

Equity Compensation Legal Update

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This is our Journal's annual review of developments in the equity compensation field, covering stock options and other plans. It is not a comprehensive review of every case and ruling but rather an overview of current trends and approaches.

Every spring we take a look at the case and agency law that was made with respect to stock options and other forms of equity compensation in the previous calendar year. Below are some highlights from 2007 and 2008:

- Stock option backdating issues have continued to play out since our last update. During 2007 and 2008, many companies received good news in the form of “no-action letters” stating that the Securities and Exchange Commission (SEC) would not be taking any enforcement action against them for their stock option granting practices. In addition, a number of high-profile backdating cases against companies and their top executives were settled. “When this all started, we made it clear that we did not

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Reprinted from the *Journal of Employee Ownership Law and Finance*, vol. 20, no. 3 (summer 2008), published by the National Center for Employee Ownership (NCEO). © 2008 by Alisa Baker and the NCEO. See www.nceo.org.

want to file hundreds and hundreds of backdating cases,” Marc Fagel, the SEC’s associate regional director in the San Francisco regional office, told the *Recorder*, a legal newspaper in Northern California. The agency says it is looking at all cases closely and following up only where fraud is suspected, not in cases that appear to concern only erroneous accounting. Moreover, in April 2008 the Internal Revenue Service (IRS) demoted its “Backdated Stock Option” issue from Tier I to Tier II status, signaling that backdating now has “diminished importance” for enforcement purposes.

- As always, litigation over the meaning of language in option plans and agreements continues in both state and federal courts, particularly with respect to employment termination disputes.
- The final Section 409A regulations on nonqualified deferred compensation were published on April 10, 2007, but subsequent IRS rulings have extended the effective date for full compliance to January 1, 2009. As noted previously, the new rules do not differ substantially from the old rules with respect to equity compensation. We have included a brief synopsis of the final regulations. Additionally, the NCEO has a detailed white paper available that covers the almost 400-page final regulations in a shorter format (47 pages).¹

A final note: Although this review of cases and rulings is not necessarily comprehensive, it gives an indication of the direction of the law and the various approaches being taken by the courts (and litigants) to resolving disputes involving equity compensation. Please be aware that the following summaries are no more than that; they should not be relied upon without first consulting primary sources for details.

1. Christine Zwerling, *Issue Brief: The Final 409A Deferred Compensation Regulations* (NCEO, 2008).

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Tax Cases and Rulings

In this part, we review tax cases in federal and state court, as well as IRS and state tax agency determinations. Tax issues can come up for resolution in a variety of settings. Most litigation arises out of a tax audit (either federal or state) that is contested and ultimately appealed to the court by the taxpayer. The chief federal judicial forum for tax disputes is the U.S. Tax Court in Washington D.C., which issues opinions at both the trial (Tax Court Memorandum) and appellate (Tax Court Opinion) levels.

Tax Decisions in the Courts

AMT Not Avoided Despite Blackout Period

In *Merlo v. Commissioner of Internal Revenue*, No. 06-60723 (5th Cir. July 17, 2007), the U.S. Court of Appeals for the Fifth Circuit affirmed the Tax Court's summary judgment in favor of the IRS, finding that: (1) the lower court did not err in concluding that there was no "substantial risk of forfeiture" at the time the petitioner exercised his stock option in 2000, even though the exercise occurred during a blackout period when he was not allowed to sell the stock; and (2) a loss when the stock became worthless in 2001 did not entitle the plaintiff to an alternative tax net operating loss (ATNOL) deduction that he could carry back to 2000. For the facts in this case, see *Merlo v. Commissioner*, T.C.M. 2005-178 (2005) (discussed in Alisa Baker, *The Stock Options Book*, 9th ed. [NCEO, 2008] at p. 223).

