The problem of “cheap options”

The implications of IRC 409A for startups and VCs: What you need to know
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Focus: Impact of IRC Section 409A on Private Companies
- A new set of regulations have been adopted that affect public and private companies, including emerging growth companies
- Primary Impact: New requirements for setting the strike price of options; need to know Fair Market Value of Common Stock
- These regulations are wide-ranging and complex, but they affect you and you should be aware of them

Goal: By the end of this session
- You will know the rules
- You’ll know what you need to do and when to avoid problems
- We’ll give you a look inside the process – how Fair Market Value is determined to comply with the regulations
- You’ll know how to handle practical dilemmas
Agenda

- Objectives
- Scope of IRC 409A
- Penalties & Compliance Requirements
- Process – 409A Valuation
- Why This Matters & Practical Issues
- Conclusion
What is IRC 409A?

- Internal Revenue Code 409A is a tax law and a set of regulations that were enacted in response to perceived abuse in compensation practices – it can be punitive in nature
  - First enacted in 2004 as part of the American Jobs Creation Act
  - Final regulations issued in 2007, all aspects fully effective as of Jan. 1, 2009

- Broad scope – applies to “non-qualified deferred compensation”
  - Deferred Compensation: “vests” in one year (legally binding right), but is taxable in another (e.g. upon exercise)
  - Intent: reduce ability to control what time you receive and are taxed on deferred compensation; raise revenue?
  - Embodies: Constructive Receipt & Economic Benefit doctrines
  - Captures: stock options or similar instruments unless exempt

- Anything caught by 409A can result in onerous tax and penalties
  - Option holder – tax & penalties from time of vesting
  - Company – reporting and tax penalties

Tough Legislation, Sweeping Scope
When does IRC 409A Apply?

Captures “Deferred Compensation” and defines it broadly – can include:

- Severance Plans
- Employment Agreements
- Bonus Plans
- **Stock Rights** (Options, Warrants, SARs, other similar instruments) that are not exempt
- NOT stock grants

Applies to Deferred Compensation issued to a “service provider”

- Employees and Officers
- Members of the Board of Directors
- “Dedicated” consultants
- NOT investors/lenders

IF 409A applies, options must adhere to very specific rules including narrow prescriptions on the nature and timing of exercise to avoid punitive consequences

Most options will be caught by 409A, unless they can be exempted
What Options are Exempted?

- ISOs (in principle) exempted*, NSOs exempted if:

  - Strike Price is at or above Fair Market Value
  - Rules for NSO Exemption
  - As of the most recent Grant Date
  - No additional deferral features

ESTABLISHING FAIR MARKET VALUE IS CRITICAL
Incentive Stock Options (ISOs) are covered by Internal Revenue Code 422.

By definition they must be issued with a strike price at or above Fair Market Value of the underlying stock in order to qualify as an ISO.

Consequently, they are “exempted” from 409A provisions by virtue of their definition; consequently, many analysts often refer to the fact that “Section 409A does not apply to ISOs.”

However, while factually correct this is misleading.

Section 409A has redefined the parameters of FMV in a way that did not exist when section 422 was promulgated; if an ISO is granted at less than FMV it is by definition a NSO and therefore potentially subject to 409A.

The ISO requirements for FMV must now be read in light of 409A; the new standards will apply to ISOs; care must be taken when valuing Common Stock, regardless of whether the options granted are ISOs or NSOs.

409A has redefined FMV for ISOs.
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Penalties for Non-Compliance

➢ Employee:
  ➢ Taxed upon vesting, not exercise
    ➢ Option spread: difference between exercise price at grant and FMV in the year of vesting is treated as taxable income
  ➢ Subject to tax every year thereafter on additional increases in value until option is exercised
  ➢ 20% penalty on top (and another 20% in California)
  ➢ Interest and penalties from prior years if tax not paid

➢ Company:
  ➢ Obligation to withhold taxes (from time of vesting)
  ➢ Reporting requirements on employee’s W-2
  ➢ Penalties and interest charges for non-compliance
  ➢ Accounting Implications

Applies to C-Corps, S-Corps, LLCs and Partnerships
Example of Penalties

- CTO received 1,000,000 options with a strike price of $0.10 on December 31, 2008
  - 4 year vesting period, ¼ vest on grant date
  - IRS later ruled that fair market value was $0.25 at grant date

- As at grant date – 250,000 options vested, all caught by 409A; remainder of the options will be caught by 409A as they vest

- Illustrative tax consequences for the CTO in 2008 could be up to 80% of the option spread/taxable income

