



**The New Section 409A Guidance —
Implications for Equity Compensation Arrangements**

October 5, 2005

The most recent round of guidance furnished by the Treasury Department and the Internal Revenue Service with respect to deferred compensation arrangements under section 409A of the Internal Revenue Code provides a number of important clarifications with respect to equity compensation vehicles, such as stock options, stock appreciation rights, restricted stock, restricted stock units and phantom stock. The key points of the new guidance, as it relates to such equity compensation programs, may be summarized as follows:

1. ***Exemption of Stock Options and Stock Appreciation Rights***

Both stock options and stock appreciation rights to purchase service recipient stock will generally be exempt from section 409A if the exercise price of the option or the base price for the stock appreciation right can never be less than the fair market value of the underlying stock on the grant date and there are no deferral features that would delay the recognition of income beyond the exercise date (other than the receipt of unvested stock). Stock appreciation rights will be eligible for the exemption even if the underlying stock is not traded on an established securities market (e.g., stock appreciation rights granted by privately-held companies) or if settlement is to be made in cash rather than in shares of stock.

Dividend equivalent rights can result in the loss of the exemption if the right to receive the accumulated dividends is tied to the exercise of the option or stock appreciation right. In such instance, the regulations treat the dividends paid pursuant to the arrangement as a reduction to the exercise price or base price, resulting in a below-market grant. However, a dividend equivalent right will not result in the loss of the section 409A exemption if the right is explicitly set forth as a separate arrangement. Accordingly, the accumulated dividends would have to be payable other than upon the exercise of the related stock option or stock appreciation right. For example, the separate arrangement could be structured so that the accumulated dividends on vested shares underlying the stock option or stock appreciation right would be paid by March 15 of the calendar year following the calendar year in which declared (i.e., within the short-term deferral period permitted under section 409A), and dividends credited to unvested shares would not be paid until those shares vested. Later payment dates could also be utilized, but the designated dates would have to satisfy the distribution provisions of section 409A.

2. *Stock of Service Recipient*

The stock underlying an exempt stock option or stock appreciation right must be common stock of the service recipient that is readily tradable on an established securities market or, if there is none, then common stock that represents the highest-value class of outstanding common stock of the service recipient (disregarding any differences in voting rights). In no event may such stock be subject to any preferences as to dividends or liquidation rights or non-lapse put or call rights or mandatory repurchase obligations based on a value other than the fair market value of the stock. American depository receipts relating to such service recipient stock will also qualify as service recipient stock for purposes of the exemption.

Stock options or stock appreciation rights covering common stock of a parent corporation can qualify as service recipient stock with respect to individuals who perform services for a subsidiary, provided the parent owns stock representing at least 50% of the fair market value or voting power of that subsidiary's outstanding stock. In addition, in certain limited circumstances, the ownership interest can be as low as 20%. For example, service recipient stock will be deemed to exist where a corporation participating in a joint venture with an operating business grants a stock option or stock appreciation right covering its common stock to former employees currently in the service of the joint venture, provided the corporation owns stock representing at least 20% of the fair market value or voting power of the venture's outstanding stock. However, stock of a corporation which serves primarily as an investment vehicle will not qualify as service recipient stock except as to its direct service providers.

3. *Stock Valuation*

A stock option or stock appreciation right will qualify for the exemption from Section 409A only if the exercise price or base price is at least equal to the fair market value of the underlying common stock on the grant date. The following standards will be applicable to the valuation process.

Stock Readily Tradable on Established Securities Market: The fair market value may be determined on the basis of the last sale price before or the first sale price after the grant, the closing selling price on the grant date or the immediately preceding trading day or any other reasonable basis using actual transactions in the stock in the applicable market (e.g., the average of the reported high and low sale prices for the grant date or the immediately preceding trading day). It is also permissible to utilize an average selling price over a specified period within 30 days before or 30 days after the grant, provided (i) the commitment to grant the option or stock appreciation right based on such value must be irrevocable before the start of the averaging period and (ii) such valuation method must be consistently used for all grants under the same program.

Stock Not Readily Tradable on Established Securities Market: The proposed regulations indicate that the following valuation factors should be taken into account: the value of the tangible and intangible assets of the corporation, the present value of future cash-flows, the market value of stock or equity interests in similar corporations or entities engaged in substantially the same business and other relevant factors, such as control premiums or minority discounts. The regulations further caution that a valuation method will not be deemed reasonable unless all available information material to the corporation is considered.

The following valuation methods will be presumed to result in a reasonable valuation, unless the IRS can establish that the use of such method was grossly unreasonable:

- a valuation established by an independent appraisal that meets certain prescribed statutory standards under the Internal Revenue Code and applicable Treasury Regulations, with such appraised value to be as of a date not more than 12 months prior to the relevant grant date;
- a valuation formula based on the tax principles governing the valuation of shares subject to non-lapse restrictions, provided the formula governs the subsequent transfer of any shares subject to the non-lapse restriction and is used for all compensatory and non-compensatory valuations of the stock, including regulatory filings, loan covenants and transactions involving the issuance or repurchase of the stock; or
- for an illiquid stock not subject to any non-lapse put or call right or obligation (other than a first refusal right) and issued by a start-up corporation that has no trade or business which it has conducted for a period of 10 years or more, a written valuation report which takes into account the valuation factors listed above and is prepared by a person with significant knowledge and experience or training in performing similar valuations. However, this valuation method will not be permissible if a change in control or initial public offering of the stock is reasonably anticipated to occur within the succeeding 12 months.

