerging companies determine fair market value every time an option is granted. The most conservative approach is to use an independent valuation expert. However, this can be an expensive process and early stage companies generally do not find the independent valuation expert to be cost effective. At some point though, an emerging company will want to get an independent valuation for purposes of granting stock options.

Instead of the independent valuation, early stage companies may rely on a safe harbor valuation method set forth in the Code Section 409A regulations. The Code Section 409A regulations generally require that the valuation method used to price stock options must be reasonable. Three key factors in determining reasonableness are:

- A valuation method is not reasonable if the methodology does not take into account all available information material to the value of the corporation.
- A value previously determined cannot be used if the valuation

does not reflect a later corporate event, or if the value was calculated more than 12 months earlier.
- Consistent application of a valuation method is a factor supporting reasonableness.

There is a presumption of reasonableness if the stock is valued using a safe harbor method. However, the IRS may rebut this presumption by showing that either the valuation method or the application of the valuation method was *grossly unreasonable*. The key safe harbor for early stage start-up companies requires that the valuation be:

- Made reasonably and in good faith.
- Evidenced by a written report.

Factors that the person determining the value should consider include:

- Value of tangible and intangible assets;
- Present value of anticipated future cash flows;
- Market value of stock in similar corporations;
- Recent arm's length transactions; and
- Other relevant factors such as control premiums or discounts for lack of marketability.

This safe harbor method is not available if a change in control is anticipated in next 90 days or an IPO is anticipated in next 180 days. Nor is the safe harbor method available if the company has been in existence for more than ten years.

The kicker in this safe harbor valuation method is who performs the valuation. The Code Section 409A regulations require that the valuation be performed by one or more persons reasonably determined to be qualified to perform the valuation based on significant knowledge, experience, education or training. This generally means that a reasonable individual would reasonably rely on the valuation after being told of the knowledge, experience, education or training of the person performing the valuation. For this purpose, significant experience generally means at least five years of relevant experience in valuation or appraisal, financial accounting, investment banking, private equity, secured lending, or other comparable experience in the line of business or industry of the corporation.

As stated above, Code Section 409A compliance is a hot topic for the IRS and there are reported circumstances where the IRS has imposed penalties on employees with respect to stock options granted at a discount. However, this issue most frequently arises in connection with mergers and acquisitions of emerging companies. Acquiror's counsel will focus on Code Section 409A issues in the due diligence process. If acquiror's counsel determines that the target company's board of directors did not adequately address the fair market value issue when granting stock options, acquiror's counsel will make the case for a purchase price adjustment or a special indemnity. Not only can Code Section 409A issues impact the value of the transaction, it is fair to say a substantial amount of legal fees and administrative time will be consumed in addressing these issues in the midst of a fast moving and busy transaction.

Code Section 409A compliance is worth the time and effort. Stock options should be granted at a meeting of the Board of Directors either in person or on the phone and specific attention should be paid with respect to the determination of fair market value with respect to each stock option grant.

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