



FENWICK & WEST LLP

Executive Compensation and Benefits

Publication of IRC Section 409A Proposed Regulations

SEPTEMBER 30, 2005

On September 29, 2005, the Treasury Department released the much anticipated Proposed Regulations to Section 409A of the Internal Revenue Code (the "Proposed Regulations"). This is a summary of some of the more relevant points of the Proposed Regulations with respect to the equity compensation issues for public companies. We are reviewing the Proposed Regulations, which are 238 pages in length, and we will be preparing a more detailed analysis in the near future.

Stock Options

The Proposed Regulations confirm that options granted by a *service recipient* with an exercise price equal to or greater than the fair market of the issuer's stock on the date of grant will not be subject to Section 409A. The fair market value of the stock may be determined by a variety of methods, including using the last trading price before or the first trading price after the date of grant, provided the method used is applied consistently. There are special rules that define service recipient to include companies outside of a corporate "affiliated group."

Stock Appreciation Rights

The Proposed Regulations confirm that, if a stock appreciation right (an "SAR") is granted with a measurement price (the price over which appreciation will be measured upon settlement) equal to or greater than the fair market value of the issuer's stock on the grant date, the SAR will not be subject to Section 409A. SARs granted with measurement prices at or above fair market value will be

exempt from Section 409A regardless of whether they may be settled in stock or cash or some combination thereof.

Modifications of Stock Options and SARs

The Proposed Regulations provide that a modification or amendment of a stock option or SAR that accelerates the vesting of such award will not be deemed a new grant at below fair market value under Section 409A. Likewise, a modification that extends the term of an award will not be deemed a new grant at below fair market value, provided the term of the award is not extended beyond the later of the 15th day of the third month following the date at which, or the end of the calendar year in which, the award would have otherwise expired prior to modification or amendment.

Mergers and Acquisitions

The assumption or substitution of an equity award in the context of a merger or an acquisition pursuant to a merger agreement negotiated at arms length generally will not result in an impermissible modification under Section 409A provided the ratio of the per share exercise price, or per share measurement price in the case of SARs, to the fair market value of the underlying stock is not altered.

Again, we plan on providing additional analysis after we have had a chance to further review the Proposed Regulations. If you have any questions please contact Scott Spector at 650-335-7251 or sspector@fenwick.com.

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