Use of Margin Loan Does Not Skirt "Transfer" for Section 83 Purposes

In *Racine v. Commissioner of Internal Revenue*, No. 06-4103 (7th Cir. July 3, 2007), the U.S. Court of Appeals for the Seventh Circuit affirmed a U.S. Tax Court ruling that financing the exercise of a nonstatutory stock option with a broker loan does not change the date of transfer for purposes of Section 83 of the Internal Revenue Code (the "Code"). The case arose after the IRS sought to reclaim a \$368,000 tax refund Racine had improperly received in the year of sale. She argued that the shares were not transferred to her until she sold them and that borrowing to finance the transaction amounts

to a second option that replaces the first. The Tax Court held that the transfer occurred when the options were exercised because Racine acquired full legal and beneficial ownership of the shares on that date: she could sell them outright, vote them, hypothecate them, and so on. This ruling is consistent with other courts' rulings, as well as with the regulations under Section 83 of the Code. See *Palahnuk v. United States*, 475 F.3d 1380 (Fed. Cir. 2007); *Cidale v. United States*, 475 F.3d 685 (5th Cir. 2007); and *United States v. Tuff*, 469 F.3d 1249 (9th Cir. 2006).

Tax Court Rules That Effective Date of Transfer Occurs at Time of Exercise Commitment

In another Section 83 case, *Edward W. Walter et al. v. Commissioner*, T.C.M. 2007-2 (2007), the U.S. Tax Court held that the effective date of exercise of a nonstatutory stock option occurred at the time the optionee faxed an exercise commitment to the issuer, rather than on the date that the money to fund the commitment was actually transferred. In this case, the plan language specified that a transaction was considered effective as of the date of notice of exercise, not as of the date of the actual transfer of funds.

IRS Rulings and Announcements

Below is a summary of significant IRS pronouncements since our last update. A quick review of the hierarchy of IRS rulings: At the federal agency level, the IRS has the authority to issue rulings at both public and private determinations in writing. Public determinations are called "revenue rulings" (Rev. Rul.), and they state the IRS position on the interpretation of the Code and its regulations. They are frequently accompanied by IRS notices, announcements, or other interpretive documents. Revenue rulings are citable as precedent and may accordingly be relied upon by taxpayers. Private written determinations are directed to an individual taxpayer (or IRS field agent auditing a taxpayer) and as such may be relied upon only by that individual. Although such private rulings are available to the public, they are intended only to serve as an indication of the IRS position on any issue and may not be cited or relied upon as precedent.

IRS Resolves Key Uncertainties Related to Section 83(b)

In an important revenue ruling, Rev. Rul. 2007-49, 2007-31 IRB (July 30, 2007), the IRS clarified the tax consequences of a typical scenario for employee-stockholders of venture-backed companies: imposition of a requirement by investors and/or acquirers that, in connection with a transaction, a key employee agree to accept new restrictions on his or her otherwise vested stock. Under Section 83 of the Code, the transfer of property in exchange for services is taxed at the earlier of when the property actually “vests” (i.e., is no longer subject to a substantial risk of forfeiture or is first freely transferable) or when a Section 83(b) election is made. But what happens when fully vested property becomes subject to newly imposed restrictions? Is it vested or unvested?

Practitioners have long understood Section 83 to be inapplicable to situations where employees contractually agree to new restrictions after their stock has already vested. Rev. Rul. 2007-49 confirms this understanding in three common fact settings. *Situation 1* describes a financing in which a condition of the investment is that the employee accepts a new two-year vesting schedule on his otherwise vested stock. In this situation, the IRS recognizes that under Section 83, the property transfer occurred at the initial vesting—i.e., the employee already owns the stock for tax purposes. Therefore, adding additional contractual restrictions “has no effect for purposes of §83.”

Situation 2 describes a tax-free (stock for stock) merger in which the employee agrees to take unvested stock in exchange for his otherwise vested stock. Again, the IRS recognizes that the initial stock is already vested under Section 83. However, the stock received in the exchange is *not* vested—it is a new grant of unvested shares that has been paid for with vested shares. Accordingly, the employee may file a Section 83(b) election at the time of the merger. Because the (old) vested stock necessarily has a fair market value equal to the (new) unvested stock, the employee has no compensation income in the year of the merger, so his basis in the new shares is the same as his basis in the old shares. When he sells the stock some years later, he will recognize capital gain in excess of his original basis only.

