

## Pricing public company stock options and SARs in the 409A era

Recently-issued proposed regulations under Section 409A of the Internal Revenue Code provide some guidance and flexibility for public companies in setting the exercise prices for their stock options, base prices for stock appreciation rights (“SARs”), and values for other stock-based compensation. This Alert summarizes the option pricing rules for public companies in the proposed regulations and their expected impact on stock option grant practices. (We will not mention SARs specifically in this Alert, but the same pricing rules will apply to the base price of a SAR, from which future appreciation is measured.) Although these are “proposed regulations,” they can be relied on currently, and we expect that most companies and tax advisors will treat them as applicable immediately, particularly with respect to stock options.<sup>1</sup> Click on the following links for Cooley Alerts describing the background and enactment of Section 409A, initial guidance from the IRS and Treasury, and other aspects of the new proposed regulations.

- ▶ **Enactment of Section 409A** [www.cooley.com/news/alerts.aspx?ID=000038715520](http://www.cooley.com/news/alerts.aspx?ID=000038715520)
- ▶ **Initial guidance under Section 409A** [www.cooley.com/news/alerts.aspx?ID=000038783320](http://www.cooley.com/news/alerts.aspx?ID=000038783320)  
[www.cooley.com/news/alerts.aspx?ID=000038824620](http://www.cooley.com/news/alerts.aspx?ID=000038824620)
- ▶ **Initial Alert on the Section 409A proposed regulations** [www.cooley.com/news/alerts.aspx?ID=000039067020](http://www.cooley.com/news/alerts.aspx?ID=000039067020)
- ▶ **Pricing private company stock options** [www.cooley.com/news/alerts.aspx?ID=39093920](http://www.cooley.com/news/alerts.aspx?ID=39093920)

Check [www.cooley.com](http://www.cooley.com) periodically for new Alerts on the proposed regulations, including an upcoming Alert on how the proposed regulations affect other aspects of equity compensation.

### Discounted stock options under Section 409A

Under Section 409A, any stock option having an exercise price less than the fair market value of the underlying stock determined as of the option grant date constitutes a deferred compensation arrangement that typically will result in adverse tax consequences for the option recipient and tax withholding responsibility for the granting company. (We will refer to such stock options as “discounted options.”) These adverse tax consequences are described in more detail in our prior Alerts on Section 409A. They include taxation at the time of option vesting rather than the date of exercise (or later), a 20% additional tax on the optionee in addition to regular income and employment taxes, and a potential interest charge. The granting company is required to withhold applicable income and employment taxes at the time of option vesting, and possibly additional amounts as the underlying stock value increases over time.<sup>2</sup>

### Public company valuation methods

The proposed regulations specify several methods that taxpayers may use to value stock that is readily tradable on an established securities market for purposes of setting option exercise prices. Over-the-coun-

ter markets and many foreign markets are considered established securities markets. But stock listed on such markets must in fact be “readily tradable” to be eligible for the valuation methods described below.

Under the proposed regulations, the fair market value of readily tradable stock may be based upon any of the following methods:

- ▶ the last trading price before the grant;
- ▶ the first trading price after the grant;
- ▶ the closing price on the trading day before the grant;

### KEY ATTORNEY CONTACTS

Dan Meehan . . . . .	720/566-4061 dmeehan@cooley.com
Buff Miller . . . . .	650/843-5351 bmiller@cooley.com
Bill Morrow . . . . .	415/693-2170 morrowwb@cooley.com
Susan Philpot . . . . .	415/693-2078 philpotsc@cooley.com
Thomas Reicher . . . . .	415/693-2381 treicher@cooley.com
David Walsh . . . . .	703/456-8021 dwalsh@cooley.com
Thomas Welk . . . . .	858/550-6016 twelk@cooley.com

This information is a general description of the law and is not intended to provide specific legal advice.

Copyright © 2005 Cooley Godward LLP, 3000 El Camino Real, Palo Alto, CA 94306. Permission is granted to make and redistribute, without charge, copies of this entire document provided that such copies are complete and unaltered and identify Cooley Godward LLP as the author. All other rights reserved.

- ▶ the closing price on the trading day of the grant;
- ▶ the average trading price taken from a specified period that is within 30 days before or after the grant, but only if the commitment to grant the option with a price based on such average is irrevocable before the beginning of the specified period;
- ▶ any other reasonable method that is based upon actual trading prices reported by the established securities market.

Regardless of which method is chosen, employers should be consistent in their approach. In particular, the proposed regulations specify that if either of the last two methods above is used, the chosen method must be consistently applied to option grants under similar programs.

### Practical implications for public companies

We do not expect the proposed regulations to have a significant effect on public company stock option pricing practices. The proposed regulations do provide welcome clarification and flexibility concerning the permissible trading prices that may be used to price options. It has long been unclear whether public companies should price an option based on the closing price from the day prior to the grant, the average of the high and low on the day of the grant, or the closing price on the day of grant. The proposed regulations clarify that any of these methods, consistently applied, will be respected.

### What to do about previous option grants

Some public companies have outstanding options that were granted intentionally with a discounted exercise price. Some of these stock options are subject to Section 409A because they were granted after October 3, 2004, or because they vested (in whole or in part) after December 31, 2004. What should companies do about such option grants? There are several available alternatives. The proposed regulations and

IRS Notice 2005-1 allow companies time to “fix” discounted stock options and other deferred compensation arrangements that do not comply with Section 409A. The chart accompanying this Alert describes various option grant permutations, whether Section 409A is applicable, whether a correction is appropriate, and the applicable deadline.

