technology, or historical earnings. However, much of the value of a business is often driven by key individuals or relationships. Key executives, employees, suppliers, and customers can be both a source of value and risk that must be carefully analyzed and understood.

Just as beauty is in the eye of the beholder, perceived value is often dramatically different among different buyers. Most valuation work is completed on the premise of estimating the value to a hypothetical buyer who would continue to operate the company as a stand-alone enterprise. In the real world, this is often not the case. Many acquisitions are made by “strategic” buyers. Such buyers are often willing to pay a substantial premium relative to other buyers due the real or perceived benefits from combining their operations with those of the target company.

Many are surprised to learn that business appraisers are not licensed. Anyone can hang out a shingle in California and conduct business valuation work. Business appraisers are not legally required to be bound by any professional standards or to have acquired any particular training or demonstrated competence. Under these circumstances, a business appraiser must be chosen carefully. Well-recognized appraisal organizations, such as the American Society of Appraisers, provide continuing education and professional designations to their qualified members. These organizations also require that their members adhere to published ethical guidelines and standards of practice.

Summary

Business appraisals are being conducted in a broad, increasing array of contexts. At the same time, the shift to a service-dominated economy and the increasing importance of intangible value make determining the value of a business much more challenging. Now, more than ever, it is critical for appraisers to closely coordinate their efforts with the legal

“SO LET IT BE WRITTEN” — THE FIRST COMMANDMENT OF SUCCESSFUL EMPLOYEE EQUITY ARRANGEMENTS

By Ben D. Orlanski and John J. Heber
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Of all the daunting challenges facing start-up companies, there is one that is acute, overlooked and, with careful planning, easily avoidable. This all-too-common mistake is the failure to properly and timely document employee equity arrangements. Many experienced corporate counsel understand the problem but believe that there are relatively serviceable (if not good) solutions to improperly or untimely documented equity arrangements. This may have once been the case, but recently enacted federal legislation — the American Jobs Creation Act of 2004 (the “Jobs Act”) — adds a new wrinkle that makes proper and timely documentation of equity arrangements absolutely critical to a successful start-up business.

In addition, the recent intense scrutiny by the Securities and Exchange Commission on apparent option backdating at major public companies makes the soundness of employee equity arrangements even more important for any private company that aspires to ultimately go public, or be acquired by a public company — which is to say virtually every private company.¹

¹ UnitedHealth Group Inc. and Vitesse Semiconductor Corp. are among two of a number of public companies that are embroiled in the ongoing option backdating controversy. Both companies came under fire after Wall Street Journal articles showed that the timing of stock option grants to senior executives at these companies seemed to miraculously coincide (in some cases, having a statistical probability of 1 in 200 million) with low-points in the stock’s trading history — enabling these executives to reap huge rewards when the stock later appreciated and the options vested or were exercised. See “The Perfect Payday,” by Charles Forelle and James Bandler, The Wall Street Journal, March 18, 2006; and
The Typical Scenario

Business founders well understand the need to bring talent on board early-on in a new venture, and to incentivize employees who are taking significant risks on an enterprise that is untested, unfunded and (statistically) unlikely to succeed. Founders will often make commitments — oral or written — to give a key employee some equity interest in the venture. A founder may simply tell the key employee that he will receive “5% of the equity” or “10% over the next 4 years.” More typically (because the employee will insist), the founder will give the employee a memorandum or simple letter, stating that the employee will receive some percentage of the company’s stock, perhaps with a vesting condition. Less typically, the founder will actually have a restricted stock or stock option plan and agreement, but, through inattention or distraction, these documents are not properly drafted or timely executed.