Situation 3 sets out the same facts as Situation 2, but in a taxable merger (half cash and half stock). Because the transaction is taxable, the exchange of the (old) vested shares for the (new) unvested shares

results in taxable (capital) gain at the time of the merger equal to the difference between the employee's original basis and the fair market value of the new shares. The employee takes a tax basis in the new shares equal to the amount he paid for them (i.e., their already taxed fair market value) and may file a Section 83(b) election for the new shares. Future gain (or loss) will be capital gain (or loss).

Certain Amounts Payable on Termination May Not Qualify as "Performance-Based Compensation" Under Section 162(m)

In Rev. Rul. 2008-13 (Feb. 21, 2008), the IRS officially reversed its long-time position regarding the deductibility of amounts paid to departing executives with respect to (otherwise unvested) performance bonuses. Affirming its (surprise) ruling in a January 2008 private letter ruling (PLR 200804004), the IRS now takes the position that severance amounts attributable to performance bonuses will not qualify as performance-based (and thus deductible) under Section 162(m) if they will be paid regardless of whether performance goals have been met on the date of a covered employee's termination. It is possible that most stock options will be unaffected by Rev. Rul. 2008-13, because such grants are already "performance based" under Section 162(m). However, it is important to keep an eye on this issue, which applies (subject to a transition period) to all performance periods beginning after January 1, 2009.

CFOs No Longer Subject to \$1 Million Compensation Deduction Limit

IRS Notice 2007-49 acknowledges the effect the new disclosure rules promulgated last year by the Securities and Exchange Commission (SEC) have on the determination of "covered employees" under Code Section 162(m). Rather than align the definition of a covered employee under Section 162(m) with the definition of "named executive officers" under the Securities and Exchange Act of 1934, the IRS interprets covered employees to include a company's principal executive officer or an individual acting in such capacity, and the three highest-paid officers whose compensation is required to be reported under the Exchange Act (other than the principal executive officer or the principal financial officer). As a result, compensation

paid to the principal financial officer will not be subject to the deduction limitations under Section 162(m).

Guidance on ESPP and ISO Reporting

The Tax Relief and Health Care Act of 2006 amended the information reporting requirements of Section 6039 concerning exercises of incentive stock options (ISOs) and sales of shares acquired under tax-qualified employee stock purchase plans (ESPPs) to require reporting to the IRS. Until the amendment, corporations were required to file information statements only with their optionees. The amended Section 6039 requires corporations to file information returns with the IRS by January 31 of each year, in addition to providing the information to the employee.

Final regulations for Section 6039 were published in a “Notice of Proposed Rulemaking” on July 17, 2008, although the initial effective date of the amendment was January 1, 2007. The 2008 final regulations provide that the requirement to file an information return with the IRS will be waived for transactions occurring during 2007 and 2008. Before issuing this notice, the IRS had already issued Notice 2008-8, which exempted reporting to the IRS for transactions occurring in 2007. Note that the requirement to furnish information to *optionees* has remained in place throughout the amendment process.

Change Affects the Alternative Minimum Tax (AMT) Application to Options

Beginning with the 2007 tax year, certain taxpayers can claim old, unrecovered AMT credit, even if it means getting a refund that exceeds the current year’s taxes. The Tax Relief and Health Care Act of 2006 allows a refundable credit for a prior year AMT liability after a period of years. Specifically, the Act provides that if an individual has a long-term unused minimum tax credit for any taxable year beginning before January 1, 2013, the applicable credit limitation for the taxable year at issue will not be less than the AMT refundable amount (Act Section 402; Code Section 53).

Private Letter Ruling Affirms ISO Division in Divorce

In PLR 200737009 (June 15, 2007), the IRS affirmed a divorcing taxpayer's plan for dividing ISOs in a community property state. The ISOs are to remain in the name of the employee spouse, who would hold them as trustee for the non-employee former spouse (NEFS). The NEFS would direct the employee spouse when to exercise the option. After the exercise, the stock would be transferred to the NEFS. The IRS affirmed that the arrangement would not violate the requirement that ISOs may be held only by employees. The NEFS should report the alternative minimum tax (AMT) income relating to the exercise of the ISO. After exercise, the transfer of the shares from the employee spouse to the NEFS would not be a disqualifying disposition. The NEFS would report the future consequences of disposing of the ISO shares, including the availability of AMT credits.

