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Commentary to Model Equity Compensation Plan Exempt From Section 409A

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The ABC, Inc. Equity Compensation Plan (the ''Model Plan'') is designed to satisfy the exemptions from Section 409A of the Internal Revenue Code of 1986, as amended (the ''code'')[1] for equity compensation plans under the final Section 409A regulations (the ''Final Regulations'').[2] The Final Regulations contain exemptions for nonqualified stock options,[3] incentive stock options,[4] stock appreciation rights (''SARs''),[5] and restricted stock.[6]

The Model Plan contains the provisions that satisfy the requirements of the exemptions for equity compensation plans. It also contains provisions that satisfy the requirements of the Final Regulations for nonqualified deferred compensation plans that are subject to Section 409A, but are not otherwise necessary to satisfy the requirements for the exemptions for equity compensation plans. Service recipients[7] may wish to use the provisions that satisfy the requirements for nonqualified deferred compensation plans in their equity compensation plans so that the equity compensation plans are consistent with the nonqualified deferred compensation plans that cover the same group of service providers. In this manner, the service recipient can seek to achieve the elusive goal of having a compensation program that makes sense.

The Promised Land of Exemption From Section 409A

In the absence of exemption from Section 409A, service providers can exercise options and SARs only on one or more[8] of the following six permissible payment events and times for nonqualified deferred compensation plans: (1) separation from service;[9] (2) disability;[10]

[1] Section 409A was added to the code by the American Jobs Creation Act of 2004, Pub. L. No. 108-375, § 885, 118 Stat. 1418, 1634-41. (This article and Model Plan update a version published last year (38 PBD, 2/26/13;40 BPR 560, 3/5/13).

[2] Department of the Treasury, Internal Revenue Service, Application of Section 409A to Nonqualified Deferred Compensation Plans, Final Regulations, 72 Fed. Reg. 19,234 (April 17, 2007), and Department of the Treasury, Internal Revenue Service, Application of Section 409A to Nonqualified Deferred Compensation Plans, Correction, 72 Fed. Reg. 41,620 (July 31, 2007).

[3] Treas. Reg. § 1.409A-1(b)(5)(i)(A).

[4] Treas. Reg. § 1.409A-1(b)(5)(ii).

[5] Treas. Reg. § 1.409A-1(b)(5)(i)(B).

[6] Treas. Reg. § 1.409A-1(b)(6).

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[7] The Final Regulations define service recipient as the person for whom services are performed and with respect to whom the legally binding right to compensation arises, and all persons with whom such person would be considered a single employer under I.R.C. §§ 414(b) or 414(c). Treas. Reg. § 1.409A-1(g). The Final Regulations modify this definition for determining the service recipient employer on a separation from service. Treas. Reg. § 1.409A-1(h)(3). See discussion of this modification *infra* notes 121-122 and accompanying text. The service provider is the person that performs services for the service recipient. Treas. Reg. § 1.409A-1(f). The Final Regulations contain detailed rules for determining whether an independent contractor is a service provider subject to I.R.C. § 409A. Treas. Reg. § 1.409A-1(f)(2).

[8] Treas. Reg. § 1.409A-3(b) (a plan of nonqualified deferred compensation may provide for payment upon the earliest or latest of more than one event or time, provided that each event or time is described in Treas. Reg. § 1.409A-3(a)(1)-(6)).

[9] I.R.C. § 409A(a)(2)(A)(i) (separation from service as determined by the Secretary is a permissible payment event); I.R.C. § 409A(a)(2)(B)(i) (required six month delay in payment to a specified employee on separation from service); Treas. Reg. § 1.409A-1(h) (definition of separation from service); Treas. Reg. § 1.409A-3(a)(1) (separation from service is a permissible payment event for nonqualified deferred compensation); Treas. Reg. § 1.409A-3(i)(2) (required six month delay in payment to a specified employee on separation from service).

[10] I.R.C. § 409A(a)(2)(A)(ii) and (C) (disability as defined in the statute is a permissible payment event); Treas. Reg. § 1.409A-3(a)(2) and (i)(4) (disability as defined in the Final Regulations is a permissible payment event).

(3) death;[11] (4) at a specified time or pursuant to a fixed schedule;[12] (5) a change-in-control;[13] and (6) the occurrence of an unforeseeable emergency.[14]

The provision for payments to be made at a specified time or pursuant to a fixed schedule limits the service provider's flexibility as to when the service provider can exercise options and SARs. Amounts are payable at a specified time or pursuant to a fixed schedule if objectively determinable amounts are payable at a date or dates that are nondiscretionary and objectively determinable at the time the amount is deferred.[15] If an amount is payable in a service provider's taxable year (or pursuant to a fixed schedule of the service provider's taxable years) that is designated at the time that the amount is deferred and that is objectively determinable, the amount is treated as payable at a specified time (or pursuant to a fixed schedule). A specified time or fixed schedule also includes the designation at the time that the amount is deferred of a defined period or periods within the service provider's taxable year or taxable years that are objectively determinable.[16]

Under these provisions, a stock right subject to Section 409A can provide the service provider with the right to exercise the stock right in only one specified taxable year, or on another permissible payment event, such as separation from service or change-in-control. Because most service providers want the discretion to exercise a stock right at any time after vesting, complying with Section 409A's payment rules deprives the service provider of much of the flexibility to choose when to exercise the stock right.

Another way to comply with Section 409A's payment rules is for the stock right to permit exercise at any time after vesting, but to provide for payment only at a specified time, such as the last year of the term of the stock right, or on a permissible event, such as separation from service or change-in-control. This approach also deprives the service provider of much of the flexibility to choose when to exercise a stock right.

Similarly, a promise to transfer stock or other property in a future taxable year in which the stock or property will be substantially vested is subject to Section 409A's payment rules.[17] This means that the service recipient can transfer the stock or property to the service provider only on a Section 409A permissible payment event or time.

In light of the inflexibility that results from complying with Section 409A, equity compensation that is exempt from Section 409A preserves the service provider's discretion to exercise an option or SAR at any time after vesting. Furthermore, the prohibition on the acceleration of the time or schedule of any payment does not apply.[18] The service recipient can freely accelerate the vesting of the service provider's right to exercise an option or SAR, or the vesting of restricted stock.

Equity compensation plans often grant the service recipient the discretion to accelerate vesting on a change-in-control, an involuntary separation from service within two years after a change-in-control, or a separation from service for good reason within two years after a change-in-control. In addition, when the plan is exempt from Section 409A, the plan's definition of change-in-control does not have to satisfy the definition in the Final Regulations. Finally, executive employment agreements often provide for the acceleration of vesting of all or a portion of equity compensation on a separation from service without cause or resignation for good reason.

Thus, exemption from Section 409A is truly the promised land wistfully reminiscent of a prior time when parties could negotiate the terms of their arrangements free from the shackles of Section 409A.[19]

Exemption for Nonqualified Stock Options

The Final Regulations provide that a nonqualified stock option is not a deferral of compensation subject to Section 409A when the following requirements are satisfied:

(1) the issuer of the stock is an eligible issuer of service recipient stock;[20]

(2) the option is an option to purchase service recipient stock;[21]

(3) the exercise price may never be less than the fair market value of the underlying stock, disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i), on the date the option is granted, and the number of shares subject to the option is fixed on this date;[22]

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[11] I.R.C. § 409A(a)(2)(A)(iii) (death is a permissible payment event); Treas. Reg. § 1.409A-3(a)(3) (same).

[12] I.R.C. § 409A(a)(2)(iv) (a specified time (or pursuant to a fixed schedule) specified under the plan at the date of deferral of the compensation is a permissible payment date); Treas. Reg. § 1.409A-3(a)(4) and (i)(1) (a specified time or fixed schedule, as defined in the Final Regulations, is a permissible payment date).

[13] I.R.C. § 409A(a)(2)(A)(v) (to the extent provided by the Secretary, a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, is a permissible payment event); Treas. Reg. § 1.409A-3(a)(5) and (i)(5) (a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, as these terms are defined in the Final Regulations, is a permissible payment event).

[14] I.R.C. § 409A(a)(2)(A)(vi) (occurrence of an unforeseeable emergency is a permissible payment event); Treas. Reg. § 1.409A-3(a)(6) and (i)(3) (occurrence of an unforeseeable emergency, as defined in the Final Regulations, is a permissible payment event).

[15] Treas. Reg. § 1.409A-3(b) and (i)(1).

[16] *Id.*

[17] Treas. Reg. § 1.409A-1(b)(6)(ii).

[18] See discussion of acceleration of vesting *infra* notes 114-128 and 135-141 and accompanying text.

[19] *Cf.* Carole King, *Been to Canaan*, *on* Rhymes & Reasons (Ode Records 1972) (''Green fields and rolling hills, room enough to do what we will. Sweet dreams of yestertime are running through my mind of a place I left behind. Been so long, I can't remember when. I've been to Canaan and I want to go back again. Been so long, I'm living till then, 'cause I've been to Canaan and I won't rest until I go back again.'').

See generally Alex B. Long, ''[Insert Song Lyrics Here]: The Uses and Misuses of Popular Music Lyrics in Legal Writing,'' 64 *Washington & Lee Law Review* 531 (Spring 2007).

[20] Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(1).

[21] Treas. Reg. § 1.409A-1(b)(5)(iii)(A).

[22] Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1).

(4) the transfer or exercise of the option is subject to taxation under code Section 83 and Treasury Regulation Section 1.83-7; [23]

(5) the option does not have any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option under Treasury Regulation Section 1.83-1, and the time that the stock acquired pursuant to the option's exercise first becomes substantially vested under Treasury Regulation Section 1.83-3(b);[24] and

(6) the holder of the option does not have any right, contingent on the exercise of the option, to receive an amount equal to all or part of the dividends declared and paid between the date of grant and the date of exercise on the number of shares underlying the option. This amount is an impermissible offset or reduction to the exercise price.[25]

The exemption for incentive stock options does not contain any requirements in addition to the requirements for incentive stock options under code Section 422.[26] Under the incentive stock option regulations, the plan must designate the maximum aggregate number of shares issuable as incentive stock options.[27] Section 2(b) of the Model Plan satisfies this requirement. When a plan provides for nonqualified options or other stock-based awards, the plan may separately designate the terms for each type of option or other stock-based awards, and designate the maximum number of shares that may be issued under such option or other stock-based awards.[28] Section 2(a)-(b) of the Model Plan provides for the separate designation of the maximum

[23] Treas. Reg. § 1.409A-1(b)(5)(i)(A)(2).

[24] Treas. Reg. § 1.409A-1(b)(5)(i)(A)(3). The Final Regulations refer to the exercise or disposition of the option under Treas. Reg. § 1.83-7, rather than Treas. Reg. § 1.83-1, but this reference is apparently an error.

The Final Regulations provide that the following arrangements are not a feature for the deferral of compensation: (1) the right to receive substantially nonvested stock (as defined in Treas. Reg. § 1.83-3(b)) on exercise of the option; and (2) the right to pay the exercise price with previously acquired shares. Treas. Reg. § 1.409A-1(b)(5)(i)(D).

A classic feature for the deferral of compensation is the conversion of the intrinsic value of an option into an unfunded, unsecured promise to pay further in the future. In addition, the conversion or exchange of an option for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation prohibited by Treas. Reg. § 1.409A-1(b)(5)(i)(A)(3), is an impermissible extension of the option. Treas. Reg. § 1.409A-1(b)(5)(v)(C)(1). An impermissible extension does not occur when the exercise price equals or exceeds the fair market value of the service recipient stock subject to the option. *Id.* When an impermissible extension occurs, the option is treated as having had an additional deferral feature from the original date of grant, with the result that the option is treated as providing for the deferral of compensation from this date. Treas. Reg. § 1.409A-1(b)(5)(v)(A). Accordingly, the option is retroactively treated as subject to I.R.C. § 409A as of the date of grant. When the holder has the discretionary right to exercise a vested option at any time, rather than on the permissible payment events and times of I.R.C. § 409A(a)(2) and Treas. Reg. § 1.409A-3(a), most options will not satisfy I.R.C. § 409A. Thus, an impermissible extension results in a retroactive violation of I.R.C. § 409A as of the date of grant. Under proposed regulations, the tax for violation of I.R.C. § 409A is not imposed until the option vests. Prop. Treas. Reg. § 1.409A-4(a)(1)(i).

The Final Regulations contain the following rule regarding rescission of changes to avoid a modification or extension of a stock right. A change to the terms of a stock right (or change in the terms of the plan under which the stock right was granted or in the terms of any other agreement governing the stock right) is not a modification or extension to the extent that the change is rescinded by the earlier of the date that the stock right is exercised, and the last day of the service provider's taxable year in which the change occurred. Treas. Reg. § 1.409A-1(b)(5)(v)(I).

[25] Treas. Reg. § 1.409A-1(b)(5)(i)(E). In addition, a plan providing a right to dividends or other distributions (other than stock dividends under Treas. Reg. § 1.409A-1(b)(5)(v)(H)) declared and paid on the number of shares underlying an option, the payment of which is not contingent on, or otherwise payable on, exercise of the option, may provide for a deferral of compensation. However, the existence of the right to receive such an amount will not by itself be treated as a reduction to the exercise price of the option. Thus, a right to such dividends or distributions that is not contingent, directly or indirectly, upon exercise of the option will not cause the option to lose its exemption from I.R.C. § 409A. *Id.* Under this rule, service recipients should provide for the payment of dividend equivalents that accrue over time on vesting of the option. Once vesting of the option and payment of the dividend equivalents have occurred, the option holder will no longer be entitled to dividend equivalents. The option holder will also not be entitled to dividends on the underlying stock until after the holder exercises the option. This arrangement encourages the holder to exercise the option early to regain the economic benefit of the dividends.

Similarly, under the I.R.C. § 162(m) regulations for deductible qualified performance-based compensation, an option is deemed to satisfy the requirement that compensation be contingent on attainment of one or more permissible performance goals when the amount that the employee could receive is based solely on an increase in the value of the stock after the date of grant. This determination is made without regard to any dividend equivalent that may be payable provided that payment of the dividend equivalent is not contingent on the exercise of the option. Treas. Reg. § 1.162-27(e)(2)(vi)(A).

[26] Treas. Reg. § 1.409A-1(b)(5)(ii). The exemption does not apply to a modification, extension, or renewal of an incentive stock option that is treated as the grant of a new option that is not an incentive stock option under Treas. Reg. § 1.424-1(e). In this situation, the option is treated as if it had been a nonqualified stock option from the date of the original grant. Accordingly, if the modification, extension, or renewal of the option would have been treated as the grant of a new option, or as causing the option to have had a deferral feature from the date of grant under Treas. Reg. § 1.409A-1(b)(5)(v), the modification, extension, or renewal is treated as the grant of a new option, or as causing the option to have had a deferral feature from the date of grant. Treas. Reg. § 1.409A-1(b)(5)(ii).

[27] Treas. Reg. § 1.422-2(b)(3)(i). The requirement that the plan state the maximum number of shares issuable as incentive stock options under the plan is not satisfied if the plan provides that the number of shares may not exceed a stated percentage of the shares outstanding at the time of each offering or grant. This requirement is satisfied if the plan states that limit as a percentage of the authorized, issued, or outstanding shares when the plan was adopted. In addition, the plan may specify that the maximum aggregate number of shares available for grants may increase annually by a specified percentage of the authorized, issued, or outstanding shares when the plan was adopted. Finally, if the plan provides that the maximum aggregate number of shares issuable as incentive stock options may change based on any other specified circumstances, this provision is permissible only if the shareholders approve an immediately determinable maximum aggregate number of shares issuable under the plan in any event. Treas. Reg. § 1.422-2(b)(3)(ii).

[28] Treas. Reg. § 1.422-2(b)(3)(i).

number of Shares that the Company may issue through all Awards, and the maximum number of Shares that the Company may issue through Incentive Stock Options.

Under the code Section 162(m) regulations for deductible qualified performance-based compensation for options and SARs, the plan must designate ''the maximum number of shares with respect to which options or rights may be granted during a specified period to any employee.''[29] IRS has proposed amendments to this regulation to provide that the plan under which the option or SAR is granted must state ''the maximum number of shares with respect to which options or rights may be granted during a specified period to any individual employee.''[30]

The comment letter of the American Bar Association Section of Taxation on the proposed amendments recommends that the IRS explicitly state that if a plan designates the aggregate maximum number of shares with respect to which options, SARs, and other forms of stock-based compensation may be granted during a specified period to an individual, the plan satisfies the per-employee limit. In addition, it is unnecessary to specify a separate maximum for each form of stock-based compensation.[31] Section 2(e) of the Model Plan follows this recommendation, and provides for the maximum aggregate number of Shares that the Company may issue through Awards per individual employee. For the more conservative practitioner, Section 2(d) provides for the maximum aggregate number of Shares that the Company may issue through Options and SARs per individual employee.

Exemption for SARs

The Final Regulations provide that an SAR is not a deferral of compensation subject to Section 409A when the following requirements are satisfied:

(1) the issuer of the stock with respect to which the SAR is granted is an eligible issuer of service recipient stock;[32]

(2) the stock with respect to which the SAR is granted is service recipient stock;[33]

(3) the compensation payable under the SAR cannot be greater than the excess of the fair market value of the stock, disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i), on the date that the SAR is exercised, over an amount specified on the date of grant (the SAR exercise price) for a number of shares fixed on or before the date of grant;[34]

(4) the SAR's exercise price may never be less than the fair market value of the underlying stock, disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i), on the date that the SAR is granted;[35]

(5) the SAR does not have any feature for the deferral of compensation other than the deferral of recognition of income until the SAR is exercised;[36] and

(6) the holder of the SAR does not have any right, contingent on the exercise of the SAR, to receive an amount equal to all or part of the dividends declared and paid between the date of grant and the date of exercise on the number of shares underlying the SAR. This amount is an impermissible increase in the amount payable under the SAR.[37]

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[29] Treas. Reg. § 1.162-27(e)(2)(vi)(A).

[30] Department of the Treasury, Internal Revenue Service, Certain Employee Remuneration in Excess of $1,000,000 Under Internal Revenue Code Section 162(m), Notice of Proposed Rulemaking, 76 Fed. Reg. 37,034, 37,036-37 (June 24, 2011).

[31] Letter of William M. Paul, Chair, American Bar Association Section of Taxation, to Hon. Douglas Shulman, Commissioner, Internal Revenue Service, Comments on Proposed Regulations Under Section 162(m) (Oct. 14, 2011) (available at http://meetings.abanet.org/meeting/tax/FALL13/media/empben-sub-execomp-tackney-outline.pdf).

[32] Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(1).

[33] Treas. Reg. § 1.409A-1(b)(5)(iii)(A).

[34] Treas. Reg. § 1.409A-1(b)(5)(i)(B)(1).

[35] Treas. Reg. § 1.409A-1(b)(5)(i)(B)(2).

[36] Treas. Reg. § 1.409A-1(b)(5)(i)(B)(3). The Final Regulations provide that the right to receive substantially nonvested stock (as defined in Treas. Reg. § 1.83-3(b)) on exercise of the SAR is not a feature for the deferral of compensation. Treas. Reg. § 1.409A-1(b)(5)(i)(D).

A classic feature for the deferral of compensation is the conversion of the intrinsic value of an SAR into an unfunded, unsecured promise to pay further in the future. In addition, the conversion or exchange of an SAR for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation prohibited by Treas. Reg. § 1.409A-1(b)(5)(i)(B)(3), is an impermissible extension of the SAR. Treas. Reg. § 1.409A-1(b)(5)(v)(C)(1). An impermissible extension does not occur if the exercise price equals or exceeds the fair market value of the service recipient stock subject to the SAR. *Id.* When an impermissible extension occurs, the SAR is treated as having had an additional deferral feature from the original date of grant, with the result that the SAR is treated as providing for the deferral of compensation from that date. Treas. Reg. § 1.409A-1(b)(5)(v)(A). Accordingly, the SAR is retroactively treated as subject to I.R.C. § 409A as of the date of grant. When the holder has the discretionary right to exercise a vested SAR at any time, rather than on the permissible payment events and times of I.R.C. § 409A(a)(2) and Treas. Reg. § 1.409A-3(a), most SARs will not satisfy I.R.C. § 409A. Thus, an impermissible extension results in a retroactive violation of I.R.C. § 409A as of the date of grant. Under proposed regulations, the tax for violation of Section 409A is not imposed until the SAR vests. Prop. Treas. Reg. § 1.409A-4(a)(1)(i).

The Final Regulations contain the following rule regarding rescission of changes to avoid a modification or extension of a stock right. A change to the terms of a stock right (or change in the terms of the plan under which the stock right was granted or in the terms of any other agreement governing the stock right) is not a modification or extension to the extent that the change is rescinded by the earlier of the date that the stock right is exercised, and the last day of the service provider's taxable year in which the change occurred. Treas. Reg. § 1.409A-1(b)(5)(v)(I).

[37] Treas. Reg. § 1.409A-1(b)(5)(i)(E). In addition, a plan providing a right to dividends or other distributions (other than stock dividends under Treas. Reg. § 1.409A-1(b)(5)(v)(H)) declared and paid on the number of shares underlying a SAR, the payment of which is not contingent on, or otherwise payable on, exercise of the SAR, may provide for a deferral of compensation. However, the existence of the right to receive such an amount will not by itself be treated as an increase to the compensation payable under the SAR. Thus, a right to such dividends or distributions that is not contingent, directly or indirectly, upon exercise of an SAR will not cause the SAR to lose its exemption from I.R.C. § 409A. *Id.* Under this rule, service recipients should provide for the payment of dividend equivalent rights that accrue over time on vesting of the SAR. Once vesting of the SAR and payment of the dividend equivalents

Nonqualified stock options and SARs are called ''stock rights'' under the Final Regulations.

Exemption for Restricted Stock

The Final Regulations provide that restricted stock is not a deferral of compensation subject to Section 409A when the following requirements are satisfied:

(1) the service provider receives property from the service recipient, or pursuant to a plan maintained by the service recipient, that is substantially nonvested (as defined in Treasury Regulation Section 1.83-3(b)), or is includible in income solely due to a valid election under code Section 83(b);[38] and

(2) the arrangement is not a plan under which a service provider obtains a legally binding right to receive property in a future year in which the property will be substantially vested (as defined in Treasury Regulation Section 1.83-3(b)) at the time of transfer of the property.[39]

Under these rules, the following transfers of restricted stock are exempt from Section 409A: (1) the transfer of vested stock in the year in which the service provider has a legally binding right to the stock; (2) the transfer of unvested stock in the year in which the service provider has a legally binding right to the stock regardless of whether the service provider has made a Section 83(b) election; and (3) the service provider has a legally binding right to the transfer of unvested stock in a later year, unless the right is offered in conjunction with another legally binding right that constitutes a deferral of compensation.[40]

When the service provider has a legally binding right to the transfer of vested stock in a later year, the arrangement is subject to Section 409A.[41]

Thus, whether a transfer occurs on grant of restricted stock or on a later date is of critical importance to the operation of these rules.[42]

The Commentary will now discuss the requirements for exemption in further detail, and the tax and drafting issues raised by these requirements.

Eligible Issuer of Service Recipient Stock

''Eligible issuer of service recipient stock'' means the corporation to which the service provider provides services on the date of grant, or a parent corporation of that corporation.[43] Section 4(a) of the Model Plan satisfies this requirement by providing for the grant of nonqualified stock options and SARs for the Company's common stock to service providers to the Company and its Related Entities (as defined in section 25(mm) of the Model Plan) on the Grant Date.

Because the date for determining the status of an eligible issuer of service recipient stock is the date of grant, the definition of the date of grant is important. The Final Regulations define the date of grant as the date on which the granting corporation completes the corporate action necessary to create the legally binding right constituting the stock right.[44] This action is not considered complete until the date on which the maximum number of shares that can be purchased under the stock right and the minimum exercise price are fixed or determinable, and the class of underlying stock and the identity of the service provider are designated.[45] Sec-

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have occurred, the holder of the SAR will no longer be entitled to dividend equivalents. The holder of the SAR will also not be entitled to dividends on the underlying stock until after the holder exercises the SAR. This arrangement encourages the holder to exercise of the SAR early to regain the economic benefit of the dividends.

[38] Treas. Reg. § 1.409A-1(b)(6)(i).

[39] Treas. Reg. § 1.409A-1(b)(6)(ii); Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, § III(E) (first paragraph), 72 Fed. Reg. 19,234, 19,243 (April 17, 2007). A legally binding right to receive property in a future taxable year in which the property will be substantially nonvested (as defined in Treas. Reg. § 1.83-3(b)) at the time of the transfer of the property does not provide for the deferral of compensation. It will not be a nonqualified deferred compensation plan unless offered in conjunction with another legally binding right that is a deferral of compensation. *Id.*

[40] Regina Olshan, ''Coverage,'' in *Section 409A Handbook* 11, 26 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[41] *Id.*

[42] For a discussion of the factors for determining whether a transfer has occurred, see *infra* notes 66-113 and accompanying text.

[43] Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(1). A parent is defined as a member in a single chain of corporations that owns at least 50 percent of the voting power or value of all classes of stock of another member in the chain. In addition, when there are legitimate business criteria, a 20 to 50 percent ownership test is permissible. Whether there are legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate nontax business purpose other than simply providing compensation to the service provider that is exempt from I.R.C. § 409A. *Id.*

The requirement that the issuer of the stock right be the corporation to which the grantee provides services or a parent of this corporation on the date of grant does not prevent subsequent transfers of the stock right by the grantee. The Final Regulations provide that when the grantor corporation exercises discretion specifically reserved to it under a stock right with respect to the stock right's transferability, a modification of the stock right does not occur. Treas. Reg. § 1.409A-1(b)(5)(v)(B). A modification results in the grant of a new stock right that must satisfy the requirements for exemption anew. Treas. Reg. § 1.409A-1(b)(5)(v)(A). See definition of modification *infra* note 210. Section 5(g)(iii) of the Model Plan grants the Administrator the discretion to permit transfers of Nonqualified Stock Options, SARs, and Restricted Stock by lifetime gift to members of the Grantee's Immediate Family, or by domestic relations order to members of the Grantee's Immediate Family.