Illustrative 409A Tax Consequences for 2008
You can access a safe harbor

- Regulations have provided for “safe harbors” that reverse the Burden of Proof
  - If you successfully access a safe harbor, the IRS has to prove gross unreasonableness – tough standard
  - If no safe harbor, the you must prove reasonableness - full compliance with the regulations/guidelines

- 3 Safe Harbors
  - Outside, Independent Appraisal
  - Inside Valuation: written report by insider with significant knowledge and experience that reflects IRS guidelines
  - Binding Formula (highly restrictive, generally won’t be used)

Safe Harbors available, must follow IRS guidelines
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Valuation Methodology

- Value determined “by the reasonable application of a reasonable valuation method” - IRS

- IRS has provided some guidance
  - MUST consider all material information available
    1. Value of the company’s tangible and intangible assets
    2. Present value of anticipated future cash flows
    3. The market value of stock or equity interests in similar companies and other entities in businesses substantially similar to those engaged in by the company
    4. Recent arm’s length transactions
    5. Other relevant factors like control premiums or lack of marketability discounts
  - Cannot be more than 12 months old & must reflect any material event that would affect value of the common stock
  - Method chosen should be on a consistent basis

Old rules of thumb cannot be used.
1. Determine Enterprise Value

2. Allocate Value Within Capital Structure

3. Determine Value of Common Stock Using Discounts and Other Methodology
Valuation Process – Enterprise Value

- **Market Approach**
  - Comparable public companies and acquisitions
  - For pre-revenue startups, a multiple of assets instead of sales
  - Recent acquisitions often the best data source

- **Income Approach**
  - Discounted Cash Flow analysis
  - Appropriate for later stage companies

- **Asset Approach**
  - Liquidation value of company

- **Company Specific Approaches**
  - Secondary sales of common stock
  - Other relevant data
Simplified Example – NewCo Inc.

- Founded two years ago with 1mm shares of common stock
  - Raised $6mm by issuing 1.5mm shares of Series A Preferred
  - Post money valuation of $10 million, VC owns 60%
- 2009 revenue was $1mm
- 1x Participating Liquidation Preference
- No dividends, convertible into common stock at 1:1 ratio
Applying **market method** since Altius is contemplating changing its main product and future cash flows are hard to reliably project.

A peer set of small cap public semiconductor companies had a valuation multiple of 2.64x Sales
- On a **minority basis**
- Pick companies similar in size, geography, product portfolio

Recent acquisitions of small cap public semiconductor companies suggest an acquisition multiple of 4x Sales
- On a **control basis**
- Research indicates a minority discount of 18% is appropriate
### NewCo – EV Determination (Simplified)

#### Market Method

<table>
<thead>
<tr>
<th>Method</th>
<th>Result</th>
<th>Discount</th>
<th>Value</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public Comparables</td>
<td>2.64x</td>
<td>0%</td>
<td>$2.64mm</td>
<td>50%</td>
</tr>
<tr>
<td>Guideline Transactions</td>
<td>4.00x</td>
<td>18%</td>
<td>$3.28mm</td>
<td>50%</td>
</tr>
</tbody>
</table>

**Indicated Value = $2.96 million**
Valuation Process

1. Determine Enterprise Value

2. Allocate Value Within Capital Structure

3. Determine Value of Common Stock Using Discounts, Premiums, and Other Methodology
Valuation Process – Capital Structure

- Allocate enterprise value to capital structure
- AICPA approves 3 methods

<table>
<thead>
<tr>
<th>Current Value</th>
<th>Probability Weighted Return</th>
<th>Option Pricing Method</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Assumes liquidation today</td>
<td>• Forecast possible scenarios</td>
<td>• Black Scholes or Binomial Lattice</td>
</tr>
<tr>
<td>• Easiest and most widely used</td>
<td>• Relies on many assumptions</td>
<td>• Widely accepted by auditors</td>
</tr>
<tr>
<td>• Past inception stage, <strong>often rejected by auditors</strong></td>
<td>• <strong>Can be speculative – easy to challenge</strong></td>
<td>• Preferred by Oxford Valuation Partners</td>
</tr>
</tbody>
</table>
Some of the Terms that Matter

- Anti dilution
- Dividends – cumulative vs. noncumulative
- Redemption rights
- Liquidation preferences
- Existing option structure
- Warrant coverage
The method “treats common stock and preferred stock as call options on the enterprise’s value, with exercise prices based on the liquidation preference of the preferred stock.”