For existing discounted stock options, one of the following correction methods may be used in order to avoid the adverse consequences of Section 409A:

- ▶ Before January 1, 2007, raise the strike price of the noncomplying option to fair market value as of the option grant date. In addition, it is permissible for the company to pay the optionee a cash or stock bonus (which will be taxable) to compensate for any lost economic benefit. If the company “ties” the cash or stock bonus to the increase in the option price (i.e., as a means of obtaining optionee consent), the cash or stock bonus must be paid before January 1, 2006 (notwithstanding that the increase in the exercise price need not occur until January 1, 2007). Alternatively, the cash or stock bonus may be made subject to a vesting schedule and/or delivered in the future as part of a deferral arrangement. If the cash or stock is to be paid or delivered in the future, such arrangement would need to comply with the requirements of Section 409A, unless payment or delivery is made within a short period of time after vesting pursuant to the short-term deferral exception (2 ½ months after the taxable year of vesting).
- ▶ Exercise the option before January 1, 2006.
- ▶ Before January 1, 2006, exchange the discounted option for stock having a value equal to the difference between the fair market value and the exercise price (i.e., the “spread” on the option).
- ▶ Before January 1, 2006, exchange the discounted option for cash equal to the spread on the option. Alternatively, the

cash may be made subject to a vesting schedule and paid at a future date; such an arrangement would need to comply with the requirements of Section 409A, unless payment is made within a short period of time after vesting pursuant to the short-term deferral exception.

Note that any corrective action, other than merely raising the exercise price of the option, may result in immediate or deferred application of income and employment taxes, but if properly structured would avoid the application of the additional taxes imposed by Section 409A. Corrective action will usually require board approval and optionee consent as well. In certain cases, corrective action may have financial accounting consequences.

### Conclusion

We expect that the proposed regulations, along with recent changes in the financial accounting rules and practices, will usher in a new era of stock option pricing and compensatory stock valuation among private companies. Boards of directors should be consulting with counsel now to determine how best to address these changes. Please feel free to call any member of the Cooley Godward Compensation & Benefits Group or Tax Group with questions about Section 409A and the proposed regulations.

### Circular 230 Disclosure

The following disclosure is provided in accordance with the Internal Revenue Service’s Circular 230 (21 CFR Part 10). Any tax advice contained in this Alert is intended to be preliminary, for discussion purposes only, and not final. Any such advice is not intended to be used for marketing, promoting or recommending any transaction or for the use of any person in connection with the preparation of any tax return. Accordingly, this advice is not intended or written to be used, and it cannot be used, by any person for the purpose of avoiding tax penalties that may be imposed on such person.

## Decision Matrix for Previously-Granted Discounted Options

Description of Option	Status under 409A	Corrective Action Needed?
At-the-money (nondiscounted) stock option granted at any time	Exempt from 409A by virtue of the general rule exempting at-the-money option grants	None needed—make sure no material modifications are made that will result in loss of exemption
Discounted stock option granted prior to 10/4/04 and earned and vested by 12/31/04	Exempt from 409A by virtue of the grandfather provisions.	None needed—make sure no material modifications are made that will result in loss of grandfather status
Discounted stock option granted after 10/3/04 and before 12/31/04 and earned and vested by 12/31/04. (Option not yet exercised.)	Potentially subject to 409A unless it can be shown to be part of a pattern and practice	Determine if a pattern and practice of granting discounted options in the relevant time period can be established. If yes, see above. If no, see below.
Discounted stock option granted prior to 12/31/04 but not earned and vested by 12/31/04. (Option not yet exercised.)	Subject to 409A since it qualifies for neither the general exemption nor the grandfather exemption, but eligible for transition relief	See list of correction alternatives in text of Alert and discuss with counsel.
Discounted stock option granted after 12/31/04 and prior to 12/31/05	Subject to 409A, but eligible for transition relief	See list of correction alternatives in text of Alert and discuss with counsel.
Option (whether or not discounted) that is with respect to stock other than common stock and was not earned and vested on 12/31/04. An option of this type may be part of a “carve out plan” for a privately held company.	Does not qualify for the at-the-money exemption, but arguably can rely on Notice 2005-1 until 1/1/07. Can still qualify for the ISO exclusion.	Corrective action may be required. Discuss with counsel.
Option having a “feature for the deferral of compensation” (other than vesting)	Apparently subject to 409A	Corrective action required. Discuss with counsel.

### Notes

1 Although the proposed regulations are not yet technically effective, IRS Notice 2005-1 (guidance under Section 409A that is currently effective) requires taxpayers to comply with Section 409A in “good faith” during this transition period. Compliance with the proposed regulations will be considered good faith for this purpose. Because the

proposed regulations contain the only rules on numerous issues under Section 409A, the IRS is likely to apply the principles described in the proposed regulations even before they become effective, and many companies likely will wish to utilize those principles to ensure good faith compliance during this transition period.

2 Although the IRS has informally indicated that the 20% additional tax is not a withholding tax, no formal guidance to this effect has been issued.