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Re: Application of Code §409A to Stock Rights and Other Equity-Based Compensation

Dear Clients and Other Friends:

This installment of our series of letters on the proposed regulations under Code §409A discusses the proposed rules for stock options and stock appreciation rights (which the proposed regulations refer to collectively as “stock rights”), as well as the rules regarding restricted stock and dividend equivalent rights.

I. Stock Options

Like the initial guidance under Code §409A, the proposed regulations take the position that stock rights and other equity-based compensation may be subject to §409A, but then create substantial exceptions. Stock options generally avoid §409A if:

- the exercise price can never be less than the fair market value of the underlying stock on the date of grant;
- the option does not include any feature for the deferral of compensation other than deferral until the exercise or disposition of the option or vesting of the stock received upon exercise;¹ and
- the option is on common stock of the service recipient.

The bulk of the new guidance for stock options relates to the last point, i.e., identifying the permissible stock on which an exempt option may be based.

Briefly, the stock of the service recipient upon which an exempt option may be based must be actual common stock that is readily tradable on an established securities market, or if there is none, the actual common stock that has the greatest aggregate value among the issued and outstanding classes, or common stock with substantially similar rights (disregarding voting rights). Any preference as to liquidation rights or dividends, and any mandatory repurchase obligation, put or call that is not based on fair market value, will take options for those shares out

¹ The proposed regulations also state that the transfer or exercise of the option must be subject to taxation under Code §83, a condition that should be met by virtually all compensatory options. Transfer or exercise would not be taxed under §83 if the options were readily tradable on an established market and taxed at the time of grant. Readily tradable – and therefore taxed at grant – options are seldom if ever used for compensatory purposes.

of the exception. Except for American depositary receipts (ADRs) and certain mutual company units, stock-like units will not qualify.

The proposed regulations also provide new detail regarding who is the service recipient, for the purpose of identifying which entity's stock can be used for an exempt option. Generally, the familiar common control standards of Code §414(b) and (c) apply, but a stock right, or the plan under which a right is granted may elect to substitute a 50% standard for the usual 80% standard, and if there are "legitimate business criteria" for doing so (e.g., a joint venture employing former employees of one of the venture's shareholders), an even lower standard of 20% may be elected.

II. Stock Appreciation Rights

The most significant development in the proposed regulations for stock rights is the expansion of the exception for stock appreciation rights (SARs) to include rights settled in cash and rights regarding stock that is not publicly traded.

Under the proposed regulations, SARs that satisfy conditions similar to those applicable to stock options also will not be subject to §409A. The initial guidance limited the exception to stock-settled SARs of public companies due to concern that employers would manipulate grant and exercise date stock prices to circumvent Code §409A if prices were not set by public trading. The proposed regulations eliminate those limitations, though, overcoming the early misgivings about price manipulation by setting detailed standards for determining fair market value.

When a stock is readily tradable on an established securities market, the proposed regulations allow the use of any reasonable method to establish fair market value, so long as that value is set using actual transactions as reported by the market and is consistently applied. Value can also be determined using an average selling price over a period within 30 days of the date of grant, so long as the commitment to use that method is irrevocably made before the start of the averaging period and the method is consistently used for "the same and substantially similar programs."

When a stock is not readily tradable, fair market value must be determined by the "reasonable application of a reasonable valuation method." Factors to be considered under a reasonable method are listed. Valuations as of a date more than 12 months before the date of use are not reasonable. Consistent use of one of the following methods is presumed to be reasonable:

- independent appraisal;
- a formula, if the same valuation rules are used for any nonlapse restriction and for all noncompensatory purposes; or
- for illiquid start-up corporation stock only, a reasonable, good faith, written valuation.

III. Restricted property

While transfers of restricted stock and other restricted property obviously delay taxation, no deferral subject to §409A will occur simply because of the transfer of substantially nonvested property (i.e., property that is subject to a substantial risk of forfeiture and is nontransferable). A grant of restricted stock may be subject to §409A, however, if the stock recipient is also given an opportunity to defer receipt of the proceeds after the applicable restrictions lapse (e.g., by surrendering the shares for a contractual right to later payment).

A legally binding right to receive restricted (or unrestricted) property in the future also may be subject to §409A. For example, some employers issue restricted stock units (“RSUs”) rather than restricted stock. An RSU is a promise to issue a share of real stock on a future date. An RSU may or may not be subject to §409A:

- If the RSU is subject to a substantial risk of forfeiture and the real stock is issued to the employee not later than 2½ months after the year in which the RSU ceases to be subject to the risk of forfeiture, the whole arrangement is subject to the short-term deferral rule (discussed in our previous letter), and §409A does not apply. For example, if (i) an RSU with a four-year term is issued to an employee January 1, 2006, (ii) the RSU will be forfeited if the employee terminates employment before December 31, 2009, (iii) the employee continues working for the employer through December 31, 2009, and (iv) the employee receives the stock by March 15, 2010, then the short-term deferral rule applies and §409A is not applicable.
- However, if the RSU in the preceding example vested immediately (i.e. was not subject to forfeiture if the employee terminated during the four-year term), the short-term deferral rule would not apply, and the arrangement would be subject to §409A, regardless of whether the employee terminated during the four-year term.