To the founders and the employees, either the oral commitment, the loosely documented “deal memo” or the fully (but belatedly) documented equity grants represents an unambiguous business deal: the employee is supposed to have a certain portion of the upside of the business, and the allocation of that upside is (hopefully) clearly understood by founder and employee. That certainty about the business deal, the incredible pressure to move the nascent venture forward as fast as possible, and frequently, a high degree of trust between founder and employee, often causes them both to “paper the deal later,” putting off for weeks, months or (in extreme cases) years the formal documentation of their division of the business’s ownership interests. Even if the arrangement is timely put into writing, it lacks the degree of specificity necessary to avoid the legal pitfalls that the founder and employee sought to avoid by documenting their arrangement. In either case, the founder and employee do not realize that, if and when the venture becomes successful — or, even if it merely attracts enough outside attention to merit potential financing — the failure to fully and timely document their equity arrangement has very likely “baked in” a nettlesome, sizeable and largely unfixable economic and tax problem for both of them.

The Problem Defined

The basic problem stems from the fact that under the Internal Revenue Code (“Code”), the date of acquisition of an asset can be critical in determining a taxpayer’s tax liability related to that asset. Ordinarily, there is no question as to when an asset is acquired. If an employer pays his employee $100 Tuesday for the work done Monday, it is clear the employee was paid Tuesday. Stock and options are not so simple. Is the date the employee acquired the stock the date of the oral agreement, the date of the written deal memo, the date of the full-blown stock or option agreement, the date of board approval of the arrangement or the date the stock certificate is finally delivered to the employee? The date of the oral agreement could be, for example, in January and, as is often the case, the date of the board approval or the actual date on which the equity agreements are executed could be much later in the year, say September. If, the company has increased in value between January and September, did the employee acquire his equity interest when

misunderstandings that can and do arise from loose documentation of equity arrangements other than the problems described in this article.
the value was lower (in January) or higher (in September)? Although the general rule, for tax purposes, is that the date of the grant is when all corporate action has been completed, this standard is not without uncertainty in actual application. But one thing is certain: if there is any ambiguity, and the grant is challenged, the IRS will take the position that will maximize tax to the taxpayer.

The IRS has plenty of arguments for increasing the tax on service providers. In order to understand them, it is helpful to briefly review the basic federal taxation of stock and option grants to service providers.

Generally, options granted to employees that are not intended to qualify for special tax treatment as incentive stock options (“non-qualified options”), are not taxable upon grant to the employee, except to the extent that the exercise price of the option is less than the fair market value of the underlying stock on the date of grant. Upon exercise of non-qualified options, the employee has taxable income equal to the difference between the exercise price of the option and the fair market value of the underlying stock, and that income would be taxable at ordinary income rates. (With incentive stock options, certain restrictions apply, but the employee will be able to defer the recognition of income until he sells the underlying stock, and any gain over the exercise price would be taxable at capital gain rates.)

Under Section 83 of the Code, a grant of stock (as opposed to an option to purchase stock) to an employee must immediately be taken into income at the fair market value of the stock. However, if that stock is subject to a “substantial risk of forfeiture,” the recognition of income is deferred until that risk of forfeiture is eliminated. For example, with restricted stock, it is typical that stock can be repurchased for a nominal price by the issuer if the employee leaves his job before the stock has vested. As the stock vests, the risk of forfeiture disappears, and, under Section 83, the employee must, at each point in time that the option vests, take into income the then fair market value of the stock — in effect “marking to market” the value of the stock. If the stock appreciates over time, then, as the restricted stock vests, the employee will have to take an ever higher amount into income, because the fair market value is also increasing. To avoid this problem, Section 83(b) permits a service provider to make an election (a “Section 83(b) election”) to take into income, on the date of grant, the fair market value of the stock. If the employee makes this election timely (within 30 days of grant), he need not mark to market the stock he received. For private companies with modest stock values, making a Section 83(b) election might make sense for an employee, if he can afford to pay tax on the stock that was granted before any liquidity can be achieved from selling that stock.