Under the incentive stock option rules, transfers are not permitted other than by will or the laws of descent and distribution. I.R.C. § 422(b)(5); Treas. Reg. §§ 1.421-1(b)(2) and 1.422-2(a)(2)(v). Section 5(g)(ii) and (iv) of the Model Plan satisfies this requirement. The incentive stock option regulations also provide that a pledge of the stock purchasable under an option as security for a loan that is used to pay the option price is permissible. Treas. Reg. § 1.421-1(a)(2). In addition, the transfer of an option to a trust is permissible if, under I.R.C. § 671 and applicable state law, the individual is considered the sole beneficial owner of the option while held in the trust. *Id.* Finally, if an option is transferred incident to divorce (within the meaning of I.R.C. § 1041), or pursuant to a domestic relations order, the option no longer qualifies as an incentive stock option as of the date of the transfer. *Id.*

[44] Treas. Reg. § 1.409A-(b)(5)(vi)(B)(1) and (H).

[45] *Id.* The regulation also states that if the corporate action provides for an immediate offer to sell stock to a service pro-

tion 25(w) of the Model Plan defines Grant Date using this definition.

Under the definition of eligible issuer of service recipient stock, nonqualified stock options for subsidiary stock cannot be granted to the service providers of a parent. Under the incentive stock option rules, incentive stock options for subsidiary stock can be granted to employees of a parent.[46] Accordingly, section 4(b) of the Model Plan provides for grants of Incentive Stock Options for subsidiary stock to employees of a Parent (as defined in section 25(jj)). If an incentive stock option held by an employee of a Parent no longer qualifies as an incentive stock option and becomes a nonqualified stock option, that option is not for service recipient stock of an eligible issuer, and the IRS may take the position that a violation of Section 409A has occurred.

The $100,000 per year first exercisable limitation for incentive stock options[47] can trigger this scenario. Under this limitation, options are not treated as incentive stock options to the extent that the aggregate fair market value of stock with respect to which incentive stock options are exercisable for the first time during any calendar year exceeds $100,000. Fair market value is determined as of the date of grant of the incentive stock option.[48] When the grantee holds more than one incentive stock option, the options are taken into account in the order granted, with the options granted first accorded incentive stock option status.[49]

For example, on July 1, 2012, ABC grants an employee of a parent an incentive stock option for 1,000 shares of ABC common stock with a fair market value of $90 per share. Half of the shares vest on July 1, 2013, and the remainder vests on July 1, 2014. The shares that vest on July 1, 2013, are valued at $45,000, and they all qualify as an incentive stock option. On July 1, 2013, ABC grants that parent employee an option for an additional 1,000 shares of ABC common stock with a fair market value of $100 per share; those shares vest on July 1, 2014. The remaining 500 shares from the July 1, 2012, grant that vest on July 1, 2014 are valued at $45,000, and they all qualify as an incentive stock option. But only the portion of the shares from the July 1,

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vider, or specifies a date on which the offer is to be made, the date of grant is the date of the corporate action (in the case of an immediate offer), or the date specified for the offer. An unreasonable delay in notifying the service provider of the offer will be considered as indicating that the corporation made the offer on the date it gave notice. *Id.* If the fair market value of the underlying stock increases between the date of the corporate action and the date of the notice, and the stock right uses the fair market value on the date of the corporate action as the exercise price, that would be a violation of I.R.C. § 409A. Accordingly, when a corporation grants a stock right, it should promptly notify the grantee.

If the corporation imposes a condition on granting a stock right (as distinguished from a condition governing the exercise of the stock right), that condition will generally be given effect. However, if the grant of a stock right is subject to approval by shareholders, the date of grant will be determined as if the stock right had not been subject to this approval. A condition that does not require corporate action, such as approval of, or registration with, a regulatory or government agency (for example, a stock exchange or the SEC), is usually considered a condition on the exercise of the stock right unless the corporate action clearly indicates that the stock right is not to be granted until that condition has been satisfied. Treas. Reg. § 1.409A-1(b)(5)(vi)(B)(2) and (H). In general, a condition imposed on the exercise of a stock right will not operate to make the grant of that stock right ineffective. Treas. Reg. § 1.409A-1(b)(5)(vi)(B)(3) and (H).

The incentive stock option regulations contain a similar definition of the date of grant. Treas. Reg. § 1.421-1(c).

Stock rights intended to be exempt from I.R.C. § 409A are eligible for correction of the operational failure of an exercise price erroneously established at less than the fair market value of the underlying stock on the date of grant. Notice 2008-113, 2008-51 I.R.B. 1305, 1311, 1314, §§ IV.D and V.E (Dec. 22, 2008). Before the stock right is exercised and not later than the last day of the service provider's taxable year in which the service recipient granted the stock right, the exercise price may be corrected by resetting it to an amount not less than the fair market value of the underlying stock on the date of grant. *Id.* at 1311, § IV.D. In addition, for service providers who are not insiders during the service provider's taxable year of the date of grant or during the immediately following taxable year, the exercise price may be corrected as follows. Before the stock right is exercised and not later than the last day of the service provider's taxable year immediately following the service provider's taxable year in which the service recipient granted the stock right, the exercise price is reset to equal or exceed the fair market value of the underlying stock on the date of grant, and at all times before that increase in the exercise price the stock right otherwise would not have provided for a deferral of compensation. *Id.* at 1314, § V.E. An ''insider'' is: (1) a director or officer of the service recipient; or (2) the direct or indirect beneficial owner of more than 10 percent of any class of equity security of the service recipient. These determinations are to be made in accordance with the rules of the SEC under Section 16 the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78p (the ''Act''), without regard to whether the service recipient has any class of equity securities registered under Section 12 of the Act. See 17 C.F.R. § 240.16a-1(a) and (f) (definition of beneficial owner and officer). In the case of a service recipient that is not a corporation, these rules are applied by analogy. *Id.* at 1307, § III.G.

The relief under Notice 2008-113 applies only to operational failures that are inadvertent and unintentional. *Id.* at 1307, § III.D. The Notice elliptically defines an inadvertent and unintentional operational failure as a failure to comply with plan provisions that satisfy the requirements of I.R.C. § 409A(a), or an inadvertent unintentional failure to follow the requirements of I.R.C. § 409A(a) in practice, due to one or more inadvertent and unintentional errors in the operation of the plan. *Id.*

In addition, the service recipient must take commercially reasonable steps to avoid having the operational failure recur. If the same or a substantially similar operational failure has occurred previously, the relief will be unavailable for any taxable year of the service provider beginning after Dec. 31, 2009, unless the service recipient or service provider demonstrates that the service recipient had established practices and procedures reasonably designed to ensure that such an operational failure would not recur and had taken commercially reasonable steps to avoid having the operational failure recur, and the operational failure occurred despite the service recipient's diligent efforts. *Id.* at 1306, § III.B.

The relief under Notice 2008-113 is unavailable if a federal income tax return of the service provider at issue for the service provider's taxable year in which the operational failure occurred is under examination with respect to the plan. An individual service provider is treated as under examination with respect to the plan if the individual is under examination with respect to the individual's federal income tax return (for example, Form 1040) for the taxable year. *Id.* at 1306, § III.C.

Finally, Notice 2008-113 contains information and reporting requirements. *Id.* at 1320-21, § IX.

[46] I.R.C. § 422(a)(2).

[47] I.R.C. § 422(d); Treas. Reg. § 1.422-4(a).

[48] I.R.C. § 422(d)(3); Treas. Reg. § 1.422-4(b)(2).

[49] I.R.C. § 422(d)(2).

2013, grant that vest on July 1, 2014, with a value of $55,000 qualifies as an incentive stock option. The remaining shares, with a value of $45,000, do not qualify and so constitute a nonqualified stock option. Since the stock is subsidiary stock, the IRS can take the position that a violation of Section 409A has occurred.

In addition, the service recipient and service provider will not always know on the date of grant whether an option runs afoul of the $100,000 limitation. If the service recipient accelerates vesting of the option after the date of grant, the option can lose its status as an incentive stock option on the date of acceleration. For example, assume that in the previous example the second grant provides for vesting on July 1, 2015. If on June 1, 2014, the service recipient accelerates vesting from July 1, 2015, to July 1, 2014, the same result as in the previous example occurs.[50]

If vesting is accelerated, the parties can take the position that since the eligible issuer is determined on the date of grant, and on that date the exemption for incentive stock options applied, no violation occurred. But this is uncharted territory, so relying on this interpretation is risky business. Moreover, depending on the circumstances, the IRS has at its disposition two anti-abuse rules. First, the Final Regulations contain an anti-abuse rule for service recipient stock. An eligible issuer of service recipient stock does not include any corporation within a group of entities treated as a single service recipient if a purpose of that ownership structure, or a purpose of a significant transaction between two or more entities comprising that single service recipient, was to provide deferred compensation that was not subject to Section 409A.[51]

Second, the Final Regulations contain a general anti-abuse rule. If a principal purpose of a plan is to achieve a result with respect to the deferral of compensation that is inconsistent with the purposes of Section 409A, the Commissioner may treat the plan as a nonqualified deferred compensation plan under Section 409A and the Final Regulations.[52]

Section 20(d) of the Model Plan addresses these scenarios by providing that if as a result of the conversion of an Incentive Stock Option to a Nonqualified Stock Option, the Option held by an Employee of a Parent would not satisfy Section 409A or an exemption thereto, the Incentive Stock Option will terminate on the date that it no longer qualifies as an Incentive Stock Option.

''Service recipient stock'' means a class of stock that, as of the date of grant, is common stock of an eligible issuer under code Section 305.[53] Service recipient stock does not include a class of stock that has any preference as to distributions other than distributions on liquidation.[54] Section 25(xx) of the Model Plan defines ''Share'' as a share of common stock.

In addition, service recipient stock acquired on exercise of the stock right must not be stock that is subject to a mandatory repurchase obligation, other than a right of first refusal, or subject to a put or call right that is not a lapse restriction under Treasury Regulation Section 1.83-3(i), if the purchase price is based on a measure other than fair market value determined by disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i).[55] Section 5(c) of the Model Plan satisfies this requirement.

Section 6(b)-(c) of the Model Plan satisfies the requirement that the exercise price for an option or SAR be the fair market value of the underlying stock on the Grant Date. The Final Regulations provide rules for determining the fair market value of stock readily tradable on an established securities market,[56] and stock that is not so tradable.[57] The Model Plan's definitions of Fair Market Value in section 25(s) and Securities Market in section 25(vv) are consistent with these rules.

Section 7(a)(i)-(ii) of the Model Plan satisfies the requirement that the holder of the option or SAR not have the right contingent on the exercise of the option or SAR to receive dividends paid on the underlying stock between the dates of grant and exercise on the underlying stock. This section provides that the Grantee is not entitled to any dividends declared and paid on Shares between the dates of grant and exercise.

Section 409A Treatment of Discounted Nonqualified Stock Options

In *Sutardja v. United States*,[58] the United States Court of Claims addressed the Section 409A treatment of discounted nonqualified stock options, which are options with an exercise price of less than the fair market value of the underlying stock on the date of grant. Un-

[50] If an incentive stock option is not immediately exercisable in full, changing the terms of the option to accelerate the exercise date for all or any portion of the option would not be a modification treated as the grant of a new option that must satisfy the requirements for an incentive stock option anew. In addition, a modification does not occur if a provision accelerating the exercise date is removed before the year when it would have otherwise been triggered. For example, if an acceleration provision is timely removed to avoid exceeding the $100,000 limitation, a modification does not occur. Treas. Reg. § 1.424-1(e)(2) and (4)(ii).

[51] Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(3).

[52] Treas. Reg. § 1.409A-1(a)(1).

[53] Treas. Reg. § 1.409A-1(b)(5)(iii)(A). The incentive stock option rules permit common stock and preferred stock. I.R.C. § 422(b). Thus, if an incentive stock option for preferred stock loses its status as an incentive stock option, such as by running afoul of the $100,000 per year first exercisable limitation, the IRS can take the position that a violation of I.R.C. § 409A has occurred. See discussion of the effect of loss of incentive stock option status *supra* notes 46 to 52 and accompanying text.

[54] Treas. Reg. § 1.409A-1(b)(5)(iii)(A).

[55] *Id.*

[56] Treas. Reg. § 1.409A-1(b)(5)(iv)(A). An ''established securities market'' means an established securities market under Treas. Reg. § 1.897-1(m). Treas. Reg. § 1.409A-1(k). Under Treas. Reg. § 1.897-1(m), an established securities market means: (1) a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934, as amended, 15 U.S.C. § 78f; (2) a foreign national securities exchange that is officially recognized, sanctioned, or supervised by government authority; or (3) any over-the-counter market. An over-the-counter market is any market that uses an interdealer quotation system. An ''interdealer quotation system'' is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of that broker or dealer. The definition of Securities Market in section 25(vv) of the Model Plan is consistent with the regulatory definition.

[57] Treas. Reg. § 1.409A-1(b)(5)(iv)(B).

[58] 109 Fed. Cl. 358, 2013 BL 55025 (2013).

der the Final Regulations, discounted stock options are ineligible for the exemption for nonqualified options.

Under general tax principles, when an option is granted with an exercise price equal to or greater than the fair market value of the underlying stock, there is no taxable event. The taxable event occurs when the grantee exercises the option, and not on the date of grant or vesting.[59] The IRS continued this tax treatment under Section 409A for options with an exercise price equal to or greater than the fair market value of the underlying stock on the date of grant. However, the IRS did not provide for this treatment under Section 409A for discounted options.[60] Rather, discounted options are treated as a deferral of compensation and are included in income in the taxable year to the extent that they are not subject to a substantial risk of forfeiture.

The Court of Claims held that Section 409A is triggered when a legally binding right to compensation is created. In determining whether a legally binding right is created, courts initially look to state law to determine the rights and interests that the taxpayer has in the property that the government seeks to reach.[61] Once this determination is made, the federal tax laws designate which rights or interests are subject to tax.[62]

Under California law, vested options give the optionee the legally binding right to purchase shares at a designated price.[63] The next inquiry is whether this right is a legally binding right to compensation under federal tax law. Under general tax principles, the grant of the option is a legally binding right to compensation regardless of when the grantee realizes compensation from the option for tax purposes. The realization event generally occurs on the date of exercise.[64]

Finally, the Court of Claims held that when an option agreement permits exercise of vested options beyond the fifteenth day of the third month of the taxable year after the taxable year in which the option vests, the short-term deferral exemption does not apply regardless of whether the grantee exercises the option before this date.[65] In addition, the thirty-day period provided to an employee to exercise the option after the date of termination of employment did not create a rolling thirty day short-term deferral period.

Section 83 and Section 409A Treatment of Restricted Stock

An important issue in an award of restricted stock is its tax treatment under code Sections 83 and 409A. The threshold question is whether a transfer of stock on the date of grant occurs. If a transfer on the date of grant occurs, Section 83 governs the tax treatment, and the transfer is exempt from Section 409A.

If a transfer on the date of grant does not occur, the issues are: (1) whether a transfer occurs after the date of grant and whether the transfer occurs before or after a vesting date; and (2) whether on the service provider's separation from service the service recipient has a redemption obligation or a discretionary call right, or the service provider has a discretionary put right.

Thus, the definition of transfer is at the heart of the analysis. The Final Regulations rely on the definition of transfer under Section 83.[66] The regulations under Section 83 provide that a ''transfer of property occurs when a person acquires a beneficial ownership interest in such property (disregarding any lapse restriction, as defined in § 1.83-3(i)).''[67] The grant of an option to purchase property is not a transfer of the property.[68]

In determining whether a person acquires a beneficial ownership interest, the regulations under Section 83 apply two broad principles. The first principle is the

[59] *Commissioner v. LoBue*, 351 U.S. (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945).

[60] Treas. Reg. § 1.409A-1(b)(5)(i)(A)(1); IRS Notice 2005-1, 2005-1 C.B. 274.

[61] *Drye v. United States*, 528 U.S. 49, 51 (1999); Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, § III(B) (first paragraph), 72 Fed. Reg. 19,234, 19,236 (April 17, 2007).

[62] *Morgan v. Commissioner*, 309 U.S. 78, 80 (1940).

[63] It is important to note that under the Final Regulations, vesting is not required to create a legally binding right to compensation. Furthermore, a legally binding right to compensation includes a contractual right, even if the right is conditional or contingent, that is enforceable under the law governing the contract. It also includes an enforceable right created under governing law, such as a statute. For example, an agreement to pay an employee a bonus equal to a percentage of the amount that the employer receives on sale of a property is a legally binding right to compensation. The requirement that the property be sold is a condition to the right to the payment, but the right to payment is a legally binding right created when the parties enter into the agreement. Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, § III(B) (first and second paragraphs), 72 Fed. Reg. 19,234, 19,236 (April 17, 2007).

[64] *Commissioner v. LoBue*, 351 U.S. (1956); *Commissioner v. Smith*, 324 U.S. 177 (1945); *Racine v. Commissioner*, T.C. Memo. 2006-162 (2006).

[65] Treas. Reg. § 1.409A-1(b)(4)(D); IRS Notice 2005-1, 2005-1 C.B. at 280.

[66] Treas. Reg. § 1.409A-1(b)(6)(i); Application of Section 409A to Nonqualified Deferred Compensation Plans, Explanation of Provisions and Summary of Comments, § III(E) (first paragraph), 72 Fed. Reg. 19,234, 19,243 (April 17, 2007); Regina Olshan, ''Coverage,'' in *Section 409A Handbook* 11, 25-27 (Regina Olshan & Erica F. Schohn eds., BNA 2010); Erica F. Schohn, ''Equity Arrangements,'' in *Section 409A Handbook* 419, 452-54 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[67] Treas. Reg. § 1.83-3(a)(1). Similarly, the Final Regulations define the transfer of a share of stock under the exemptions for nonqualified stock options and stock-settled SARs as ''the transfer of ownership of such share, or the transfer of substantially all the rights of ownership. Such transfer must, within a reasonable time, be evidenced on the books of the corporation. A transfer may occur even if a share of stock is subject to a substantial risk of forfeiture or is not otherwise transferable immediately after the date of exercise. A transfer does not fail to occur merely because, under the terms of the arrangement, the individual may not dispose of the share for a specified period of time, or the share is subject to a right of first refusal, or a right to acquire the share at the share's fair market value at the time of the sale.'' Treas. Reg. § 1.409A-1(b)(5)(vi)(F)-(G).

See also PLR 200820010 (transfer of stock did not occur and section 83(b) election was invalid when employer granted employee stock under a restricted stock agreement, but subsequently informed the employee that the employer did not have authorized employer stock available for grant); PLR 8028048 (transfer of stock to employees occurred when employer delivered shares to escrow agent to hold while restrictions on stock continued in effect). Section 5(h) of the Model Plan contains the transfer provisions on grant for Restricted Stock.

[68] Treas. Reg. § 1.83-3(a)(2).

extent to which the terms of an arrangement are similar to an option.[69] The second principle is whether the arrangement contains terms that require the return of property upon the happening of an event that is certain to occur, such as the service provider's separation from service.[70]

With respect to the principle of similarity to an option, the regulations under Section 83 provide that if the amount paid for the property is nonrecourse debt secured by the transferred property on which there is no personal liability to pay all or a substantial part of the indebtedness, the economic substance of the transaction may be the same as the grant of an option.[71] The determination of a transaction's substance will be based on all the facts and circumstances. The factors to be taken into account include: (1) the type of property involved; (2) the extent to which the risk that the property will decline in value has been transferred; and (3) and the likelihood that the purchase price will in fact be paid.[72]

One commentator provides the following thoughtful analysis of how the purchase of property with nonrecourse debt is similar to an option. The option holder's decision of whether to exercise the option turns on whether the underlying property's value is greater or less than the exercise price. If the value of the underlying property is greater than the exercise price, the option holder can exercise the option for its exercise price and obtain the appreciation in the value of the property over the exercise price without any additional cost. If the value of the underlying property is less than the exercise price, the option holder will not exercise the option and will walk away from the transaction.[73]

Similarly, when a person purchases property with nonrecourse debt, the purchaser's decision of whether to pay the debt turns on the underlying property's value. When the property's value is equal to or greater than the principal amount of the nonrecourse note, the purchaser will pay the debt and obtain the appreciation in value over the note's principal amount without any additional cost. When the property's value is less than the note's principal amount, the purchaser will not pay the debt and will walk away from the transaction. The purchaser's position is similar to that of an option holder, with the principal amount of the nonrecourse note analogous to the exercise price of the option. In other words, if the property declines in value neither the purchaser of property with nonrecourse debt nor the option holder bears the risk of loss.[74]

The factor of the extent to which the risk that the property will decline in value has been transferred usually turns on whether the purchaser has any capital at risk. A purchaser who uses nonrecourse debt does not have any risk that the property will decline in value until the purchaser invests his or her capital into the transaction. Once the purchaser has sufficient capital at risk, a transfer of the property occurs because the purchaser will pay the debt to avoid losing the capital he or she has invested if the lender were foreclose on the property that secures the debt on the purchaser's default. In this situation, even if the property declines in value, the purchaser will pay the debt. As the purchaser pays the debt, the risk of the decline in value of the property shifts to the purchaser, and a transfer occurs once the purchaser becomes the beneficial owner of the property. The practical difficulty is determining how much of the debt that the purchaser needs to pay before a transfer occurs.[75]

The Section 83 regulations provide the following example of how the use of nonrecourse debt affects the determination of whether a transfer has occurred:

Example (2). On Nov. 17, 1972, W sells to E 100 shares of stock in W corporation with a fair market value of $10,000 in exchange for a $10,000 note without personal liability. The note requires E to make yearly payments of $2,000 commencing in 1973. E collects the dividends, votes the stock and pays the interest on the notes. However, he makes no payments towards the face amount of the note. Because E has no personal liability on the note, and since E is making no payments towards the face amount of the note, the likelihood of E paying the full purchase price is in substantial doubt. As a result, E has not incurred the risks of a beneficial owner that the value of the stock will decline. Therefore, no transfer of the stock has occurred on Nov. 17, 1972, but an option to purchase the stock has been granted to E.[76]

With respect to the principle of the return of property upon the happening of an event that is certain to occur, its application in the transfer analysis depends on all the facts and circumstances.[77] Factors that indicate the absence of a transfer are: (1) the extent to which the conditions relating to the transfer are similar to an option;[78] (2) the extent to which the amount to be paid to the grantee on surrender of the property does not approach fair market value at the time of surrender;[79] and (3) the extent to which the grantee does not incur the risk of loss of a beneficial owner that the value of the property at the time of transfer will decline substantially.[80]

Risk of loss is not limited to the risk that any amount paid for the property may be lost.[81] One commentator points out that this factor means that if there is a bargain element in the property at the time of grant that the service provider can lose due to a decline in the property's value, the service provider has the risk of loss of a beneficial owner.[82] This risk of loss is illustrated by the following example:

In 2011, P grants F 1,000 shares of its common stock for $5 per share. The stock is subject to the restriction that it must be returned to P on F's separation from service. On separation from service, F is entitled to the greater of $5 per share, and the fair market value of the stock at that time. The value of the P stock in 2011 is $10 per share. Even though F must return the stock on

[69] Treas. Reg. § 1.83-3(a)(2) and (4).
[70] Treas. Reg. § 1.83-3(a)(3).
[71] Treas. Reg. § 1.83-3(a)(2).
[72] *Id.*
[73] Eickman, 384-5th T.M., *Restricted Property – Section 83*, at 10.
[74] *Id.*
[75] *Id.* at 11.
[76] Treas. Reg. § 1.83-3(a)(7), ex. 2.
[77] Treas. Reg. § 1.83-3(a)(3).
[78] Treas. Reg. § 1.83-3(a)(4).
[79] Treas. Reg. § 1.83-3(a)(5).
[80] Treas. Reg. § 1.83-3(a)(6).
[81] *Id.*
[82] Eickman, 384-5th T.M., *Restricted Property – Section 83*, at 12.

separation from service (the condition is certain to occur), the IRS is likely to find a transfer because the amount that F will receive for the P stock approaches its fair market value. F has a risk of loss because F can lose the bargain element at the time of grant in 2011 of $5 per share. F cannot lose the amount paid, but the risk of loss is broader than that in the Section 83 regulations.[83]

The factor of payment of fair market value on surrender of the property is especially important in the equity compensation arrangements of privately-held companies. These arrangements often provide that on a service provider's separation from service, the service recipient has the obligation to redeem the stock. Alternatively, these arrangements grant the service recipient a discretionary call right to redeem the stock, or the service provider a discretionary put right for the service recipient to redeem the stock.