SEC Rulings and No-Action Letters

Securities Decisions in the Courts

IBM Settles with SEC over Expensing of Options

In June 2007, the SEC settled an enforcement action against IBM for making materially misleading statements in a chart concerning the impact that the company's decision to expense employee stock options would have on its 2005 financial results. The misleading chart caused analysts to lower their EPS estimates for the company. IBM did not admit or deny the findings in the settlement announcement and has agreed not to commit future disclosure violations. The SEC did not impose any monetary penalties.

Sample SEC Letter Provides Reporting Guidance for Companies with Backdated Options

In a January 2007 sample letter, Carol Stacey, chief accountant at the SEC's Division of Corporate Finance, said that companies that have backdated options can consolidate their reporting of the financial impact from the backdating into a single 10-K filing. The staff will not raise further issues if the company amends its most recent 10-K filing to disclose the impact from backdating for all relevant prior

periods. The amendment must include several disclosure elements outlined in the letter, available at <http://www.sec.gov/divisions/corpfina/guidance/oilgasltr012007.htm>.

SEC and Accounting Guidance

PCAOB Issues Guidelines for Auditing Option Practices

The Public Company Accounting Oversight Board (PCAOB) has issued guidelines in the form of a staff question-and-answer document for auditors looking at stock option practices. The guidelines can be found at http://www.pcaobus.org/Standards/Staff_Questions_and_Answers/2006/Stock_Options.pdf. The guidelines focus on what auditors should be looking for in option practices. For instance, one of the key issues is valuing options at the time of grant for income statement purposes. Among other things, auditors should assess whether the company is relying too heavily (or too little) on historic volatility, variations in predictions of exercise periods from historical precedents, inconsistent applications of assumptions, and so on. Similarly, predictions about exercise patterns that deviate from past experience without a good rationale would be suspect. Assumptions that produce results lower exercise rates than observed in the past also need to be carefully evaluated. In general, absent a good reason to the contrary, the guidelines favor using models more capable of capturing exercise patterns than the Black-Scholes model, such as the binomial lattice approach.

SEC Proposes to Allow Companies to Use International Accounting Standards for Financial Statements

On June 20, 2007, the SEC agreed to issue a “proposing release” that would allow companies to use international financial reporting procedures consistent with International Financial Reporting Standards (IFRS) as published by the International Accounting Standards Board. The SEC also is expected to issue a “concept release” targeted at U.S. domestic issuers to allow them to comment on this proposal. The SEC would then decide whether to make the change. In the equity compensation area, international and U.S. standards are very similar, but not identical.

SEC Adopts Revisions to Rule 144 and Rule 145

On November 15, 2007, the SEC adopted amendments relaxing the limitations on resales of restricted and control securities under Rules 144 and 145 as well as rules providing for exemptions from Exchange Act registration for compensatory stock options. It also restructured the reporting requirements applicable to smaller companies. The revisions were adopted substantially in the form proposed by the SEC, with the following exceptions:

- The SEC did not adopt proposed tolling provisions that would have required that the Rule 144 holding period be suspended up to an additional six months during any period in which the restricted security was hedged by a put equivalent position.
- The final rule provides an alternative volume limit for debt securities equal to 10% of a particular tranche in any three-month period, which should greatly expand the availability of Rule 144 to sellers of debt securities.

California Commissioner of Corporations Amends Compensatory Benefit Plan Regulations

Traditionally, California has had the nation's strictest rules for the issuance of equity awards in closely held companies. Among other rules, awards had to be issued at not less than 85% of fair market value, vesting for non-management employees had to be at least 20% per year over a five-year period from the grant date, there were specific repurchase requirements for shares bought back from employees, there was a 30% limit on the amount of equity that could be issued unless there was a two-thirds vote of shareholders to approve more, and shareholders had to approve a plan within 12 months of the plan's adoption (as opposed to the issuance of awards, as is the case in federal rules). In July, California changed these rules to make them more consistent with federal rules, particularly the exemptions from registration requirements under Rule 701 under the Securities Act of 1933.