4. *Modifications and Renewals of Outstanding Awards*

Certain modifications to an existing stock option or stock appreciation right will, for purposes of section 409A, be treated as a new grant which will be subject to section 409A if that grant has a below-market exercise or base price at the time of such modification. The types of modifications that will result in a new grant include a direct or indirect reduction to the exercise price, the addition of a deferral feature or the extension or renewal of the grant (except for a permissible extension discussed below).

Although the repricing of an outstanding option or stock appreciation right will be treated as a new grant, the new grant may still continue to qualify for the exemption if that grant does not have a below-market exercise or base price. However, multiple repricings of the same option or stock appreciation right may indicate that the exercise price or base price is a floating or adjustable price, with the result that the option or stock appreciation right would fail to qualify for the section 409A exemption from the date of the original grant.

The following changes to an existing grant will **not** be treated as a modification:

- the acceleration of the exercise date,
- the cash-out of the grant for an amount equal to that otherwise payable upon exercise,

- the addition of a right to deliver previously acquired shares in payment of the exercise price, and
- the addition of stock withholding rights to satisfy applicable withholding taxes.

An extension of the period for which a stock option or stock appreciation right remains exercisable will result in the loss of the section 409A exemption, retroactive to the original grant date. However, such a disqualifying extension will *not* be deemed to occur if the exercise period is not extended beyond the later of (i) the end of the calendar year in which the grant would have expired in the absence of such extension or (ii) the 15th day of the third month following that normal expiration date.

An inadvertent modification to an outstanding stock option or stock appreciation right which would otherwise trigger the application of section 409A to that grant can be rescinded, provided such rescission occurs prior to the earlier of (i) the date the modified grant is exercised or (ii) the last day of the calendar year in which the modification occurs.

5. ***Restricted Stock/Restricted Stock Units/Phantom Stock.***

The issuance of restricted stock will not be subject to section 409A, whether or not the recipient makes a section 83(b) election with respect to that stock.

Restricted stock units that entitle the recipient to receive stock following the satisfaction of a specified service or vesting condition will not be subject to Section 409A if the stock will be issued in compliance with the short-term deferral exception (either at the time of vesting or within two and one-half months following the close of the year in which vesting occurs). If issuance of the stock is to be deferred beyond the short-term deferral period, then the arrangement must be structured to comply with Section 409A.

Restricted stock units that provide for issuance of vested shares within the short-term deferral period can be structured to allow the recipient to defer the issuance of those shares beyond the short-term deferral period. To achieve such result, the initial vesting of the award must not occur for at least 13 months following the award date and the recipient must make his or her deferral election (time and form of distribution) within 30 days after the award date.

Phantom stock will be subject to section 409A. However, if the vesting of the phantom stock is tied to the satisfaction of performance factors that qualify as performance-based compensation under section 409A, then the phantom stock holder may make an initial deferral election at any time prior to the last six months of the performance vesting period.

6. ***Earn-Outs and Other Delayed Payments***

Compensation payable with respect to the purchase of service recipient stock or stock rights (such as stock options or restricted stock units) in a change-in-control transaction will be treated as paid at a specified time or pursuant to a fixed schedule in compliance with section 409A distribution requirements, provided (i) the compensation is paid on the same schedule and in accordance with the same terms and conditions as payments are to be made to the stockholders in an acquisition of their stock or to the corporation in an acquisition of its assets and (ii) the payments are made within five

years after the change-in-control event. Accordingly, it should be possible to structure most earn-out arrangements and indemnity escrows relating to the purchase of service recipient stock or stock rights so that they are in compliance with section 409A.

7. *Transitional Relief*

The new guidance makes it clear that a 2005 calendar-year exercise of a below-market option grant subject to section 409A will constitute a permissible cancellation of the deferred compensation element inherent in that grant and thereby avoid the penalty provisions of the statute. However, such relief will not be extended beyond December 31, 2005.

If not exercised in 2005, the grant can still avoid the application of section 409A if the exercise price is increased to the fair market value of the underlying common stock on the original grant date. Such increase, however, must be effected on or before December 31, 2006.

The proposed regulations do not permit the service recipient to compensate the optionee for any such increase to the exercise price by paying that individual a cash sum (or delivering vested property) equal to the amount of that increase, unless that cash payment is made on or before December 31, 2005. However, if the exercise price of the option is increased in 2006, it would be possible to compensate the optionee for the lost discount with cash or restricted stock, provided the optionee's right to such cash or property does not vest during the 2006 calendar year.

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