Under this framework, the date of grant of options or stock becomes crucial, because the federal taxation is in large part determined by the fair market value on the date of grant. If options are granted on a date when the IRS can show that the fair market value exceeded the exercise price, there will be tax liability — even if the option cannot be sold due to liquidity restrictions. Similarly, for stock, the fair market value on the date of grant determines the amount that must be taken into income under Section 83, and even if there is a substantial risk of forfeiture and the employee makes a Section 83(b) election, the employee must still take into income the fair market value on the date of the grant — again, making the date of grant crucial for determining the ultimate tax liability.

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1 See Treas. Reg. Section 1.421-1(c)(1): “For purposes of this section and §§1.421-2 through 1.424-1, the language “the date of the granting of the option” and “the time such option is granted,” and similar phrases refer to the date or time when the granting corporation completes the corporate action constituting an offer of stock for sale to an individual under the terms and conditions of [an incentive stock option]. A corporate action constituting an offer of stock for sale is not considered complete until the date on which the maximum number of shares that can be purchased under the option and the minimum option price are fixed or determinable.” This regulation pertains to incentive stock options. Section 83 governs the taxation of nonqualified options. There is no reference in the Section 83 regulations to determining the grant date of options as there is in this regulation. Nevertheless, it is common practice to use the incentive stock option regulations for purposes of non-qualified options when no other authority exists.
The application of these principles in reality historically has been vexing to employees and employers, and as discussed further below, can now be quite harsh under new Section 409A of the Code, ushered in by the Jobs Act.

Suppose, for example, that in January, a company is formed and is capitalized by the founder with $1 million in cash. The founder gives his first employee — who is probably working for a salary far below what he could get from an established company — a “deal memo” that says the employee will receive “5% of the equity or options, vesting over the next 12 months” of the new venture (“Newco”). In September, Newco is lucky enough to attract the interest of a venture capital firm (“VC”) that is willing to invest $3 million in Newco, valuing Newco at $9 million on a pre-transaction basis. By mid-September, Newco has hired a competent lawyer and shortly thereafter Newco and the VC sign a non-binding term sheet for the transaction. By mid-October, Newco and VC have closed the offering. Between signing and closing, Newco and the employee fully and properly document their relationship.

Unfortunately, this course of events has in all likelihood created problems, entirely avoidable, for all concerned. Let’s analyze the fairly vague grant of “5% of the equity or options, vesting over the next 12 months” from a tax and economic perspective. In doing so, we can also indulge in some arm-chair mind-reading, and suppose that the founder and the employee, while sophisticated in their business, are not tax experts, and so probably thought about their deal along the following lines:

“The employee will work for 12 months to earn this equity. He doesn’t have to “pay” anything. His good efforts are more than enough, given the risk he is taking. We can’t imagine that giving the employee this equity will create any tax issues, but even if it does, they should be very modest — after all, this company isn’t worth more than $1 million right now, and the employee hasn’t even received any stock yet, because of the 12-month vesting requirement. We can work out the mechanics of stock vs. options later — I know there can be some tax and accounting issues, which the lawyers and accountants will sort out once we have the money to pay their bills. What is important now is that the employee is motivated knowing that he has 5% of the upside if he does a good job for the next 12 months.”

To the lawyer looking at this fact pattern, a few key questions emerge:

A. Is this a grant of stock or a grant of options? If options, were they granted at fair market value, and what was the exercise price?

B. When was the grant made — in January or October?

There are 4 permutations of these questions, each of which raises different tax and business issues:

1. It is a grant of stock that occurred in January.
2. It is a grant of stock that occurred in October.
3. It is a grant of options that occurred in January.
4. It is a grant of options that occurred in October (or between January and October).

