



New Stock Option Rules for Early Stage Companies

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Agenda

- I. Overview of Fair Value Changes Relevant for Early Stage Companies
- II. Update on Final 409A Regulations
- III. Valuation of Early Stage Companies for 409A and 123R Expense Calculations
- IV. What is a CFO to Do?



II. Update on Final 409A Regulations

Ken Appleby



Section 409A – An Overview

- Most far reaching benefits legislation since ERISA – Impact is felt in all types of benefits and many types of transactions
- Intended to address perceived abuses in executive compensation practices but goes well beyond that in application
- Replaces informal rules with specific legal rules



Section 409A – An Overview

- Documentary or operational violations will result in ineffective deferrals and severe penalties on executives and other employees
- Scope of new law is broad – any plan providing for the deferral of compensation, unless expressly excluded
- New rules are in addition to traditional concepts of constructive receipt, economic equivalence, etc.



Section 409A – An Overview

- Effective January 1, 2005
- Good faith compliance required until January 2008 given absence of guidance
- Documentary compliance required by end of 2007
- Final regulations effective January 2008
- Imposes reporting requirements on employers



409A and Equity Based Compensation Plans

- 409A applies to all deferrals of compensation not excluded by statute or regulation
 - Deferral arises from legally binding right during a taxable year to compensation that is or may be payable in a later year
 - Legally binding right may be subject to a substantial risk of forfeiture and still constitute a deferral



409A and Equity Based Compensation Plans

- Equity based compensation plans may involve 409A compensation deferrals
 - Restricted stock – no deferral as taxable when the restriction lapses
 - Restricted stock unit plans - deferral if delivery of the shares is deferred after right vests
 - Options and SARs – can result in deferral once exercisable
 - Equity based contract rights – generally involve deferral
 - Partnership and LLC carried interests have not been dealt with yet



409A and Equity Based Compensation Plans

- Application of 409A to Options/SARs
 - Statute – ISO and 423 Plan options are not subject to 409A
 - Legislative History – “409A does not cover grants of stock options where the exercise price can never be less than the fair market value of the underlying stock at the date of grant”
 - Notice 2005-1 – SARs are subject to 409A unless tied to public company stock and settled in stock; FMV NQOs excluded



409A and Equity Based Compensation Plans

- Application of 409A to Options/SARs
 - October 05 Proposed Regulations
 - The four tests for exclusion
 - NQOs and SARs not subject to 409A if:
 - Granted at FMV or higher
 - Number of shares is fixed
 - No other income deferral feature
 - Tied to service recipient stock



409A and Equity Compensation Plans

- Application of 409A to Options/SARs
 - October 05 Proposed Regulations - Definition of Service Recipient Stock
 - Common stock
 - If private, tied to most widely held common
 - If public, the common which is registered
 - Services are provided to the entity issuing the stock or an affiliate
 - No preferences as to liquidation or dividends
 - No put or call rights which are not section 83 lapse restrictions and not based on FMV
 - If issuer is investment vehicle, grants are only to direct service providers



409A and Equity Compensation Plans

- Application of 409A to Options/SARs
 - Final Regulations
 - Similar to proposed regulations in that NQOs and SARs excluded if four tests of proposed regulations are met
 - Broader affiliate definition, but anti-abuse rules added
 - No upstream grants
 - Service recipient stock definition expanded
 - Companies may issue options and SARs on any common shares (but see valuation issues below)
 - Common may be non-voting
 - Liquidations preferences are allowed
 - Rights of first refusal are allowed



409A and Equity Compensation Plans

- Application of 409A to Options/SARs
 - Other deferral features which would bring an option or SAR under 409A
 - A right to dividends during the option period (unless in separate plan)
 - A right to receive other than cash or stock on exercise
 - A right to exchange an option or SAR for tax deferred rights



