Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 5 -
Why is a 409A Valuation Important?

By Megan Monson, Christine Osvald-Mruz, and Chandra Shih
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Megan Monson: Welcome to the latest episode of Just Compensation. I'm one of your hosts today, Megan Monson, Counsel in Lowenstein Sandler's Employee Benefits and Executive Compensation Group. And I'm joined by my co-host.

Christine Osvald-Mruz: Hi, I'm Christine Osvald-Mruz. I'm a partner in the same group as Megan.

Megan Monson: And we're also very lucky today to be joined by a special guest speaker, Chandra.

Chandra Shih: Hi, everyone. I'm Chandra Shih. I'm a partner here at Lowenstein Sandler in the Tech Group on what we lovingly call the deal team.

Christine Osvald-Mruz: Today, we're going to talk about what is a 409A valuation and why is it important. When a company grants stock options, a key question is how to set the exercise price? To avoid adverse tax consequences, options usually need to be granted with an exercise price of no less than fair market value on the date of grant. So how do you determine fair market value?

Megan Monson: That's going to be a question we're going to get into in more detail as we dive into the substantive discussion. Before we get there, we want to lay the groundwork and cover some basics. We're going to focus on non-qualified stock options versus incentive stock options, as both of these different types of options are subject to tax rules. In particular, non-qualified stock options can be governed by rules regarding deferred compensation under Code Section 409A. The rules Under Section 409A in general set parameters for determining the exercise price of stock options.

Christine Osvald-Mruz: And for non-public companies, fair market value must be determined under these rules by what's called a reasonable application of a reasonable valuation method. So what is that? There are three valuation methods that result in a presumption that the valuation that's being used for determining the exercise price of options is reasonable. One of these, and today's topic, is

a valuation performed by a qualified independent appraiser. So today, we're going to focus on how and when a 409A valuation is needed. We'll also look at the benefit it affords and how business operations can impact a valuation.

Megan Monson: We've receive questions about 409A valuations all of the time. So our goal today is to focus on the basics and some commonly asked questions.

Christine Osvald-Mruz: So, we'll start at the top. Why is a 409A valuation needed? Megan.

Megan Monson: So as Chris mentioned, 409A valuations are used when stock options are being granted to set the exercise price at no less than fair market value on the date of grant. And if a 409A valuation is used, it's presumed that the options granted using a reasonable methodology. A 409A valuation is performed by getting a valuation done by an independent appraisal or third-party provider.

Christine Osvald-Mruz: So what are the alternatives if you don't obtain a 409A valuation?

Megan Monson: So if you still want to fall within the reasonableness presumption that we mentioned, the other two valuation methods are a formula valuation, which isn't very frequently used but that requires looking at the value of stock that's used for other purposes and looking at the non-lapse restrictions. Another alternative that we see some companies utilize is the startup exception, which is generally available for companies that have existed for less than 10 years, their options and their shares are not subject to any sort of put or call right, and the valuation is done internally by somebody who has significant experience, whether it's in financial accounting, banking, private equity, but somebody who's really been working and knows that field and has been doing so for at least five years. And if that type of person performs that valuation, that, again, could be presumed to be reasonable.

Megan Monson: The benefits by utilizing one of these three methods is that one, it's helpful in case there's an IRS audit or challenge of options, or in the case of the sale of the company it's something a buyer is going to specifically look at.

Chandra Shih: And I think, Megan, that's a great point because there are lots of situations in a company's life where folks are looking back to see whether options were granted properly. And one of the things that can be a big focus in that review is whether or not the options were granted at fair market value and whether you did so using a 409A valuation or one of the other methods you described.

Chandra Shih: I think one of the biggest issues companies have with using one of the alternative methods is that they oftentimes don't have folks internally at the company who meet the criteria necessary to qualify, and so what ends up happening is startup companies might try to prepare their own sort of self-evaluation, don't fall within what's required under the startup exception or the formula valuation, and end up with the self- valuation that doesn't give them the benefit of that presumption. And so that is a path we see some early startups take. It's just a risk that the board has to choose to move forward with instead of getting a valuation prepared by that independent expert.

