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Structuring Stock Options and Severance Payments after Section 409A:

Practical Advice for Venture-backed Companies

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with special thanks to Edward Young

Most venture-backed companies do not have deferred salary or bonus plans and thus, understandably, expected the new tax rules on deferred compensation to be of little relevance to their day-to-day operations. However, Section 409A of the Internal Revenue Code reaches many arrangements not historically considered deferred compensation—including stock options and severance payments—and imposes steep penalties for violations of the new law. As a result, management and directors of venture-backed companies must understand the implications of Section 409A on such compensation arrangements.

There are two methods for avoiding the penalty provisions of Section 409A: (i) find a specifically enumerated exemption for the compensation arrangement (the preferable method) and stay clearly within it; or (ii) structure the arrangement to comply with Section 409A, which typically allows for much less flexibility. In most instances, stock options and severance arrangements can be structured to be exempt from, or to comply with, Section 409A. Generally, it is preferable for such arrangements to be exempt from Section 409A; however, the narrow scope of the exemptions is not always consistent with the economic agreement between, and business goals of, the parties. In fact, efforts to comply with Section 409A often force the parties to more fully discuss the arrangement and its retentive and motivational purposes. Undoubtedly, the only result to be avoided is noncompliance with Section 409A, which, as further explained below, results in draconian tax consequences for the employees and other service providers who are crucial to the growth of the company.

Following is a brief overview of Section 409A, some practical advice for venture-backed companies on how to implement and administer stock option programs and severance payment arrangements in light of Section 409A, and a discussion of the role of management and directors in the analysis of Section 409A issues related to the company's compensation arrangements. Also discussed are the potential liability issues that could arise in a case of gross negligence on the part of management and directors in undertaking that analysis.

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Overview

Section 409A applies to all deferred compensation plans and agreements entered into, or vesting after, January 1, 2005. The provision:

- establishes timing rules specifying when an election to defer compensation must be made; and
- dictates the permissible distribution events for deferred compensation.

If a compensation arrangement is not compliant with, or exempt from, Section 409A, the recipient will be required to pay income tax when the arrangement vests and, possibly, interest and a 20% penalty tax. In addition, the company may have reporting and withholding obligations.

Deferred compensation includes any agreement, plan or arrangement that provides for a deferral of compensation, with very limited exceptions. A deferral of compensation exists when there is a legally binding right in a tax year to compensation that is payable in a later year. A legally binding right can exist even if payment of the compensation is subject to contingencies, such as continued service or termination of service. Deferred compensation:

- Includes: salary and bonus deferrals (including accrued salary not paid); options and stock appreciation rights with below-market exercise prices; some employment severance and change-in-control agreements; and SERPs or excess benefit plans; but
- Excludes: retirement plans; vacation, sick, death and disability benefits; most options and stock appreciation rights with fair market value exercise prices; ESPPs; restricted stock; short-term deferrals; and certain foreign plans.

Issues Related to Stock Options

As mentioned above, the application of Section 409A to stock options continues to surprise many companies. Moreover, Section 409A must be considered at many stages with respect to an option. In particular, Section 409A must be considered upon:

- the grant of stock options;
- the modification of stock options; and
- the adjustment or cash-out of stock options in a merger or acquisition transaction.

While the IRS has not yet published guidance regarding the taxation of a stock option that is not exempt from, or compliant with, Section 409A, it is likely that the excess of the fair market value of the stock over the exercise price (i.e., the spread) will be taxable to the employee on the date that the option *vests*, and that the spread will also be subject to a 20% penalty tax and, possibly, interest. In light of these drastic consequences, most companies are taking great efforts to understand the rules related to the application of Section 409A to stock options.

The Grant of Stock Options

Companies must decide at the time of grant whether to structure their stock options to be exempt from Section 409A, or whether to forego exempt status, but otherwise comply with Section 409A.

Exempt Stock Options. Stock options will be exempt from Section 409A provided that they (i) are exercisable for the company's common stock; (ii) do not have a deferral feature; and (iii) have an exercise price that is at least equal to the fair market value of the common stock on the date of grant. As a result, the most significant issue for venture-backed companies under Section 409A has become whether the board's process for determining fair market value will be sufficient to exempt stock option grants from the new law. The IRS has provided the following guidance on this issue:

- For stock options granted before January 1, 2005, a good faith attempt to establish a fair market value exercise price for stock options (that is, the same standard historically used for incentive stock option purposes) is sufficient.
- For stock options granted on or after January 1, 2005, the more exacting standard of "any reasonable valuation method" must be used to establish fair market value.