Find breakpoints where claim on value changes

<table>
<thead>
<tr>
<th>Exit Value</th>
<th>What Happens</th>
</tr>
</thead>
<tbody>
<tr>
<td>$0 to $6 million</td>
<td>Series A claims all value</td>
</tr>
<tr>
<td>Over $6 million</td>
<td>Series A gets $6 million plus 60% of remainder</td>
</tr>
<tr>
<td></td>
<td>Common gets 40% of remainder</td>
</tr>
</tbody>
</table>

Breakpoint at $6 million
NewCo – Option Pricing Method

Theoretical option price = \( pN(d_1) - se^{-rt}N(d_2) \)

where \( d_1 = \frac{\ln\left(\frac{p}{s}\right) + (r + \frac{v^2}{2})t}{v\sqrt{t}} \)

\( d_2 = d_1 - v\sqrt{t} \)

- \( \rho = $6mm, \) breakpoint where preferences are satisfied
- \( s = $2.96mm, \) enterprise value calculated in first step
- \( \nu = \) volatility, estimated by analyzing the historical volatilities of a basket of comparable public companies
- \( t = \) time to exit, estimated by consulting with management and looking at historical VC/private equity liquidity horizons
- \( r = \) current risk free interest rate
- \( \ln = \) natural logarithm \( \quad e = \) base of natural logarithms
- \( N(x) = \) cumulative normal density function
Valuation Process

1. Determine Enterprise Value

2. Allocate Value Within Capital Structure

3. Determine Value of Common Stock Using Discounts and Other Methodology
The model estimated the common value was $2 million.

“Valuation specialists may adjust for differences between private and public enterprises by using a variety of discounts and premiums” – AICPA Practice Aid

- Discount for Lack of Marketability
- Minority Discount or Control Premium

Discounts need to be backed up with studies, market data, and numerous citations.

Often a material factor in determining valuation.

<table>
<thead>
<tr>
<th>Common Value</th>
<th>Discount Type</th>
<th>Discount</th>
<th>Final Value</th>
<th>Per Share</th>
</tr>
</thead>
<tbody>
<tr>
<td>$2mm</td>
<td>DLOM</td>
<td>44%</td>
<td>$1.12mm</td>
<td>$1.12</td>
</tr>
</tbody>
</table>
NewCo – 4 Years Later

- Several financings, a recap, a down round…
- Why late stage 409As are more complex

<table>
<thead>
<tr>
<th></th>
<th># of shares</th>
<th># of shares fully diluted</th>
<th>Liquidation (Including Dividend)</th>
<th>Total Liquidation</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Common Stock</td>
<td>93,243,264</td>
<td>93,243,264</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Series A</td>
<td>8,740,368</td>
<td>-</td>
<td>$ 0.6135</td>
<td>$5,362,122</td>
<td>1.63%</td>
</tr>
<tr>
<td>Series B</td>
<td>23,323,936</td>
<td>-</td>
<td>$ 0.4919</td>
<td>$11,471,997</td>
<td>4.34%</td>
</tr>
<tr>
<td>Series C</td>
<td>2,259,121</td>
<td>-</td>
<td>$ 1.0000</td>
<td>$2,259,121</td>
<td>0.42%</td>
</tr>
<tr>
<td>Series D</td>
<td>375,000</td>
<td>-</td>
<td>$ 1.0000</td>
<td>$375,000</td>
<td>0.07%</td>
</tr>
<tr>
<td>Series D - 1</td>
<td>7,338,769</td>
<td>10,817,967</td>
<td>$ 2.3700</td>
<td>$17,392,883</td>
<td>1.37%</td>
</tr>
<tr>
<td>Series E</td>
<td>29,404,456</td>
<td>29,404,456</td>
<td>$ 0.9182</td>
<td>$27,000,000</td>
<td>5.47%</td>
</tr>
<tr>
<td>Series F - 1</td>
<td>8,319,818</td>
<td>12,264,117</td>
<td>$ 2.3700</td>
<td>$19,717,969</td>
<td>1.55%</td>
</tr>
<tr>
<td>Series F - 2</td>
<td>4,338,408</td>
<td>6,395,181</td>
<td>$ 2.3700</td>
<td>$10,282,027</td>
<td>0.81%</td>
</tr>
<tr>
<td>Series F - 3</td>
<td>1,265,823</td>
<td>1,865,930</td>
<td>$ 2.3700</td>
<td>$3,000,001</td>
<td>0.24%</td>
</tr>
<tr>
<td>Series F - 4</td>
<td>16,877,637</td>
<td>24,879,067</td>
<td>$ 2.3700</td>
<td>$40,000,000</td>
<td>3.14%</td>
</tr>
<tr>
<td>Series F - 5</td>
<td>5,882,364</td>
<td>8,671,103</td>
<td>$ 2.3700</td>
<td>$13,941,203</td>
<td>1.09%</td>
</tr>
<tr>
<td>Series G</td>
<td>12,248,642</td>
<td>18,969,740</td>
<td>$ 2.4900</td>
<td>$30,499,119</td>
<td>2.28%</td>
</tr>
<tr>
<td>Series H</td>
<td>21,084,337</td>
<td>32,653,774</td>
<td>$ 2.4900</td>
<td>$52,499,999</td>
<td>3.92%</td>
</tr>
<tr>
<td>Series I</td>
<td>190,839,694</td>
<td>190,839,694</td>
<td>$ 0.9694</td>
<td>$184,999,999</td>
<td>35.51%</td>
</tr>
<tr>
<td>Options</td>
<td>65,744,872</td>
<td>65,744,872</td>
<td></td>
<td></td>
<td>12.23%</td>
</tr>
<tr>
<td>Warrants</td>
<td>46,154,141</td>
<td>46,154,141</td>
<td>$0</td>
<td></td>
<td>8.59%</td>
</tr>
<tr>
<td>Total</td>
<td>537,440,650</td>
<td>541,903,308</td>
<td></td>
<td>$418,801,439</td>
<td>100%</td>
</tr>
</tbody>
</table>
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- Process – 409A Valuation

