

Client Alert

Equity Arrangements Under 409A's Final Regulations

The Treasury Department and Internal Revenue Service recently issued final regulations under Internal Revenue Code Section 409A. Generally, the final regulations liberalize 409A's rules regarding equity arrangements (specifically, stock options and stock appreciation rights, which are referred to in 409A parlance as "stock rights"). This relief was much needed, as many clients and practitioners were unhappy with the proposed regulations' application to equity arrangements.

The following is a summary of 409A's application to equity arrangements. To view the final regulations, prior 409A guidance, and our related client alerts, please [click here](#) or go to www.chadbourne.com/409A.

Highlights of the Final Regulations

1. What are some highlights of the final regulations?

Expanded definition of "service recipient stock." This definition is important because, in order to qualify for the equity exemption under 409A, a stock right must be issued with respect to "service recipient stock." Under the proposed regulations, only the class of common stock with the highest aggregate value outstanding could be "service recipient stock." Also, if the stock had a liquidation preference, it could not be "service recipient stock." The final regulations eliminate these limitations. *See Question 4 below.*

Simplified rules for determining controlled group service recipient stock. *See Question 5 below.*

More liberal rules on stock option and stock appreciation right extensions. The final regulations permit companies to extend exercise periods for stock rights over a longer period of time and provide greater flexibility for "under water" stock rights. Under the proposed regulations, the exercise period generally could be extended no more than one year and often much less. *See Question 11 below.*

409A and the Equity Exemption

2. Does 409A apply to equity arrangements?

Yes, it can. The final regulations, as well as prior guidance under 409A, make clear that 409A can apply to equity arrangements. 409A's application to equity arrangements depends upon how the equity is structured and how it is handled after it has been awarded. Most companies will want to structure their equity arrangements to be exempt from 409A.

Equity awards that were earned and vested as of December 31, 2004, and which were not "materially modified" after October 3, 2004, are not subject to 409A (so-called "grandfathered" awards).

3. How do you structure an equity arrangement to be exempt from 409A?

Stock Options. The exercise price of the option must be at least fair market value on the date of grant, the number of shares subject to the option must be fixed on the date of grant, the option must cover “service recipient stock,” and the option may not include any other feature for the deferral of compensation. The right to receive restricted stock upon the exercise of an option is not considered to be a feature for the deferral of compensation.

Incentive stock options and options to purchase stock granted pursuant to a qualifying employee stock purchase plan are also exempt from 409A.

Stock Appreciation Rights. The SAR may not provide for a payment greater than the difference between the fair market value of shares on the date of grant and the fair market value of those shares on the date of exercise, the number of shares subject to the SAR must be fixed on the date of grant, the SAR must cover “service recipient stock,” and the SAR may not include any other feature for the deferral of compensation. The right to receive restricted stock upon the exercise of a SAR is not considered to be a feature for the deferral of compensation.

Restricted Stock. The transfer of substantially non-vested property (*e.g.*, restricted stock), as defined under Internal Revenue Code Section 83, is not subject to 409A.

RSUs and Phantom Equity Awards. Restricted stock units (RSUs) and phantom equity awards are not exempt from 409A under the equity exemption. This means that these awards must either comply with 409A’s short-term deferral exemption (essentially, the award must always be paid out upon vesting) or comply with 409A (including making payment of the award only upon permissible 409A payment events).

Service Recipient Stock

4. What is “service recipient stock?”

“Service recipient stock” is any class of stock that, as of the date of grant, is considered to be common stock under Internal Revenue Code Section 305. However, the stock may not have any distribution preferences other than liquidation preferences. Finally, the stock generally may not be subject to a mandatory repurchase right, or a put or call right, if the price to be paid in connection with such right is other than fair market value.

5. Which company within a group of related companies can issue “service recipient stock?”

Either the company for which the individual directly performs services (the “serviced company”), or, in most cases, any company that is “up the chain” from that serviced company. In other words, the parent of the serviced company could issue service recipient stock to that individual, but a subsidiary of the serviced company could not.

Note that each entity going up the chain must have a controlling interest in the company below it (meaning at least 50% ownership). Although, depending on the facts and circumstances, a less-than-50% interest may still qualify.

Fair Market Value

6. How is “fair market value” determined for the stock of a publicly traded company?

Fair market value is determined by reference to the trading price of the stock on the date of grant, or the last trade made before the grant or the first trade made after the grant. An average

of these prices may also be used. Finally, an average price over a period of no more than thirty days before and thirty days after the date of grant may be used, provided that such formula is irrevocably specified in advance.

Note that “publicly traded” companies include companies whose stock is traded on an established foreign exchange.

7. *How is “fair market value” determined for the stock of a privately held company?*

The fair market value of stock of a privately held company must be determined by a “reasonable application of a reasonable valuation method” that takes into consideration all available, material information. This is a facts and circumstances test, but the final regulations list a number of factors that should be considered, including the value of all assets, anticipated cash flow, the value of similar businesses, recent arm’s-length transactions, discounts for lack of marketability, and a company’s use of the same method for other material purposes.

The use of a prior valuation will not be reasonable if new information has since become available that would materially affect the prior valuation, or if the prior valuation is more than one year old.