Stock Grant in January

If Newco and the employee take the position that stock was granted in January (and let us ignore for the time being whether other extrinsic evidence supports that position), the stock may or may not be considered to be subject to a “substantial risk of forfeiture” under Section 83 of the Code. The ambiguous phrase “over the next 12 months” in all probability indicates a vesting arrangement, though a properly drafted provision would have clearly stated it as such.
If, as is likely, the stock is subject to a substantial risk of forfeiture, and if, as we are assuming, the grant took place in January, an immediate problem is presented: As noted above, Section 83 requires that, when and if the stock vests (i.e., the risk of forfeiture is eliminated as to the vested stock), the employee must take into income the excess of the fair market value of the stock on the vesting date over the amount he paid for the stock. Since he paid nothing, at each vesting date (presumably, each month), he must take into income the new fair market value of 1/12 of 5% of Newco minus a zero basis. This would not be a problem immediately (because the value of Newco at the outset is presumably very low, giving rise to little if any taxable income), but if the value of Newco increases, at each vesting date the employee will have taxable income but no related liquid income to pay it, i.e., dreaded phantom income. If we assume (as the IRS might) that the value of Newco didn’t just jump up to $9 million from $1 million overnight, but rather steadily increased between January and September by about $1 million per month, then the employee could potentially have phantom income of about $4,166 in the first month, and aggregating to $300,000 over the course of the year. Keep in mind that the employee will also be paying tax on any cash income he is collecting, and it is easy to see why the employee would not be at all pleased by this outcome.

Section 83(b) permits an effective solution to this problem of granting stock subject to risk of forfeiture: the employee can make a Section 83(b) election to take into income the excess of the fair market value of the restricted stock upon grant over what he paid for it. Then, if and when the stock vests, he does not have to take into income any appreciation in the value of the stock. Only one problem: Section 83(b) requires that this election be made within 30 days of grant, and neither founder nor employee had the faintest awareness of Section 83(b), much less the potential benefits of making a timely Section

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4 Potential, because making a Section 83(b) election when the stock already has a high value may be undesirable: the employee must take into income the excess of the fair market value of the stock (which we are now presuming is high) over the amount paid for it (zero, in the case of an outright restricted stock grant). Thus, Section 83(b) elections are made more often when the stock being granted is granted before significant appreciation has occurred.

5 The employer could agree to “gross up” the employee by reimbursing him for the tax, and then reimbursing him for making that reimbursement, which itself is taxable income, and so on. The total cost of a “gross up” can be considerably, nearly doubling the cost of the original tax sought to be reimbursed. The formula for calculating the cost of a gross up is: Tax Due (without the gross up)/[1 - Effective Combined Federal, State and Employment Tax Rate]. Assuming a combined rate of 50%, a $100,000 tax bill becomes $200,000 when grossed up.
grant was made before closing. Even assuming (heroically) that these arguments support a 50% discount in the value of the stock grant, the employee still has a very large amount of taxable income without having received a penny of cash to pay the tax on it.

Again, the unhappy employee and founder put their heads together, with their attorney, and begin to wonder about the phrase "or options" in their original deal memo. What if this entire transaction was really an option grant?

**Option Grant in January**

This seems like a promising line of inquiry. If this grant were treated as an option, granted in January, many problems can be avoided. First of all, the employee has no tax upon grant of the option, assuming the exercise price of the option was at least equal to the fair market value of the underlying stock on the grant date. Second, unlike for restricted stock where no Section 83(b) election was made, the employee has no tax on the mere appreciation of the value of Newco and its equity. True, the employee will have taxable income when and if he exercises the option, but he can control when that happens, and presumably it will only happen if Newco goes public or is sold, in which case the employee will have liquidity to pay the tax liability that will be incurred.

The fly in the ointment appears to be the fact that this grant just isn't an option. It is missing a critical feature of an option: the exercise price. If the grant is not an option, the employee and founder are back in the other two unappealing scenarios discussed above where the grant is treated as one of stock.

