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Sarb-Ox for Private Companies? Does Your Deal Qualify for Safe Harbor? A Mistake in this Determination Can be Disastrous

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With the first quarter rapidly drawing to a close, many businesses have completed their budgeting process for 2006. But if you are a private enterprise, you had better leave room for a new line item in your budget: "409A Compliance."

Just as public companies have struggled with Sarbanes-Oxley compliance, private companies face the new Internal Revenue Code Section 409A, which takes a much more critical, and expensive, view of stock options.

Private companies fix a valuation when funds are raised; but valuations can swing wildly depending on the eye – and agenda – of the beholder of a term sheet. Liquidation preferences, voting agreements, and director seats are also typically part of the negotiation of a funding deal, all of which make it more difficult to correctly value common stock, which is usually used in the option pool.

But it is clear that Congress, by passing 409A and empowering the IRS to enforce it, is turning a skeptical eye to the valuations used to calculate option-grants. The proposed regulations state that companies must follow designated procedures for valuing stock options (called "safe harbors").

What are the proposed "safe harbors"? For tech companies, there would seem to be two relevant ones: (1) a written valuation report made by a person (think: independent board member) who has "significant knowledge and experience"; or (2) an "independent appraisal" made not more than 12 months before the relevant option-grant. Realistically, without a board member who is willing to commit to a written valuation, most young companies will have to turn to a third-party valuation. And such valuations, which themselves will incur potential liability, seem likely to be expensive.

Failure to qualify for a safe harbor, followed by IRS disallowance of the ultimate valuation used, would subject grantees (employees) to a penalty of 20%. Such a penalty will sting: an employee tagged with a 20% penalty on "phantom income" (remember, options are stock in a private company, so there is no liquidity) might turn to the company's officers and/or directors who failed to ensure that the stock options were issued through a 'safe harbor.' Whether that claim would be covered under D&O insurance is not clear at this time, and it seems reasonable to assume that insurers will disclaim such coverage unless specifically purchased (like terrorism coverage).

The underlying law – Section 409A – is in effect right now; in the version of the proposed regulations published in October, 2005, the IRS went so far as to state stated that although the rules were not in final form, companies were expected to behave as if they were – and the rules would be retroactive to January 1, 2005! (However, on December 23, 2005, the IRS reversed itself and stated that the proposed regulations, if and when effective, would take effect prospectively.)

With these proposed regulations, Congress and the IRS are reviewing private company valuations very closely. Companies will be under pressure to insure that those valuations – when related to option grants – can be justified via a "safe harbor." But imposing strict regulations on private tech companies carries its own risks. And more to the point, 409A seems likely to impose costs on young companies that no one is budgeting for right now.

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