The final regulations set forth three specific valuation methods that will be presumed reasonable if used to value a privately held company: (i) an independent appraisal that meets the requirements of Internal Revenue Code 401(a)(28)(C); (ii) a valuation that would meet the requirements of Treasury Regulation § 1.83-5, provided that valuation is used for all share transfers back to the company or to any person that owns more than 10% of the company’s voting shares; and (iii) a good faith valuation of a start-up company’s illiquid stock.

8. *Can one valuation method be used to determine value on the date of grant and another method used to determine value on the date of exercise?*

Yes. The final regulations make this clear. This rule only applies, however, if each valuation method independently satisfies 409A, and once a method is used, it is not retroactively altered for that valuation.

9. *On what date is a stock right considered “granted?”*

Generally, it is the date on which the granting company has completed all corporate action necessary to give the award recipient a legally binding right to the award, including the setting of the number of shares subject to the stock right and the exercise price.

Changing an Existing Stock Right

10. *Will a modification of an existing stock right that is exempt from 409A cause the stock right to lose its exemption?*

It can. A modification is any change to the existing stock right that could provide for a direct or indirect reduction in the exercise price. A change in the terms of the stock underlying the stock right can also be considered to be a modification. If a stock right is modified, it is treated as a new grant on the date of modification, and is analyzed at that time under the exemption requirements noted in Question 3 above. Essentially, if the modification occurs at a time when the fair market value of the stock is greater than the exercise price of the stock right being modified, the stock right will lose its exemption because it will be treated as a below market value stock right issued on the date of the modification.

Note that accelerating the vesting of a stock right that is exempt from 409A is not considered to be a modification and is permissible.

11. *Can the exercise period of a stock right be extended without causing the stock right to lose its 409A exemption?*

Yes, as long as the extension is not beyond the earlier of (i) the latest date on which the stock right could have expired under its original terms or (ii) the tenth anniversary of the date of grant of the stock right. Also, if the stock right is “under water” (that is, not in the money) at the time the extension is made, even longer extensions will generally be permissible.

12. *What if you provided a longer extension of the exercise period before the final 409A regulations were published?*

The final regulations provide relief in such a case. The final regulations were published on April 10, 2007, and provide that any extension of the exercise period of a stock right made on or before April 9, 2007 is disregarded.

13. *Can stock rights be assumed, substituted, or exchanged in connection with a corporate transaction without losing their 409A exemption?*

Yes, as long as the action with respect to the stock right satisfies certain rules under Treasury Regulation § 1.424-1. Also, pro rata adjustments made to reflect a stock split or a stock dividend will generally not cause the stock right to lose its 409A exemption.

14. *What if you impermissibly modified or extended an exempt 409A stock right?*

Generally, this will result in a 409A violation. However, if the impermissible change is rescinded before the earlier of (i) the exercise of the stock right or (ii) the end of the year in which the change was made, then no 409A violation will be deemed to have occurred.

Dividends

15. *Will the right to receive dividends affect the underlying stock right’s exemption from 409A?*

It can. Dividends must not be accumulated while the stock right is outstanding and then paid out upon exercise. This is viewed as an offset to the exercise price. Instead, dividends must be paid out when they are earned, even if the stock right is not yet exercised, or otherwise structured to be exempt from or comply with 409A (for example, paying the dividends on a fixed payment date or dates).

Private Equity

16. *How does 409A apply to private equity funds and related arrangements?*

To the extent that a private equity fund compensates its service providers via partnership interests (including profits interests), it may, at least for now, apply by analogy the equity exemptions noted above in order to exempt those partnership interests from 409A. This rule may be temporary, as it is addressed in the preamble to the final regulations and not in the regulations themselves. Treasury and the IRS continue to analyze the application of 409A to partnership arrangements and we await further guidance.

Otherwise, to the extent that the equity exemption is not applicable, compensation provided by a private equity fund or related arrangement is subject to the same 409A rules as is cash compensation. This means that such compensation must either be exempt from 409A (for example, if it is paid when it is earned or vested) or comply with 409A.

In order to comply with 409A's payment rules, there is a special rule for "back-to-back" arrangements. To illustrate, where an individual provides services to a management company, which in turn provides services to a group of investors, to the extent that the management company makes a payment of deferred compensation to the individual following a permitted 409A payment event, the group of investors may make a similar payment to the management company without that payment violating 409A. Without this special rule, the payment from the group of investors to the management company would arguably be a payment of deferred compensation that is made before the occurrence of a permissible 409A payment event with respect to the management company, which would be a 409A violation.

The preamble to the final regulations specifically rejected adding a special rule for "reverse back-to-back" arrangements. Staying with the above example, commentators had requested that the management company be permitted to make a payment to the individual, regardless of whether a permissible 409A payment event occurs with respect to the individual, when the group of investors makes certain payments to the management company. This request was not adopted, but Treasury and the IRS stated that they would continue to consider the issue.

Transition Rule

17. What is the deadline for fixing stock rights that are currently neither exempt from 409A nor compliant with 409A?

Generally, non-compliant stock rights must be amended to be exempt from or compliant with 409A by December 31, 2007. Otherwise, as of January 1, 2008, an automatic 409A violation will occur. Note that the transition deadline for certain corporate insiders of public companies expired on December 31, 2006.

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For Additional Information

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