In addition, the IRS has issued proposed valuation regulations that may be relied on immediately even though they are not scheduled to become effective before January 1, 2007. The proposed regulations provide that the fair market value of private company stock must be determined by the reasonable and consistent

application of a reasonable valuation method that considers all relevant facts and circumstances. A valuation performed by an independent third party no more than 12 months before the option grant date will be presumed to result in a reasonable valuation. The proposed regulations provide that the factors to be considered under a reasonable valuation method (whether undertaken by an independent third party or by the board) include, as applicable:

- the value of tangible and intangible assets;
- the present value of future cash flows;
- the market value of stock or other equity interests in similar companies;
- control premiums and discounts for lack of marketability; and
- whether the valuation is consistent with valuations used for other corporate purposes.

What does the IRS guidance mean from a practical perspective? Our thoughts and recommendations are as follows:

Pre-2005 Grants. Stock options granted before January 1, 2005, should be exempt from Section 409A provided the board made a good faith attempt to establish a fair market value exercise price for the options and the options do not otherwise include a deferral feature. A company that can satisfy this standard only needs to consider the application of Section 409A to those pre-2005 stock options that were intentionally issued at a discount or that include a deferral feature.

We recommend that companies carefully consider whether they complied with the good faith standard. Historically, the only consequence of a failure to make a good faith attempt to establish a fair market value exercise price was that options intended to be incentive stock options would be nonqualified stock options. In light of Section 409A, however, the stakes are now higher because such options could also be subject to the penalty provisions under the new law. Moreover, a finding by the IRS that the board did not act in good faith might have other far-reaching consequences besides the tax status of options.

Post-January 1, 2005, Grants. The standard of "any reasonable valuation method" for determining fair market value under Section 409A became applicable on January 1, 2005, and will remain in effect until final regulations are issued. It is clear that this standard is higher than the incentive stock option standard. Moreover, while the regulations are not yet effective, and may be revised before issued in final form, they are indicative of the approach and level of scrutiny that the IRS expects with respect to valuation. As a result, the common practice of valuing private company stock based on rule-of-thumb discounts and cursory board resolutions stating that "the Board has determined that the fair market value of the common stock is $X," will not be sufficient for purposes of Section 409A.

Therefore, for stock options granted by venture-backed companies on or after January 1, 2005, boards should carefully scrutinize their valuation process and confirm that the valuation would satisfy the "any reasonable valuation" standard. In the event the standard was not satisfied, the transition rules for Section 409A permit companies to amend stock options that are not compliant with, or exempt from, Section 409A before the option is exercised, and, in any event, before December 31, 2006. After December 31, 2006, stock options with below-market exercise prices that do not comply with Section 409A will be subject to early taxation and penalty tax. As a result, this review of post-January 1, 2005, stock options is important for employees, and could be important for the company to satisfy withholding obligations with respect to illiquid stock options.

For future stock option grants:

- At a minimum, the board should undertake a rigorous assessment of the qualitative and quantitative facts and circumstances related to the value of the company's stock in order to establish the fair market value of such stock. This analysis should be fully documented in corporate records, including board minutes.
- The safest approach is to have an independent third-party valuation of the company's stock contemporaneous with option grants. For practical rea-

sons, this may require a company to limit the number of times that options are granted each year.

- If recurring third-party valuations would be prohibitively expensive, the board might engage a third party to value the company's stock as of a specific date and to provide the methodology used to determine that value. The board could then use that methodology each time it subsequently grants stock options. The methodology may need to be updated from time to time as the company matures.

It is too soon to tell if one of the above valuation methods will emerge as the standard practice for venture-backed companies. We expect that the method used by such companies will change as they mature. A very early stage company may rely on its board to make the determination of fair market value because the relevant facts and circumstances may be limited during the company's infancy. Conversely, a more mature venture-backed company will likely turn to a valuation firm as the facts relating to valuation become more numerous and complex—and more subject to second-guessing by the IRS. Recent SEC guidance on cheap stock is another reason for later-stage companies that may be IPO candidates to seek an independent appraisal.

Compliant Stock Options. Structuring a stock option to comply with Section 409A will require, among other things, that the option be exercisable only upon a 409A-permissible event (which includes a specified date, termination of employment or a change in control). A stock option that complies with Section 409A has no restrictions as to the exercise price (and thus, can have a below-fair-market-value exercise price), and also can be over any company stock (including preferred stock).

As a practical matter, most private company stock options are exercised only upon a liquidity event (such as a change in control) or in connection with a termination of employment. As such, structuring a stock option to comply with Section 409A may not impose any meaningful limitations on the employee. However, the above terms must be fixed at the time the stock option is granted and, generally, may not be changed without triggering the 20% penalty tax under Section 409A. Moreover, the benefit of a stock option versus other forms of equity compensation has always been the ability of the employee to decide when to exercise, and thus dictate his/her tax event. To preserve that flexibility, a stock option must be structured in a manner that exempts it from Section 409A.