- Why This Matters & Practical Issues
- Audience Q&A
Stock option issuance is coming under increasing scrutiny from acquirers - looking for any/all potential liability in all option issuances going back to company founding.

Public companies are increasingly reluctant to assume private-company options unless they were granted in reliance on a safe harbor.

Even in cases where the acquirer refuses to assume stock options of the target company, acquirers are demanding that target companies make representations in the merger agreement or other documents to warrant that there is no exposure to IRC 409A liability.

If unsatisfied with 409A liability assurance:
- Acquirer may knock down purchase price
- Acquirer may require re-issuance of exposed options

Can cost the company significantly – in some cases, millions.
Practical Matters

- **When to act – before you issue options**
  - Get a valuation that reflects any anticipated financing events
  - Get board approval
  - Then issue options at the board-approved strike price
  - Begin your valuation documentation or speak with a valuation appraiser before you close a financing round

- **When to update your valuation**
  - New financing
  - 12 months have passed
  - Material change

- **Modifications matter – Otherwise Exempt Options can be swept under 409A**
  - A modification of an option can be treated as a new grant
  - “Exempt” NSOs and ISOs can get caught under 409A; FMV on new date
  - Issues: changing exercise price (direct or indirect), extending exercise period
  - Some limited exceptions
Trending Issues

- **Secondary Transactions**
  - Transactions by founders/staff – to investors adjunct to a funding round or via new secondary share markets can impact the FMV of shares

- **Offers to Buy**
  - Offers to buy the company or shares can impact the FMV
  - More SEC scrutiny if company is buying/selling own shares

- **Transfers of Stock – Gifts/Trusts**
  - Tax law changes created estate planning opportunities through 2012 - $5M gift tax exemption
  - Many transfers of vested stock – after gift completed, any appreciation is not subject to gift tax
  - BUT stock needs to be transferred at current FMV
Common Pitfalls

- Failure to disclose all material information
  - Inadvertent
  - Tactical

- Not getting a valuation contemporaneous or close in time with the event/transaction at issue - greater scope for challenge

- Not keeping up to date with valuations in a fast growing company

- Failure to consider impact of recent offers or impact of secondary transactions

- Failure to update valuation to reflect material changes
Top 5 Things to Remember

① Know the steps: Valuation, Board Approval, Option Grant; be wary of grants before big events, between Board meetings

② Offer Letters: Don’t promise exercise price; don’t grant options prior to start of employment; vesting can start at hire/start date

③ Update the valuation (refresh): 12 months, new funding, material change

④ If you make a change to the option it may get captured by 409A; ISOs may be vulnerable to challenge

⑤ Use an approved methodology to value your stock; safe harbor can make your life easier

Clean up is costly so get it right the first time
Oxford Valuation Partners provides valuation and advisory services to leading public companies and private emerging growth companies and investors. Our experienced professionals assist clients with regulatory compliance, litigation support, charitable donations of private stock, mergers and acquisition support, dispute resolution and portfolio valuation.

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When would a startup benefit from an independent valuation?

- Buying back shares
- Transferring assets between foreign and US entities
- M&A (evaluate options, purchase price allocation)
- Transferring shares (gift, trust, charity)
- Corporate Conversions (BIG tax liability)
- Cashless warrant exercise
- Disputes: among Founders/Shareholders, between Founders/Shareholders and Board
- Issuing restricted stock, options or other equity-based compensation (IRC 409A)
OVP Staff: Selected Certified Reports