**Option Grant in October**

The founder and employee may point out, however, with some justice, that they did, in fact, use the word "option" in their original deal memo, and that they could both truthfully swear under oath that their mutual intention was to structure this arrangement in the most tax efficient way, and that had they known tax law, they would have provided for an exercise price equal to the fair market value of the underlying stock in January, when they struck their original deal. The employee and founder may therefore insist that an option was in fact intended, and that it was created in January. However, when Newco grows and ultimately must have an audit of its financial statements, it will likely find that its auditor accepts only half of this argument. The auditor may accept that an option was intended in January, but, based on the fact that proper stock option documentation was not entered into until much later (in October), reject the argument that the option was effectively granted in January. Instead, the auditor might well take the position that the option was granted in October (when the work was completed), but at January's exercise price. In effect, the auditor would be saying that the option was granted, but at a discount. This may not seem like a bad solution, especially to the employee, who retains his in-the-money option grant. Under new accounting rules, Newco will most likely incur additional non-cash compensation expense on its income statement equal to the difference between the fair value of the option in October and the fair value in January. However, Newco may well be willing to suffer that additional expense if the employee is important. After all, Newco is not likely to go public any time soon, and there is a general belief that investors do not really care about accounting charges, such as this additional compensation expense, that do not derive from actual cash outlays.

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6 See Treas. Reg. Sec. 1.421-1 (a)(1): "While no particular form of words is necessary, the option must express, among other things, an offer to sell at the option price, the maximum number of shares purchasable under the option, and the period of time during which the offer remains open."

7 Of course, this assumes no foul play, such as option backdating. Option backdating is not necessarily illegal in itself, but it could lead to inaccurate tax, accounting and securities disclosures, which may well be illegal. See footnote 1 regarding the current problems of public companies that may have backdated option grants to senior executives.

8 See Statement of Financial Accounting Standards No. 123 (revised 2004). This is analogous to "cheap stock" problems for initial public offerings.
risk of this position, by pointing out that not just accountants but also the IRS may reject the contention that an option was ever intended as evidenced by the lack of the exercise price. But, the founder and employee, now better understanding how the rules work, may well argue that if the IRS loses on that point, employee will be better off with the option, and if the IRS wins, then there was no harm in trying (assuming that no fines or penalties apply).

Impact of Section 409A

The founder and employee may have a point, or at least, they would have, before the enactment of Code Section 409A under the Jobs Act. Prior to the January 1, 2005 effective date of Section 409A, the founder, employee, and their attorneys may well have decided that they really did intend an option, and it is their absolute right — legally and morally — to defend that characterization before the IRS, the SEC, any court or any auditor. If they lose, the employee is willing to pay the tax that he would have to pay if the grant were treated as a stock grant. Newco may even be willing to provide a tax loan or tax indemnity as an accommodation to its valued employee, knowing that the tax risk is definable and probably not that large, and preferable to losing the employee. Newco is also certain, and is willing to defend the proposition, that no option backdating has occurred; rather, this entire circumstance came about because of a genuine business deal in January that, quite innocently, was not properly documented until October.

Those calculations of risk, however, must now be radically adjusted. The enactment of Section 409A has resulted in significant challenges for private companies that award stock options to their employees. Under recently proposed Treasury regulations, stock options that are awarded with an exercise price less than the fair market value of the underlying stock on the date of grant ("discounted stock options") constitute deferred compensation and will typically result in adverse tax consequences to the option holder and tax withholding responsibility for the awarding company. The adverse tax consequences include immediate taxation at vesting, which most likely will be based on the "intrinsic value" of the option on the vesting date (i.e., fair market value of the stock at vesting less the exercise price). In addition to immediate taxation, an additional 20% penalty tax will be imposed on the amount subject to tax at vesting, and interest at the underpayment rate plus 1% if the violation is discovered in a later tax year. Further, it is likely that the IRS will continue to impose Section 409A sanctions on discounted stock options after they become vested and remain unexercised.

