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NEW TAX AND ACCOUNTING GUIDELINES AFFECT STOCK OPTION PLANS AND OTHER EQUITY INCENTIVE PLANS

Public and private companies with stock option plans and other equity incentive plans need to evaluate how to deal with these important developments in tax law and accounting principles:

- Section 409A of the Internal Revenue Code, which imposes strict requirements for deferred compensation programs and imposes an individual 20% additional tax on deferred compensation programs that do not satisfy those requirements. Under recently proposed regulations, most stock option programs and other equity compensation plans should be exempt from the Section 409A requirements. However, there are some practices under equity compensation plans that are problematic under Section 409A.

- Statement of Financial Accounting Standards 123R, which changes the accounting treatment for most equity compensation plans. FAS 123R must be adopted by public companies (other than small business issuers) by the beginning of the next fiscal year that starts after June 15, 2005, and by all other companies by the beginning of the next fiscal year that starts after December 15, 2005.

This memorandum is not intended to provide a comprehensive discussion of Section 409A or FAS 123R, both of which are extremely complex. The purpose of this memorandum is to describe particular problem areas for equity incentive plans and describe actions that companies should consider in the near future under these new guidelines.

SECTION 409A

Beginning in 2005, Section 409A governs deferred compensation plans and places significant limitations on the structure of traditional deferred compensation programs and severance payment arrangements. Section 409A has little or no impact on most traditional stock option plans and other equity compensation programs which include stock appreciation rights (SARs), restricted stock and most other stock-based benefits. Under the proposed regulations issued by the IRS in October 2005, stock options are exempt from 409A restrictions as long as (1) the exercise price can never be lower than the exercise price on the date of grant and (2) there are no special "deferral features" to defer income. SARs are similarly exempt in most cases. Restricted stock is also generally not subject to Section 409A.

However, the proposed IRS regulations under Section 409A create new issues, as described below, that must be considered immediately by any company with a stock option

plan or SAR program. It is critical that public and private companies conform their equity compensation practices to Section 409A requirements immediately, as Section 409A already applies. Outstanding compensation agreements and arrangements that do not comply with Section 409A can be amended before the end of 2006, if they follow the rules before the amendment. However, in limited circumstances as described below, certain amendments are only permitted on or before December 31, 2005.

Valuation Issues That Affect Option Exercise Price Under Section 409A

The proposed regulations provide that stock options are not exempt from Section 409A, unless their exercise price can never be less than the "fair market value" of the underlying stock on the date of grant. The proposed regulations provide specific guidance for determining the fair market value of the underlying stock for purposes of Section 409A. The chosen method must be applied consistently for all options.

Public companies should consider the following:

- In order for an option to be exempt from Section 409A, the exercise price must be based on the fair market value of stock on the "date of grant". The date of grant is the date on which the options are authorized by the person or persons with the authority to grant options under the plan – generally, the compensation committee. The fair market value will generally be based on the trading price on that date or the preceding trading day. Therefore, if an option is granted with an exercise price based on the trading value of the stock on a date earlier than the authorizing action (for example, based on the trading value on the date of an earlier offer letter), this may create tax problems for the recipient under Section 409A.

- As an alternative, Section 409A permits the calculation of the fair market value based on the average trading price for a range of dates before or after the grant date. This practice may become more attractive under the new accounting rules described below (FAS 123R), because the compensation expense for accounting purposes will not be greatly different whether the price is based on a single trading date or the average of a range of dates. In order to qualify under Section 409A, the range of dates may not extend more than 30 days before or after the grant date, and the other terms of the option must be fixed prior to the beginning of the period. In any event, the method of determining the exercise price must be consistently applied to all options.

Privately held companies should consider the following in determining the exercise price of options:

- A private company may use several methods for determining the fair market value of its stock. However, no matter what method is used, it must be reasonable and must be used consistently. In order to be considered reasonable, the valuation must consider all available information material to the company, and generally should take into account: the value of tangible and intangible assets, present value of future cash flows, the market value of stock or equity interests in similar corporations or entities engaged in

substantially the same business and other relevant factors, such as control premiums or minority discounts.