In determining fair market value, the nonlapse restriction rules under Treasury Regulation Section 1.83-5(a)(1) apply.[84] A nonlapse restriction not only affects the determination of fair market value,[85] it also is a factor in showing the absence of a transfer.[86]

The Section 83 regulations provide the following examples of how the service recipient's obligation to repurchase stock from the service provider affects the transfer determination:

Example (1). On Jan. 3, 1971, X corporation sells for $500 to S, a salesman of X, 10 shares of stock in X corporation with a fair market value of $1,000. The stock is nontransferable and subject to return to the corporation (for $500) if S's sales do not reach a certain level by Dec. 31, 1971. Disregarding the restriction concerning S's sales (since the restriction is a lapse restriction), S's interest in the stock is that of a beneficial owner and therefore a transfer occurs on Jan. 3, 1971.[87]

Example (3). On Jan. 3, 1971, X corporation purports to transfer to E, an employee, 100 shares of stock of X corporation. The X stock is subject to the sole restriction that E must sell such stock to X on termination of employment for any reason for an amount which is equal to the excess (if any) of the book value of the X stock at termination of employment over book value on Jan. 3, 1971. The stock is not transferable by E and the restrictions on transfer are stamped on the certificate. Under these facts and circumstances, there is no transfer of the X stock within the meaning of section 83.[88]

Example (4). Assume the same facts as in example (3) except that E paid $3,000 for the stock and that the restriction required E upon termination of employment to sell the stock to M for the total amount of dividends that have been declared on the stock since September 2, 1971, or $3,000, whichever is higher. Again, under the facts and circumstances, no transfer of the X stock has occurred.[89]

Example (5). On July 4, 1971, X corporation purports to transfer to G, an employee, 100 shares of X stock. The stock is subject to the sole restriction that upon termination of employment G must sell the stock to X for the greater of its fair market value at such time or $100, the amount G paid for the stock. On July 4, 1971, the X stock has a fair market value of $100. Therefore, G does not incur the risk of a beneficial owner that the value of the stock at the time of transfer ($100) will decline substantially. Under these facts and circumstances, no transfer has occurred.[90]

Under Section 83, the tax stakes of whether a transfer occurs are that a transfer enables the service provider to close the compensation element of an award of

[83] *Id.*

[84] Treas. Reg. § 1.83-3(a)(5).

[85] A nonlapse restriction is a permanent limitation on the transferability of property that will require the transferee to sell, or offer to sell, the property at a price determined under a formula, and that will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor). A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent nonlapse restriction. Limitations imposed by registration requirements of state or federal securities laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. An obligation to resell or offer to sell property transferred in connection with the performance of services to a specific person or persons at its fair market value at the time of the sale is not a nonlapse restriction. Treas. Reg. § 1.83-3(h). For example, an investment letter restriction is not a nonlapse restriction, and is disregarded in determining a share's fair market value. Treas. Reg. § 1.83-5(c), ex. 3.

In the case of property subject to a nonlapse restriction, the price determined under the formula price will be considered to be the fair market value of the property unless established to the contrary by the Commissioner, and burden of proof shall be on the Commissioner. If stock in a corporation is subject to a nonlapse restriction that requires the transferee to sell the stock only at a formula price based on book value, a reasonable multiple of earnings, or a reasonable combination thereof, the price so determined will ordinarily be regarded as determinative of fair market value. However, in certain circumstances the formula price will not be considered to be the fair market value of the property subject to the formula price restriction, even though the formula price restriction is a substantial factor in determining the value. For example, when the formula price is the current book value of the stock, the book value at some time in the future may be a more accurate measure of the value of the stock than the current book value for purposes of determining the fair market value of the stock at the time that the stock becomes substantially vested. Treas. Reg. § 1.83-5(a).

[86] *See Riverton Investment Corp. v. United States*, 170 F. Supp. 2d 608 (W.D. Va. 2001) (no transfer of stock on grant to employees due to nonlapse restriction that prevented employees from selling the stock for more than 60 percent of book value, and prohibited a sale to anyone other than the employer).

[87] Treas. Reg. § 1.83-3(a)(7), ex. 1.

[88] Treas. Reg. § 1.83-3(a)(7), ex. 3. One commentator points out that the restricted stock arrangement in this example is similar to a performance share or phantom stock arrangement. Both a performance share or phantom stock arrangement, and a restricted stock arrangement, pay the service provider an increase in the value of the service recipient's stock. With a performance share or phantom stock arrangement, no stock is issued and the payment of the increase in value is always ordinary compensation income. With a restricted stock arrangement, beneficial ownership of stock is transferred, and the service provider can make a Section 83(b) election to convert the increase in value from ordinary compensation income to capital gain. The criteria for determining whether a transfer occurs seek to prevent a service provider from using a restricted stock arrangement that does not transfer beneficial ownership of the stock to convert the ordinary compensation income in a performance share or phantom stock arrangement to capital gain. Eickman, 384-5th T.M., *Restricted Property – Section 83*, at 11 n. 76.

[89] Treas. Reg. § 1.83-3(a)(7), ex. 4.

[90] Treas. Reg. § 1.83-3(a)(7), ex. 5.

restricted stock on a Section 83(b) election, or in the absence of a Section 83(b) election, on vesting. The closing of the compensation element results in ordinary compensation income to the service provider,[91] and a deduction to the service recipient.[92] Once the compensation element is closed and the service provider subsequently realizes any increase in the stock's fair market value on a redemption or sale, the realization of this increase is treated as capital gain. When the redemption or sale occurs after the service provider satisfies any holding period requirement, the gain will be long-term capital gain taxed at favorable rates.

An important component of the Section 83 regime is the Section 83(b) election by which service providers close the compensation element of an award of unvested restricted stock as of the date of transfer.[93] In the absence of a transfer, the Section 83(b) election is ineffective.[94]

When a transfer does not occur on grant but occurs later, then as the stock vests at the time of transfer or thereafter, the service provider recognizes ordinary compensation income.[95] As a result, any increase in fair market value between the date of the grant and the date of vesting will result in ordinary compensation income, rather than capital gain.

The application of these rules is illustrated by the following scenarios. Assume that a privately-held service recipient grants restricted stock to a service provider. The service provider vests in one-third of the stock on each anniversary of the grant. On the service provider's separation from service, the service recipient must redeem the vested stock for its then fair market value. The fair market value of the stock on grant is $1,000, and on the first anniversary of the grant the value of the stock is $1,100, on the second anniversary the value is $1,200, and on the third anniversary the value is $1,300.

Under Section 83, a transfer occurs on grant. The tax consequences to the service provider under Section 83 are that the service provider does not recognize any income on grant, recognizes ordinary compensation income of $366.30 on the first anniversary of the grant,[96] $555.24 of ordinary compensation income on the second anniversary,[97] and $377.86 of ordinary compensation income on the third anniversary.[98]

If the service provider has a separation from service on the seventh anniversary of the grant when the stock has a fair market value of $2,000, on the mandatory redemption for $2,000 the service provider recognizes long-term capital gain of $700.[99]

Since a transfer occurs on grant, all the transactions are exempt from Section 409A.

If the service provider makes a Section 83(b) election on grant, he or she would recognize the fair market value of the stock on grant, $1,000, as ordinary compensation income. The service provider would not recognize any income on any of the vesting dates.[100]

If the service provider has a separation from service on the seventh anniversary of the grant when the stock has a fair market value of $2,000, on the mandatory redemption for $2,000 the service provider recognizes long-term capital gain of $1,000.[101] Thus, an additional $300 in appreciation in value after the date of grant is taxed as long-term capital gain rather than as ordinary compensation income.

For another scenario, assume that a privately held service recipient grants restricted stock to a service provider. The service provider vests in one-third of the stock on each anniversary of the grant. On the service provider's separation from service, the service recipient must redeem the vested stock for an amount equal to the excess (if any) of the book value of the stock at separation from service over the book value on the date of grant. The fair market value of the stock on grant is $1,000, and on the first anniversary of the grant the value of the stock is $1,100, on the second anniversary the value is $1,200, and on the third anniversary the value is $1,300. The book value on grant is $500.

Under Section 83, no transfer occurs on grant or at any time thereafter. Therefore, there is an unfunded promise to pay the redemption price on separation from service.[102] Accordingly, the service provider does not recognize any income on grant or on any vesting date. In addition, the absence of a transfer means that the exemption from Section 409A does not apply, and the arrangement is subject to Section 409A.

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[91] I.R.C. § 83(a); Treas. Reg. §§ 1.83-1(a)(1) and 1.83-3(c)(4), ex. 3 and 4.

[92] I.R.C. § 83(h); Treas. Reg. §§ 1.83-6.

[93] I.R.C. § 83(b); Treas. Reg. § 1.83-2.

[94] Treas. Reg. § 1.83-2(a).

[95] I.R.C. § 83(a); Treas. Reg. §§ 1.83-1(a)(1) and 1.83-3(c)(4), ex. 3 and 4.

[96] The amount of income is equal to the product of $1,100 (the fair market value of the stock on the first vesting date) multiplied by .333 (the vesting percentage on the first vesting date), which is $366.30.

[97] The amount of income is equal to the product of the difference between $1,200 minus $366.30 (the fair market value of the stock of $1,200 on the second vesting date minus the amount of income previously recognized) multiplied by .666 (the vesting percentage on the second vesting date). The difference is $833.70, and the product of $833.70 multiplied by .666 is $555.24.

[98] The amount of income is equal to the product of the difference between $1,300 minus $366.30 minus $555.24 (the fair market value of $1,300 on the third vesting date minus the amount of income previously recognized) multiplied by 1.00 (the vesting percentage on the third vesting date). The difference is $377.86, and the product of $377.86 multiplied by 1.00 is $377.86.

[99] The amount of gain is equal to the difference between $2,000 (the fair market value redemption price) and $1,300 (the sum of the amounts of income previously recognized on the vesting dates).

[100] I.R.C. § 83(b)(1); Treas. Reg. § 1.83-2(a).

[101] The amount of gain is equal to the difference between $2,000 (the fair market value redemption price) and $1,000 (the amount of income previously recognized on the Section 83(b) election).

[102] Treas. Reg. § 1.451-2(a) (''Income although not actually reduced to a taxpayer's possession is constructively received by him in the taxable year in which it is credited to his account; set apart for him, or otherwise made available so that he may draw upon it at any time, or so that he could have drawn upon it during the taxable year if notice of intention to withdraw had been given. However, income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. This, if a corporation credits its employees with bonus stock, but the stock is not available to such employees until some future date, the mere crediting on the books of the corporation does not constitute receipt.''); Rev. Rul. 60-31, 1960-1 C.B. 174 (the mere promise to pay that is not represented by notes or secured in any way does not result in the receipt of income by a cash method taxpayer), *modified by* Rev. Rul. 70-435, 1970-2 C.B. 100.

If the service provider has a separation from service on the seventh anniversary of the grant when the stock has a fair market value of $2,000 and a book value of $800, the service provider recognizes ordinary compensation income of $300.[103] Since separation from service is a permissible payment event under Section 409A,[104] as long as the arrangement satisfies the timing rule for designation of permissible payment events,[105] and the timing rule for payments on separation from service,[106] the arrangement satisfies Section 409A. If the arrangement does not satisfy these rules, it runs afoul of Section 409A.

Since a transfer does not occur on grant or at any time thereafter, the service provider cannot make a Section 83(b) election.

Alternatively, if the service recipient does not have a redemption obligation on the service provider's separation from service, but has a discretionary call right on separation from service or at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy the timing rule for designation of permissible payment events, or the timing rule for payments on separation from service. As a result, the arrangement runs afoul of Section 409A. Similarly, if the service recipient does not have a redemption obligation on the service provider's separation from service, but the service provider has a discretionary put right on separation from service or at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy these rules, and runs afoul of Section 409A.

[103] The amount of the income is equal to the difference between $800 (the book value on separation from service) minus $500 (the book value on grant).

[104] I.R.C. § 409A(a)(2)(A)(i); Treas. Reg. § 1.409A-1(h) (definition of separation from service); Treas. Reg. § 1.409A-3(a)(1) (separation from service is a permissible payment event for nonqualified deferred compensation).

[105] A nonqualified plan of deferred compensation that does not provide the service provider with an opportunity to elect the time or form of payment must designate the time and form of payment by no later than the later of the time that the service provider first has a legally binding right to the compensation, or if later, the time that the service provider would be required under Treas. Reg. § 1.409A-2 to make such an election if the service provider were provided with such an election. Treas. Reg. § 1.409A-2(a)(2).

[106] A plan provides for payment on separation from service if it provides that the date of separation from service is the payment date, or specifies another payment date that is objectively determinable and nondiscretionary at the time the event occurs. A plan may also provide that a payment on separation from service is to be made in accordance with a schedule that is objectively determinable and nondiscretionary based on the date that the event occurs and that would qualify as a fixed schedule under Treas. Reg. § 1.409A-3(i)(1) if separation from service were instead a fixed date, provided that the schedule must be fixed at the time that the permissible payment event of separation from service is designated. In addition, a plan may provide that a payment, including a payment that is part of a schedule, is to be made during a designated period objectively determinable and nondiscretionary at the time the payment event occurs, but only if the designated period both begins and ends within one taxable year of the service provider, or the designated period is not more than 90 days and the service provider does not have a right to designate the taxable year of payment (other than an election that complies with the subsequent deferral election rules of Treas. Reg. § 1.409A-2(b)). Treas. Reg. § 1.409A-3(b).

For another scenario, assume that a privately-held service recipient sells restricted stock with a fair market value of $1,000 to a service provider for a $1,000 nonrecourse note. The note requires the service provider to make annual principal payments of $200 commencing one year after the grant. The service provider votes the stock and pays interest on the note, but does not make any payments of principal. The service provider vests in one-third of the stock on each anniversary of the grant. On the service provider's separation from service, the service recipient must redeem the vested stock for its then fair market value. The fair market value of the stock on grant is $1,000, and on the first anniversary of the grant the value of the stock is $1,100, on the second anniversary the value is $1,200, and on the third anniversary the value is $1,300.

Under Section 83, no transfer occurs on grant or at any time thereafter. As a result, the arrangement is an unfunded promise to pay the redemption price on separation from service. Accordingly, the service provider does not recognize income on grant or on any vesting date, but on the date of receipt of payment of the redemption price. In addition, the absence of a transfer means that the exemption from Section 409A does not apply, and the arrangement is subject to Section 409A.

If the service provider has a separation from service on the seventh anniversary of the grant when the stock has a fair market value of $2,000, the service provider recognizes ordinary compensation income of $2,000. Since separation from service is a permissible payment event under Section 409A, as long as the arrangement satisfies the timing rule for designation of permissible payment events, and the timing rule for payments on separation from service, it satisfies Section 409A. If the arrangement does not satisfy these rules, it runs afoul of Section 409A.

Since a transfer does not occur on grant or at any time thereafter, the service provider cannot make a Section 83(b) election.

Alternatively, if the service recipient does not have a redemption obligation on the service provider's separation from service, but has a discretionary call right on separation from service or at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy the timing rule for designation of permissible payment events, or the timing rule for payments on separation from service. As a result, the arrangement runs afoul of Section 409A. Similarly, if the service recipient does not have a redemption obligation on the service provider's separation from service, but the service provider has a discretionary put right on separation from service or at any time thereafter, or during a specified window period after separation from service, the arrangement does not satisfy these rules, and runs afoul of Section 409A.

For the final scenario, assume that a privately-held service recipient sells restricted stock with a fair market value of $1,000 to a service provider for a $1,000 nonrecourse note. The note requires the service provider to make a principal payment of $500 on the fifth anniversary of the grant, and $500 on the tenth anniversary of the grant. On the service provider's separation from service, the payments of principal are accelerated pro-rata based on the service provider's then vested percentage. The service provider votes the stock and makes annual payments of interest, and timely makes the $500 principal payment on the fifth anniversary.

The service provider vests in one-third of the stock on each anniversary of the grant. On the service provider's separation from service, the service recipient must redeem the vested stock for its then fair market value. The fair market value of the stock on grant is $1,000, and on the first anniversary of the grant the value of the stock is $1,100, on the second anniversary the value is $1,200, and on the third anniversary the value is $1,300. The fair market value on the fifth anniversary is $1,700.

The IRS can take the position that under Section 83 no transfer occurs on grant, and a transfer occurs on the fifth anniversary of the grant when the service provider makes the $500 principal payment. Since the transfer occurs after vesting, the service provider recognizes ordinary compensation income of $1,700 on the fifth anniversary. If the service provider has a separation from service on the seventh anniversary of the grant when the stock has a fair market value of $2,000, on the mandatory redemption for $2,000 the service provider recognizes long-term capital gain of $300.[107] On separation from service the service provider also has the obligation to make the remaining principal payment of $500.

Under Section 409A, the IRS can take the position that the arrangement is a promise to transfer vested stock. Although the arrangement is not exempt from Section 409A as a transfer of property, the parties can take the position that the arrangement is exempt from Section 409A as a short-term deferral.[108] The short-term deferral exemption should apply because the service provider recognizes income on the transfer of the vested stock.[109]

When the arrangement is exempt from Section 409A, if the service recipient has a discretionary call right on separation from service or at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A. Similarly, if the service provider has a discretionary put right on separation from service or at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A.

Alternatively, the arrangement provides for 100 percent cliff vesting on the eighth anniversary of the grant when the stock has a fair market value of $2,100. The service provider has a separation from service on the tenth anniversary of the grant when the stock has a fair market value of $2,500. Again, the IRS can take the position that under Section 83 no transfer occurs on grant, and a transfer occurs on the fifth anniversary of the grant when the service provider makes the $500 principal payment. Since the stock is unvested on transfer, the service provider does not recognize any income at that time. On vesting on the eighth anniversary of the grant, the service provider recognizes ordinary compensation income of $2,100. On the mandatory redemption for $2,500 on separation from service, the service provider recognizes capital gain of $400.[110] On separation from service the service provider also has the obligation to make the remaining principal payment of $500.

If the service provider makes a Section 83(b) election when the transfer occurs on the fifth anniversary, the service provider recognizes ordinary compensation income of $1,700. The service provider does not recognize any income on vesting on the eighth anniversary of the grant. On the mandatory redemption for $2,500 on separation from service, the service provider recognizes capital gain of $800.[111] Thus, an additional $400 in appreciation in value after the date of transfer is taxed as long-term capital gain rather than ordinary compensation income.

Under Section 409A, the IRS can take the position that the arrangement is a promise to transfer unvested stock. The parties can take the position that the arrangement is exempt from Section 409A as a transfer of property, and also as a short-term deferral.[112] The short-term deferral exemption should apply because the service provider recognizes income on vesting of the previously transferred stock.[113]

When the arrangement is exempt from Section 409A, if the service recipient has a discretionary call right on separation from service or at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A. Similarly, if the service provider has a discretionary put right on separation from service or at any time thereafter, or during a specified window period after separation from service, there should not be any violation of Section 409A.

Acceleration of Vesting and Extension of Exercise Period

A major benefit of exemption from Section 409A is escaping from the unforgiving clutches of its prohibition on the acceleration of the time or schedule of any payment.[114] If an equity compensation plan is subject to

[107] The amount of gain is equal to the difference between $2,000 (the fair market value redemption price) and $1,700 (the amount of income previously recognized on the transfer of the vested stock).

[108] *See* Erica F. Schohn, ''Equity Arrangements,'' in *Section 409A Handbook* 419, 454 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[109] See discussion of short-term deferral exemption *infra* notes 179-185 and accompanying text.

[110] The amount of gain is equal to the difference between $2,500 (the fair market value redemption price) and $2,100 (the amount of income previously recognized on vesting).

[111] The amount of gain is equal to the difference between $2,500 (the fair market value redemption price) and $1,700 (the amount of income previously recognized on the Section 83(b) election).

[112] *See* Erica F. Schohn, ''Equity Arrangements,'' in *Section 409A Handbook* 419, 453-54 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[113] See discussion of short-term deferral exemption *infra* notes 179-185 and accompanying text.

[114] I.R.C. § 409A(a)(3); Treas. Reg. § 1.409A-3(j)(1). Except as provided in Treas. Reg. § 1.409A-3(j)(4), a nonqualified deferred compensation plan may not permit the acceleration of the time or schedule of any payment or amount scheduled to be paid pursuant to the plan's terms. An impermissible acceleration does not occur if payment is made in accordance with plan provisions or an election as to the time and form of payment in effect at the time of initial deferral (or added in accordance with the rules for subsequent deferral elections under Treas. Reg. § 1.409A-2(b)) pursuant to which payment is required to be made on an accelerated schedule as a result of an intervening permissible payment event of separation from service, disability, death, change-in-control, and the occurrence of an unforeseeable emergency. Treas. Reg. § 1.409A-3(j)(1).

Section 409A, acceleration of vesting of the service provider's right to exercise an option or SAR would run afoul of this prohibition.[115] Acceleration of vesting of restricted stock would also run afoul of this prohibition.

The Final Regulations permit accelerated vesting for nonqualified stock options and SARs that satisfy the requirements for exemption from Section 409A.[116] Since incentive stock options and restricted stock are exempt from Section 409A, accelerated vesting of these forms of equity compensation is also permissible.[117]

The primary events for which equity compensation plans, employment agreements, severance plans and agreements, and change-in-control plans and agreements provide for accelerated vesting are: (1) involuntary separation from service without cause; (2) separation from service for good reason; (3) separation from service on death or disability; (4) the single-trigger event of a change-in-control; and (5) the double-trigger events of a change-in-control followed within a specified period after the change-in-control by an involuntary separation from service without cause or a separation from service for good reason.

For plans of deferred compensation subject to Section 409A, separation from service is a permissible payment event.[118] It is important to note that the reference group for an eligible issuer of service recipient stock is not as broad as the reference group for separation from service from the service recipient employer. The reference group for an eligible issuer of service recipient stock is a single parent-subsidiary chain of corporations or other entities based on 50 percent ownership of voting power or the value of all classes of stock.[119]

There are two reference groups for separation from service from the service recipient employer.[120] The first reference group is all parent-subsidiary chains of corporations and other entities with a common parent based on 50 percent ownership of voting power or the value of all classes of stock.[121] The second reference group is a group of trades or businesses under common control, or a combined group of trades or businesses under common control, each one based on 50 percent ownership of voting power or the value of all classes of stock.[122] Under section 25(g) of the Model Plan, a Broader Related Entity is defined by reference to both groups. Under section 25(ww) of the Model Plan, Separation From Service is defined by reference to termination of employment with all Broader Related Entities.

Section 7(d) of the Model Plan accelerates vesting and establishes the exercise periods for Options and SARs on: (1) Separation From Service for Good Reason; (2) Involuntary Separation From Service without Cause; (3) Separation From Service due to Disability; and (4) death.

Section 8(a)-(d) of the Model Plan grants the Administrator or Board the discretion to accelerate vesting on the single-trigger event of a Change-in-Control.[123] If the

For plans of deferred compensation subject to I.R.C. § 409A, whether acceleration of vesting triggers income recognition turns on whether the acceleration of vesting results in the acceleration of the date of payment when the payment is originally scheduled to be paid on a fixed date. It is not an acceleration of the time or schedule of payment of a deferral of compensation if a service recipient waives or accelerates the satisfaction of a condition constituting a substantial risk of forfeiture, provided that the requirements of I.R.C. § 409A (including the requirement that the payment be made upon a permissible payment event) are otherwise satisfied. For example, if a nonqualified deferred compensation plan provides for a lump sum payment of the vested benefit on separation from service, and the benefit vests under the plan only after 10 years of service, it is not a violation of I.R.C. § 409A if the service recipient reduces the vesting requirement to five years of service, even if a service provider becomes vested as a result and receives a payment on a separation from service before the service provider would have completed 10 years of service. However, if the plan had provided for a payment on a fixed date, rather than on separation from service, the date of payment could not be accelerated due to the accelerated vesting. *Id.*

[115] The payment with respect to a stock right generally occurs upon exercise of the stock right. Treas. Reg. § 1.409A-3(d).

[116] Treas. Reg. § 1.409A-1(b)(5)(v)(E).

[117] The incentive stock option regulations permit accelerated vesting. Treas. Reg. § 1.424-1(e)(4)(ii). For restricted stock, I.R.C. § 83 and its regulations permit accelerated vesting. I.R.C. § 83(a)(1) and (c)(1); Treas. Reg. §§ 1.83-1(a)(1) and 1.83-3(c).

[118] I.R.C. § 409A(a)(2)(A)(i) (separation from service as determined by the Secretary is a permissible payment event); I.R.C. § 409A(a)(2)(B)(i) (required six month delay in payment to a specified employee on separation from service); Treas. Reg. § 1.409A-1(h) (definition of separation from service); Treas. Reg. § 1.409A-3(a)(1) (separation from service is a permissible payment event); Treas. Reg. § 1.409A-3(i)(2) (required six month delay in payment to a specified employee on separation from service).

[119] Treas. Reg. §§ 1.409A-1(b)(5)(iii)(E)(1). In addition, when there are legitimate business criteria, a 20 to 50 percent ownership test is permissible. Whether there are legitimate business criteria is based on the facts and circumstances, focusing primarily on whether there is a sufficient nexus between the service provider and the issuer of the stock right so that the grant serves a legitimate nontax business purpose other than simply providing the service provider with compensation that is exempt from I.R.C. § 409A. *Id.*

[120] Treas. Reg. § 1.409A-1(g) and (h)(3). In addition, the service provider generally must terminate service both as an employee and independent contractor for a separation from service to occur. Treas. Reg. § 1.409A-1(h)(5). In contrast, under the incentive stock option regulations, a change in status from employee to independent contractor is a termination of employment. Treas. Reg. § 1.421-1(h)(2).

[121] Treas. Reg. §§ 1.409A-1(g) and (h)(3), and 1.414(b)-1(a). In determining the parent-subsidiary chains of ownership, a plan may also use a greater than 50 percent but not greater than 80 percent ownership test. In addition, when there are legitimate business criteria, a 20 to 50 percent ownership test is permissible. When a percentage other than 50 percent is used, the plan must designate in writing the alternate definition no later than the last date at which the time and form of payment of the amount deferred must be elected under Treas. Reg. § 1.409A-2(a). Any change in the definition for the amounts deferred will be a change in the time and form of payment subject to the rules governing subsequent deferral elections under Treas. Reg. § 1.409A-2(b), and the acceleration of payments under Treas. Reg. § 1.409A-3(j). Treas. Reg. § 1.409A-1(h)(3).