As a result of the harsh sanctions of Section 409A, the employee will want to avoid any award that has the potential to be classified as a discounted stock option by the IRS. Although the proposed regulations provide detailed guidelines to determine fair market value to avoid Section 409A sanctions, many start-up companies have no real assets or financial history to allow for a meaningful valuation, making the award of stock options particularly challenging and risky to the recipient employee. Stock grants, on the other hand, are exempt from Section 409A because they are taxed under Section 83. Given this new tax landscape as a result of the Jobs Act, the founder, employee and their attorney are unlikely to argue that the award was intended to be an option granted in October. To avoid the application of Section 409A, they may therefore be tempted to argue that a stock grant was really intended all along, but as noted above, taxation of stock grants under

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10 It is not clear from the Treasury's proposed regulations on Section 409A how the post-vesting date appreciation and depreciation will be treated for 409A purposes. One possible approach would be to immediately tax and apply the 20% penalty and interest (if applicable) to the post-vesting date appreciation either at the end of each tax year or on a quarterly basis until the option is exercised. A question that remains, however, is whether the taxpayer will receive any credit against the amounts previously taxed when the option depreciates in value. It is expected that future IRS releases will provide guidance on these issues.
11 In fact, mergers and acquisition lawyers are now finding that both buyers and sellers are willing to expend considerable effort before closing a transaction seeking to avoid or mitigate Section 409A problems for employees of the seller.
Section 83 has its own pitfalls, especially if a Section 83(b) election was not timely made.

The Final Option

The employer and employee, now wise to the draconian effects of Section 409A and the difficulty with characterizing this equity arrangement as a stock grant, are likely pushed to accept the fact that the option was granted in October, and at an exercise price equal to the fair market value of the stock in October — in other words, at a less favorable exercise price to the employee. The typical solution to this loss of future upside resulting from the higher exercise price is to give additional compensation to the employee, probably in the form of more stock options (also at the higher exercise price). This of course can create considerable additional dilution depending on the magnitude of the loss of upside on the options to the employee, but either the employee or the employer (or both) will have to sacrifice, which leaves them none too pleased. Although start-ups are notoriously unfond of staffing up with lawyers at the incipient stages of their operations, this less than happy ending could have easily been avoided had they done just that and been more careful about documenting the specific equity arrangement at the time that they struck their business deal. In the examples above, a simple, though detailed, written stock option plan and stock option agreement, duly approved by the board, with all of the key elements of a stock option (date of grant, offer to sell at a given exercise price, maximum number of shares purchasable under the option, duration of option, etc.), would almost certainly have avoided all of the problems above. The trap for the unwaried created by Section 409A, for better or worse, demands that experienced counsel or other benefits professionals be brought on at the earliest stages of any growth business that plans to incentivize employees with equity.

“PRO BONO” DOESN’T HAVE TO MEAN “LITIGATION”: PUBLIC COUNSEL’S COMMUNITY DEVELOPMENT PROJECT GIVES TRANSACTIONAL LAWYERS THE CHANCE TO HELP NONPROFITS AND SMALL BUSINESSES

By Shashi K. Hanuman
Public Counsel Law Center

In the Fall of 2003, attendees at a forum for start-up businesses heard about Public Counsel’s Community Development Project (CDP) and the free transactional legal services it provides for micro businesses in low-income communities. Among the audience members was a low-income, minority woman who dreamed of owning and operating her own business. Fueled by a passion for creating children’s educational materials, she wanted to design and produce a DVD that would use music and animated characters to teach kids colors and increase their vocabulary skills. Unfortunately, her inability to pay for legal counsel was one of the major obstacles standing in the way of her dream.

Upon learning about CDP’s services, she applied and was accepted as a client. Over the years, Public Counsel staff and volunteer attorneys helped her to incorporate, register a trademark covering her product, and draft investment agreements to finance her start-up phase. After years of developing her small business and product, a major online bookseller agreed to sell her DVD. Last month the product went online and it became an instant success.

Thanks in large part to the generosity of volunteer attorneys who donated their time and talent, Public Counsel was able to help make her dream a reality. This is just one example of the variety of clients that CDP assists. We are committed to providing qualifying small businesses and nonprofits the transactional legal assistance they need to develop, grow and sustain their organizations, and thereby better their chances of success.