Option Backdating

Resolution of Various Enforcement Actions

As noted in the introduction to this article, in 2007 and 2008 the SEC resolved many of its outstanding option backdating cases by entering into settlements with the defendants. A partial list of these settlements follows (including the date of the SEC press release announcing resolution):

- *SEC v. Sycamore Networks, Frances M. Jewels, Cheryl E. Kalinen and Robin A. Friedman* (July 9, 2008).
- *SEC v. Analog Devices and Jerald Fishman* (May 30, 2008)
- *SEC v. Marvell Technology Group and Weili Dai* (May 8, 2008)
- *SEC v. Andrew J. McKelvey (Monster)* (Jan. 23, 2008)
- *SEC v. William W. McGuire M.D. (UnitedHealth)* (Dec. 6, 2007)
- *SEC v. Juniper Networks* (August 28, 2007)
- *SEC v. KLA-Tencor* (July 25, 2007)
- *SEC v. Mercury Interactive* (May 31, 2007)

Note: in a number of these cases, SEC actions were settled with the company, but actions against individual officers are still pending as of this writing.

Contract and Employment Cases Related to Stock Options

Suit Against Company for Abusive Equity Incentive Plan Can Go Forward

In *Sample v. Morgan*, No. 1214-N (Del. Ch. Jan. 23, 2007), Vice-Chancellor Strine ruled that defendants “amazingly” moved to dismiss a suit in which shareholders contended that the company had wasted assets and misled investors about an incentive plan that provided insiders with 46% of the company’s stock. Shareholders of Randall Bearings approved an incentive plan allowing the company to issue an additional 200,000 shares of stock to key employees. The information provided to shareholders, however, neglected to

disclose that only three existing executives would get the stock, that the stock would have voting rights, that no more stock could be issued for five years, that executives would pay only one-tenth of one cent per share on stock valued at \$5.60, and that the money-losing company would borrow money to pay their taxes. The judge called the defendants' arguments "just ducky."

Clear Language of Waiver Overrides Seemingly Contradictory Prefatory Language

In *Aho v. Cleveland-Cliffs Inc.*, No. 06-3553 (6th Cir. Mar. 6, 2007, unpublished), the U.S. Court of Appeals for the Sixth Circuit ruled that language an employee signed waiving rights to stock options as part of a separation agreement overrode potentially conflicting prefatory language in the agreement stating, "Employee has been paid or will be paid all wages, incentives and benefits owed."

Options Do Not Count in Top-Hat Benefit Plan Calculations

In *Crowell v. Shell Oil Co.*, No. H-05-03412 (S.D. Tex. Mar. 7, 2007), a district court ruled that stock options were not properly part of the compensation eligible for top-hat benefit calculations when Shell purchased Pennzoil in 2002, because the contract unambiguously defined the options as not part of that compensation calculation.

Change in Number of Board Members Not a Change in Control; Options Are Not Wages

In *Paolini v. Albertson's Inc.*, No. 03-35724 (9th Cir. Apr. 6, 2007), the U.S. Court of Appeals for the Ninth Circuit affirmed a lower court's ruling that a change in the number of directors at Albertson's did not trigger change of control provisions that would have allowed a former employee to exercise his options. The contract language's definition of change in control specified that a 20% change in board composition was part of the definition of a change in control, but that the language was clear that it had to be in conjunction with a merger, consolidation, or reorganization, the court held.

Employment-Practices Insurance Does Not Cover Stock Redemption Liability

In *Krueger Int'l Inc. v. Royal Indemnity Co.*, No. 06-2611 (7th Cir. Apr. 9, 2007), the U.S. Court of Appeals for the Seventh Circuit upheld a lower court's summary judgment, saying that employment-practice liability insurance does not cover an oral misrepresentation of a written stock option agreement between employees and the company because the agreement was a shareholder, not employment, agreement. Moreover, the misrepresentation (about the price at which employees could exercise their options) was by an officer to whom the company had delegated this task. The company later repudiated the representation that officer made to the employee. In any event, it could not file a claim under the oral misrepresentation clause of its insurance because that insurance is meant to cover things that the employer cannot control. The repudiation was within its control.