The proposed regulations clarify what happens when there is a substantially nonvested right to the future receipt of stock, and the stock to be received will be substantially nonvested (such as in the case of bonus compensation that pays benefits in the form of restricted stock). In that case, the whole arrangement will be subject to the short-term deferral rule, and §409A will not apply.²

IV. Dividend Equivalents

The proposed regulations offer the first explicit guidance regarding the treatment of dividend equivalent rights. Dividend equivalents will be treated as amounts that reduce the stock right exercise price, and therefore may reduce that price below the exception threshold, unless the right is “explicitly set forth as a separate arrangement”. (The regulations do not elaborate on this requirement. Presumably, the separate arrangement must be in writing, but could be stated in the same document, so long as its separateness is explicitly acknowledged.) If established as a separate arrangement, the separate arrangement may be subject to §409A, but it will not jeopardize the exception for the options or SARs that triggered the grant of dividend equivalents.

² The proposed regulations do not discuss when the election must be made if the bonus program gives participants the choice between cash and a greater amount of restricted property.

V. Modifications, Extensions and Renewals

The proposed regulations offer a considerable amount of new guidance regarding the effect of post-grant changes to stock rights. Generally, any modification other than an extension or renewal will be treated as the grant of a new stock right and will therefore require reevaluation under §409A. Extensions or renewals will be treated as “additional deferral features” that were present in the right from the beginning and therefore cause the right to fail the stock right exception rules from the start.

The complications proposed by these general rules, however, are mitigated by a variety of exceptions. For example, the proposed regulations limit the definition of a “modification” to changes that provide the stock right holder with a direct or indirect reduction in the exercise price, an additional deferral feature, or an extension or renewal of the right, whether or not the holder actually benefits from the change. It is not a modification for purposes of these rules to shorten the exercise term, allow tender of shares in lieu of cash, allow withholding for required taxes, or exercise discretion regarding transferability.

Similarly, a short extension of the right to exercise – to a date not later than December 31 of the year in which a right would expire or, if later, until the 15th day of the third month after expiration would otherwise occur – will not be treated as an extension, and therefore will not prevent a stock right from qualifying for exception from the §409A rules.

Finally, the proposed regulations offer relief for the assumption and substitution of stock rights, so long as requirements similar to those already used in connection with incentive stock options are used to assure that the assumption or substitution does not create new benefits for the holders of the rights.

Bottom line, the proposed regulations offer welcome relief from the application of §409A for the great majority of “plain vanilla” stock options and SARs that can take advantage of the regulatory exceptions. Sponsors of more complicated rights, and sponsors that make changes to existing rights, however, will need to be wary of the potential §409A consequences. If options or SARs will not escape the application of §409A, alternative designs will be needed to satisfy §409A. (For example, a non-exempt private company SAR could be issued to an executive on January 1, 2006, with payment scheduled for January 1, 2011. The arrangement could allow the executive to freely “exercise” her SAR by converting it into a dollar-based deferred compensation account, but prohibit actual receipt of the account balance until the scheduled payment date in 2011. Exercise in that case merely changes the investment of the deferred compensation, and payment is made only on a fixed payment date, satisfying §409A.)

If you have questions about these or other §409A issues, please let us know.

Sincerely,

John W. Haine

JWH/jks

Quick Summary of §409A Impact of Select Stock Right Features and Events

Features that may trigger §409A trouble at grant:

- Rights are not for service recipient stock
- Exercise price could go below fair market value at grant
- Additional compensation (in excess of spread at exercise) payable
- Additional rights granted that allow for deferral of compensation, other than: right to be paid in unvested stock and right to pay exercise price with already-owned shares
- Dividend rights that are NOT explicitly set forth as a separate arrangement

Features/events that may trigger Code §409A trouble AFTER grant:

- Changes that may reduce the exercise price
- Changes that may allow additional deferral
- Extensions other than (i) very short-term extensions to a date not later than the later of 15th day of third month after date at which or end of calendar year in which right would have expired or (ii) extensions of up to 30 days to prevent securities law violations
- Renewals
- Changes in the underlying stock that increase its value, unless action is a permitted substitution
- ISO modifications that cause recharacterization as NQSOs

Actions AFTER grant that should not trigger adverse §409A consequences:

- Shortening exercise period
- Stock tender in lieu of cash
- Share withholding to pay employment taxes or REQUIRED withholding taxes
- Exercise of specifically reserved authority to permit or deny transfer
- Substitutions or assumptions that would meet the ISO rules as modified by the proposed regulations
- Accelerated vesting/exercisability (so long as the stock right has not become subject to §409A for some other reason)
- Stock splits and stock dividends that cause only a pro rata change in number of shares owned, provided stock right is proportionally adjusted to reflect the event and aggregate exercise price is not less after the event