[122] Treas. Reg. § 1.409A-1(g) and (h)(3). A group of trades or businesses under common control can be a parent-subsidiary group as defined under Treas. Reg. § 1.414(c)-2(b), a brother-sister group as defined under Treas. Reg. § 1.414(c)-2(c), and a combined group of trades or businesses under common control as defined under Treas. Reg. § 1.414(c)-2(d). *Id.* The rules discussed *supra* note 121 for adjusting the ownership percentages also apply in determining the controlled group under Treas. Reg. § 1.414(c)-2. *Id.*

[123] *See generally* Joseph A. Hearn & Marc R. Trevino, ''Compensating and Protecting Executives in a Change-in-Control Context,'' in *Hot Issues in Executive Compensation 2013*, at 73, 77 n. 3, 86 & n. 9 (PLI Aug. 4, 2013) (''[T]he past

service recipient wishes to accelerate vesting on the double-trigger events of a Change-in-Control followed within a specified period after the Change-in-Control by a Separation From Service for Good Reason or Involuntary Separation From Service without Cause,[124] the service recipient would not use section 8(a)-(d). Rather,

several years have seen a trend toward 'double trigger' vesting (i.e., requiring a qualifying termination of employment during a specified period following a change-in-control), to the point where recent studies have found that double-trigger vesting is nearly as common as single-trigger.'') (a study by Meridian Compensation Partners, LLC, *2011-2012 Study of Executive Change-in-Control Agreements*, found a 50%-62% prevalence of single-trigger, depending on the type of equity award, versus 31%-36% for double-trigger) (a study by Frederic W. Cook & Co., Inc., *Evolution of Change-in-Control Practices: 2007 vs. 2010* (2010), which focused on very large companies, found 43% prevalence of single-trigger versus 39% prevalence of double-trigger); Jeannemarie O'Brien, ''Change-of-Control Protections,'' in *Hot Issues in Executive Compensation 2013*, at 101, 125-26 (PLI Aug. 4, 2013) (''There is a growing trend for public company equity plans to provide for double-trigger vesting of awards, unless the awards are not assumed by the purchaser in the transaction (in which case, single-trigger vesting applies). . . . Single-trigger vesting of stock-based incentives has been for many years the practice for the vast majority of public companies. To the extent that a target company does not have single-trigger equity vesting as the default provision in its plans, it is common for the target company to negotiate accelerated vesting on the change of control in the context of a transaction, and, in all cash deals and ongoing private transactions, is often the most practical alternative.'').

Liz Hoffman, ''Investors Close Golden Parachutes,'' *The Wall Street Journal*, June 6, 2014, at B1, B4 (''Shareholders now appear to be ratcheting up the pressure against a perk that persists [in change-in-control transactions]: stock awards. Companies often grant top executives shares that vest, or become available, at a future date, and often only if the company hits certain performance goals. But in an M&A deal, these shares can vest automatically when a deal closes, even if the executive keeps his or her job. That is the case at 44 percent of Russell 3000 companies, according to proxy adviser Institutional Shareholder Services Inc. For example, Matthew Shattock, CEO of liquor producer Beam Inc., received about $20.9 million from previously unvested stock options and awards in the company's sale to Suntory Holdings Ltd., according to a regulatory filing. Mr. Shattock remains CEO of Beam, which was renamed Beam Suntory Inc. after the sale to Japan's Suntory closed in April. C. Larry Pope, CEO of Smithfield Foods Inc., received about $18 million from similar perks that were cashed out when the pork producer was sold to a Chinese company last year. Mr. Pope is still the CEO of Smithfield, now a subsidiary of WH Group Ltd. Beam and WH Group declined to comment.'').

[124] *See Gorog v. Best Buy Co., Inc.*, 2014 U.S. App. LEXIS 14063, 2014 BL 204251 (8th Cir. July 24, 2014) (award agreement between CEO of Napster and Napster, a wholly owned subsidiary of Best Buy, provided that CEO had the right to earn a performance-based award consisting of a series of interim payments with a target value of $2,925,000 at four specific performance target dates; award agreement required that CEO remain employed and Napster achieve certain performance criteria measured on the performance target dates; award agreement also contained the following forfeiture and acceleration clauses: (a) if CEO's employment is terminated due to death or disability, he will be entitled to an award equal to 100 percent of the target value; (b) if CEO's employment is terminated without cause or for good reason, he will be entitled to an award equal to a pro-rata portion based on the number of whole months served during the performance period; (c) if majority ownership of Napster is sold by Best Buy or spun-off to its shareholders, of if the venture ceases operations, he will be entitled to an award equal to 100 percent of the target value; and (d) if CEO's employment is terminated for any other reason, his rights to an award will be immediately and irrevocably forfeited; in 2009 CEO resigned and in 2011 Best Buy sold Napster to Rhapsody, which ceased operating Napster and transferred Napster's subscribers to Rhapsody's platform; court rejected CEO's claim that since clause (c) did not refer to a termination of employment, the clause did not require a termination of employment for payment of an award; court held that forfeiture and acceleration clauses were mutually exclusive for four reasons; first, since clause (d) referred to a termination for any other reason, this language implied that the clauses preceding it described the circumstances in which CEO's termination would give rise to an award; second, even without the word ''terminated,'' clause (c) described a method by which CEO's employment relationship with Best Buy could end since on the sale of Napster, CEO's employment relationship with Best Buy would terminate because Best Buy would no longer own Napster, the CEO's employer; third, construing clause (c) not to require a termination of employment would create a conflict with the other clauses; for example, if CEO had been terminated for cause before the sale of Napster, then clause (c) would entitle CEO to an award of 100 percent and clause (d) would forfeit CEO's right to an award; as another example, if CEO had been terminated without cause before the sale of Napster and Napster later achieved the performance criteria, then clause (c) would entitle CEO to an award of 100 percent and clause (b) would entitle CEO to a pro-rata award; in these examples, both sections cannot apply, for one necessarily renders the other null; and fourth, since the award agreement provided for a single award, if the forfeiture and acceleration clauses were not read as mutually exclusive, they would provide for two awards if CEO's employment had been terminated due to death or disability or without cause, and the majority ownership of Napster had been sold; this interpretation would conflict with the language of the award agreement that provided for a single award); *Adams v. Anheuser-Busch Companies Pension Plan*, 2014 U.S. App. LEXIS 13146, 2014 BL 191810 (6th Cir. July 11, 2014) (ERISA-governed, tax-qualified defined benefit plan of Anheuser-Busch provided for enhanced benefits for participants ''whose employment with the Controlled Group is involuntarily terminated within three (3) years after the Change-in-Control;'' enhanced benefits consisted of an additional five years of Credited Service and an additional five years of age; InBev, the successor to Anheuser-Busch in a Change-in-Control, spun off four Metal Container plants in a sale to Ball Corporation, and participants became employees of Ball and ceased to be participants in the Anheuser-Busch plan; court held that the plan's language was unambiguous and required only that the individual's employment with the Controlled Group be involuntarily terminated, not that the individual experience a job loss or some otherwise undefined period of unemployment; under this language, participants' employment with the Controlled Group was involuntarily terminated when InBev sold Metal Container to Ball and the participants became Ball employees; plan's provision for enhanced benefits was not designed to ameliorate the loss of pay if a participant became unemployed, but to provide a substitute for the lost opportunity to earn service and age credit toward retirement under the plan) (Jacklyn Wille, ''Sixth Circuit Orders Anheuser-Bush to Pay Increased Pension Benefits to Former Employees'' (134 PBD, 7/14/14; (41 BPR 1472, 7/15/14).

See also Daniel N. Janich, ''It's A Trap!: Poorly Worded Pension Plans Cost Employers,'' *Law 360 Employment* (Aug. 6, 2014) (plan sponsor in *Anheuser-Busch* would have prevailed had the plan required that the participant's employment with the Controlled Group is involuntarily terminated within three years after a Change-in-Control, and the participant is ineligible to participate in any qualified retirement plan for a specified period after involuntary termination of employment)

the service recipient would use the accelerated vesting provisions of section 7(d)(ii). Alternatives 3 and 4 of section 7(d)(ii) also provide for a longer exercise period on a Separation From Service for Good Reason or an Involuntary Separation From Service without Cause within two years after a Change-in-Control.[125]

The argument in favor of single-trigger vesting is that it aligns the interests of equity award grantees with that of the shareholders,[126] and rewards the grantees for delivering the deal to the shareholders. In contrast, double-trigger vesting immediately rewards the grantees whose employment is terminated, while delaying accelerated vesting for grantees who stay to integrate the combined companies until separation from service. As a result, double-trigger vesting can encourage grantees to seek to be among those who are terminated so that they can obtain the value of their equity awards on consummation of the change-in-control.[127]

The argument in favor of double-trigger vesting is that it encourages executives to stay on for a transition period after the change-in-control, and thereby maintain a sufficient degree of continuity of management. It also provides the executives with protection from the consequences of an involuntary termination or resignation for good reason. In contrast, with single-trigger vesting the executives can cash out and leave immediately after the change-in-control, leaving the service recipient without experienced executives. In addition, single-trigger vesting often limits the acquiror's ability to roll equity awards into the acquiror's stock.

Section 7(d)(ii)-(iv) provides for accelerated vesting on Separation From Service for Good Reason, Involuntary Separation From Service without Cause, Separation From Service due to Disability, and death. These provisions also contain the introductory proviso, ''Except as otherwise provided in an Award or Award Agreement.'' Accordingly, the service recipient can use an Award or Award Agreement to limit a service provider's right to accelerated vesting under the Model Plan.[128]

The definition of ''Involuntary'' in section 25(cc) of the Model Plan satisfies the definition in the Final Regulations.[129]

The definition of ''Good Reason'' in Alternative 2 of section 25(u) of the Model Plan is intended to satisfy the general definition of good reason in the Final Regulations.[130] For the prongs of the definition dealing with a Material diminution of the Grantee's authority, duties, or responsibilities, and a Material diminution of the authority, duties, or responsibilities of the person to whom the Grantee reports, Alternative 2 of section 25(u)(i)(B) and (C) contains three further alternatives. Alternative A provides that the Material diminution can occur by reason of a transaction or other event that results in a change in any business, status, or structure of the Company or a Broader Related Entity. Alternative B provides that the Material diminution determination is made by reference to the entire affiliated group resulting from a Reorganization or Sale. Alternative C provides that upon consummation of a Reorganization or Sale in which more than 50 percent of the voting securities entitled to elect directors of the Surviving Entity is owned by a Parent Entity, the Material diminution determination is made by reference to the Parent Entity. In this manner, the Company cannot prevent a Grantee from having a Separation From Service for Good Reason by manipulating the Company's corporate structure.

Counsel must be wary of the risk that by specifying the events that constitute a Material diminution, or the reference group used to determine a Material diminution, a court may apply the principle of contract construction of *ejusdem generis* to limit the events that constitute a Material diminution.[131] The reason for

(available at http://www.law360.com/articles/562957/it-s-a-trap-poorly-worded-pension-plans-cost-employers).

[125] In addition, the Model Plan grants the Administrator the discretion to: (1) accelerate the vesting of Options, SARs, and Restricted Stock in section 5(d)(i); (2) extend the exercise dates of Options and SARs in section 5(d)(ii); (3) waive the attainment of performance goals and any forfeiture conditions in section 5(d)(iii); and (4) adjust performance goals and forfeiture conditions in section 5(d)(iv).

[126] *See* Jeannemarie O'Brien, ''Change-of-Control Protections,'' in *Hot Issues in Executive Compensation 2013*, at 101, 125 (PLI Aug. 4, 2013) (''Shareholders are generally free to sell their shares immediately following consummation of a stock-for-stock transaction and realize the economic benefits of a well-managed target, and employees should not be in a position where they are unable to realize immediately the benefit of their successful management prior to closing, as there have been situations in which former target company employees held unexercisable options that were 'in-the-money' prior to consummation of the transaction that became 'underwater' after consummation of the transaction due to poor management at the acquiror level.'').

[127] *See* Jeannemarie O'Brien, ''Change-of-Control Protections,'' in *Hot Issues in Executive Compensation 2013*, at 101, 126 (PLI Aug. 4, 2013). In addition, double-trigger vesting often provides for vesting on a separation from service without cause, and separation from service for good reason. Since equity awards are often granted to a broad group of service providers, there is a high likelihood of post-change-in-control disputes over whether a separation from service is for good reason, especially when the definition of good reason uses subjective factors, such as a materiality qualification. Moreover, double-trigger vesting requires the good reason determination to be made post-change-in-control when the target's pre-change-in-control management will likely no longer make this determination. *Id.*

[128] *See Green v. Delphi Financial Group, Inc.*, 2014 U.S. Dist. LEXIS 96996, 2014 BL 197813 (E.D. Pa. July 16, 2014) (equity compensation plan provided that unless otherwise provided by the Compensation Committee at the time of an award grant, a participant's awards vested on a Change of Ownership; court found that the Compensation Committee provided otherwise in a participant's award agreement, which provided that if the participant terminated employment during the performance period other than for good reason, death, or disability, the participant forfeited the award; subsequent merger agreement in a Change of Ownership provided for the deemed satisfaction of performance-based vesting conditions, but maintained the requirement of continued employment; since the participant resigned before the end of the performance period, he was not entitled to accelerated vesting).

[129] Treas. Reg. § 1.409A-1(n)(1).

[130] Treas. Reg. § 1.409A-1(n)(2)(i). The Final Regulations also contain a safe harbor definition of good reason. Treas. Reg. § 1.409A-1(n)(2)(ii). Alternative 1 of section 25(u) of the Model Plan uses the safe harbor definition.

[131] *See VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC*, 735 F.3d 25, 31 (1st Cir. 2013) (a subsequent specification impliedly limits the meaning of terms in preceding general language) (Massachusetts law); *Aspen Advisors LLC v. United Artists Theater Co.*, 861 A.2d 1251, 1265 (Del. 2004) (under the principle of *ejusdem generis*, when an agreement contains a general provision and specific items that result from

specifying the events and reference group is to provide greater protection to the Grantee's ability to Separate From Service for Good Reason, and that protection would be jeopardized were a court to apply the principle of *ejusdem generis*.

To address this risk, the Model Plan uses two drafting conventions. First, each alternative in Alternative 2 of section 25(u)(i)(B) and (C) provides that the specification is in furtherance of, and not in limitation of, the Material diminution determination.[132] Second, each alternative contains the following rule of contractual construction: ''The principle of *ejusdem generis* will not apply in determining whether an event is a Material diminution.''[133]

In addition, the Model Plan in other provisions uses the drafting convention of ''including without limitation.'' To address the risk of a court applying the principle of *ejusdem generis* to undermine the parties' intent with respect to this drafting convention, section 24 of the Model Plan provides the following rule of contractual construction:

The terms ''includes,'' ''including,'' ''includes without limitation,'' and ''including without limitation'' are not to be construed to limit any provision or item that precedes or follows these terms (whether in the same section or another section) to the specific or similar provisions or items that follow these terms. The principle of *ejusdem generis* will not apply when any of these terms are used.[134]

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the application of the general provision, the scope of the general provision is limited to items or events similar to the specific items); *Seibold v. Camulos Partners LP*, 2012 Del. Ch. LEXIS 216 (Sept. 17, 2012) (attorney's fees clause in subscription agreement applied to breach of covenants or agreements set forth in subscription agreement or in any other document provided by the subscriber to the fund; court held that the term ''other document'' is general language that must be interpreted in accordance with the specific references in the subscription agreement; since the ''other document'' must be related in some way to the subscription agreement, the term ''other document'' did not cover a confidentiality agreement; confidentiality agreement was likely signed by employees of fund's investment manager who did not necessarily subscribe to the fund, and subscription agreement was signed by subscribers to the fund who were not employees of the investment manager); *In re IAC/Interactive Corp.*, 948 A.2d 471, 482 n. 16, and 494-96 (Del. Ch. 2008) (corporate governance agreement required corporation's consent to any transaction ''that will impose material additional restrictions or limitations on such Person's [the corporation or Barry Diller, the corporation's Chairman and CEO] full rights of ownership (including, without limitation, voting);'' under the principle of *ejusdem generis*, this provision was limited to regulatory matters similar to those described in prior clauses); *Kel Kim Corp. v. Central Markets, Inc.*, 524 N.Y.S.2d 384 (1987) (catchall language at the end of a force majeure clause of ''other similar causes beyond the control of such party'' was limited to events of the same kind or nature as the events listed before the catchall language); *Camperlino v. Bargabos*, 946 N.Y.S.2d 814, 816 (App. Div. 2012) (when a release contains specific recitals as to the claims being released, and concludes with an omnibus clause that the releasor releases all claims that he or she may have against the releasee, under the principle of *ejusdem generis* the general words of the release are limited by the recital of a particular claim).

[132] *See* Nancy M. Persechino, ''Force Majeure,'' in *Negotiating and Drafting Contract Boilerplate* 319, 332-33 (Tina L. Stark ed., ALM 2003).

[133] *See* Marvin Garfinkel, *Real World Document Drafting* ¶ 4.17 (2d ed. ALI-ABA 2010) (to avoid application of *ejusdem generis*, the document can contain a general provision that the rule of *ejusdem generis* does not apply in the interpretation of any provision); Tina L. Stark, *Drafting Contracts* ¶ 23.6 (2d ed. Wolters Kluwer 2014) (''Parties can attempt to overcome the application of *ejusdem generis* by stating that it does not apply.''); Nancy M. Persechino, ''Force Majeure,'' in *Negotiating and Drafting Contract Boilerplate* 319, 332-33 (Tina L. Stark ed., ALM 2003).

Cf. Senior Housing Capital, LLC v. SHP Senior Housing Fund, LLC, 2013 WL 1955012 (Del. Ch. May 13, 2013) (court enforced provision in operating agreement that waived principle of *contra preferendum* that an ambiguous provision is construed against the party that drafted it); *Hexion Specialty Chemicals, Inc. v. Huntsman Corp.*, 2008 WL 4457544 (Del. Ch. Sept. 29, 2008) (parties can allocate by contract which party bears the burden of proof to show that a material adverse effect has occurred; in absence of clear language in the contract to the contrary, the burden of proof with respect to a material adverse effect rests on the party seeking to excuse its performance under the contract).

[134] *See* Marvin Garfinkel, *Real World Document Drafting* ¶ 4.17 (2d ed. ALI-ABA 2010); Tina L. Stark, *Drafting Contracts* ¶ 23.5.5 (2d ed. Wolters Kluwer 2014).

Cf. Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶ 13.281 (3d ed. ABA 2013) (''[I]f you're relying on the general word to convey its everyday meaning, use *includes* or *including* only to make it clear that the preceding noun in fact includes something that otherwise might not fall within its scope—*fruit, including tomatoes*. (Are tomatoes a fruit or a vegetable? Your answer might depend on whether you're a botanist or a cook.) Doing so leaves little possibility for mischief—given that *tomatoes* is lurking on the edge of *fruit*, a court couldn't reasonably conclude that fruit in fact means only tomatoes or tomato-like produce.''). For example, the alternatives in definition of Cause in section 25(h)(i) of the Model Plan often require that the Grantee's conduct cause or threaten to cause a Material or Significant loss to any business of the Company or any Broader Related Entity. Section 25(h)(i)(V) provides that a Material or Significant loss includes without limitation the Company's or any Broader Related Entity's restatement of one or more of its financial statements for a completed fiscal period after the statement or statements were filed with the SEC. Without this provision, the restatement of financial statements may not otherwise be a Material or Significant loss.

Adams also takes the position that when a drafter determines that a nonexclusive list of examples is appropriate, the drafter avoid using the drafting convention of ''including without limitation.'' Rather, the drafter should place the general term last as a means to prevent the list from imposing a restrictive meaning on the general term: ''*oranges, lemons, grapefruit, and other fruit, whether or not citrus*.'' Kenneth A. Adams, ''The First Circuit on 'Including,' '' *Adams on Contract Drafting*, Jan. 3, 2014 (available at http://www.adamsdrafting.com/the-first-circuit-on-including/).

But cf. VFC Partners 26, LLC v. Cadlerocks Centennial Drive, LLC, 735 F.3d 25, 31 (1st Cir. 2013) (indemnity agreement provided that borrower would indemnify lender against all costs, demands, and other liabilities sought or asserted against lender in connection with the presence, suspected presence, release, suspected release, or threat or release of any hazardous materials; agreement also specified categories of liability, one of which was the cost required to take necessary precautions to protect against the release of any hazardous materials; court held that specification of liabilities imposed reasonable limitations on the preceding sentence, and did not provide nonexclusive examples of liabilities covered; since environmental test results did not show that a hazardous level of PCE was likely to be released into the air, there was never a point at which the servicer of the loan or the receiver of the property took steps to prevent a release; accordingly, the tests were not necessary precautions to protect against the release

With respect to accelerated vesting and the exercise period on Separation From Service due to Disability or death, section 7(d)(iii) of the Model Plan provides for full vesting and an exercise period of one year after the date of Separation From Service. Section 25(p) of the Model Plan provides three alternative definitions of ''Disability.'' Each of the definitions in Alternatives 1 and 2 is one of the permissible definitions under the Final Regulations that a nonqualified deferred compensation plan subject to Section 409A can use when disability is a payment event.[135] The definition in Alternative 3 is the definition that the Final Regulations use to determine an employee's date of separation from service when the employee has a disability and is on a bona fide leave of absence during which the employee does not perform services.[136]

The service recipient is free to use the definition of Disability in Alternatives 1, 2, or 3, or any other definition, for two reasons. First, the Model Plan is exempt from Section 409A. Second, the vesting and payment event is Separation From Service due to Disability, and not the Disability itself.[137]

An incentive stock option retains its status as an incentive stock option when the plan or award agreement provides that the grantee may exercise the option within three months after termination of employment.[138] When the plan or award agreement allows the option to be exercised beyond this period, the option loses its status as an incentive stock option and becomes a nonqualified stock option.[139] When termination of employment is due to disability, the plan or award agreement can provide that an incentive stock option can be exercised for up to one year after termination of employment and maintain its status as an incentive stock option.[140]

Under the incentive stock option regulations, disability is defined by reference to the definition under code

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of hazardous materials; court relied on the principle of contract construction that a subsequent specification impliedly limits the meaning of terms in preceding general language; court also noted that the specification of categories of liability did not use the typical language parties often use to introduce a list of nonexclusive examples, such include but not limited to, or without limiting the foregoing the term includes; ''Although such language is of course not obligatory, its absence does weigh against reading the second sentence as a list of nonexclusive examples.'') (Massachusetts law); *In re Estate of Meyer*, 668 N.E.2d 263, 265 (Ind. Ct. App. 1996) (''If he had intended to use the word 'including' as a term of enlargement rather than a term of limitation, [the testator] could have modified 'including' with the phrase 'but not in limitation of the foregoing.' '').

See generally Auer v. Commonwealth of Virginia, 621 S.E.2d 140, 144-45 (Va. Ct. App. 2005) (''Generally speaking, the word 'include' implies that the provided list of parts or components is not exhaustive and, thus, not exclusive. . . . However, the word 'include' is also commonly used in a restrictive, limiting sense. . . . Used in this limiting sense, the term typically introduces an exhaustive list of all the components or members that make up the whole. . . . Thus, when a statute uses the word 'include' in this restrictive, limiting sense to define a term, it sets forth the entire definition, and no other elements or items are includable. . . . Because the word 'include' is susceptible to more than one meaning and because it is not immediately clear from the word's context which meaning is meant to apply . . . we conclude that the statute's provision . . . is ambiguous.'').

[135] I.R.C. § 409A(a)(2)(A)(ii) and (C); Treas. Reg. § 1.409A-3(a)(2) and (i)(4)(i)(A) and (B). Under the Final Regulations, a plan subject to I.R.C. § 409A may also provide that a service provider will be deemed disabled if determined: (1) to be totally disabled by the Social Security Administration or Railroad Retirement Board; or (2) to be disabled in accordance with a disability insurance program as long as the definition of disability under the program satisfies Treas. Reg. § 1.409A-3(i)(4). Treas. Reg. § 1.409A-3(i)(4)(iii). In addition, a plan subject to I.R.C. § 409A may provide for a payment upon any disability, and need not provide for a payment upon all disabilities, provided that the disability upon which a payment is made satisfies the requirements of Treas. Reg. § 1.409A-3(i)(4). Treas. Reg. § 1.409A-3(i)(4)(ii).

[136] Treas. Reg. § 1.409A-1(h)(1)(i). Under the Final Regulations, the employment relationship is treated as continuing intact while the employee is on military leave, sick leave, or other bona fide leave of absence if the period of leave does not exceed six months, or if longer, so long as the employee retains a right to reemployment with the service recipient under statute or contract. A leave of absence is bona fide only if there is a reasonable expectation that the employee will return to perform services for the employer. If the period of leave exceeds six months and the employee does not retain a right to reemployment under statute or contract, the employment relationship is deemed to terminate on the first date immediately following the six month period. When the leave of absence is due to any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than six months, and the impairment causes the employee to be unable to perform the duties of the employee's position of employment or any substantially similar position of employment, a 29 month period may be substituted for the six month period. *Id.*

Under the incentive stock option regulations, the employment relationship is treated as continuing intact while the employee is on military leave, sick leave, or other bona fide leave of absence if the period of leave does not exceed three months, or, if longer, so long as the employee's right to reemployment with the corporation granting the option (or a related corporation of such corporation), or a corporation (or a corporation related to such corporation) substituting or assuming a stock option in a transaction to which Treas. Reg. § 1.424-1(a) applies, is provided by statute or contract. If the period of leave exceeds three months and the employee's right to reemployment is not provided by statute or contract, the employment relationship is deemed to terminate on the first date immediately following the three month period. Treas. Reg. § 1.421-1(h)(2) and (h)(4), ex. 7. Thus, the rule for determination of the date of termination of employment under the incentive stock option regulations is different from the rule for determination of the date of separation from service under the Final Regulations.