- There are a few methods for determining fair market value that will be *presumed* to result in a "reasonable" valuation (unless the IRS can establish that the use of the method was grossly unreasonable), including (1) a formal appraisal by an independent appraiser; (2) for certain early stage ("start-up") corporations that do not have a trade or business they have conducted for ten years, a written valuation report by a person who need not be independent but has significant knowledge and experience or training in performing similar valuations, if certain other requirements are met; or (3) certain valuation formulas, provided that the subsequent sale of the shares will be at a price determined by the same formula and other conditions are met.

- Once the fair market value is calculated, it is not reasonable to continue to use the same valuation if (1) the valuation is more than 12 months old or (2) there is subsequent information that materially affects the value of the company (e.g., settlement of litigation or issuance of a material patent).

Outstanding Options That Were Granted Below Fair Market Value

Outstanding options that may have been granted at an exercise price lower than the fair market value of the underlying stock on the date of grant, under the standards described above ("discounted options"), must be reviewed to determine whether they need to be amended to avoid tax liability under Section 409A:

- Outstanding discounted options that became fully vested on or prior to December 31, 2004, are exempt from 409A requirements, unless they were amended on or after October 3, 2004 to provide any extension of their termination date or make certain other "material modifications" enhancing the participant's rights. Under a transition rule, outstanding discounted options are also exempt from Section 409A if they are exercised on or before December 31, 2005.

- Outstanding discounted options that are not exempt may be amended, before the end of 2006, to increase the exercise price so that it is not less than the fair market value on the date of the original grant. If the company chooses to compensate the participant for the loss of the discount, generally the compensation to the option holder must be in the form of deferred compensation or restricted stock. (If the amendment is completed and the compensation is paid on or before December 31, 2005, it may also be in the form of cash or stock.) Alternatively, the outstanding discounted options must be amended to provide for a fixed payment time and payment schedule.

Material Modifications to Options

"Modified options" are options where the terms have been changed, such that the holder may be provided with an direct or indirect reduction in the exercise price of the stock right, or an additional deferral feature, or an extension or renewal of the stock right, regardless of whether the holder actually benefits from the change in terms. Such modifications are treated as the grant

of a new stock right as of the date of the modification. The new grant may be exempt from Section 409A if the new stock right is not a discounted option and does not otherwise contain a deferral feature.

However, if the modification involves an extension of the exercise period of the option, the extension may be deemed to be a deferral feature which will cause the original and the new grant to be subject to Section 409A from the date of the original grant. Consequently, the modification will create a violation of Section 409A, unless the grant otherwise satisfied the requirements for deferred compensation under Section 409A, including a fixed exercise date and other provisions not contained in the typical option grant. The proposed regulations do permit the Company to extend (or allow the option holder to extend) the exercise date up to the later of (a) the 15th day of the third month following the end of the original exercise period or (b) December 31 of the calendar year in which the stock right would have expired if it had not been extended.

Most other amendments to stock options, including acceleration of vesting (where the option is not otherwise subject to Section 409A) will not trigger a violation of Section 409A.

Deadlines/Action Items Under Section 409A

You should quickly review all equity and other compensation arrangements to determine whether they may involve deferred compensation, and if so whether such arrangements must comply with Section 409A.

Generally, you will have until December 31, 2006, to amend deferred compensation arrangements (including stock option and other equity compensation plans) to comply with Section 409A. However, all plans must currently be administered in compliance with Section 409A. Based on the requirements of Section 409A described above, the following is a list of items that should be considered immediately:

- Avoid Discounted Options. Do not grant discounted options. The date of grant is the date on which the options are authorized by the person or persons with the authority to grant options under the plan. Avoid offer letters or correspondence setting an exercise price which may not be the fair market value of the stock on the date the grant becomes authorized.