409A and Equity Compensation Plans

- Options and SARs – Valuation Issues
 - Public Companies
 - Plan should specify how exercise price is determined based on reported prices
 - May use closing price on day before or day of grant
 - May use mean of high and low prices on either day
 - May use an average selling price over specified period within 30 days after grant date
 - May use an average selling price over a specified period prior to the date of grant, but only if grantee, number of shares, and method are specified before beginning of specified period
 - May use averaging as required by foreign law up to 30 days



409A and Equity Based Compensation Plans

- Options and SARS – Valuation Issues
 - Public Companies
 - Need proper, timely administrative process, particularly regarding grant date
 - Risk if administrative process fails
 - No ISO safe harbor for good faith



409A and Equity Based Compensation Plans

- Options and SARs -Valuation Issues
 - Private Companies – Basic Standard
 - “reasonable application of reasonable valuation method”
 - Not reasonable if valuation does not take into account all available information material to the value of the employer
 - Must consider all factors that would be considered in a formal valuation



409A and Equity Based Compensation Plans

- Options and SARs -Valuation Issues
 - Private Companies – Presumptions
 - Formal current valuation satisfying ESOP rules
 - Formula value, but only if also applied to 10% shareholders
 - Good faith internal valuation meeting formal valuation standard
 - Business must be less than 10 years old
 - No put or call right
 - No reasonably anticipated future change in control



409A and Equity Compensation Plans

- Options and SARs – Modifications
 - Changes in terms may result in new grant and application of 409A
 - Acceptable changes
 - Acceleration of vesting
 - Adding cash-less exercise
 - Grantor exercising discretion regarding transferability
 - Waiving or reducing exercise window following termination
 - Tolling exercise window under limited circumstances
 - Substitutions meeting 1.424-1 requirements following corporate transaction



409A and Equity Compensation Plans

- Options and SARs – Modifications
 - Prohibited Changes
 - Any direct or indirect reduction in exercise price
 - Extending original exercise period, unless underwater
 - Adding any new deferral feature
 - Exchanging right for a right to compensation in the future

Note – 409A rules do not line up with accounting rules for determining whether a new grant has occurred



409A and Equity Compensation Plans

- Equity Based Contract Rights
 - Generally subject to 409A requirements
 - Time and form of payment must be specified when right granted
 - Payment may be accelerated only based on permitted events (e.g., termination of employment, CIC)
 - Limited ability to extend initial deferral period



409A and Equity Compensation Plans

■ Foreign Employees

- 409A applies if employees subject to US tax
- 409A does not apply to broad based foreign retirement plans if:
 - Employee not eligible under US qualified plan;
 - Deferrals are non-elective, apply only to foreign income, and do not exceed Section 415 caps



409A and Equity Compensation Plans

- Transitional Rules – before 12/31/07 may:
 - Amend plans to satisfy 409A requirements, if applicable
 - Fix below market options, except for 16A executives
 - Add fixed payment term
 - Set exercise price to FMV on date of grant



409A and Equity Based Compensation Plans

- Some Closing Thoughts - Public Companies –
 - By end of 2007
 - Eliminate any deferral features in existing option, SAR or restricted stock plans or amend to comply with 409A
 - Incorporate 409A FMV language and consider need to use 409A definitions of disability, change in control, termination of service
 - Incorporate procedures for determining exercise price into option/SAR plan documents and establish good administrative practices
 - Bring other equity based plans into documentary compliance with 409A



409A and Equity Compensation Plans

- Some Closing Thoughts – Private Companies
 - By end of 2007 -
 - Bring all plans subject to 409A into documentary compliance
 - Review exercise price of all prior option and SAR grants (get appraisals)
 - Restate exercise price to FMV on date of grant
 - Substitute restricted stock or other excluded right
 - Substitute 409A compliant rights



409A and Equity Based Compensation Plans

- Some Closing Thoughts – Private Companies
 - Going forward
 - Obtain current appraisals for all future grants, or
 - Consider advisability of using traditional Options/SARs and consider increased use of restricted stock or contract rights
 - Create administrative procedures to promptly document all grants



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