



What Kind of Equity Plans Are Exempt, and What Are Not?

Presented by

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Professional Biography

Dan is an Officer of Greensfelder, Hemker & Gale, P.C. with over 25 years of experience representing business entities and executives in employee benefits and executive compensation law. A great deal of his law practice is devoted to equity compensation matters. His writings include published articles and book chapters on equity compensation issues. He is a frequent speaker at annual meetings of various professional trade organizations and bar associations.

Dan is a Fellow of the American College of Employee Benefits Counsel and Senior Editor of the highly regarded BNA treatise *Employee Benefits Law*.



What Will We Discuss?

- Equity-Based Arrangements Subject to § 409A
- Equity-Based Arrangements Not Subject to § 409A
- “Service Recipient Stock”
- “Eligible Issuer of Service Recipient Stock”
- Valuation Issues: Public & Private Companies
- “Material Modifications” of Stock Rights
- What Happens if § 409A is Violated?



Equity-Based Arrangements Subject to § 409A

§ 409A applies to any equity arrangement with a deferral feature, including—

- Non-qualified stock options or stock appreciation rights with exercise price below FMV on grant date or with a deferral feature
- Restricted or Deferred Stock Units Not Paid Upon Vesting
- Options to acquire (or stock appreciation rights relating to) stock that is not service recipient stock
- Stock options defer payment of cash or securities upon exercise



Equity-Based Arrangements Not Subject to § 409A

- Incentive Stock Options
- § 423 Employee Stock Purchase Plans
- Non-qualified stock options or stock appreciation rights with an exercise price at least equal to FMV on grant date, and with no other deferral features
- Restricted stock
- Promise to deliver stock in future upon satisfaction of vesting requirement (if delivery is made within short-term deferral period)
- Grandfathered arrangements, such as stock rights granted and vested before December 31, 2004



What is “Service Recipient Stock”?

- “Service Recipient Stock” refers to any class of stock considered common stock other than:
 - Classes of stock with preferences (other than a liquidation preference); and
 - Classes of stock subject to either mandatory repurchase obligation or a put or call right if stock price upon exercise is not based on FMV of stock
- Stock rights with respect to stock other than “service recipient stock” are subject to § 409A



Who is an “Eligible Issuer of Service Recipient Stock”?

- “Eligible Issuer of Service Recipient Stock” is direct service recipient or any higher entity up the corporate chain with a “controlling interest” in the direct service recipient
 - If parent is service recipient, service provider cannot receive stock rights of subsidiary
 - “Controlling interest” generally refers to at least 50% ownership in an entity.
 - May mean 20% ownership if legitimate business criteria exists to establish a connection between service provider and issuer of stock right



Valuation Issues: Publicly Traded Stock

- The Deferral Feature: Stock rights with an exercise price below FMV are subject to § 409A

FMV Methods for Publicly Traded Stock:

- Price of last sale before or first sale after grant
- Closing price on trading day before or trading day of grant
- Average of high and low prices on trading day before or trading day of grant
- Any other reasonable method using actual transactions in service recipient stock as reported by the markets



Valuation Issues: Publicly Traded Stock

(continued):

- Average of selling prices on all trading days during specified period within 30 days before or after applicable valuation date
- Weighted average of selling prices over specified period based on trading volume of the stock during that same period
- If required by applicable foreign law, a specified price averaging method and period which does not exceed 30 days



Valuation Issues: Private Company Stock

FMV Methods for Private Company Stock:

- FMV determined by “reasonable application of reasonable valuation method”
- Test of “reasonableness” is fact & circumstances on valuation date. Factors include:
 - Value of tangible/intangible company assets
 - Present value of expected future cash flows
 - Market value of stock or equity of similar businesses
 - Recent arm’s length sales or transfers of company stock
 - Control premiums or discounts for lack of marketability



Valuation Issues: Private Company Stock

Three FMV methods presumptively reasonable:

- Independent appraisal within last 12 months
- Formula that will not lapse
- For start-ups, method made in good faith and evidenced by written report. Cannot have change in control within 90 days or IPO within 180 days of valuation



“Material Modifications” of Stock Rights

“Material modifications” may result in treatment as new grant subject to § 409A. These include:

- Reduction in exercise price*
- Discretion to provide added benefits
- Change to stock terms that increase its value
- Increase number of shares subject to stock right*

[*other than stock split, stock dividend or corporate transaction]



“Material Modifications” of Stock Rights

“Material Modifications” do not include:

- Extension of exercise period to earlier of remaining original term or 10th anniversary of grant date
- 30-day extension needed due to foreign law requirements
- Reduction of exercise period
- Addition of ability to tender previously owned stock to pay exercise price
- Addition of provision allowing shares to be withheld to satisfy tax withholding
- Acceleration of vesting or exercisability



“Material Modifications” of Stock Rights

“Oops! I made a mistake! Now What?”

To avoid application of § 409A “inadvertent changes” to stock rights must be corrected by the earlier of:

- The date stock right is exercised or
- The last day of calendar year during which change is made



What Happens If § 409A Is Violated?

Stock rights or other equity awards subject to § 409A must comply or else—

- The failure will subject award holder to income tax upon vesting, plus 20% penalty tax and interest



Questions ?

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