The Modification of Stock Options

Certain modifications of outstanding stock options can cause otherwise exempt stock options to become subject to Section 409A. Significantly, these types of modifications—particularly extensions of the option exercise period—have historically been quite common and have not had significant tax consequences. As a result, companies should carefully consider the following rules prior to any such modifications.

Reductions in Exercise Price. A change in the terms of a stock option that provides the holder with a direct or indirect reduction in the exercise price will cause Section 409A to apply to the option to the extent that the new exercise price is less than the fair market value of the stock as of the date of the reduction. Thus, an option repricing should not cause Section 409A to apply, provided that the repriced options do not have an exercise price that is below fair market value at the time of the repricing. The IRS has warned, however, that repeated repricings may indicate that the option exercise price is floating, thus triggering the application of Section 409A.

While direct reductions in option exercise prices are fairly obvious (for example, in connection with a repricing), indirect reductions are just as likely to occur. For instance, management incentive and retention plans (also known as "carve out" plans) are often implemented by a company in connection with a down-round of financing or when a company is otherwise struggling with its enterprise value. Allocations to employees under those plans are regularly tied to the number of stock options held by the employees, and may even provide that the payment under the plan is offset by the value of any options. If the allocations to employees under the plan are too closely tied to the employees' stock options and/or have offset provisions, it is likely that the plan will have the effect of reducing the exercise

price of those options to a price that is less than the fair market value of the company's stock on the date the plan is implemented. As a result, Section 409A could become applicable to those stock options even though the options are not directly modified.

Extension of Option Exercise Period. The extension of the exercise period of a stock option to a date beyond that originally permitted under the option will cause Section 409A to apply to that option unless the extension is limited to a safe harbor period. The safe harbor permits an extension of the stock option exercise period to the later of:

- the 15th day of the third month following the date in which the option otherwise would have expired; and
- December 31 of the year in which the option otherwise would have expired.

Extending the exercise period beyond the safe harbor without further modifications to the stock option could result in immediate taxation for all vested tranches of the option, a 20% penalty tax and interest. Because extensions of the option exercise period are fairly common, particularly in connection with terminations of employment, companies should exercise caution to limit any such extensions to the safe harbor period in order to avoid the application of Section 409A.

Acceleration of Vesting. The acceleration of vesting of a stock option generally will not cause Section 409A to apply to that option. This is the case both when the acceleration is pursuant to a provision contained in the option at the time of grant and when the acceleration is approved at a later date, for example, in connection with a change in control. However, for a 409A-compliant stock option, the acceleration of vesting cannot result in an acceleration of the date of payment (i.e., exercise) of the option, except in limited cases.

The Adjustment or Cash-Out of Stock Options in Connection with a Merger or Acquisition

An adjustment to stock options in connection with a merger or acquisition transaction generally will not cause Section 409A to apply to the options, provided that the adjustment does not increase the value to the holder. More specifically, an adjustment is permitted if the ratio of the exercise price to the fair market value of the shares subject to the stock option immediately before the adjustment is not greater than the ratio of the exercise price to the fair market value of the shares subject to the stock option immediately after the adjustment. As such, ordinary course adjustments to the number of shares and exercise price to reflect the exchange ratio for a transaction typically will not trigger Section 409A.

A cash-out of stock options in connection with a merger or acquisition transaction also, in most cases, will not cause Section 409A to apply to the proceeds of that transaction, even if some of the proceeds are paid in a later tax year, provided that:

- any payments made to the holders of stock options are made on the same schedule and under the same terms and conditions as payments to stockholders generally; and
- any such payments are made within five years of the transaction.

Thus, subject to the foregoing limitations, holders of stock options should be able to participate proportionately with stockholders in multi-year escrows and earnouts that may be established as part of the transaction without triggering the application of Section 409A.

Severance Payments

In another surprise to many venture-backed companies, Section 409A applies to severance payments, or "separation pay" in 409A parlance. Therefore, in order to avoid adverse consequences to employees, separation pay arrangements should be structured to be exempt from, or compliant with, Section 409A.

The proposed regulations include several potential exemptions for separation pay arrangements for involuntarily terminated employees. However, the proposed exemptions are available only for involuntary terminations, and no specific exemption has been provided for separation payments upon voluntary terminations. For

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Conclusion

In the past few years, buyout funds increasingly have begun to offer parallel AIVs to tax-exempt and non-U.S. investors to "block" UBTI and ECI from investments by the funds in pass-through operating companies. These structures are offered to investors either to satisfy the funds' UBTI and ECI undertakings in their partnership agreements—which have specifically been drafted with parallel AIVs in mind—or simply to be "investor friendly."

Although parallel AIVs do not prevent tax-exempt and non-U.S. investors from indirectly bearing U.S. federal income tax (and actually may increase the indirect tax cost as a result of the branch profits tax), they should prevent such investors from receiving allocations of UBTI and ECI, if the fund's partnership agreement is drafted properly.