Pfizer Employee Forfeited Options by Terminating Employment Before Age 55

In *Bell v. Pfizer Inc.*, No. 110:A-4 (S.D.N.Y. June 8, 2007), a district court ruled that the plaintiff submitted sufficient evidence of both omission and negligent misrepresentations for an ERISA fiduciary duty breach claim to survive in a suit over early retirement, but she did not provide evidence to prove that her "retirement" would allow for retention of her stock options.

Delaware Ruling Awards Damages to Underwater Option Holders in Cash Merger

A recent decision from the Delaware Chancery Court, *Lillis v. AT&T Corp.*, No. 717-N (Del. Ch. July 20, 2007), provides guidance on the issue of the right of acquirors to cash out and cancel underwater compensatory stock options in cash merger transactions. The court held that in a 2004 merger transaction, a target and acquiror improperly cancelled options for their "intrinsic value." The court instead applied a Black-Scholes valuation to the cancelled options.

Stock Options Properly Treated in Merger; Retention Bonus Plan “Last Man Standing” Payout Denied

In *Biko v. Siemens Corp.*, No. 05-05-01318-CV (Tex. App.-5th Oct. 17, 2007). In 2001, Efficient Networks, Inc. merged with Siemens. Because Siemens stock was not then publicly traded in the U.S., employees who held Efficient stock were paid a per-share price upon tendering their stock. Employees holding in-the-money stock options were paid their intrinsic value. However, employees holding “underwater” options were not paid anything. The Texas appellate court affirmed a prior ruling that Siemens had properly assumed and canceled the options in accordance with the stock plan’s provision.

In an effort to retain these new employees, Siemens negotiated a three-year employee retention cash bonus program. There was some debate about whether the retention program contained a “last man standing” provision (i.e., whether the remaining Efficient employees were contractually entitled to any leftover money). At the conclusion of the fully funded plan, approximately \$80 million in unallocated funds remained. The court found that the retention plan contract did not satisfy Texas law because most documents were not properly signed and the signed documents appeared not to be final agreements.

Employment for Stock Option Purposes Ended When Merger Closed

In *Kinsey v. Cendant Corp.*, No. 04-CV-0582-RWS (S.D.N.Y. Nov. 14, 2007), the U.S. district court for the Southern District of New York ruled that Cendant Corp. properly handled a stock option granted to an employee of Fairfield Resorts Inc. upon the close of Cendant’s acquisition of Fairfield in April 2001. An employee of Fairfield was hired by Cendant upon acquisition; thus, his employment by Fairfield was terminated at that time. Under the employee’s stock option agreement, he had one year to exercise his Fairfield options before they expired. The employee contended that because his employment did not terminate but transferred to Cendant, his options should not expire due to termination. The court affirmed that employment terminated when the merger closed, so the employee

had only the original exercise grace period to exercise before the option expired.

Update: Deferred Compensation Rules and Equity Compensation

Code Section 409A Final Deferred Compensation Regulations Released

Enacted in 2002, Section 409A of the Code provides that unless certain requirements are met, amounts deferred under a “nonqualified deferred compensation plan” are immediately includible in gross income to the extent the income is not subject to a substantial risk of forfeiture (i.e., time-based vesting, future events, and so on) and was not previously included in income.

After several years of attempts at interpreting this complicated (and poorly drafted) provision, the IRS and the Treasury Department released the final regulations under Section 409A of Code in April 2007. It was originally intended to be effective on January 1, 2008, but the problems with the regulations and the statute proved too great to permit early enforcement. Final regulations are now scheduled to go into effect on January 1, 2009. To this end, Notice 2007-86 provides that transition relief is extended through December 31, 2008, and Notice 2007-89 provides guidance to employers and taxpayers on the reporting and wage withholding requirements for Section 409A amounts includible in income (or deferred) in 2007.

All nonqualified deferred compensation arrangements must be amended to conform to the final regulations by that date to avoid award recipients being hit with noncompliance penalties—the assessment of a 20% penalty tax plus interest, in addition to regular income and, if applicable, employment taxes. For periods before January 1, 2009, in most cases the transition rules and guidance previously published apply in a good-faith manner. These transition rules are very complex, so companies should check carefully with counsel regarding which rules require immediate compliance.