Megan Monson: Yeah. And that's actually a great point because you're right, this does seem to come up often at the time of sale and people aren't really thinking about it. And so I know one of the things that we try to recommend to our clients is yes, it does cost some money to get the 409A valuation, but it's really going to help you in the long run because even if whatever valuation you're using seems reasonable and seems a good gauge of fair market value so you're not running into a 409A issue per se, you're still having to face those discussions and scrutiny from a buyer.

Chandra Shih: Absolutely. And it's not just buyers in a sales context. It's investors who may be putting money into the company in minority stock investments. And it's something that gets looked at each time. We always sort of joke with clients that the 409A valuation really is what lets you sort of sleep at night, that you've got sort of the thing you can point to if the IRS does come calling or if an investor's legal counsel or a buyer and diligence process really wants you to prove that you kicked the tires around valuation. It's really the gold standard.

Christine Osvald-Mruz: So just to recap, what do you both see as the key benefit or protection of getting the 409A valuation?

Megan Monson: I think as Chandra just mentioned, it really gives you kind of the ease of being able to "sleep at night," that you know that you're granting options in a way that is going to withstand scrutiny, whether it's from a buyer, whether it's from an investor, whether it's from the IRS. It's just you have something you can hold up and point to and say this is why we valued the options and granted them at a particular price.

Chandra Shih: Yeah. I think that's exactly right. It's so much easier if the IRS, for example, were to question the price, to say you prove that my price was wrong than it is for you to have to prove that the price was right. Because you have to remember, this type of review isn't going to happen the day after you grant the option. It's typically months, years down the line. You may not even remember what was going on at the time. And so having this sort of written report that you can point back to that was prepared by an expert in the field is just so much peace of mind for you.

Christine Osvald-Mruz: And just for the broader context, Megan you might want to address this one, what are the consequences if you have an exercise price that is below fair market value?

Megan Monson: So that's a great question that actually comes up often. So the first being, in general, you would have a 409A violation because by the rule of thumb, options are required to be granted under 409A at an exercise price no less than fair market value. So what that would mean is if you're violating 409A, the options are going to be subject to a 20% penalty tax and the company would have to both report a 409A violation and withhold the additional excise tax on that.

Megan Monson: There is a way to get around that. And that is for non-qualified stock options, you can grant options at a discount, which means they're being granted at less than fair market value. But your plan would have to allow for that and the

options would have to be structured in a particular way to comply with the deferred comp rules. So it gets just much more complicated and not many companies utilize that. So we typically recommend against that. And if it's something that's not being thought of at the time the options are granted, you're most likely going to have an issue.

Chandra Shih: I think the other thing that comes up a lot when you start to think about what the consequences are of pricing options at something less than fair market value, a lot of times we see companies say, well, why does it sort of matter to me? Isn't it a tax that impacts the employee and not me? You know, I think at the end of the day, as Megan mentioned, there's withholding obligations that the company might be subject to, but you also have to remember that you'll have a pretty upset set of folks who were or are service providers of the company or employees that thought they were receiving this great benefit, this sweat equity, and these stock options and suddenly that benefit is costing them a lot of real money and penalties and fees.

Chandra Shih: And so it is a real problem that I think companies need to pay attention to. And you have to remember that these folks who are receiving the stock options have literally zero say in what the strike price is. They are relying entirely on the company and its board to have gotten this right. And so that's really where the rub is, I think.

Megan Monson: Yeah. No, and that's a great point. And especially because in the startup context, a good portion of people's comp packages may be the options that they're being granted. Right? And so getting something that has less value than they think and they're being hit with potentially an additional penalty tax, to me that would disincentivize working for that company and just you lose faith in the company on a going-forward basis.

Chandra Shih: Oh, absolutely. And for all of these sort of non-public companies, you have to remember the stock is a liquid, right? So it's not like folks can sell their stock options to try to pay the penalty taxes they owe. They're literally out-of-pocket cash to cover this stuff. So it can be a huge deal.

Christine Osvald-Mruz: That's a really good context. Can we turn to the new nitty-gritty for a moment of how do you go about getting a 409A valuation if you're a company?

Megan Monson: The steps really are retaining or engaging a third- party independent appraiser. So, I mean, there's a couple names that are used pretty frequently. A lot of our clients in the tech startup space use Carta just more generally to keep track of their cap table and other related work. And Carta does also perform 409A valuations.