[137] *See* Randy L. Gegelman, ''Disability,'' in *Section 409A Handbook* 395, 412 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[138] I.R.C. § 422(a)(2); Treas. Reg. § 1.422-1(a)(1)(i)(B). The reference group for termination of employment under the incentive stock option regulations is the granting corporation and the parents and subsidiaries of the granting corporation. Treas. Reg. § 1.421-1(h). See discussion of when termination of employment occurs under the incentive stock option regulations *supra* note 136.

[139] Treas. Reg. § 1.421-1(h)(2).

[140] Treas. Reg. § 1.422-1(a)(3). In addition, when an employee dies while employed or within the three months after termination of employment, an incentive stock option can be exercised for the period provided by the plan or award agreement by the employee's estate, any person who acquires the option by bequest or inheritance, or by reason of the death of the employee, such as a beneficiary designated by the employee under the provisions of the plan. Treas. Reg. § 1.421-2(c)(1). Section 5(g)(iv) of the Model Plan contains the designation of beneficiary provisions.

Section 22(e)(3).[141] This definition is also used in code Section 409A(a)(2)(C)(i), Treasury Regulation Section 1.409A-3(i)(4)(i)(A), and Alternative 1 of section 25(p) of the Model Plan. In addition, for purposes of determining the term of an incentive stock option, Alternatives 2 and 3 of section 25(p) of the Model Plan define Disability as provided under code Section 22(e)(3).

When the service recipient wishes to coordinate the vesting of equity awards on separation from service due to disability with the payments under its nonqualified deferred compensation plans subject to Section 409A on separation from service due to disability, the service recipient should use the definition of disability in the nonqualified deferred compensation plans in the equity compensation plan.

The Final Regulations provide that an impermissible extension of a stock right does not occur if the expiration date of the exercise period is tolled when exercise would violate federal, state, local, or foreign law, or would jeopardize the service recipient's ability to continue as a going concern.[142] Once exercise would no longer violate applicable law or jeopardize the ability of the service recipient to continue as a going concern, the exercise period is extended for thirty days.[143] Sections 7(d)(vii) and 9(d) of the Model Plan contain these rules.

It is unclear whether the provision for the tolling of the expiration date applies in the following situations. First, the service recipient does not have a valid Form S-8 registration statement in effect, but exercise in the absence of a Form S-8 would not violate the securities laws, and another registration statement is filed or another exemption from registration is available.[144] Second, the service provider cannot exercise the stock right because the service provider is subject to a blackout period on the sale of stock.[145]

With respect to the termination and forfeiture of Awards on an Involuntary Separation From Service for Cause, section 7(d)(i) of the Model Plan provides two alternatives. Alternative 1 provides for termination of unexercised Options and SARs, whether vested or unvested, and forfeiture of unvested Restricted Stock. Alternative 2 provides for termination of unvested Options and SARs, and forfeiture of unvested Restricted Stock.

Section 25(h) of the Model Plan defines ''Cause,'' and contains an extensive list of the events that constitute Cause. Counsel should review the list to determine which events are appropriate for the service recipient's business needs. In addition, the definition uses the term ''intentional,'' rather than ''willful,'' for a number of the events, such as the Grantee's intentional interference with the business of the Company or any Broader Related Entity. The term ''willful'' can mean intentional, or malicious.[146] To avoid this ambiguity, the Model Plan uses the term ''intentional.''

For many of the events in the definition of Cause, the definition offers the alternatives that the event causes or threatens to cause a Material loss, or a Significant loss, to any business of the Company or any Broader Related Entity. Section 25(ff) of the Model Plan defines ''Material'' as a level of importance that would have affected a reasonable person's decision. Section 25(yy) of the Model Plan defines ''Significant'' as important

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[141] Treas. Reg. § 1.422-1(a)(3).

[142] Treas. Reg. § 1.409A-1(b)(5)(v)(C)(1). A provision of foreign law applies only to foreign earned income (as defined under I.R.C. § 911(b)(1) without regard to I.R.C. § 911(b)(1)(B)(iv) and without regard to the requirement that the income be attributable to services performed during the period described in I.R.C. § 911(d)(1)(A) or (B)) from sources within the foreign country that promulgated such law. *Id.*

[143] Treas. Reg. § 1.409A-1(b)(5)(v)(C)(1). The Final Regulations also provide that an impermissible extension of a stock right's exercise period does not occur when the exercise period is extended to a date no later than the earlier of: (1) the latest date on which the stock right could have expired by its original terms under any circumstances; and (2) the tenth anniversary of the stock right's original date of grant. *Id.* An impermissible extension of the exercise period also does not occur if it is extended when the stock right's exercise price equals or exceeds the fair market value of the service recipient stock that could be purchased (in the case of an option), or the fair market value of the service recipient stock used to determine the payment to the service provider (in the case of an SAR). *Id.*

When an impermissible extension occurs, the stock right is treated as having had an additional deferral feature from the original date of grant, with the result that the stock right is treated as providing for the deferral of compensation from that date. Treas. Reg. § 1.409A-1(b)(5)(v)(A). Accordingly, the stock right is retroactively treated as subject to I.R.C. § 409A as of the date of grant. When the holder has the discretionary right to exercise a vested stock right at any time, rather than on the permissible payment events and times of I.R.C. § 409A(a)(2) and Treas. Reg. § 409A-3(a), most stock rights will not satisfy I.R.C. § 409A. Thus, an impermissible extension results in a retroactive violation of I.R.C. § 409A as of the date of grant. Under proposed regulations, the tax for violation of I.R.C. § 409A is not imposed until the stock right vests. Prop. Treas. Reg. § 1.409A-4(a)(1)(i).

The Final Regulations contain the following rule regarding rescission of changes to avoid a modification or extension of a stock right. A change to the terms of a stock right (or change in the terms of the plan under which the stock right was granted or in the terms of any other agreement governing the stock right) is not a modification or extension to the extent that the change is rescinded by the earlier of the date that the stock right is exercised, and the last day of the service provider's taxable year in which the change occurred. Treas. Reg. § 1.409A-1(b)(5)(v)(I).

[144] Erica F. Schohn, ''Equity Arrangements,'' in *Section 409A Handbook* 419, 445 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[145] *Id.*

[146] *Johnson & Johnson v. Guidant Corp.*, 525 F. Supp. 2d 336, 349 (S.D.N.Y. 2007) (" 'Willful' is a notoriously ambiguous word, which can indicate any of a number of mental states.'') (footnote omitted); Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶¶ 13.761-62 (3d ed. ABA 2013) (when drafters use *willful*, they usually don't make it clear whether the focus is on the party's action or on the consequences of the party's action; one can act intentionally without intending to cause damages; instead of *willful*, drafters should use *intentional* and specify that the party's intent pertains to the consequences of its action, unless given the context it makes more sense to have the party's intent pertain to its taking that action); Marvin Garfinkel, *Real World Document Drafting* ¶ 5.6 (2d ed. ALI-ABA 2010) (''It is often not clear whether to be 'willful,' there must be a specific intent to injure or a venial [*sic*] [venal] motive.'').

See also Age Discrimination in Employment Act, 29 U.S.C. § 626(b) (employee can recover liquidated damages in an amount equal to the unpaid wages awarded if employer is found to have committed a willful violation of the Act); *Trans World Airlines, Inc. v. Thurston*, 469 U.S. 111, 126 (1985) (a violation of the ADEA is willful ''if the employer knew or showed reckless disregard for the matter of whether its conduct was prohibited by the ADEA.'')

enough to merit the attention of a reasonable person. Thus, Material has a higher level of importance than Significant, and also includes Significant.[147]

Qualified Performance-Based Compensation Under Code Section 162(m)

Under code Section 162(m), the deductibility of restricted stock turns on satisfying the requirements for deductible qualified performance-based compensation.[148] Alternative 4 of section 7(d)(ii) of the Model Plan addresses the performance goal requirement prong of qualified performance-based compensation for Restricted Stock on Separation From Service.[149]

Alternative 4 of section 7(d)(ii) provides two alternatives for accelerated vesting of Restricted Stock on a Separation From Service for Good Reason or an Involuntary Separation From Service without Cause. These alternatives are set forth in section 7(d)(ii)(B) of Alternative 4. Alternative A of Alternative 4 provides that the Grantee will be deemed to satisfy the solely service-based vesting requirements. For performance goals the satisfaction of which does not require the Grantee's continued service, the performance goals previously established for the one year following the date of Separation From Service will continue in effect, and their satisfaction will be determined without regard to the Grantee's Separation From Service.

Alternative B of Alternative 4 provides that the Grantee will be deemed to satisfy the solely service-based vesting requirements. Satisfaction of performance-based vesting requirements will be determined as follows. For performance goals the satisfaction of which requires the Grantee's continued service, the Grantee's Separation From Service will be taken into account. For performance goals the satisfaction of which does not require the Grantee's continued service, the performance goals previously established for the one year following the date of Separation From Service will continue in effect, and their satisfaction will be determined without regard to the Grantee's Separation From Service.

The issue under these alternatives in section 7(d)(ii)(B) of Alternative 4 is whether they satisfy the requirements for deductible qualified performance-based compensation. The answer to this question is whether the restricted stock is payable on the attainment of a permissible performance goal.

The mere continued employment of the covered employee is not a permissible performance goal.[150] Thus, when the vesting of Awards under the Model Plan is based solely on continued service for a specified period, the Award does not qualify as deductible qualified performance-based compensation.

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[147] The drafting convention of Material and Significant is discussed in detail in Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶ 9.1-32 (3d ed. ABA 2013).

[148] Treas. Reg. § 1.162-27(e)(2)(vi)(A). Whether a grant of restricted stock or other stock-based compensation satisfies the requirements of qualified performance-based compensation is determined without regard to whether dividends, dividend equivalents, or other similar distributions on such stock-based compensation are payable prior to the attainment of the performance goal. Dividends, dividend equivalents, or other similar distributions with respect to stock that are treated as separate grants are not performance-based compensation unless they separately satisfy the requirements for performance-based compensation. Treas. Reg. § 1.162-27(e)(2)(iv).

In Revenue Ruling 2012-19, the IRS ruled that dividends and dividend equivalents were qualified performance-based compensation in the following situation. Under a corporation's plan, restricted stock vested on the attainment of preestablished, objective performance goals and otherwise met the requirements of Treas. Reg. § 1.162-27(e). The plan provided that dividends and dividend equivalents otherwise payable to an employee during the period from grant through vesting with respect to performance-based restricted stock were accumulated and became vested and payable only if the related performance goals for the underlying restricted stock were satisfied. The IRS ruled that since the dividends and dividend equivalents vested and became payable only if the same performance goals for the underlying restricted stock were satisfied, the dividends and dividend equivalents were qualified performance-based compensation. 2012-28 I.R.B. 16 (July 9, 2012).

The IRS also ruled that dividends and dividend equivalents were not qualified performance-based compensation in the following situation. Under a corporation's plan, restricted stock vested on the attainment of preestablished, objective performance goals and otherwise met the requirements of Treas. Reg. § 1.162-27(e). The plan provided for payment to an employee during the period from grant to vesting of dividends and dividend equivalents with respect to performance-based restricted stock at the same time dividends were paid on the corporation's common stock, and regardless of whether the performance goals for the underlying restricted stock were satisfied. The IRS ruled that since the dividends and dividend equivalents did not vest and become payable solely on account of the attainment of preestablished performance goals, the dividends and dividend equivalents were not qualified performance-based compensation. *Id.*

[149] I.R.C. § 162(m)(4)(C); Treas. Reg. § 1.162-27(e)(2)(v); Rev. Rul. 2008-13, 2008-10 I.R.B. 518 (March 10, 2008). The performance goal requirement prong for qualified performance-based compensation does not apply when options or SARs satisfy the following requirements. First, the grant or award is made by a compensation committee of outside directors that satisfies the requirements of Treas. Reg. § 1.162-27(c)(4) and (e)(3). Second, the plan under which the option or SAR is granted states the maximum number of shares with respect to which options or SARs may be granted during a specified period to any employee. Third, under the terms of the option or SAR, the amount of compensation that the employee could receive is based solely on an increase in the value of the stock after the date of the grant or award. Conversely, if the amount of compensation that the employee will receive is not based solely on an increase in the value of the stock after the date of grant (e.g., in the case of restricted stock, or an option that is granted with an exercise price that is less than the fair market value of the stock as of the date of grant), none of the compensation attributable to the grant or award is qualified performance-based compensation. Whether a stock option grant is based solely on an increase in the value of the stock after the date of grant is determined without regard to any dividend equivalent amount that may be payable, provided that payment of the dividend equivalent is not made contingent on the option's exercise. The rule that the compensation attributable to a stock option or stock appreciation right must be based solely an increase in the value of the stock after the date of grant or award does not apply if the grant or award is made on account of, or if the vesting or exerciseability of the grant or award is contingent on, the attainment of a performance goal that satisfies the requirements of Treas. Reg. § 1.162-27(e)(2). Treas. Reg. § 1.162-27(e)(2)(vi)(A). See discussion of the proposed amendment to this regulation *supra* notes 29-31 and accompanying text.

[150] Treas. Reg. § 1.162-27(e)(2)(i).

The code Section 162(m) regulations provide that compensation is not deductible qualified performance-based compensation if the covered employee would receive all or part of the compensation regardless of the attainment of a permissible performance goal.[151] However, compensation that is otherwise qualified performance-based compensation retains this status when the compensation is also payable on death, disability, or change-in-control regardless of the attainment of a permissible performance goal.[152] Thus, the compensation paid on the attainment of a permissible performance goal is deductible qualified performance-based compensation when it is also payable before the attainment of the permissible performance goal on death, disability, or change-in-control. However, the compensation actually paid on these events and before the attainment of the permissible performance goal is not deductible qualified performance-based compensation.[153]

In Revenue Ruling 2008-13,[154] the IRS ruled that the compensation payable on an involuntary termination without cause, termination for good reason, and retirement is not deductible qualified performance-based compensation. Thus, the compensation paid on attainment of the performance goal is not deductible qualified performance-based compensation when it is also payable on involuntary termination without cause, termination for good reason, and retirement. The compensation actually paid on these events is also not deductible qualified performance-based compensation.

Under Revenue Ruling 2008-13, there are three ways for compensation to maintain its status as qualified performance-based compensation.[155] First, the arrangement does not provide for payment of compensation on involuntary termination without cause, termination for good reason, and retirement that is otherwise payable on the attainment of a performance goal. Instead, on these events the employer can pay compensation that does not have a nexus with the compensation payable on the attainment of the performance goal. For example, the employer can pay separation benefits equal to the product of two multiplied by the average base salary for the three years before the year in which termination occurs. For equity compensation, the employer can accelerate vesting of awards equal to the average vesting that occurred in these years.

Second, the arrangement waits until the end of the performance period to see whether the performance goal has been attained. Alternatives A and B of Alternative 4 of section 7(d)(ii)(B) use this approach. Employers that use this approach should consider whether to require that the covered employee work a minimum

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[151] Treas. Reg. § 1.162-27(e)(2)(v); *see also Friedman v. Khosrowshahi*, 2014 Del. Ch. LEXIS 121, 2014 BL 197381 (July 16, 2014) (stock and annual incentive plan provided for performance goals for Qualified Performance-Based Awards intended to qualify for exemption under I.R.C. § 162(m)(4)(C), and prohibited any amendment of a Qualified Performance-Based Award or exercise of discretion by the Compensation Committee that would cause loss of the exemption; in addition to the authority to establish performance goals that satisfied the exemption, the plan granted the Committee the discretion to require satisfaction of any other conditions, such as continued employment, as the Committee may determine to be appropriate; plan also granted the Committee the authority to interpret the plan and any award; Committee awarded restricted stock units that contained performance goals relating to the company's EBITA or stock price, and an additional goal of a target operating income before amortization; Committee later accelerated vesting of the award before the target operating income before amortization goal had been met; court rejected a challenge to the acceleration of vesting as a violation of the plan's prohibition on the exercise of discretion that would cause loss of the exemption; Committee reasonably exercised its discretion and interpreted the award agreement to make the EBITA or stock price goal as the performance goal necessary to satisfy the exemption under I.R.C. § 162(m)(4)(C), and the operating income before amortization as a separate, additional vesting condition of the award).

In the following situation, a board's decision to adopt a cash bonus plan that did not satisfy the requirements for deductible performance-based compensation under I.R.C. § 162(m) did not constitute waste of corporate assets, and satisfied the business judgment rule. The board made its decision because it believed that it needed to retain the flexibility to pay the executives whatever reasonable amount was required to retain their services. The lost tax deductions were just another component of compensation expense. Furthermore, the board believed that it received consideration for forgoing the tax deduction in the form of the flexibility to set executive compensation without the constraints of I.R.C. § 162(m). *Freedman v. Adams*, 2012 Del. Ch. LEXIS 74, 2012 BL 80278 (March 30, 2012), *aff'd*, 58 A.3d 414, 417, 2013 BL 13108 (Del. 2013) (Delaware Supreme Court affirmed Chancery Court's decision on two grounds; first, the complaint did not allege that any of the bonuses would have been tax deductible under a Section 162(m) plan; second, the board ''believed that a Section 162(m) plan would constrain the compensation committee in its determination of appropriate bonuses. The decision to sacrifice some tax savings in order to retain flexibility in compensation decisions is a classic exercise of business judgment. Even if the decision was a poor one for the reasons alleged by Freedman, it was not unconscionable or irrational'').

See generally Staff of Joint Committee on Taxation, 108th Cong., *Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations* 42-43 (Comm. Print 2003) (11 percent of compensation for Enron executives was nondeductible under code Section 162(m) because it exceeded the $1 million annual cap; Joint Committee found that cap did not accomplish its goal and recommended repeal of I.R.C. § 162(m), and that Congress use nontax laws to regulate executive compensation) (available at www.gpo.gov/fdsys/pkg/GPO-CPRT-JCS-3-03/pdf/GPO-CPRT-JCS-3-03-1-1.pdf); Andrew C.W. Lund, ''Tax's Triviality as a Pay-Reforming Device,'' 57 *Villanova Law Review* 571, 583 (2012) (''[A] large number of firms simply forgo deductions because of Section 162(m) rather than limit an executive's salary to $1 million. Steven Balsam and Jennifer Yin studied a number of 'firm years' between 1994 and 1998 and found that in almost 38 percent of them the firm forfeited deductions by failing to comply with Section 162(m). That percentage consisted of one or more firm years at almost exactly half of the sample firms. About a third of the forfeiting firms qualified their short-term bonus plans as performance-based. Firms consistently opted for compensation flexibility over tax savings.'') (footnotes omitted).

[152] Treas. Reg. § 1.162-27(e)(2)(v).

[153] *Id.*

[154] 2008-10 I.R.B. 518 (March 10, 2008); *see also Seinfeld v. Slager*, 2012 Del. Ch. LEXIS 139, 2012 BL 165263 (June 29, 2012) (decision of an independent board to rely on an IRS revenue ruling comes within the board's business judgment; court upheld board's reliance on Revenue Ruling 2008-13 in structuring bonuses to satisfy requirements of I.R.C. § 162(m) for deductible performance-based compensation).

[155] Sean M. Donahue, ''Section 162(m): Executive Compensation and the Implications of Revenue Ruling 2008-13,'' 8 *Appalachian Journal of Law* 89, 98-99 (Winter 2008).

portion of the performance period to be eligible for the compensation or vesting.

Third, the arrangement measures the amount of compensation based on the covered employee's actual performance through the date of termination of employment against the attainment of the performance goal. Employers that use this approach must make sure that the arrangement satisfies the requirement that not more than 25 percent of the performance period has elapsed before the performance goal is established.[156]

Finally, the qualified performance-based compensation regulations permit the compensation committee to reduce or eliminate the compensation or other economic benefit that is due on attainment of the performance goal.[157] Section 5(b)(vi) of the Model Plan grants the Director and Officer Committee the discretion to reduce or eliminate any Award.

Interplay Between Code Sections 162(m) and 280G

It is important to note that under the golden parachute rules of code Sections 280G and 4999, when an acceleration of vesting occurs on a change-in-control,[158] the acceleration is treated as an acceleration of payment and an acceleration of vesting.[159] Both forms of acceleration are treated as payments contingent on a change-in-control in the calculation of parachute payments and excess parachute payments. Excess parachute payments have the adverse tax consequences of a 20 percent excise tax on the disqualified individual,[160] and disallowance of a compensation deduction to the employer.[161]

Thus, the critical issue is the determination of the amount of the payment contingent on a change-in-control. It is in this determination that the code extracts its price for the use of performance goals for the vesting of options, SARs, and restricted stock to satisfy the performance goal requirement prong of deductible qualified performance-based compensation.[162] The same performance goals that assist in procuring the deduction under code Section 162(m) preclude a substantial reduction in the amount of the payment contingent on a change-in-control under code Sections 280G and 4999.[163]

The determination of the amount of the payment contingent on a change-in-control consists of three components: (1) determination of the value of the restricted stock or option; (2) determination of the portion of the value that is attributable to the acceleration of payment; and (3) determination of the portion of the value that is attributable to the acceleration of vesting.

The value of restricted stock is the excess of its fair market value on the date of vesting over the purchase price, if any, for the restricted stock.[164] The definition of fair market value under the Final Regulations provides useful guidance for determining the fair market value of restricted stock.[165]

The value of an option is based on all the facts and circumstances, including: (1) the difference between the exercise price and the underlying stock on the date of vesting; (2) the probability of the value of the stock increasing or decreasing; and (3) the length of the period during which the option can be exercised.[166] Under Revenue Procedure 2003-68,[167] the use of any valuation method consistent with generally accepted accounting principles is permissible, such as Financial Accounting Standards Board Accounting Standards Codification Topic 718, ''Stock Compensation.'' Black-Scholes and binomial models are also permissible. In addition, the Revenue Procedure contains a safe-harbor based on the Black-Scholes method.

Once the value of the restricted stock or option is determined, the amount of the payment contingent on a change-in-control is then determined. If the requirements for the reduction in the amount of the payment contingent on a change-in-control are not satisfied, the amount of the payment contingent on a change-in-control is the value of the restricted stock or option on the date of accelerated vesting.[168] If the requirements for the reduction in the amount of the payment contingent on a change-in-control are satisfied, the amount of the payment contingent on a change-in-control is equal to the sum of the value assigned to the accelerated timing of payment component, and the value assigned to the accelerated vesting component.

The value of the accelerated timing component is the amount by which the value of the restricted stock or option on the accelerated vesting date exceeds the present

[156] Treas. Reg. § 1.162-27(e)(2)(i).

[157] Treas. Reg. § 1.162-27(e)(2)(iii)(A) and (vii), ex. 6 and 8.

[158] The definition of change-in-control under I.R.C. §§ 280G and 4999 is found in Treas. Reg. § 1.280G-1, Q&A-27, 28, and 29. The change in ownership or control rules treat all members of the affiliated group as one corporation. I.R.C. § 280G(d)(5); Treas. Reg. § 1.280G-1, Q&A-46. Accordingly, the sale of stock or assets of a subsidiary, or the sale of all or substantially all of the assets of a trade or business, may not be a change in ownership or control because the value of items sold may not represent a sufficiently large enough portion of the affiliated group's business. In comparison, the definition of change-in-control under the Final Regulations focuses on the corporation for which the service provider performs services at the time of the change-in-control, the corporation that is liable for the payment for the deferred compensation, or the corporation that is the majority shareholder of one of these corporations. Treas. Reg. § 1.409A-3(i)(5)(ii). See discussion of the definition of change-in-control under the Final Regulations *infra* notes 205-208 and accompanying text. Under the Final Regulations, the sale of stock or assets of a subsidiary for which the service provider performs services, or the sale of all or substantially all of the assets of a trade or business for which the service provider performs services, will be a change-in-control.

[159] Treas. Reg. § 1.280G-1, Q&A-24(c)(2).

[160] I.R.C. § 4999(a).

[161] I.R.C. § 280G(a).

[162] I.R.C. § 162(m)(4)(C); Treas. Reg. § 1.162-27(e)(2). Employers can structure options and SARs to be deductible qualified performance-based compensation without the use of performance goals. Treas. Reg. § 1.162-27(e)(2)(vi)(A). The requirements of this regulation are discussed *supra* note 149.

[163] Section 5(b)(ii)-(vii) of the Model Plan grants the Administrator the discretion to use performance goals for Awards.

[164] Treas. Reg. § 1.280G-1, Q&A-12(a) (regulation incorporates the income recognition rules of I.R.C. § 83(a)).

[165] Treas. Reg. § 1.409A-1(b)(5)(iv)(A)-(B); Jeffrey A. Martin, ''Golden Parachute Payments: How Stock Options and Restricted Stock Can Be Costly,'' *Journal of Taxation*, at 29, 36 (July 2011).

[166] Treas. Reg. § 1.280G-1, Q&A-13(a).

[167] 2003-2 C.B. 398.

[168] Treas. Reg. § 1.280G-1, Q&A-12 and 13.

value of the amount absent the accelerated vesting.[169] The value of the accelerated vesting component is the product of 1 percent of the value of the restricted stock or option on the date of accelerated vesting multiplied by the number of full months between the accelerated vesting date and the date that the stock or option would have vested in the absence of the change-in-control.[170]

There are three requirements for the reduction in the amount of the payment contingent on a change-in-control. First, the grant of the restricted stock or option must not be contingent on the change-in-control.[171] There is a presumption that the grant of restricted stock or an option is contingent on a change-in-control if the grant occurs within one year before the change-in-control.[172] Second, the vesting of the restricted stock or option must be attributable, at least in part, to the performance of services before the date that the payment is made or becomes certain to be made.[173] Third, without regard to the change-in-control, the payment is contingent solely on the continued performance of services for a specified period.[174] Restricted stock or an option does not satisfy the third requirement if vesting is based on the occurrence of an event, such as attainment of a performance goal, and the event has not occurred before the change-in-control.[175]

For example, on Jan. 1, 2012, ABC grants a disqualified individual 1,000 shares of ABC common stock. If the disqualified individual continues employment through Jan. 1, 2015, the disqualified individual will become fully vested in the shares on Jan. 1, 2015. A change-in-control under Section 280G occurs on July 1, 2013, and full vesting is accelerated on that date. The fair market value of the stock on July 1, 2013, is $1,000,000.