- Amend Outstanding Discounted Options to Eliminate Discount. Any options (*including* compensatory warrants that were granted to consultants) that were granted at below fair market value must be either eliminated or amended to comply with Section 409A on or before December 31, 2006, and should not be exercised after 2005, unless they are amended to comply with Section 409A prior to their exercise. Although a company has until December 31, 2006, to amend its plans or arrangements to comply with Section 409A, **if a company wants to pay a cash or stock amount to the option holder to compensate for the loss of the discount, the discounted options must be eliminated or amended and the payment made on or before December 31, 2005**.

- No Extensions of Exercise Period. In order to avoid Section 409A liability for employees, the company must not extend the exercise period of any option beyond the

later of (a) the 15th day of the third month following the end of the exercise period or (b) December 31 of the calendar year in which the stock right would have expired if it had not been extended, unless such extension otherwise satisfies the requirements of Section 409A.

- Revocation of Amendments or Elections; Termination of Participation in the Plan. If amendments or elections have previously been made with respect to options or other awards that would otherwise result in a violation of Section 409A or make the option subject to Section 409A, those amendments and elections can generally be revoked as long as revocations are completed before December 31, 2005 (or, if earlier, the date the option or other award is exercised). This would apply, for example, to a stock option that was amended during 2005 to extend the exercise period. If the plan needs to be amended to provide for revocation of amendments or elections or termination of participation, the amendment must be enacted and effective on or before December 31, 2005, or the date of the amendment, termination, or revocation, if earlier.

- Seek the Advice of Counsel before Granting, Modifying or Exercising Options. You should obtain legal advice before granting or modifying any options or equity compensation plan, and before allowing any employee to exercise any option or other stock right, to ensure that the grant, modification or exercise will not violate Section 409A.

FAS 123R

As you are probably aware, FAS 123R will result in a charge to earnings for stock options granted with an exercise price equal to or greater than the fair market value of the stock on the date of grant. For most companies, FAS 123R will not require any amendments to the company's stock plan or stock option agreements. However, companies should do some planning now to prepare for the change:

- Under FAS 123R, restricted stock is becoming more popular, as grants of restricted stock can be made that have the same value to employees as a stock option grant and an equivalent accounting charge but use fewer shares from the plan reserve. More companies will also consider issuing other equity-based awards, such as performance shares and restricted stock units. Companies should make sure that their stock incentive plans provide maximum flexibility and should consider adopting a so-called omnibus plan that permits a wide range of equity compensation.

- SARs that are paid out in shares of stock will also become more popular under FAS 123R. SARs are similar to stock options but ultimately use fewer shares, because only a portion of the shares subject to the SAR are issued upon exercise. SARs are similar to stock options with a cashless exercise feature. Under the previous accounting rules, SARs resulted in very unfavorable variable accounting, whereas under FAS 123R, stock-settled SARs generally involve the same accounting treatment as stock options. Companies may want to ensure that their stock incentive plans permit the granting of SARs. **Note**: SARs are not advisable for privately held companies, because SARs for such companies will be

subject to deferred compensation restrictions and possible individual tax liability under Section 409A, described above.

- Companies will also want to consider changes in the terms of their stock option grants that will result in smaller charges to earnings in future periods. For example, many companies are considering granting options with shorter terms and longer vesting periods. These changes in terms tend to reduce the fair value of the options at the time of grant.

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If you have questions about the effects of Section 409A and FAS 123R on your company's stock option plans or other equity compensation plans, you may contact any member of our executive compensation and tax team. This team includes, among others, Marty Rosenbaum (612-672-8326), Mark Baumann (612-672-8339), Larry Koch (612-672-8322) and Barry Gersick (612-672-8384).

Limited Use of Tax Advice. Treasury Circular 230 requires our firm to add the following statement to this letter, because this letter is not intended to be a formal tax opinion that would satisfy the Circular's rules for such opinions. Any tax advice included in this letter is not intended to be used, and cannot be used, by any taxpayer for the purpose of avoiding tax penalties that may be imposed under the Internal Revenue Code.

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