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COVID-19 and Equity Compensation Valuations

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As companies consider the business impacts of the 2019 Novel Coronavirus (“COVID-19”), it is important to recognize that the effects of COVID-19 may be a significant intervening event such that prior valuations may no longer be reasonable for equity compensation grant purposes.

Section 409A – Option Exercise Price Valuations

Section 409A of the Internal Revenue Code of 1986, as amended, (“Section 409A”) generally imposes adverse tax consequences on U.S. taxpayers who are granted options with an exercise price less than fair market value of the covered shares on the date of grant. For public companies, a fair market value determination is simple; fair market value is determined by reference to a publicly reported price, typically the per share closing price on the trading day before the date of grant or the closing price on the date of grant. For private companies, Section 409A requires that fair market value for option grant purposes be determined “by the reasonable application of a reasonable valuation methodology.”

Section 409A regulations contain a list of factors to be considered for a valuation methodology to be reasonable. These factors include various financial metrics, the market value of equity in similar companies engaged in substantially similar trade or business, which can be determined through nondiscretionary, objective means (such as a publicly reported trading prices), and recent arm’s-length transactions involving the sale of the equity to be valued. Furthermore, a valuation determined by an independent appraisal, as of a date no more than 12 months prior to the option grant date, is presumed to be reasonable if the valuation meets the requirements of Section 401(a)(28)(C) of the Internal Revenue Code of 1986, as amended, and the regulations promulgated thereunder.

Many private companies obtain an annual “409A valuation” to support option grant exercise prices. Often a private company board will rely on the valuation for 12 months. Private equity portfolio companies frequently rely on the private equity fund acquisition purchase price as an indicator of valuation for 12 months and then commence an annual valuation process. Venture capital-backed companies often look to financings within the prior 12 months as an indication of fair market value.

Partnership Profit Interest Valuation

For companies that grant partnership profit interests, a similar valuation exercise occurs. Grants of profit interest awards must be structured to provide that the recipient is not entitled to any distributions if, immediately prior to the grant of the award, the partnership’s assets were sold at fair market value and the proceeds were distributed in a complete liquidation of the partnership. Often, this is stated as requiring that holders of profit interest awards be entitled to benefit only from future appreciation or future profits. If a partnership grants an award that had been intended to be an award



of profits interests, but the grant is based on a valuation less than actual current partnership fair market value, the award is taxed as a capital interest and not as a profit interest award.¹

Consider COVID-19 Valuation Implications Before Granting Equity Compensation

Significant events, such as the business impacts of COVID-19, call into question prior valuations. Section 409A regulations provide that “the use of a value previously calculated under a valuation method is not reasonable as of a later date if such calculation fails to reflect information available after the date of the calculation that may materially affect the value of the corporation.” A similar analysis holds for the grant of partnership profit interest awards—valuations should take into account all current information that may affect the value of the granting entity. Granting options with an exercise price greater than fair market value, while perhaps not intended, is not problematic from the tax perspective; a company may always grant premium priced options. Similarly, “premium valuation” profit interest awards do not result in a loss of profit interest status. However, if company value has increased as a result of COVID-19,² a managing board may not realize that it is granting “discount” options (i.e., options with an exercise price less than fair market value) or that it is granting partnership equity that does not qualify as a profit interest award. While a managing board or the appropriate board committee should always consider whether a prior valuation still holds whenever equity compensation is granted, it is imperative that companies granting equity compensation in the near future consider the valuation implications of COVID-19.



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¹ The grant of capital interests result in tax on vesting, or, in some cases, upon grant. Profit interest awards are not taxed on grant or vesting.

² An increase in value could occur because of the industry in which a company operates (for example, production of in demand medical equipment or hand sanitizer, provision of supply-chain management and support, or facilitation of work from home arrangements). An increase in value also could occur because a company has a major competitor experiencing a significant disruption to its workforce (for example, a competitor’s only manufacturing operations are in a European country experiencing shutdowns and the competitor is not able to deliver product to the marketplace).

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