Assuming that the discount rate is .5 percent, the present value of the stock is $992,537. The value of the accelerated timing component is the difference between $1,000,000 and $992,537, which is equal to $7,463. The value of the accelerated vesting component is equal to the product of 1 percent of $1,000,000 multiplied by 18 (the number of full months between the date of accelerated vesting and the date that the stock would have vested in the absence of the change-in-control). This amount is equal to $180,000. The amount of the payment contingent on a change-in-control is the sum of $7,463 and $180,000, which is equal to $187,463.

If vesting had been based on attainment of a performance goal, such as attainment of an EBITDA amount, and this goal had not been attained on the date of the change-in-control, the amount of the payment contingent on a change-in-control is $1,000,000. Thus, the use of performance goals results in an additional payment contingent on a change-in-control of $812,537.

Definition of Change-in-Control

Since the Model Plan is intended to be exempt from Section 409A, the service recipient does not have to use the definition of change-in-control required by the Final Regulations when a change-in-control is a payment event for nonqualified deferred compensation subject to Section 409A.[176] When a service recipient seeks to coordinate the definition of change-in-control in its equity compensation plans with the definition in its nonqualified deferred compensation plans, the service recipient can use the definition in the nonqualified deferred compensation plans in its equity compensation plans.[177]

The definition of ''Change-in-Control'' in Alternative 1 of section 25(i) of the Model Plan uses the definition in the Final Regulations.[178] The definition of ''Change-in-Control'' in Alternative 2 is a classic definition that was often found in equity compensation plans before issuance of the Final Regulations, and that continues to be used after their issuance.

The definition of change-in-control in a nonqualified deferred compensation plan subject to Section 409A does not have to satisfy the definition under the Final Regulations in three scenarios. The service recipient will often wish to use a different definition than the definition under the Final Regulations when the service recipient wishes to provide benefits on an event with lesser degree of change than that provided under the Final Regulations, such as a spin-off or sale of a business, or on an event that does not usually constitute a change-in-control under the Final Regulations, such as an initial public offering.

The first scenario is the single-trigger event of continued employment until the date of the change-in-control, and payment of benefits within the short-term deferral period after the change-in-control.[179] This scenario

[169] Treas. Reg. § 1.280G-1, Q&A-24(b) and (e). Present value is determined using a discount rate of 120 percent of the applicable federal rate compounded semiannually under I.R.C. § 1274(d) in effect on the date of the accelerated vesting. Treas. Reg. § 1.280G-1, Q&A-31(a) and 32. Whether the short-term, mid-term, or long-term applicable federal rate is used is determined by the length of the remaining vesting period on the date of accelerated vesting. Treas. Reg. § 1.280G-1, Q&A-32.

[170] Treas. Reg. § 1.280G-1, Q&A-24(c).

[171] Treas. Reg. § 1.280G-1, Q&A-24(a)(1) and 25.

[172] Treas. Reg. § 1.280G-1, Q&A-25. The taxpayer can rebut the presumption with clear and convincing evidence that the payment is not contingent on the change-in-control. Factors in this determination include, without limitation, the content of the agreement and the circumstances surrounding its execution, such as whether it was entered into when a takeover attempt had commenced and the degree of likelihood that a change-in-control would actually occur. Even if the presumption is rebutted, some or all of the payments may still be contingent on the change-in-control under Treas. Reg. § 1.280G-1, Q&A-22. Treas. Reg. § 1.280G-1, Q&A-26.

[173] Treas. Reg. § 1.280G-1, Q&A-24(a)(1) and (c)(1)(ii).

[174] Treas. Reg. § 1.280G-1, Q&A-24(a)(1) and (c)(1)(i).

[175] Treas. Reg. § 1.280G-1, Q&A-24(d)(3).

[176] I.R.C. § 409A(a)(2)(A)(v); Treas. Reg. § 1.409A-3(a)(5) and (i)(5).

[177] *See* Jeannemarie O'Brien, ''Change-of-Control Protections,'' in *Hot Issues in Executive Compensation 2013*, at 101, 109 & n. 3 (PLI Aug. 4, 2013) (''Change-of-control definitions should generally be the same for all compensation arrangements of the same company. This will ensure that all relevant protections are triggered upon the same transactions.'') (''An exception to this general rule may be made for those arrangements that require a change-of-control definition that meets the definition of a 'change-in-control event' for purposes of Section 409A of the Code. In such instances, rather than simply using the definition of change-in-control event from Section 409A, a company should use a definition that it believes indicates a true transfer of control of the company and, to the extent required by Section 409A, provide that the definition will be triggered only if such event also constitutes a 'change-in-control event' within the meaning of Section 409A.'').

[178] Treas. Reg. § 1.409A-3(i)(5).

[179] Treas. Reg. § 1.409A-1(b)(4)(i)(A).

qualifies for the short-term deferral exemption to Section 409A. The continued employment until the date of the change-in-control is a vesting event, which means that as a result of the vesting event the right to payment is no longer subject to a substantial risk of forfeiture.[180]

The short-term deferral period is the applicable 2½ month period. The applicable 2½ month period is the period ending on the later of: (1) the fifteenth day of the third month following the end of the service provider's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture; and (2) the fifteenth day of the third month following the end of the service recipient's first taxable year in which the right to the payment is no longer subject to a substantial risk of forfeiture.[181]

A payment is defined as each separately identified amount to which a service provider is entitled to payment on a determinable date, and includes amounts applied for the benefit of the service provider.[182] An amount is separately identified only if the amount may be objectively determined under a nondiscretionary formula.[183] The entitlement to a series of installment payments that is not a life annuity is treated as the entitlement to a single payment, unless the plan provides at all times with respect to the amount deferred that the right to the series of installment payments is to be treated as a right to a series of separate payments.[184] Accordingly, to qualify the portion of installment payments paid within the applicable 2½ month period for the short-term deferral exemption, the plan must provide that the right to a series of installment payments is to be treated as a right to a series of separate payments.[185]

For example, an employment agreement provides that on separation from service without cause, the service recipient shall pay the service provider separation benefits in an amount equal to the product of two multiplied by the service provider's base salary for the calendar year before the year of separation. The service recipient shall pay the separation benefits in equal installments on the regular payroll dates under the service recipient's payroll practices that apply to the service provider on the date of separation from service. The service recipient shall pay the installments for two years commencing on the first payroll period after the thirtieth day after the date of separation from service. The employment agreement provides that the right to the series of installment payments is to be treated as a right to a series of separate payments. The service provider is not a specified employee. An involuntary separation from service occurs on July 1, 2012, and the service recipient commences payment of the installments on Aug. 15, 2012. The installments paid from Aug. 15, 2012, until March 15, 2013, satisfy the short-term deferral exemption. The installments paid after March 15, 2013, must satisfy either the involuntary separation agreement exemption,[186] or the requirements for payments made at a specified time or pursuant to a fixed schedule for payments subject to Section 409A.[187]

The second scenario is the double-trigger events of a change-in-control followed by one or more permissible vesting events, and payment of benefits within the applicable 2½ month period after the vesting event.[188] The permissible vesting events are separation from service due to involuntary termination as defined in the Final Regulations,[189] separation from service for good reason as defined in the Final Regulations,[190] or any

[180] Treas. Reg. § 1.409A-1(d)(1). Under this regulation, compensation is subject to a substantial risk of forfeiture if entitlement to the amount is conditioned on the performance of substantial future services by any person, or the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. A condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient, or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value, or completion of an initial public offering).

[181] Treas. Reg. § 1.409A-1(b)(4)(i)(A). The Final Regulations permit delayed payments made outside the applicable 2½ month period in three situations. First, the taxpayer establishes that it was administratively impracticable to make the payment by the end by the end of the applicable 2½ month period, and as of the date on which the legally binding right to the compensation arose, such impracticability was unforeseeable. An action or failure to act of the service provider or a person under the service provider's control, such as a failure to provide necessary information or documentation, is not an unforeseeable event. In addition, the payment is made as soon as administratively practicable. Second, the taxpayer establishes that making the payment by the end of the applicable 2½ month period would have jeopardized the service recipient's ability to continue as a going concern. In addition, the payment is made as soon as the payment would no longer have this effect. Third, the taxpayer establishes that the service recipient's deduction with respect to the payment otherwise would not be permitted under I.R.C. § 162(m), and as of the date that the legally binding right to the payment arose, a reasonable person would not have anticipated the application of I.R.C. § 162(m) at the time of payment. In addition, the payment is made as soon reasonably practicable following the first date on which the service recipient anticipates or reasonably should anticipate that, if the payment were made on such date, the service recipient's deduction with respect to such payment would no longer be restricted under I.R.C. § 162(m). Treas. Reg. § 1.409A-1(b)(4)(ii).

[182] Treas. Reg. §§ 1.409A-1(b)(4)(i)(F) and 1.409A-2(b)(2)(i).

[183] Treas. Reg. § 1.409A-2(b)(2)(i).

[184] Treas. Reg. § 1.409A-2(b)(2)(iii).

[185] Another arrangement that is exempt from I.R.C. § 409A is involuntary separation agreement exemption of Treas. Reg. § 1.409A-1(b)(9)(iii). This exemption applies ''to the extent that the separation pay, or portion of the separation pay, provided under the plan'' satisfies the exemption's requirements. Thus, for the exemption to apply to the portion of the separation pay that satisfies the exemption's requirements, it does not appear that the plan has to provide that the series of installment payments of separation pay is a series of separate payments.

[186] Treas. Reg. § 1.409A-1(b)(9)(iii).

[187] Treas. Reg. § 1.409A-3(a)(1) and (b) and (i)(1).

[188] Treas. Reg. § 1.409A-1(b)(4)(i).

[189] Treas. Reg. § 1.409A-1(d)(1) (if a service provider's entitlement to an amount is conditioned on the occurrence of the service provider's involuntary separation from service without cause, the right is subject to a substantial risk of forfeiture if the possibility of forfeiture is substantial); Treas. Reg. § 1.409A-1(n)(1) (definition of involuntary separation from service).

[190] Treas. Reg. § 1.409A-1(n)(2) (a service provider's voluntary separation from service for good reason is treated as an involuntary separation from service when requirements for a good reason event under the regulations are satisfied). One commentator takes the position that regardless of whether the separation from service satisfies the definition of a good reason separation under the Final Regulations, as long as the good reason event otherwise creates a substantial risk of forfeiture and the payment of separation benefits occurs within

other event that is a permissible vesting event under the Final Regulations.[191] Like the first scenario, this scenario relies on the short-term deferral exemption to free itself from the requirement that the definition of change-in-control satisfy the definition under the Final Regulations.

The second scenario raises the issue of whether a service provider's right to separation benefits under a walk-away right during a thirty day window period following the one year anniversary of a change-in-control, otherwise known as a modified single-trigger arrangement, can satisfy the short-term deferral exemption.[192] When separation from service is a within a service provider's control, such as a voluntary separation other than for good reason, the service provider's right to the benefits on separation from service is not subject to a substantial risk of forfeiture. The service provider vests in the right to the benefit when he or she obtains a legal right to the benefits, which occurs when there is a binding contract for the benefits.

For a walk-away right to satisfy the short-term deferral exemption, the arrangement must satisfy the following requirements: (1) the separation benefits are subject to a substantial risk of forfeiture until the window period opens. Continued employment can serve as the substantial risk of forfeiture. In this situation, the service provider vests in the separation benefits on the date that the window period opens; (2) the payment of separation benefits occurs no later than seventy-four days after the window period opens; and (3) the right to separation benefits ends when the window period closes.[193]

Since the first and second scenarios rely on the short-term deferral exemption, payment of benefits from the service recipient's nonqualified deferred compensation plans subject to Section 409A in these scenarios is not subject to the six month delay requirement for payments to specified employees of publicly-traded corporations on separation from service.[194]

The third scenario in which the definition of change-in-control does not have to satisfy the definition under the Final Regulations is the double-trigger events of a change-in-control followed within a specified period by separation from service. The service recipient pays the benefits on separation from service in the same time and form of payment as on all other separations from service that do not follow a change-in-control. In this scenario, the payment event is the separation from service,[195] rather than the change-in-control.

Under the Final Regulations, the general rule is that payments of nonqualified deferred compensation on each permissible payment event must have the same time and form of payment.[196] One exception to this rule is for payments made on certain separations from service.[197] This exception permits different times and forms of payment on the following separations from service: (1) a separation that occurs within two years after a change-in-control. In this situation, the definition of change-in-control must satisfy the Final Regulations;[198] (2) a separation that occurs: (a) before or after a specified date (for example, the attainment of a specified age); or (b) before or after a combination of a specified date, such as attaining a specified age, and a specified period of service determined under a predetermined, nondiscretionary, objective formula, or pursuant to the method for crediting service under a qualified plan sponsored by the service recipient;[199] and (3) a separation not described in clauses (1) and (2).[200]

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the applicable 2½ month period after the good reason event, the short-term deferral exemption is satisfied. Erica F. Schohn, ''Short-Term Deferrals,'' in *Section 409A Handbook* 149, 172-73 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[191] Treas. Reg. § 1.409A-1(d)(1).

[192] *See generally* Joseph A. Hearn & Marc R. Trevino, ''Compensating and Protecting Executives in a Change-in-Control Context,'' in *Hot Issues in Executive Compensation 2013*, at 73, 79 (PLI Aug. 4, 2013) (''One advantage to the modified single-trigger approach is the elimination of the incentive for the executive to search out and keep a 'black book' of potential good reasons following a change-in-control. The result is a heightened likelihood that the seller is able to deliver an intact management team that will be focused on transition issues for one year. The executive's negotiating position with the buyer is also enhanced. Notwithstanding the potential benefits of a modified single-trigger approach, in many recent instances the provision has not served its purpose and modified single-trigger arrangements have fallen out of favor as a result of shareholder criticism.''); Jeannemarie O'Brien, ''Change-of-Control Protections,'' in *Hot Issues in Executive Compensation 2013*, at 101, 114 (PLI Aug. 4, 2013) (''Under the so-called '30-day window provision' included in many [change-of-control severance and employment] agreements for more than a decade, a covered employee can receive severance benefits not only under the circumstances set forth in a traditional double-trigger contract, but also after a voluntary termination of employment following a change of control whether or not for good reason, provided that such termination of employment occurs during a 30-day window period one year after the change of control. The rationale for the 30-day window is that the covered employee will both render impartial advice and services during the pendency of a takeover proposal and be available and render services during the crucial one year transition period following a change of control. Institutional Shareholder Services considers severance arrangements that provide benefits without requiring a substantial diminution in duties or other meaningful change in terms and conditions of employment a problematic pay practice.'').

[193] *See* Erica F. Schohn, ''Short-Term Deferrals,'' in *Section 409A Handbook* 149, 175-76 ex. 3 (Regina Olshan & Erica F. Schohn eds., BNA 2010); Jeannemarie O'Brien, ''Change-of-Control Protections in a Changing Environment,'' in *Hot Issues in Executive Compensation 2011*, at 741, 755 & n. 2 (PLI April 19, 2011).

[194] I.R.C. § 409A(a)(2)(B)(i); Treas. Reg. §§ 1.409A-1(c)(3)(v), (i) and (k), and 1.409A-3(a)(1) and (i)(2).

[195] I.R.C. § 409A(a)(2)(A)(i); Treas. Reg. § 1.409A-3(a)(1). Alternatively, the change-in-control is the vesting event, and the service recipient makes payment on the service provider's separation from service. In this situation, the definition of change-in-control does not have to satisfy the definition under the Final Regulations. *See also* Jeannemarie O'Brien, ''Change-of-Control Protections,'' in *Hot Issues in Executive Compensation 2013*, at 101, 122 (PLI Aug. 4, 2013) (''If the effect of a change-of-control definition in a change-of-control employment agreement is simply to activate the protection period under which 'double-trigger' severance rights are in effect, compliance with the Section 409A definition is generally not required.'').

[196] Treas. Reg. § 1.409A-3(c).

[197] *Id.* Another exception to the same time and form of payment rule is for separation benefits that satisfy the involuntary separation agreement exemption of Treas. Reg. § 1.409A-1(b)(9)(iii).

[198] Treas. Reg. § 1.409A-3(c)(1).

[199] Treas. Reg. § 1.409A-3(c)(2).

[200] Treas. Reg. § 1.409A-3(c)(3).

Service recipients often use this exception to the same time and form of payment rule to pay a single lump sum payment on a separation from service within two years after a change-in-control, and installment payments on other separations from service. Service recipients often bargain for the clawback of the installments already paid and forfeiture of the remaining installments to be paid if the former service provider violates post-separation covenants. Common covenants are covenants to assign intellectual property, covenants not-to-compete, covenants not to solicit customers and employees, covenants not to disclose confidential information, and covenants against disparagement.

The second and third scenarios can be combined with each other. In this situation the critical issue is which payments qualify for the short-term deferral exemption, and which payments do not. Under the short-term deferral exemption, when two amounts are the same payment, each amount must be paid on a permissible vesting event, and within the applicable 2½ month period after the vesting event.[201] Thus, the critical issue is the determination of whether two amounts are the same payment, or separate payments.

One commentator recommends that the test for whether two amounts are the same payment ''is whether any circumstance exists under which both amounts will be paid. If there is no circumstance under which both amounts will be paid, the amounts, to the extent they overlap, may be treated as the same payment under 409A. On the other hand, any additional amount payable under only one circumstance should be treated as a separate payment.''[202]

For example, an employment agreement provides that a service provider is entitled to a separation benefit of one year's base salary on an involuntary separation from service. The service recipient will pay the benefit in a single lump sum within sixty days after the date of separation from service. The service provider also participates in a bonus deferral plan, and has elected to have benefits paid in equal installments over 10 years on any separation from service. Since the service provider is entitled to both benefits on an involuntary termination, the amounts paid for each benefit are separate payments. Accordingly, the separation benefit paid on an involuntary termination qualifies for the short-term deferral exemption.

As another example, an employment agreement provides that a service provider with a base salary of $500,000 is entitled to a separation benefit on an involuntary separation from service. The employment agreement also provides the service provider with a separation benefit if the service provider has a separation from service for any reason within two years after a change-in-control. The separation benefit before a change-in-control is a lump sum of three times base salary paid within thirty days after the date of separation from service. The separation benefit after a change-in-control is a lump sum of two times base salary paid within thirty days after the date of separation from service.[203]

The amount equal to two times base salary, which is equal to $1,000,000, represents the same payment because it is payable both before and after a change-in-control. This amount is not a short-term deferral because the separation benefits are payable outside the applicable 2½ month period. Since the right to the separation benefits vests on the change-in-control, and the service provider can separate from service for up to two years after the change-in-control, the separation benefits will not be paid within the applicable 2½ month period. The remaining one times base salary, which is equal to $500,000, is a separate payment. This separate payment qualifies as a short-term deferral because it is paid only on an involuntary separation from service before a change-in-control and within the applicable 2½ month period after separation from service.[204]

When a plan must use the definition of change-in-control under the Final Regulations, the change-in-control must relate to one of the following corporations: (1) the corporation to which a service provider performs services at the time of the change-in-control;[205] (2) the corporation that is liable for the payment of the deferred compensation or all corporations liable for the payment if more than one corporation is liable;[206] or (3) a corporation that is a majority shareholder of a corporation described in clause (1) or (2).[207] The change-in-control can also relate to any corporation in a chain of corporations in which each corporation is a majority shareholder of another corporation in the chain, ending with the corporation described in clause (1) or (2).[208]

Section 8(a)-(c) of the Model Plan grants the Administrator or Board the discretion to accelerate vesting on a Change-in-Control of the corporation for which the Grantee primarily provides services on the date of the Change-in-Control, or a Related Parent of this corporation. Section 25(nn) defines ''Related Parent'' as a majority shareholder.

Treatment of Stock Rights on a Change-in-Control and Section 424 Corporate Transactions

In a change-in-control, acquirors and targets often wish to cash-out holders of the target's options and SARs. Alternative 1 of section 8(e) of the Model Plan grants the Administrator or Board the discretion to can-

[201] Treas. Reg. §§ 1.409A-1(b)(4)(i) and 1.409A-2(b)(2).

[202] Erica F. Schohn, ''Short-Term Deferrals,'' in *Section 409A Handbook* 149, 174 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[203] It is unusual for a separation benefit on a separation from service after a change-in-control to be less than the separation benefit for other separations from service. This situation can occur when the service provider also receives other benefits on a change-in-control that are exempt from I.R.C. § 409A, such as accelerated vesting of options and SARs, or a retention bonus that satisfies the short-term deferral exemption. *Id.* at 175 ex. 2.

[204] *Id.*

[205] Treas. Reg. § 1.409A-3(i)(5)(ii)(A)(1).

[206] Treas. Reg. § 1.409A-3(i)(5)(ii)(A)(2). In addition, the deferred compensation must be attributable to the performance of services by the service provider for the corporation or corporations liable for the payment, or there is a bona fide business purpose for such corporation or corporations to be liable for the payment. In either case, no significant purpose of making such corporation or corporations liable for the payment can be the avoidance of federal income tax. *Id.*

[207] Treas. Reg. § 1.409A-3(i)(5)(ii)(A)(3). A majority shareholder is a shareholder owning more than 50 percent of the total fair market value and total voting power of the corporation. Treas. Reg. § 1.409A-3(i)(5)(ii)(B).

[208] Treas. Reg. § 1.409A-3(i)(5)(ii)(A)(3).

cel vested Options and SARs regardless of whether the Options and SARs vested before the Change-in-Control or as part of the Change-in-Control, and to pay the in-the-money value of the cancelled Options and SARs. The Preamble to the Proposed Section 409A regulations provided that the cancellation and payment is not a modification of the option or SAR.[209] A modification results in the grant of a new stock right that must satisfy the requirements for exemption anew.[210]

Alternative 2 of section 8(e) of the Model Plan grants the Administrator or Board the discretion to cash-out of Options and SARs that vested before the Change-in-Control. For the unvested Options and SARs, the acquiror will pay the in-the-money value of the Option or SAR determined as of the date of the consummation of the Change-in-Control. The acquiror will pay this amount if the vesting requirements that apply after the Change-in-Control are satisfied, and on the same schedule as the vesting schedule established on the Option's or SAR's Grant Date. Acquirors often wish to use this structure because it provides value on consummation of the change-in-control for the vested stock rights, and preserves the retention value of the unvested stock rights by requiring the service providers to remain employed to receive the in-the-money value.

Alternative 2 of section 8(e) of the Model Plan provision raises the issue of whether payment of the in-the-money value in accordance with the vesting schedule is an impermissible feature for the deferral of compensation that runs afoul of the requirements for exemption. An exempt option cannot have any feature for the deferral of compensation other than the deferral of recognition of income until the later of the exercise or disposition of the option under Treasury Regulation Section 1.83-1, and the time that the stock acquired on the option's exercise first becomes substantially vested under Treasury Regulation Section 1.83-3(b).[211] An exempt SAR cannot have any feature for the deferral of compensation other than the deferral of recognition of income until exercise of the SAR.[212]

The Final Regulations define a feature for the deferral of compensation as a right other than the right to receive cash or stock on the date of exercise, and such additional right would otherwise allow compensation to be deferred beyond the date of exercise.[213] The right to receive substantially nonvested stock (as defined in Treasury Regulation Section 1.83-3(b)) is not a feature for the deferral of compensation.[214] In addition, the definition of an impermissible extension of a stock right includes the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year, or the addition of any feature for the deferral of compensation.[215]

The answer to the question of whether the payment of the in-the-money value on the same schedule as the vesting schedule established on the date of grant is an impermissible feature for the deferral of compensation should be no for four reasons.[216] First, there is no deferral of the recognition of income beyond the stock right's date of exercise. Moreover, for options, the Final Regulations permit the deferral of recognition of income beyond the date of exercise until the date the stock received on exercise vests. Thus, the Final Regulations countenance the recognition of income beyond the date of exercise without the creation of an impermissible feature for the deferral of compensation. A grantee can exercise an option for unvested shares, and receive cash or otherwise recognize income on subsequent vesting without running afoul of the exemption from Section 409A. The payment of the in-the-money value of the stock right on the same schedule as the original vesting schedule is substantially similar economically to the deferral of income recognition until the receipt of cash or vested shares.

Second, the Final Regulations are aimed at preventing the abuse of grantees who before they exercise an option elect to defer the receipt of vested shares on exercise. This abuse is not at issue when the acquiror pays the in-the-money value on the same schedule as the original vesting schedule. Indeed, the recognition of income occurs on the original vesting schedule without any deferral or extension of the vesting schedule. Thus, there is no extension that constitutes the conversion or exchange of a stock right for a legally binding right to compensation in a future taxable year.

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[209] Department of the Treasury, Internal Revenue Service, Application of Section 409A to Nonqualified Deferred Compensation Plans, Notice of Proposed Rulemaking, Preamble § II(C), 70 Fed. Reg. 57,930, 57,935 (Oct. 4, 2005). A cash-out of an incentive stock option results in ordinary income to the employee, and a deduction to the employer. PLR 7809072.

[210] Treas. Reg. § 1.409A-1(b)(5)(v)(A) (a modification ''is considered to be the grant of a new stock right;'' new stock right may or may not be a deferral of compensation as determined on the date of grant of the new stock right); Treas. Reg. § 1.409A-1(b)(5)(v)(B) (a modification means any change in the terms of the stock right (or change in the terms of the plan under which the stock right was granted or in the terms of any other agreement governing the stock right) that may provide the holder with a direct or indirect reduction in the stock right's exercise price regardless of whether the holder in fact benefits from the change in terms).