Megan Monson: So it's really just engaging any sort of provider who does that type of work, and I'll mention should also be a reputable provider in that space. You don't want to look for the cheapest one around because, again, even if you're getting a 409A valuation, you may face scrutiny later from a buyer or investors if you're coming up with some no-name 409A provider and they're questioning the methodology or the prices used.

Chandra Shih: Yeah. I think that's a great point. You know, people tend to be hesitant to spend the money on a 409A valuation when in reality the dollars you spend to obtain one may be peanuts compared to the consequences of having done it wrong or not obtained one at all. And so I always really think that's a shortsighted view. Although, of course, startups have to be mindful of their resources and use them efficiently. And so it is nice that folks have moved into the space where they are sort of collapsing the valuation with other services they're providing to add value. You know, I think Megan mentioned Carta's a great example. There are others who do it as well. And I think it's making it much more affordable and efficient for particularly early-stage startups to start obtaining these valuations sooner.

Chandra Shih: I think one other thing just in terms of talking about how you obtain one, we should also talk briefly about timeline. People sometimes don't understand how long it takes to have a valuation prepared. You know, is it something where I fill a form out overnight and I get it tomorrow? The answer is usually no. You know, should it take more than a month? Probably not. Right? Usually a few weeks is sort of the sweet spot. But it depends on how good the valuation provider is and how good you are at providing them with the information they need. You know, they are going to need basic financial information about the company. They're going to need to know about the cap table. There's just certain stuff you'll have to have and make available for them to be able to perform the valuation. So having all of that and having good records is always a great way to make sure that your valuation gets done efficiently.

Megan Monson: Yeah. And that's a great point, Chandra, because companies I think tend to not realize that and they get in a tizzy that they want to grant equity to these employees and they want to get a plan established right away. Well, this is another step in the process that needs to be accounted for. And because of the potential really serious impacts of not having the valuation, it's going to delay their timeline. So it's just things you have to think about in terms of when you want to grant options to people, building in time to get that valuation if you don't already have one.

Christine Osvald-Mruz: And on that point, once you have one, how soon do you need to go get another one?

Megan Monson: So the general rule of thumb is a 409A valuation will typically be good for a 12-month period of time. But that's obviously going to be subject to vary, right? If there's any material event or anything that could materially impact the value of the company, those would be situations that would render the valuation no longer valid in less than 12 months. So if there's a change of control of the company, financing round that significantly changes the price, a litigation that's largely impacted the value of the company, those are all types of things that would require you to get a valuation sooner.

Chandra Shih: And I think, Megan, just to put a fine point on some of those examples you gave, even just receiving a term sheet from an investor for a potential financing transaction or from an acquirer for potential sale, that's usually the point in time when folks feel like they have to press pause on treating their current 409A value as valid. You know, we really think of those events as

rendering them stale because you've got really a written offer from a third party in the marketplace putting a value on the company, and I can guarantee that value will be different than what the valuation you have says. So really, we see folks who may have a feeling that a term sheet is coming down the pipeline and start to scramble to try to get options granted before they even get sort of a first draft of a term sheet because you just don't want to run into a situation where the price may be in question.

Megan Monson: Yeah, that's a great point. And I think that's something that comes up more often than you realize. But I think if companies are cognizant of that and mindful, it's definitely best practices to grant options appropriately around that timeline.

Chandra Shih: So one thing we also see come up now a lot more is folks use something called a SAFE, a simple agreement for future equity, as a way to fundraise. It's a way to raise money without doing a price-preferred financing round and without setting an actual valuation on the company today, similar to how a convertible promissory note might have functioned as well.

Chandra Shih: We see people feel like they're in a little bit of a gray area when SAFEs or convertible securities of other types are used for financings. There's no black or white answer on whether that's a material event or not. I think certainly features of what the convertible security look like could help dictate that. Certainly, the amount that you raise using that instrument could also have a significant impact. It's always one of those things where when in doubt, best practice is probably to go back and check with the valuation provider, see if you need a refresh. That's really the sort of safest way to deal with it. But it is something that does come up from time to time as a question.