Major Changes

The final regulations contain the basic structure and principles of the previously released proposed regulations and guidance but

clarify certain definitions and provisions. For example, under the final regulations, private companies have more leeway to set fair market value than they did under the earlier proposed regulations (from 2005). In addition, the regulations also allow companies to extend expiration dates for equity compensation awards' without triggering penalties under Section 409A. Rules governing what constitutes "involuntary termination" for purposes of triggering Section 409A have also been expanded.

For equity awards, a number of new provisions now make compliance and/or exclusion from Section 409A easier, including:

- The post-termination exercise period for exempt stock options and SARs may be extended for the lesser of the expiration date of the award or the 10-year anniversary of the grant date without concern the award will fall under Section 409A. Further, if an award is underwater, the term may be extended without limit.
- A valuation safe harbor for "any reasonable method" provides more flexibility for private company valuations, permitting more assurance that stock options and SARs are exempt when granted. The safe harbor is also more widely available to private companies that are being acquired or going public.
- The definition of the type of stock that may be granted now includes any stock in a chain of organizations and any class of common stock within the meaning of Section 305 (including stock with liquidation preferences!).

The definition of "plan" for 409A purposes is still incredibly broad and includes any compensation that is contractually binding in one fiscal year but not paid until a subsequent fiscal year. This can mean anything from an individual employment contract to a full-scale compensation program covering many employees. Moreover, Section 409A and its regulations require companies to aggregate all deferred compensation plans into nine "buckets" of similar items. If one item in a bucket is deemed to be non-compliant, then everything else in that bucket is tainted and considered non-compliant.

Approaches to Dealing with Section 409A

Two main approaches to dealing with Section 409A have emerged since its enactment. The first is to use only plans that fall outside the purview of Section 409A—i.e., plans that are specifically excluded from the rules. The second is draft or amend plans to comply with those rules on their face.

The following plan types are specifically excluded from Section 409A:

- Non-discounted stock option or stock appreciation rights (SARs) and statutory stock option plans (Section 422 [ISO] and Section 423 [ESPP] plans)
- Qualified employer plans (i.e., Section 401(k) plans)
- Certain foreign plans
- Certain welfare benefits (i.e., sick leave, disability pay)
- Plans that allow for a short-term deferral (a deferral of no more than two-and-a-half months)

Alternatively, plans that constitute “deferred compensation” for Section 409A purposes can be drafted to comply with the rules. For example:

- *Timing of deferral:* The deferred compensation plan must be written and must specify the deferral election timing. Initial deferral elections must be made in the year before the year in which the deferred income is being earned. For newly eligible participants or if the compensation is subject to a substantial risk of forfeiture (for a period of at least 13 months), the election may be made up to 30 days after becoming eligible or after the unvested compensation is awarded. For performance pay, deferral elections may be made 6 months before the end of the performance period, as long as the performance period is at least 12 months long and the compensation amount is not readily ascertainable. The time and form of payment must also be specified at the time of deferral.
- *Severance payments:* May be exempt on their face if they are limited to the lesser of two times the employee’s annual com-

pensation or two times the limit set forth in Section 401(a)(17) and are payable on or before December 31 of the second year following the separation event. Alternatively, if properly drafted, payments made in the event of an involuntary termination may be treated as short-term deferrals (taking them out of the ambit of Section 409A). As noted above, the final regulations expand on the proposed regulations by allowing a “good reason” termination to qualify for the involuntary termination exemption. For public companies, payments to certain “specified employees” will be subject to a six-month delay post-termination. Note that lump-sum payments (if properly drafted) are NOT subject to the six-month delay, even when made to a specified employee.

The above is only a brief summary of some of the key provisions of Section 409A. Including the preamble, the final regulations are 397 pages long.² As always, it is important to keep Section 409A and the other Internal Revenue Code sections in mind when drafting new compensation plans; however, it is equally important not to lose sight of the purpose of the plan.

2. As mentioned above, the NCEO has a detailed white paper on Section 409A: Christine Zwerling, *Issue Brief: The Final 409A Deferred Compensation Regulations* (NCEO, 2008), available for order at www.nceo.org.