[211] Treas. Reg. § 1.409A-1(b)(5)(i)(A)(3). The Final Regulations refer to the exercise or disposition of the option under Treas. Reg. § 1.83-7, rather than Treas. Reg. § 1.83-1, but this reference is apparently an error.

[212] Treas. Reg. § 1.409A-1(b)(5)(i)(B)(3).

[213] Treas. Reg. § 1.409A-1(b)(5)(i)(D). Under this rule the IRS would likely take the position that for vested stock rights, the payment of the in-the-money value other than as an immediate cash-out would run afoul of I.R.C. § 409A.

[214] *Id.*

[215] Treas. Reg. § 1.409A-1(b)(5)(v)(C)(1). An impermissible extension results in the stock right being treated as having had an additional deferral feature from the original date of grant, with the result that the stock right is treated as providing for the deferral of compensation from this date. Treas. Reg. § 1.409A-1(b)(5)(v)(A). Accordingly, the stock is retroactively treated as subject to I.R.C. § 409A as of the date of grant. When the holder has the discretionary right to exercise a vested option or SAR at any time, rather than on the permissible payment events and times of I.R.C. § 409A(a)(2) and Treas. Reg. § 1.409A-3(a), most stock rights will not satisfy I.R.C. § 409A. Thus, an impermissible extension results in a retroactive violation of I.R.C. § 409A as of the date of grant. Under proposed regulations, the tax for violation of I.R.C. § 409A is not imposed until the option vests. Prop. Treas. Reg. § 1.409A-4(a)(1)(i).

[216] *See* Daniel L. Hogans, ''Mergers and Other Corporate Transactions,'' in *Section 409A Handbook* 561, 583-86 (Regina Olshan & Erica F. Schohn eds., BNA 2010); Sharon J. Hendricks, ''Cash-Out/Liquidation of Options in Connection With Mergers and Acquisitions,'' *Executive Compensation: Strategy, Design, and Implementation* 29 (ALI-ABA June 2010).

Third, the Final Regulations permit a change in the vesting schedule on a change-in-control for any stock right or plan of deferred compensation that would otherwise vest on the change-in-control without treatment as an impermissible subsequent deferral election or acceleration of payments.[217] Since the creation of a new vesting schedule on a change-in-control does not run afoul of Section 409A, neither should continuation of the same vesting schedule on a change-in-control.

Fourth, the cash-out of stock rights on the same schedule as the original vesting schedule is analogous to an election as to the medium of payment of either in stock or cash. The Final Regulations provide that Section 409A does not apply to an election as to the medium of payment, such as an election between a payment of cash or a payment of property.[218] Rather, Section 409A applies to the elections as to the timing of the payment, and the form of payment as a lump sum, installments, or an annuity.

For example, a service recipient establishes a stock bonus plan, and grants unvested shares to employees on Jan. 1, 2013. If the service provider continues to be employed through Dec. 31, 2014, the service provider vests in the shares. The plan qualifies for the short-term deferral exemption. On Dec. 31, 2013, the service recipient and service provider agree to convert the shares to cash in an amount equal to the average market price for the preceding thirty days. The service recipient will pay the cash on Dec. 31, 2014. Since the payment and vesting dates remain the same, the change in the medium of payment from shares to cash does not cause the plan to lose the short-term deferral exemption.

Similarly, when the vesting and payment dates remain the same for the cash-out of unvested stock rights, the change in the medium of payment from shares to cash should not run afoul of the Final Regulations. Moreover, the abuses with which Section 409A is concerned, changes to the timing and form of payment, are not at issue.

Finally, in corporate transactions, acquirors and targets often wish to cancel unexercised options and SARs. Section 8(i) of the Model Plan provides that in a Section 424 Corporate Transaction, the Administrator or Board may: (1) contingent on consummation of the Section 424 Corporate Transaction, fully vest all or any portion of the Options and SARs at least fifteen days before the reasonably anticipated date of consummation; (2) require the Grantees to exercise their vested Options and SARs before consummation of the Section 424 Corporate Transaction; and (3) cancel the Options and SARs that are not exercised.

The Final Regulations and incentive stock option regulations provide that a change in the terms of a stock right that shortens the period during which it is exercisable is not a modification.[219]

Assumption and Substitution of Stock Rights in Section 424 Corporate Transactions

The Final Regulations provide rules for when an assumption or substitution of a stock right by reason of a corporate transaction does not cause a modification to the stock right, and does not result in the loss of the stock right's status as service recipient stock.[220] The Model Plan satisfies these rules in the Section 424 Corporate Transaction provisions in section 8(f), and in the definition of ''Section 424 Corporate Transaction'' in section 25(tt).

The rules on assumption and substitution under the Final Regulations[221] are largely borrowed from Treasury Regulation Section 1.424-1 of the incentive stock option regulations. These rules prevent any improvement in the holder's economic position without tax consequence, and allow the amount of the exercise price and underlying shares to be adjusted when the stock rights are converted from the target's stock to the acquiror's stock.

The Final Regulations do not adopt the requirement of the incentive stock option regulations that an eligible corporation assume or grant the substituted option. An eligible corporation is the employer of the optionee or a related corporation of the employer corporation determined immediately after the corporate transaction.[222] Under the Final Regulations, this requirement does not apply.[223]

Under the incentive stock option regulations, the conversion must satisfy a spread test and ratio test. Under the spread test, the new right's aggregate spread of the excess of the fair market value of the shares over the exercise price must not exceed the old right's aggregate spread at the time of conversion.[224]

Under the ratio test, on a per share basis, the ratio of the exercise price to the fair market value of the shares must not be more favorable for the new right than it was for the old right at the time of conversion.[225] Thus, the ratio for the new right can only be the same or greater than the ratio for the old right. As long as the aggregate spread is maintained, each new right can be less in-the-money than the old right.

The Final Regulations adopt the spread test, and favorably modify the ratio test. The ratio test will be deemed satisfied if, on a per share basis, the ratio of the exercise price to the fair market value of the shares subject to the stock right immediately after the conversion is not greater than the ratio of the exercise price to the fair market value of the shares immediately before the conversion.[226] Thus, the ratio for the new right can be

[217] Treas. Reg. § 1.409A-3(i)(5)(iv)(B).
[218] Treas. Reg. § 1.409A-2(a)(1).
[219] Treas. Reg. §§ 1.409A-1(b)(5)(v)(B) and 1.424-1(e)(4)(i).

[220] Treas. Reg. § 1.409A-1(b)(5)(iii)(E)(4) (upon compliance with Treas. Reg. § 1.409A-1(b)(5)(v)(D) in an assumption or substitution, the stock underlying the stock right that replaced the stock right that is substituted or assumed is treated as service recipient stock); Treas. Reg. § 1.409A-1(b)(5)(v)(D) (upon compliance with the regulation's requirements, the assumption or substitution will not be treated as the grant of a new stock right or a change in the form of payment). A ''corporate transaction'' is: (1) an acquisition of property or stock, consolidation, liquidation, merger, reorganization, or separation; (2) a distribution (excluding an ordinary dividend or a stock split or stock dividend) or change in the terms or number of outstanding shares of the corporation; or (3) such other corporate events as may be prescribed by the IRS in published guidance. Treas. Reg. § 1.424-1(a)(3).
[221] Treas. Reg. § 1.409A-1(b)(5)(v)(D).
[222] Treas. Reg. § 1.424-1(a). A ''related corporation'' is a parent or subsidiary as defined in I.R.C. § 424(e)-(f). Treas. Reg. § 1.421-1(i)(2).
[223] Treas. Reg. § 1.409A-1(b)(5)(v)(D).
[224] Treas. Reg. § 1.424-1(a)(5)(ii).
[225] Treas. Reg. § 1.424-1(a)(5)(iii).
[226] Treas. Reg. § 1.409A-1(b)(5)(v)(D).

less than the ratio for the old right. As long as the aggregate spread is maintained, each new right can be more in-the-money than the old right. This modification allows an acquiror to limit dilution by issuing options covering fewer shares than under the incentive stock option regulations, and is useful in leveraged transactions.

These rules raise the issue of whether the ratio test under the Final Regulations replaces the ratio test under the incentive stock option regulations, or is an alternative test to the test under the incentive stock option regulations. In other words, if an assumption or substitution satisfies either test, will the transaction avoid a modification and preserve service recipient stock status?

Counsel can reasonably take the position that satisfaction of either test is permissible. First, the language of the Final Regulations states that the ratio test of Treasury Regulation Section 1.424-1(a)(5)(iii) ''will be deemed to be satisfied'' if the test under the Final Regulations is satisfied. The use of this language is not language of replacement. Second, use of the alternative tests is not inconsistent with any policy of the Final Regulations.[227] Accordingly, section 8(f)(ii) of the Model Plan uses the alternative tests.

The remaining requirements for an assumption or substitution are that: (1) the assumed or new stock right must contain all the terms of the old stock right except to the extent that the corporate transaction renders these terms inoperative;[228] and (2) the assumed or new stock right must not give the holder additional benefits that the holder did not have under the old stock right.[229]

For example, an employee holds an option for 100 shares of the common stock of Oldco. Before Oldco's acquisition by Newco, the option has an exercise price of $25, and the underlying stock has a fair market value of $40. The aggregate spread is $1,500, and the ratio of the exercise price to fair market value is 25/40, which is equal to .625. After the acquisition, a Newco option is substituted for the Oldco option. The Newco option is for sixty shares of the common stock of Newco, has an exercise price of $25, and the underlying stock has a fair market value of $50. The aggregate spread is $1,500, and the ratio of the exercise price to fair market value is 25/50, which is equal to .5. The ratio after the acquisition is not greater than the ratio before the acquisition, and is more favorable to the employee. The ratio test of the Final Regulations is satisfied, but the ratio test of the incentive stock option regulations is not satisfied. The substitution does not result in a modification of the Oldco option.

As another example, the facts are the same as in the first example for the Oldco option. After the acquisition, a Newco option is substituted for the Oldco option. The Newco option is for 100 shares of the common stock of Newco, has an exercise price of $35, and the underlying stock has a fair market value of $50. The aggregate spread is $1,500, and the ratio of the exercise price to fair market value is 35/50, which is equal to .7. The ratio after the acquisition is greater than the ratio before the acquisition, and is not more favorable to the employee. The ratio test of the Final Regulations is not satisfied, but the ratio test of the incentive stock option regulations is satisfied. Under the position that the ratio tests of the Final Regulations and incentive stock option regulations are alternative tests, the substitution does not result in a modification of the Oldco option.

Adjustments on Equity Restructuring Transactions

The Final Regulations and incentive stock option regulations allow for an adjustment of the exercise price and number of shares subject to options and SARs for stock splits (including reverse stock splits) and stock dividends.[230] Section 10(b) of the Model Plan provides for this adjustment. Alternative 1 provides that the Administrator or Board in its exclusive discretion may make the adjustment. Alternative 2 provides that the Administrator or Board must make the adjustment.

Section 10(a) of the Model Plan provides for adjustments of Awards on equity restructuring events, such as an extraordinary cash dividend, merger, recapitalization, or spin-off, and an adjustment is necessary or appropriate to prevent dilution or enlargement of Grantees' rights. Alternative 1 provides that the Administrator or Board in its exclusive discretion may adjust all or any portion of the number of shares available for Awards, and the exercise or purchase price. Alternative 2 provides that the Administrator or Board must make the adjustments, but has the discretion to determine which adjustments to make.

When an adjustment is made on consummation of an equity restructuring transaction, the plan's use of a fully discretionary adjustment provision, or a mandatory adjustment provision, affects the accounting treatment of an equity compensation award. Under FAS 123(R), on the grant date a company recognizes a compensation expense equal to the fair market value of the award. On an adjustment under a fully discretionary provision, the company records an additional compensation expense equal to the excess of the fair market value of the award immediately after the adjustment over the fair market value of the award immediately before the adjustment. On an adjustment under a mandatory provision, the company does not record any additional compensation expense.

Indemnification, Advancement and Fees for Fees

The Final Regulations contain an exemption from Section 409A for the service recipient's indemnification of the service provider to the extent permissible under applicable law against all or part of the expenses incurred, or damages paid or payable by the service provider, for a bona fide claim against the service provider or service recipient.[231] The indemnified expenses include amounts paid or payable by the service provider in settlement when the claim is based on the service

[227] *See* Erica F. Schohn, ''Equity Arrangements,'' in *Section 409A Handbook* 419, 449 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[228] Treas. Reg. § 1.424-1(a)(5)(iv).

[229] Treas. Reg. § 1.424-1(a)(5)(v).

[230] Treas. Reg. §§ 1.409A-1(b)(5)(v)(H) and 1.424-1(e)(4)(v).

[231] Treas. Reg. § 1.409A-1(b)(10). The exemption also applies to the purchase of an insurance policy for payments of the items described in the text. *Id.*

provider's acts or failures to act in his or her capacity as a service provider to the service recipient.[232] The indemnification provisions of section 18(a) and (c)-(e) of the Model Plan are intended to satisfy this exemption.

It is important to note that under corporate law principles, the right to indemnification and the right to advancement of attorney's fees and litigation expenses are separate rights.[233] Accordingly, section 18(b) of the Model Plan provides for advancement. The Final Regulations do not address advancement. Counsel can reasonably take the position that since the purpose of advancement is to cover the expenses that come within the exemption for indemnification, the exemption should also apply to advancement.

To rely on the short-term deferral exemption for advancement is problematic for two reasons. First, the right to advancement may not be subject to a substantial risk of forfeiture. Under the Final Regulations, compensation is subject to a substantial risk of forfeiture if entitlement to the compensation is conditioned on the occurrence of a condition related to a purpose of the compensation, and the possibility of forfeiture is substantial. A condition related to a purpose of the compensation must relate to the service provider's performance for the service recipient, or the service recipient's business activities or organizational goals (for example, the attainment of a prescribed level of earnings or equity value, or completion of an initial public offering).[234]

Under this rule, the IRS can take the position that the indemnitee vests in the right to advancement when the indemnitee obtains the contractual right to advancement, and not when a claim is asserted that triggers the service recipient's obligation to advance the indemnified expenses. In other words, the assertion of a claim is not a condition that relates to the service provider's performance for the service recipient, or the service recipient's business activities or organizational goals. The IRS can also take the position that regardless of whether the assertion of a claim is a condition related to the service provider's performance or the service recipient's business activities, the possibility of forfeiture is not substantial.

Second, once a claim is asserted that triggers the service recipient's advancement obligation, it is unlikely that the advancement of expenses through the final resolution of the claim will be completed within the short-term deferral period.

In addition, under corporate law principles the right to indemnification or advancement does not necessarily apply to the attorney's fees and litigation expenses that a service provider incurs in bringing a claim against the service recipient to recover on the service recipient's indemnification or advancement obligation (''Fees for Fees'').[235] When the right to indemnification does not

[232] *Id.*

[233] *Aleynikov v. The Goldman Sachs Group, Inc.*, 2013 U.S. Dist. LEXIS 151603, at *16 (D.N.J. Oct. 22, 2013) (under Delaware corporation statutes, ''[t]he right to indemnification and the right to advancement are 'separate and distinct.' Indemnification depends on whether the officer's defense in underlying litigation has succeeded. Advancement, by contrast, depends on the pendency, not the merits, of the claims asserted against the corporate official.''); *United States v. Stein*, 452 F. Supp. 2d 230, 272 (S.D.N.Y. 2006) (under Delaware corporation statutes, ''a company that undertakes to advance defense costs may not avoid that obligation by claiming that the litigation against its former employee for which the employee seeks advancement of defense costs accuses the employee of conduct that, if proved, would foreclose indemnification or establish a breach of the employment contract or of a fiduciary or other duty owed to the company.''); *Homestore, Inc. v. Tafeen*, 888 A.2d 204, 212-13 (Del. 2005) (''Although the right to indemnification and advancement are correlative, they are separate and distinct legal actions. The right to advancement is not dependent on the right to indemnification. The right to indemnification requires 'success on the merits or otherwise' in defending proceedings brought under section 145(a) or (b) [of the Delaware General Corporation Law]. Section 145(e), however, expressly contemplates that corporations may confer a right to advancement that is *greater* than the right to indemnification and recognizes that advances must be repaid if it is ultimately determined that the corporate official is not entitled to be indemnified.'') (footnotes omitted); *Miller v. Miller*, 973 N.E.2d 228 (Ohio 2012) (under Ohio corporation statutes, advancement of litigation expenses for directors and officers is a remedy distinct from indemnification).

See generally William D. Johnston, ''Flexibility Under Delaware Law in Drafting Advancement Provisions on a 'Clear Day,' and Potential Surprises For Those Who Do Not Take Advantage of That Flexibility,'' 13 *Delaware Law Review* 21 (2011); Steven A. Radin, '''Sinners Who Found Religion:' Advancement of Litigation Expenses to Corporate Officials Accused of Wrongdoing,'' 25 *Review of Litigation* 251 (2006); Richard A. Rossman, Matthew J. Lund & Kathy K. Lochmann, ''A Primer on Advancement of Defense Costs: The Rights and Duties of Officers and Corporations,'' 85 *University of Detroit Mercy Law Review* 29 (Fall 2007).

[234] Treas. Reg. § 1.409A-1(d)(1).

[235] *See Random Ventures, Inc. v. Advanced Armament Corp., LLC*, 2014 U.S. Dist. LEXIS 66453, at *15-16 (S.D.N.Y. May 2, 2014) (provision for indemnification of attorney's fees in asset purchase agreement applied to intra-party litigation; agreement provided for buyer to indemnify seller for losses incurred by seller arising from any breach by buyer of its obligations under the agreement; only person with standing to sue under this provision was the seller since the purchase price and EBITDA payment were due only to the seller and not any third-party; agreement also contained separate notice provisions for intra-party claims and third-party claims); *Islip U-Slip LLC v. Gander Mountain Co.*, 2014 U.S. Dist. LEXIS 25023, at *29-30 (S.D.N.Y. Feb. 27, 2014) (''Courts in the Second Circuit have employed the following principles of construction to determine whether indemnification provisions are intended to include attorneys' fees in suits between parties to the contract: (1) the analysis begins with the presumption that the agreement does not cover attorneys' fees in an action between the parties; (2) a provision containing only broad language that does not unequivocally indicate that the parties intended to indemnify attorneys' fees will not support such a claim; (3) if it is apparent that no third-party claims were contemplated between the parties, the agreement should be construed to provide indemnity for claims between the parties; (4) likewise, if future third-party claims were possible at the time of the contract, there should be no indemnification for suits between the parties; and (5) indemnification provisions that specifically distinguish third-party claims from interparty claims indicate an intent to cover claims between the parties.''); *Berkley RegionalInsurance Co. v. Weir Bros., Inc.*, 2013 U.S. Dist. LEXIS 160492 (S.D.N.Y. Nov. 6, 2013) (indemnity agreement provided for indemnification of attorney's fees and costs for enforcement of agreement; this language was unmistakably clear that it covered claims between the parties to the agreement); *Kessler v. Gleich*, 13 A.3d 109 (N.H. 2010) (partnership agreement required general partner to indemnify the partnership, limited partners, and the other general partners ''from and against any claim, loss, expense, liability, action or damage, including, without limitation, reasonable costs and expenses of litigation and appeal (and the reasonable fees and expenses of counsel) arising out his fraud, bad faith, gross negligence, or

apply to Fees for Fees, a separate provision for the payment of Fees for Fees is necessary. Section 18(f)-(o) of the Model Plan contains a separate provision for the payment of Fees for Fees.

Under the Final Regulations, the exemption for indemnification does not apply to Fees for Fees. Instead, Fees for Fees are governed by either the short-term deferral exemption, or a separate rule for the reimbursement of expenses or provision of in-kind benefits.[236] The separate rule is a method to satisfy the permissible payment time of a specified time or fixed schedule.[237] The requirements of the separate rule are:

(1) the plan provides an objectively determinable, nondiscretionary definition of the expenses eligible for reimbursement or the in-kind benefits to be provided;

(2) the plan provides for the reimbursement of expenses incurred or the provision of the in-kind benefits during an objectively and specifically prescribed period (including the lifetime of the service provider);

(3) the plan provides that the amount of expenses eligible for reimbursement, or in-kind benefits to be provided, during a service provider's taxable year may not affect the expenses eligible for reimbursement, or in-kind benefits to be provided, in any other taxable year;

(4) the reimbursement of an eligible expense is made on or before the last day of the service provider's taxable year following the taxable year in which the expense was incurred; and

(5) the right to reimbursement or in-kind benefits is not subject to liquidation or exchange for another benefit.[238]

Section 18(f) provides for the indemnification for the reasonable accountant's, actuary's, and attorney's fees and disbursements incurred in bringing the claims for indemnification and advancement on which the Indemnitee substantially prevails. These fees and disbursements must satisfy the first requirement of an objectively determinable nondiscretionary definition of the expenses eligible for reimbursement or in-kind benefits to be provided.

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his willful failure to comply with any representation, condition, or other agreement herein contained;'' these claims could be brought by the limited partners or by third-parties; had the parties wished to demonstrate their clear intent to require the general partner to indemnify the limited partners for attorney's fees and costs incurred in an action between them, they could have used language that referred specifically to an action between them; because the intention to require indemnity in an action between the parties is not unmistakably clear from the language of the parties, the court will not infer such an intention); *Baker v. Health Management Systems, Inc.*, 745 N.Y.S.2d 741, 743, 746 (2002) (Section 722(a) of New York Business Corporation Law permitted corporation to indemnify directors and officers made or threatened to be made a party to an action or proceeding for ''attorneys' fees actually and necessarily incurred as a result of such action or proceeding;'' statute did not permit recovery of attorneys' fees incurred in action to recovery on corporation's indemnification obligation; ''[W]e observe that our holding does not leave corporate officers and directors remediless; *Business Corporation Law § 721* expressly provides that article 7 is not an exclusive remedy and, thus, corporations remain free to provide indemnification of fees on fees in bylaws, employment contracts or through insurance.''); *Hooper Associates, Ltd. v. AGS Computers, Inc.*, 549 N.Y.S.2d 365, 367 (1989) (''Inasmuch as a promise by one party to a contract to indemnify the other for attorney's fees incurred in litigation between them is contrary to the well-understood rule that parties are responsible for their own attorney's fees, the court should not infer a party's intention to waive the benefit of the rule unless the intention to do so is unmistakably clear from the language of the promise.''); *546-552 West 146th Street LLC v. Arfa*, 950 N.Y.S.2d 24 (App. Div. 2012) (operating agreement provided that company shall indemnify manager ''from and against all claims and demands to the maximum extent permitted under the Act [New York Limited Liability Company Law § 420];'' Section 420 permits company to indemnify members and managers from and against any and all claims and demands; since Section 420 does not explicitly provide for an award of fees on fees, and the operating agreement did not contain unambiguous language providing for the recovery of fees on fees, managers who successfully sued for indemnification were not entitled to fees on fees); *Gotham Partners, L.P. v. High River Limited Partnership*, 906 N.Y.S.2d 205 (App. Div. 2010) (follows *Hooper*), *leave to appeal denied*, 933 N.Y.S.2d 653 (2011).

See also George Bundy Smith & Thomas J. Hall, ''Extending Indemnification Clauses To Claims Between Contracting Parties,'' *New York Law Journal*, Aug. 20, 2010, at 3.

But cf. Zalkind v.Ceradyne, Inc., 124 Cal. Rptr. 3d 105 (Ct. App. 2011) (seller's claim against buyer for breach of asset purchase agreement came within agreement's indemnification provisions; agreement provided for indemnification against ''any and all Damages that arise from or are in connection with . . . (b) Any breach or default by the Buyer of its covenants or agreements contained in this Agreement;'' agreement defined Damages as ''(i) demands, claims, actions, suits, investigations and legal or other proceedings brought against any indemnified party or parties, and any judgments or assessments, fines or penalties rendered therein or any settlements thereof, and (ii) all liabilities, damages, losses, Taxes, assessments, costs and expenses (including, without limitation, reasonable attorneys' and accountants' fees and expenses) incurred by any indemnified party or parties, to the extent not reimbursed or paid for by insurance, whether or not they have arisen from or were incurred in or as a result of any demand, claim, action, suit, assessment or other proceeding or any settlement or judgment;'' use of broad language of ''any and all Damages'' that applied to the buyer's breach, and of ''all liabilities, damages, losses'' in the definition of Damages showed that indemnification covered claims between the parties to the agreement; in addition, the damages in clause (i) correlated to third-party claims, and the damages in clause (ii) correlated to claims between the parties to the agreement; indemnification means a shifting of losses, rather than any requirement that third-party losses be involved; if a party wishes to narrow an indemnification clause to third-party claims, it must expressly limit the scope of the clause, and absent such express limitation, the clause may apply to claims between the parties to the contract); *Stifel Financial Corp. v. Cochran*, 809 A.2d 555, 561-62 (Del. 2002) (corporate bylaws provided for indemnification ''to the full extent authorized by law;'' ''We hold that indemnification expenses incurred in successfully prosecuting an indemnification suit are permissible under § 145(a) [of Delaware General Corporation Law], and therefore 'authorized by law.' Allowing indemnification for the expenses incurred by a director in pursuing his indemnification rights gives recognition to the reality that the corporation itself is responsible for putting the director through the process of litigation. Further, giving full effect to § 145 prevents a corporation from using its 'deep pockets' to wear down a former director, with a valid claim to indemnification, through expensive litigation. Finally, corporations will not be unduly punished by this result. They remain free to tailor their indemnification bylaws to exclude 'fees on fees,' if that is a desirable goal.'').

[236] Treas. Reg. § 1.409A-3(i)(l)(iv)(A).