Christine Osvald-Mruz: We've already largely covered this, but I just wanted to ask is there anything else that would impact a 409A valuation besides getting a term sheet or having a deal going on? What are some other things that each of you have seen that could impact the valuation?

Chandra Shih: I've seen, personally, when you've got a company who maybe has no revenue, has been kind of working to prove out something, and then all of a sudden gets a life- changing set of contracts, revenue just skyrockets, some kind of crazy performance metric is met, and they are just getting tons of money in the door, that is something material enough where it's worth going back and getting a refresh on valuation and something that isn't necessarily a financing round or something like that.

Megan Monson: And I wanted to add a fine point to what Chandra mentioned earlier about granting options before a term sheet comes out. There's also the scenario where there's a term sheet or deal contemplated and people want to exercise their stock options, and it becomes a question of, okay, if they do, especially if there's non-qualified stock options, what's the fair market value for withholding purposes? So what we see a lot of companies do in that context is try to suspend option exercises for a period of time if there's a deal contemplated. And one of the issues that they can run into in that context is if there's people who terminated and their post-termination exercise window could expire. And they also may not want to disclose facts without there

being a pending deal to people. So it can be a delicate issue. On the post-termination exercise piece, there is the ability to extend that. So the company can take action to do that. But it just becomes a little bit more difficult to navigate the nuances of those situations. So there are other things to be aware of.

Christine Osvald-Mruz: Then also, I think there's in the guidelines under 409A some of the examples they give is something that would require a new valuation might be if a company resolves material litigation or they get a new patent or something along those lines could also impact that as well.

Christine Osvald-Mruz: So to wrap up, are there other practical issues that you would say employers should be aware of in this area?

Chandra Shih: Well, I was just going to say one thing actually kind of as a tie in to the point you just made Chris, but also I think to this question, which is just when we talk about options being granted and having to sort of make a determination on fair market value each time they're granted, it's really the board of the company that's tasked with making that determination. And even if you as a board do have a 409A valuation and you're within that sort of 12-month window, the board needs to be assessing each time whether or not they still think that valuation is reasonable to use, whether the methodologies used were reasonable, and whether or not there have been any of these types of material events that might impact the validity of the report.

Chandra Shih: And so that's just something that I think boards need to be really actively thinking about every time they're asked to grant options and not just sort of putting it on autopilot, you know really look at it and think about it. And you as the company and you as a director really do need to be making that assessment each time.

Megan Monson: Yeah. Just related to that, I mean making sure that that's also being documented, whether it's in your minutes or your resolutions, because, again, you're thinking about what's going to be looked at in the future, whether by an investor or a buyer. They're going to want to see that you've thought about it and you're not going to remember that conversation you may have had a year or two, five years ago. So just making sure that you have proper documentation, both of approving the 409A valuation when it first comes into your hands but also then every time you're granting stock options, that, again, the prices that those options are being granted is at the fair market value and stating what you've considered in making that determination.

Chandra Shih: And I think in order to even have an effective option grant for corporate law purposes and also for tax purposes, you do have to have that formal board approval. And we talked a lot about the date of grant, right? It has to be the fair market value on the date of grant. Well, the date of grant is the date that the board actually formally approves the option. We sometimes get questions from clients about, oh, well, we promised this option to someone and we meant to grant it six months ago when the price was different, but we never got around to having a board meeting, or we never got around to actually doing a written consent.

Chandra Shih: You know, you can't go back in time and do that. It has to be this formal board action that gets taken in order to actually grant the option. And so you have to be granting it at whatever the fair market value is on that date of that board action. You can tie vesting back to whatever date you want, but the actual grant date and the actual fair market value or strike price has to be a present date and price.

Megan Monson: Great point. Agree. Okay. Awesome. Well, that was really terrific, Chris and Chandra. I mean, thank you both so much. I think this conversation hopefully gave our listeners a strong baseline understanding of not only why a 409A valuation's important but some of the nuanced issues that come up in that context and how to mitigate and work to avoid some of those issues.

Megan Monson: Thank you both again for joining and for our listeners for tuning in. We hope that you'll join us for future episodes of Just Compensation.

Christine Osvald-Mruz: Thanks, everyone. Thanks for listening.

Chandra Shih: Yeah. Thanks for having me.

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