While this enables tax-exempt investors to avoid reporting UBTI, non-U.S. investors are still technically required to file a U.S. tax return as a result of the fund's investment in the operating LLC, even though such investors have opted out of the investment through the fund. While non-U.S. investors who have no gross ECI currently can ignore this filing requirement without penalty, they risk being taxed on their gross ECI without the benefit of related deductions if in fact they actually earned gross ECI during any year in which they failed to file a U.S. tax return.

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this purpose, under the current proposals, leaving for "good reason" is considered a voluntary termination. Thus, separation payments made upon a voluntary termination must generally be structured to comply with Section 409A if paid pursuant to an agreement in place prior to the termination, rather than negotiated at the time of termination.

Exemptions. The following exemptions to Section 409A for separation pay are the most likely to be used by venture-backed companies:

- Payments made upon an involuntary termination will be exempt from Section 409A, provided that the payments do not exceed the lesser of (i) two times the employee's annual compensation for the calendar year preceding the year in which the termination occurs; and (ii) two times the maximum amount that can be taken into account under a retirement plan for the year (for 2006, this limit is $220,000). In order to fall within this exemption, all payments must be made no later than December 31 of the second calendar year following the calendar year in which the termination occurs.
- An agreement that provides for payments to be made solely upon an involuntary termination will be exempt from Section 409A, regardless of the amount of the payments, provided that the payments are made within the "short-term deferral" period. A short-term deferral exists if the payments are made by the later of (i) the 15th day of the third month following the employee's tax year in which the involuntary termination occurs; and (ii) the 15th day of the third month following the end of the company's tax year in which the involuntary termination occurs.
- Payments negotiated at the time of termination, whether as a result of an involuntary termination or a voluntary resignation, and regardless of the amount, will be exempt from Section 409A, provided that

the payments are made in a lump sum or within the short-term deferral period described above.

Significantly, in order for the first two exemptions to apply, the employee could not have a right to get severance upon a voluntary termination, including a good reason termination. If the employee has that right, the severance would not come within the exemptions. Moreover, companies should carefully consider how Section 409A will apply if an agreement provides for severance payments solely for an involuntary termination but the company in fact pays out on a voluntary termination—for example, when a board permits an employee to resign rather than terminating him for cause. Whether or not the severance payments violate Section 409A will likely depend on the particular facts and circumstances related to the termination.

Compliance. Separation pay arrangements that do not fall within one of the above exemptions, including those with multiple-year payouts or that include pro-employee good reason triggers, must be structured to comply with Section 409A in order to avoid the 20% penalty tax. For newly hired employees and new arrangements for existing employees, compliance with Section 409A is not overly burdensome. Compliance will generally require that the agreement:

- specify the amount of the payments (or a formula under which they will be calculated, such as a multiple of salary and bonus);
- state the circumstances in which the payments will be made;
- prohibit acceleration of the payments;
- allow deferrals of the payments only as permitted under Section 409A; and
- require that any payments made under the agreement after the company becomes publicly held be delayed by six months.

Compliant separation pay arrangements may be difficult to amend without violating Section 409A. Accordingly, management and directors should exercise care when negotiating such arrangements to ensure that the terms reflect the true intent of the parties. One consequence of the effort involved in structuring separation pay arrangements may be that fewer employees are entitled to the protection of those arrangements.

Director and Company Liability

Nothing in Section 409A or in its legislative history imposes personal liability on the directors for noncompliance with the guidance. In addition, aside from the withholding and reporting obligations under Section 409A, there are no consequences to, or obligations of, companies under Section 409A. In fact, many companies take solace in the fact that the adverse consequences associated with noncompliance—in particular, the 20% penalty tax—fall solely on the employees and not on the companies themselves.

Nevertheless, directors and companies continue to be concerned about liability under general corporate law principles. The company has a duty to deal equitably with its employees and not mislead them as to the benefits that option grants or similar transactions will afford them. Whether employees could sue the company, for example, for failing to employ a consistent and defensible method of determining the fair market value of its stock would depend on many factors, including whether the company's conduct was fraudulent, willfully inattentive to the employees' interests or merely negligent. Individual directors might have personal exposure if it could be demonstrated that he or she acted fraudulently or in bad faith, but most directors would be protected against claims of mere negligence or gross negligence by exculpation provisions contained in the company's governing instruments and/or by D&O insurance.

Conclusion

Privately held venture-backed companies have, to a large extent, avoided the direct impact of the far-reaching regulatory changes in the last few years that have significantly affected public company compensation practices. Section 409A, however, requires venture-backed companies to examine and, if necessary, alter their compensation practices to ensure that the employees and advisors who are helping to build the business are not adversely affected by the new tax law. ◎