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CORPORATE LAW ISSUES

The Corporate Law Department at Murtha Cullina is pleased to provide clients and friends with information about topics of interest in the corporate law area.

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Highly Anticipated Final Regulations Under Section 409A Released

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On April 10, the Treasury issued long-awaited final regulations under Code Section 409A (the "Final Regulations"). Section 409A and the interim guidance issued under it have clearly changed nonqualified deferred compensation, including expanding those arrangements that are deemed deferred compensation. The interim guidance also raised numerous questions and concerns regarding the structure of deferred compensation. The Final Regulations answer many of these questions and allay many of these concerns. The regulations, including preambles, are 397 pages long and it is impossible to summarize all of the provisions in a bulletin of this length. However, this bulletin discusses many of the highlights of the Final Regulations. Because the Final Regulations require that all arrangements subject to Section 409A be amended by December 31, 2007, it is imperative that employers identify all arrangements that are potentially subject to Section 409A as soon as possible.

Plan Aggregation Rules

Under proposed regulations, all nonqualified deferred compensation arrangements in which an individual participates are aggregated with other arrangements of the same type that the employer sponsors for that individual. Therefore, a failure to comply with Section 409A with respect to one plan in an aggregated group generally leads to all plans in that group being subject to Section 409A's penalties. While the Final Regulations retain the notion of aggregation, they expand the categories into which plans are aggregated, reducing the likelihood that a violation of Section 409A with respect to one plan will lead to other plans being subject to penalty. Under the Final Regulations, deferred compensation is aggregated into the following categories:

- Elective account balance plans;
- Non-elective account balance plans (including employer matches);
- Non-account balance plans (such as defined benefit-type SERPs);

- Separation pay plans (solely for involuntary terminations or terminations pursuant to a voluntary window program);
- Split dollar life insurance plans;
- Reimbursement plans;
- Foreign plans;
- Plans providing for equity compensation; and
- All other plans not fitting into the categories described above.

These changes will give employers greater flexibility in structuring equity compensation arrangements...

Time and Form of Payment

Section 409A generally requires that the time and form of payment of nonqualified deferred compensation be set when the initial deferral election is made. The Final Regulations clarify issues regarding setting the time and form of payment.

- Under the proposed regulations, paying deferred compensation a day earlier than the applicable plan provided would have been a violation. The Final Regulations provide relief for certain payments made up to 30 days prior to the applicable payment date.
- The Final Regulations provide that the ability to elect one form of annuity versus another at the time benefits commence is generally not a violation of the prohibition against acceleration or a subsequent deferral of deferred compensation, provided the alternate forms are actuarially equivalent.
- The Final Regulations clarify that it is permissible to provide that payment will occur upon the earlier or later of several permissible payment events.

Equity Compensation

The proposed regulations under Section 409A exempted certain equity compensation from Section 409A, including most stock options that are granted at fair market value, provided the underlying stock is "service recipient stock." The Final Regulations broaden the definition of "service recipient stock" in two ways. First, they expand those employers within a controlled group whose stock is deemed service recipient stock. Generally, service recipient stock includes the stock of the employer, or any other corporation up the parent-subsidiary chain, provided there is at least 50% ownership. The parties may substitute a percentage as low as 20% for 50% if there is a legitimate business reason. The Final Regulations also expand what classes of stock satisfy the definition of service recipient stock. Under the Final Regulations, most classes of stock can be treated as service recipient stock, including classes that contain a liquidation preference, but not classes that provide preferential dividend rights. These changes will give employers greater flexibility in structuring equity compensation arrangements to be exempt from Section 409A.

The proposed regulations provided that most extensions of time for exercise of an otherwise exempt option would have made the option subject to Section 409A. As it is common for companies to extend the exercise period for options, this provision raised much concern. The Final Regulations liberalize the circumstances under which the exercise period can be extended. They provide that an extension will not make an option that is otherwise exempt subject to Section 409A if the option is not extended beyond the earlier of the latest date under which the option would have expired under its original terms or ten years from the date of grant. If the option is "underwater" at the time of the extension, it can be extended even further.

In addition to these changes, the Final Regulations provide more detailed guidance on permissible methods for valuing service recipient stock, as well as providing that different valuation methods may be used at different times. The Final Regulations permit an averaging method of valuation if the stock in question is traded on an established securities market, provided the averaging period begins after the grant is irrevocably made, and the grant includes the identity of recipients, the number of shares and the method for determining the exercise price.

The exemptions for certain severance pay in the proposed regulations have been clarified and expanded in the Final Regulations.

Separation Pay

The exemptions for certain severance pay in the proposed regulations have been clarified and expanded in the Final Regulations.

The Final Regulations provide exemption from Section 409A for severance pay payable on involuntary termination (or during a voluntary window program) if payment is made by the end of the second year following separation and does not exceed the lesser of two times the employee's prior year annual salary or two times the Code Section 401(a)(17) compensation limit ($225,000 for 2007). This exception can be used for a portion of separation pay, even if the total pay exceeds the time limit or the dollar amounts. The portion that falls within the dollar and time limits will be exempt from Section 409A, and anything that exceeds the limits will be subject to Section 409A. This can be of particular importance in the case of terminating executives in publicly traded companies, since exempt payments are not subject to the six-month delay on payments following separation from service that many public company executives are otherwise subject to.

The Final Regulations also provide circumstances under which a "good reason" termination will be considered an involuntary termination. This is important because under the proposed regulations it appeared that an arrangement that allowed for a good reason termination would not be eligible for the exemption discussed above, or a more general "short term deferral" exemption for amounts paid within two and a half months of the end of the year in which the employee's right to such amount vests, even if actual termination was involuntary. By providing that certain good reason terminations may be treated as involuntary terminations, the Final Regulations make these exemptions available under more circumstances. The Final Regulations provide a non-exclusive safe harbor good reason provision that will be treated as an involuntary termination. The definition includes types of events that can constitute good reason, including material diminution or changes in base pay, authority, supervised budget or work location.

The safe harbor requires the termination to occur within two years of the initial event that constitutes good reason, and that benefits paid in the event of a good reason termination be substantially the same as those paid upon involuntary termination. The safe harbor also requires that the employee give notice of the condition giving rise to the ability to terminate for good reason within 90 days of its occurrence, and allow the employer 30 days to cure the condition. Because of the complexity of rules regarding separation pay, all severance, employment and similar agreements should be carefully reviewed for compliance with Section 409A.

Other Important Changes

The Final Regulations provide relief in several other areas.

- Indemnification arrangements. These are generally exempt from Section 409A.
- Tax gross-up payments. While these are not exempt, the Final Regulations provide guidance on structuring such payments to comply with Section 409A.
- Certain reimbursements (including tuition) and in-kind benefits. Some of these benefits are exempted entirely, others are exempted for a period of time.
- Bonus plans. The Final Regulations confirm that these are generally subject to Section 409A, and generally need to be in writing and structured to meet the fixed payment requirements of Section 409A. Although some such plans may fit within the "short term deferred" exception to Section 409A, it is still recommended that such plans be put in writing.

If you would like assistance in identifying or amending arrangements subject to Section 409A, please contact Bill Keenan at 860-240-6028 or Liz Gioia at 860-240-6054.

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