[237] I.R.C. § 409A(a)(2)(A)(iv); Treas. Reg. § 1.409A-3(a)(4) and (i)(1)(iv)(A).

[238] Treas. Reg. § 1.409A-3(i)(l)(iv)(A).

Since the Final Regulations do not define either ''objectively determinable'' or ''nondiscretionary,''[239] and these terms are otherwise vague,[240] section 18(f)-(h) of the Model Plan takes a conservative approach in satisfying the first requirement. Section 18(f) caps the indemnification of the fees and disbursements incurred to the Maximum Fees and Maximum Disbursements. Section 18(g) defines ''Maximum Fees'' by reference to the average hourly rates of different groups of personnel in the 10 largest accounting firms, actuarial firms, and law firms in the United States. Section 18(h) provides a similar definition of ''Maximum Disbursements.''

Section 18(o) provides that the indemnification and advancement obligations will apply from the date that an Indemnitee first has the right to act in the Plan's administration until the expiration of the statute of limitations as it may be tolled or extended for each claim to which the Indemnitee is entitled to indemnification (the ''Claim Period''). If a claim is made during the Claim Period, the indemnification obligation will continue beyond the Claim Period until the final and nonappealable resolution of the claim. These provisions satisfy the second requirement.

Section 18(l) satisfies the third requirement.

Section 18(i) provides for payment of the Fees for Fees within sixty days after: (1) entry of a final and nonappealable judgment for an award of Fees for Fees; or (2) execution of a final and nonappealable settlement agreement for payment of Fees for Fees. In a protracted litigation this provision is unlikely to satisfy the fourth requirement of payment by the end of the taxable year following the taxable year in which the expense was incurred. One approach is to provide for advancement with a clawback right in the service recipient for the claims on which the Grantee does not substantially prevail.[241] Since the relationship between service recipient and service provider is driven by market forces that usually do not allow for this approach, this approach is unrealistic.

Rather than seek to satisfy the requirements of the separate rule, counsel can take the position that until there is a final judgment or settlement agreement, the right to reimbursement is subject to a substantial risk of forfeiture.[242] Once this risk lapses and the Indemnitee becomes vested in the right to the payment of Fees for Fees, and the service recipient pays the Fees for Fees within the applicable 2½ month period,[243] the short-term deferral exemption is satisfied.[244] Once the short-term deferral exemption is satisfied, the plan does not

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[239] Under the qualified performance-based compensation regulations of I.R.C. § 162(m), a ''performance goal is objective if a third-party having knowledge of the relevant facts could determine whether the goal is met.'' Treas. Reg. § 1.162-27(e)(2)(i). The regulations provide the following example. Corporation U establishes a bonus plan under which a specified class of employees will participate in a bonus pool if certain preestablished performance goals are attained. The amount of the bonus pool is determined under an objective formula. Under the terms of the bonus plan, the compensation committee retains the discretion to determine the fraction of the bonus pool that each employee may receive. Although the aggregate amount of the bonus pool is determined under an objective formula, a third-party could not determine the amount that any individual could receive under the plan. Treas. Reg. § 1.162-27(e)(2)(vii), ex. 7. Under this example, is there a difference between objective and nondiscretionary?

The *Shorter Oxford English Dictionary* defines ''objective'' as ''[d]ealing with or laying stress on what is external to the mind; concerned with outward things or events; presenting facts uncoloured by feelings, opinions, or personal bias; disinterested.'' 2 *Shorter Oxford English Dictionary*, ''Objective,'' sense 9, subsense a, at 1969 (6th ed. Oxford University Press 2007). In the arm's length relationship between service recipient and service provider, most expenses subject to negotiation over reimbursement should satisfy this definition. In addition, in the arm's length relationship between the service provider (e.g., the employee) and the third-party provider of services to the employee, most expenses for the services that are subject to negotiation between the employee and third-party service provider should also satisfy this definition.

The *Shorter Oxford English Dictionary* defines ''discretion'' as the ''[f]reedom to decide or act as one thinks fit, absolutely or within limits; having one's own judgment as sole arbiter.'' 1 *Shorter Oxford English Dictionary*, ''Discretion,'' sense 4, subsense a, at 701 (6th ed. Oxford University Press 2007). Does this definition mean that if the third-party service provider, such as an accounting firm or law firm, retains the discretion to increase its fees at stated intervals, the fees are discretionary? Does this definition also mean that when the expenses eligible for reimbursement are subject to negotiation between the employee and third-party service provider, or renegotiation after expiration of a contract's term, the expenses are discretionary? Finally, does this definition mean that once negotiations with a third-party service provider are concluded, the expenses are no longer discretionary?

[240] *See* Kenneth A. Adams, *A Manual of Style for Contract Drafting* ¶ 7.34 (3d ed. ABA 2013) (''Drafters invoke vagueness whenever lack of control (over the future, over someone else's conduct) renders precise standards unworkable. For example, if a provision requiring reimbursement of attorneys' fees and expenses would likely cover a broad range of litigation, it probably wouldn't make sense to cap fees and expenses at a stated amount. A drafter might instead make use of vagueness by having the provision refer to reimbursement of *reasonable attorneys' fees and expenses*.''); Tina L. Stark, *Drafting Contracts* ¶¶ 21.2.2 and 25.5 (2d ed. Wolters Kluwer 2014) (''Vagueness is neither inherently good nor bad. It depends on what concept best expresses the parties' agreement and on what best protects your client or advances his interests. Assume that you represent a senior executive in the negotiation of his employment agreement with a large, privately held company. The company's first draft of the employment agreement states that it will lend the executive '$500,000 at 3.5% per year for the purchase of a house in Manhattan.' *House* is problematic. It is too specific. Manhattan has very few houses. It has cooperatives, condominiums, townhouses, and lofts. While *house* might be perfectly appropriate in most parts of the country, in Manhattan, a more vague, more inclusive term such as *residence* or *home* is more appropriate.'') (footnote omitted) (''While vagueness may invite a dispute over a standard, sometimes it is the only way to bridge disparate positions or to provide a party with flexibility. Vagueness is the drafter's equivalent of the reasonable person standard. Parties use it to establish a facts and circumstances test. For example, if a *force majeure* event occurs, how quickly must the nonperforming party tell the other party of the occurrence? Immediately? Within 24 hours? What if the nonperforming party is cut off from all communication because of the *force majeure* event? Under those circumstances, the 24-hour cutoff is unreasonable. More equitable would be *as soon as feasible*.'').

See generally Albert Choi & George Triantis, ''Strategic Vagueness in Contract Design: The Case of Corporate Acquisitions,'' 119 *Yale Law Journal* 848 (2010).

[241] *See* Mark L. Stember & Lois Wagman Colbert, ''Reimbursement Arrangements,'' in *Section 409A Handbook* 539, 559 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[242] Treas. Reg. § 1.409A-1(d)(1).

[243] Treas. Reg. § 1.400A-1(b)(4)(i)(A).

have to satisfy the separate rule for reimbursement of expenses or provision of in-kind benefits.[245]

Section 18(m) satisfies the fifth requirement.

Finally, when a plan document does not satisfy the separate rule for reimbursements and is otherwise required to satisfy this rule, the plan is eligible for the IRS correction program for documentary failures.[246]

Section 18(j) of the Model Plan provides for the six month delay for specified employees of publicly-traded corporations when the obligation to pay Fees for Fees is triggered on a Separation From Service. If counsel seeks to satisfy the separate rule for reimbursements or provision of in-kind benefits, the plan must provide for the six month delay in the payment of Fees for Fees to specified employees of publicly-traded corporations.[247] A plan document that does not satisfy the requirements for the six month delay is eligible for the IRS correction program for documentary failures.[248]

If counsel takes the position that the short-term deferral exemption applies, the reimbursements are exempt from the six month delay requirement. Section 18(j) provides that the six month delay requirement applies to the extent that the Fees for Fees are nonqualified deferred compensation subject to Section 409A. Accordingly, the Model Plan does not impose the six month delay requirement when it is not otherwise necessary.

Section 409A Interpretive Clause

Section 20(c) of the Model Plan contains the following Section 409A interpretive clause, ''The Administrator shall administer, construe, and interpret the Plan, and exercise its authority and discretion, to satisfy Applicable Requirements, and the requirements of Code Section 409A or any exemption thereto.'' The Final Regulations provide that general provisions in a plan that purport to nullify noncompliant plan terms, or to supply any specific plan terms required by Treasury Regulation Sections 1.409A-1, 1.409A-2, or 1.409A-3, are disregarded.[249]

In IRS Notice 2010-6, the IRS loosened this rule's chokehold on a plan's ability to avoid documentary noncompliance with Section 409A.[250] Under the Notice, when a plan subject to Section 409A designates a payment event but does not define the payment event, or has an ambiguous definition of the payment event, the plan does not have a documentary failure when the plan also contains a Section 409A interpretive clause requiring that the term be interpreted to comply with Section 409A.[251]

For example, the use of the term ''termination of employment'' as a payment event could be interpreted to mean only events that are a separation from service under Treasury Regulation Section 1.409A-1(h), or also to include events that are not a separation from service under this regulation, and to exclude events that must be included in the definition of separation from service.[252] Similarly, the use of the term ''acquisition'' of the service recipient as a payment event could be interpreted to mean only events that are a change-in-control under Treasury Regulation Section 1.409A-3(a)(5), or also to include events that are not a change-in-control under this regulation.[253]

If the plan contains a Section 409A interpretive clause requiring that the term be interpreted to comply with the requirements of Section 409A, or another clause to the same effect, the term is not ambiguous and complies with the requirements of Section 409A and Treasury Regulation Section 1.409A-3(a).[254]

Notice 2010-6 also provides that an interpretive clause will not cure a payment term that explicitly includes Section 409A noncompliant payment events, or explicitly excludes required payment events. In addition, an interpretive clause will not cure an ambiguous term when the service recipient has a pattern or practice on or after Jan. 1, 2009, of applying a specific interpretation that does not comply with Section 409A. This rule applies to the plans to which the service recipient has applied the interpretation, and any other plan with substantially similar language regardless of whether

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[244] *See* Mark L. Stember & Lois Wagman Colbert, ''Reimbursement Arrangements,'' in *Section 409A Handbook* 539, 558 (Regina Olshan & Erica F. Schohn eds., BNA 2010).

[245] The Final Regulations also contain an exemption to I.R.C. § 409A for the following reimbursements. To the extent that a separation pay plan (including a plan providing payments upon a voluntary separation from service) entitles a service provider to payments by the service recipient of reimbursements that are not otherwise excludible from gross income for expenses that the service provider could otherwise deduct under I.R.C. §§ 162 or 167 as business expenses incurred in connection with the performance of services (ignoring any applicable limitation based on adjusted gross income), or of reasonable outplacement expenses and reasonable moving expenses actually incurred by the service provider and directly related to the termination of services for the service recipient, the plan does not provide for a deferral of compensation to the extent the rights apply during a limited period of time (regardless of whether the rights extend beyond the limited period of time). Treas. Reg. § 1.409A-1(b)(9)(v)(A). The reimbursement of reasonable moving expenses includes the reimbursement of all or part of any loss that the service provider actually incurs on the sale of a primary residence in connection with a separation from service. *Id.*

A limited period of time means the period until the last day of the service provider's second taxable year following the service provider's taxable year in which the separation from service occurred. The period during which the reimbursements must be paid cannot extend beyond the service provider's third taxable year following the service provider's taxable year in which the separation from service occurred. Treas. Reg. § 1.409A-1(b)(9)(v)(E).

Payment by the service recipient directly to the person providing the goods or services to the service provider is not treated as providing for a deferral of compensation if the right to reimbursement would not be treated as a deferral of compensation. Treas. Reg. § 1.409A-1(b)(9)(v)(C).

Reimbursements that satisfy this exemption do not have to satisfy the separate rule for satisfaction of payment of deferred compensation on a specified date or fixed schedule for reimbursements of expenses or provision of in-kind benefits under Treas. Reg. § 1.409A-3(i)(l)(iv)(A).

[246] IRS Notice 2010-6, 2010-3 I.R.B. 275, 287, § VII.F (Jan. 19, 2010).

[247] I.R.C. § 409A(a)(2)(B)(i); Treas. Reg. §§ 1.409A-1(c)(3)(v), (i) and (k), and 1.409A-3(a)(1) and (i)(2).

[248] IRS Notice 2010-6, 2010-3 I.R.B. 275, 289, § VIII (Jan. 19, 2010).

[249] Treas. Reg. § 1.409A-1(c)(1).

[250] 2010-3 I.R.B. 275 (Jan. 19, 2010).

[251] *Id.* at 280, § IV.B.1.

[252] *Id.*

[253] *Id.*

[254] *Id.*

the plans provide deferred compensation to the same service provider or providers.[255]

Finally, when a court with jurisdiction over enforcement of the contract has interpreted the plan term, an interpretive clause will not cure an ambiguous term for the plan subject to the court's decision, or for any other plan of the service recipient with substantially similar language over which the same court has jurisdiction. This rule applies regardless of whether the plans provide deferred compensation to the same service provider or providers.[256]

Although Notice 2010-6 addresses payment events in plans subject to Section 409A, counsel can reasonably take the position that when a Section 409A interpretive clause seeks compliance with Section 409A or an exemption thereto, the clause applies to any ambiguous term or provision.[257]

THE MODEL PLAN

ABC, INC.
EQUITY COMPENSATION PLAN

The Model Plan was prepared by Steven H. Sholk, Esq., Gibbons P.C. (ssholk@gibbonslaw.com).

1. **Purposes**. The purposes of the ABC, Inc. Equity Compensation Plan are to: (a) attract, reward, and retain the best available Employees, Directors, and Contractors; (b) provide additional incentives to Employees to contribute to the growth and profitability of the Company and its Broader Related Entities; and (c) align the interests of Employees, Directors, and Contractors with the Company's shareholders.

2. **Shares Subject to the Plan**.

(a) The maximum aggregate number of Shares that the Company may issue through Awards is _____ Shares.

(b) The maximum aggregate number of Shares that the Company may issue through Incentive Stock Options is _____ Shares.

(c) Upon the Company becoming subject to Code Section 162(m), the maximum aggregate number of Shares that the Company may issue through Options and SARs is _____ Shares.

(d) Upon the Company becoming subject to Code Section 162(m), the maximum aggregate number of Shares that the Company may issue through Options and SARs per individual Employee [Alternative 1: in a calendar year] [Alternative 2: in the Company's fiscal year] is _____ Shares.

(e) Upon the Company becoming subject to Code Section 162(m), the maximum aggregate number of Shares that the Company may issue through Awards per individual Employee [Alternative 1: in a calendar year] [Alternative 2: in the Company's fiscal year] is _____ Shares.

(f) Subject to Applicable Requirements, the Shares issued under the Plan may be: (i) authorized and unissued Shares; (ii) treasury Shares; (iii) Shares acquired by purchase in the open market or by private transaction; (iv) Shares granted or purchased under the Plan and forfeited back to the Plan; (v) Shares tendered or retained in payment of an Option's exercise price or Restricted Stock's purchase price; (vi) Shares tendered or retained for satisfaction of Tax withholding obligations; (vii) Shares subject to Awards that have expired unexercised; (viii) Shares subject to Awards that have been cancelled, forfeited, surrendered, or terminated in whole or in part; and (ix) Shares subject to Awards that have been settled in cash.

(g) [Alternative 1: Any Award will count against the Share limits as one Share for each Share subject to the Award.] [Alternative 2: Any Award that is not a Full-Value Award will count against the Share limits as one Share for each Share subject to the Award. Any Award that is a Full-Value Award will count against the Share limits as two Shares for each one Share subject to the Full-Value Award. For purposes of this section 2, "**Full-Value Award**" means any Award of Restricted Stock with a per Share purchase price of less than 100% of Fair Market Value per Share on the Grant Date.]

(h) [Alternative 1: Subject to Applicable Requirements, Shares will be added to the Share reserve and will again be available for grants of Awards in the following cases: (i) Shares subject to an Award that expires unexercised in whole or in part; (ii) Shares subject to an Award that is cancelled, forfeited, surrendered, or terminated in whole or in part; (iii) Shares subject to an Award that results in Shares not being issued; (iv) Shares tendered or retained in payment of an Option's exercise price or Restricted Stock's purchase price; or (v) Shares tendered or retained in satisfaction of Tax withholding obligations. [Alternative A: To the extent that a Share is returned to the Plan, the Share reserve will be credited with one Share.] [Alternative B: To the extent that a Share counted as one Share is returned to the Plan, the Share reserve will be credited with one Share. To the extent that a Share counted as two Shares is returned to the Plan, the Share reserve will be credited with two Shares.]] [Alternative 2: Subject to Appli-

[255] *Id.*

[256] *Id.*

[257] *See* Rosina B. Barker & Kevin P. O'Brien, ''Correcting Document Errors,'' in *Section 409A Handbook* 889, 902, 920 (Regina Olshan & Erica F. Schohn eds., BNA 2010) (''While Notice 2010-6 does not so state, it presumably covers ambiguous terms that are amended by being clarified in a manner that takes the payments out of the ambit of 409A altogether, for example, by being made short-term deferrals. Accordingly, the rule regarding ambiguous payment terms may be among the most valuable correction tools of Notice 2010-6.'') (when a plan contains a savings clause that the plan's terms are to be interpreted to comply with I.R.C. § 409A, the clause applies to all ambiguous terms in the plan document, and is not limited to the payment terms specifically addressed by § IV.B.1 of Notice 2010-6).

It is important to note that stock rights intended to be exempt from I.R.C. § 409A are ineligible for correction of document failures under IRS Notices 2010-6 and 2010-80, 2010-51 I.R.B. 853, 853-54, § III.A (Dec. 20, 2010). The only stock rights eligible for correction of document failures are those for which at the time of grant the holder has the right to exercise only on a fixed date or a period beginning and ending within one taxable year, or a permissible payment event under Treas. Reg. § 1.409A-3(a) (including any period following a payment event permitted under Treas. Reg. § 1.409A-3(b)). IRS Notice 2010-80, 2010-51 I.R.B. 853, 853-54, § III.A (Dec. 20, 2010).

Stock rights intended to be exempt from I.R.C. § 409A are eligible for correction of the operational failure of an exercise price erroneously established at less than the fair market value of the underlying stock on the date of grant. Notice 2008-113, 2008-51 I.R.B. 1305, 1311, and 1314, §§ IV.D and V.E (Dec. 22, 2008). See discussion of the requirements for correction under Notice 2008-113 *supra* note 45.

cable Requirements, unused Shares subject to an Award will be added to the Share reserve and will again be available for grants of Awards in the following cases: an Award expires unexercised in whole or in part; an Award is cancelled, forfeited, surrendered, or terminated in whole or in part; or an Award results in Shares not being issued. Shares subject to an Award will not be added to the Share reserve and will not again be available for grants of Awards in the following cases: Shares tendered or retained in payment of an Option's exercise price or Restricted Stock's purchase price; or Shares tendered or retained in satisfaction of Tax withholding obligations. [Alternative A: To the extent that a Share is returned to the Plan, the Share reserve will be credited with one Share.] [Alternative B: To the extent that a Share counted as one Share is returned to the Plan, the Share reserve will be credited with one Share. To the extent that a Share counted as two Shares is returned to the Plan, the Share reserve will be credited with two Shares.]]

(i) Any Shares underlying Substitute Awards will not be counted against the number of Shares available for issuance under Awards.

(j) The Administrator shall not grant any Award if the number of Shares to which the Award relates, when added to the number of Shares previously issued under the Plan or otherwise counted against the Share reserve, and to the number of Shares that have not been issued or otherwise counted against the Share reserve under an outstanding Award, exceeds the number of Shares reserved for issuance.

(k) The provisions of this section 2 are subject to section 10.

3. **Plan Administration**.

(a) **Administrator**.

(i) **Director and Officer Committee.** . With respect to Awards granted to Insiders at any time any class of equity security of the Company is registered under Section 12 of the Exchange Act or any similar state, local, or foreign law, the Plan will be administered by: (A) the Board; or (B) a committee appointed by the Board consisting of two or more members of the Board, each of whom is a nonemployee director under Rule 16b-3, an independent director under the listing requirements of an applicable Securities Market, and an outside director under Code Section 162(m)(4) and Treasury Regulation Section 1.162-27(e)(3) (the ''Director and Officer Committee''). The Board in its exclusive discretion may establish guidelines and restrictions for the exercise of the Director and Officer Committee's authority and discretion, and may rescind all or any portion of the Director and Officer Committee's authority and discretion. Once appointed, each member of the Director and Officer Committee will continue to serve until the member resigns, or the Board in its exclusive discretion rescinds the member's appointment or otherwise removes the member from the Director and Officer Committee. The Board in its exclusive discretion may terminate the Director and Officer Committee at any time.

(ii) **Regular Committee**. With respect to Awards granted to Employees who are not Insiders and to Contractors at any time any class of equity security of the Company is registered under Section 12 of the Exchange Act or any similar state, local, or foreign law, and with respect to Awards granted when no class of equity security of the Company is registered under Section 12 of the Exchange Act or any similar state, local, or foreign law, the Plan will be administered by: (A) the Board; or (B) a committee appointed by the Board (the ''**Regular Committee**''). The Board in its exclusive discretion may establish guidelines and restrictions for the exercise of the Regular Committee's authority and discretion, and may rescind all or any portion of the Regular Committee's authority and discretion. Once appointed, each member of the Regular Committee will continue to serve until the member resigns, or the Board in its exclusive discretion rescinds the member's appointment or otherwise removes the member from the Regular Committee. The Board in its exclusive discretion may terminate the Regular Committee at any time.

(iii) **Grant of Authority and Discretion to Officers.**. Subject to Applicable Requirements, the Board in its exclusive discretion may grant to one or more Officers the authority and discretion to grant Awards to Employees who are not Insiders. The Board shall specify the number of Shares subject to the Awards that the Officer may grant. The Officer shall not grant Awards to himself or herself, a member of the Officer's Immediate Family, or a Family Entity. The Board in its exclusive discretion may establish guidelines and restrictions for the exercise of each Officer's authority and discretion, and may rescind all or any portion of each Officer's authority and discretion. Once appointed, each Officer will continue to serve until the Officer resigns, or the Board in its exclusive discretion rescinds the Officer's authority and discretion.

(iv) **Committee Action**. A majority of the members of the Director and Officer Committee or the Regular Committee in attendance at a meeting for that Committee at which a quorum is present may take action for that Committee. Any written determination signed by all the members of the Committee will be as effective as if it had been adopted at a duly held meeting.

(v) **Finality**. The actions of the Board and each Committee will be final, conclusive, and binding on all Persons.

(vi) **Limitation of Liability**.

(A) No member of the Board or a Committee, and no Director, Officer, and Employee acting on behalf of the Board or a Committee, will be personally liable for any act or omission in the Plan's administration, other than an act or omission due to that person's gross negligence or intentional misconduct.

(B) No member of the Board or a Committee will be personally liable for any act or omission of any other member of the Board or Committee.

(C) Each member of the Board or a Committee, and each Director, Officer, and Employee acting on behalf of the Board or a Committee, may rely upon information or advice provided by the Company's Officers, accountants, actuaries, compensation consultants, and counsel. No member of the Board or a Committee, and no Director, Officer, and Employee acting on behalf of the Board or a Committee, will be personally liable for any act or omission taken in [Alternative 1: reasonable] [Alternative 2: good faith] reliance on the information or advice.

(b) **Administrator's Authority and Discretion**. Subject to Applicable Requirements and the Plan, and in addition to the other grants of authority and discretion under the Plan, the Administrator will have the exclusive authority and discretion to:

(i) select the Employees, Directors, and Contractors eligible for Awards;

(ii) determine whether, when, and to whom to grant Awards and the provisions of each Award;

(iii) determine the number of Shares subject to each Award and Award Agreement;

(iv) determine the provisions of each Award Agreement, including without limitation provisions for cancellation, forfeiture, exercisability, payment, and vesting, and the effect of the Grantee's Separation From Service and consummation of a Change- in-Control or Section 424 Corporate Transaction;

(v) [Alternative 1: amend any Award or Award Agreement. If the amendment will have a [Alternative A: Material] [Alternative B: Significant] adverse effect on a Grantee's rights, or result in a [Alternative A: Material] [Alternative B: Significant] increase in the Grantee's obligations, the Administrator must obtain the Grantee's written consent to the amendment;] [Alternative 2: amend any Award or Award Agreement. If the amendment will have a [Alternative A: Material] [Alternative B: Significant] adverse effect on a Grantee's rights, or result in a [Alternative A: Material] [Alternative B: Significant] increase in the Grantee's obligations, the Administrator must obtain the Grantee's written consent to the amendment. Notwithstanding the prior sentence, the Administrator may amend any Award or Award Agreement without the Grantee's written consent to maintain the status of an Option as an Incentive Stock Option, to satisfy the requirements of Code Section 409A or an exemption thereto, to protect against the loss of deductibility under Code Section 162(m), or to comply with any Applicable Requirement or financial accounting standard;]

(vi) construe and interpret the provisions of the Plan, Awards, and Award Agreements;

(vii) reconcile any inconsistency, correct any defect, and supply any omission in the Plan, or any Award or Award Agreement;

(viii) make all factual and legal determinations under Plan, Awards, and Award Agreements;

(ix) add provisions to an Award or Award Agreement, or vary the provisions of an Award, to accommodate the laws of applicable foreign jurisdictions and provide Grantees with favorable treatment under these laws;

(x) adopt, amend, and rescind rules and procedures; and

(xi) take all other actions necessary or appropriate in the Plan's administration.

(c) **Nonuniform Determinations**. The Administrator in its exclusive discretion may make nonuniform and selective determinations among Employees, Directors, and Contractors who are eligible to receive Awards, or who have received Awards, regardless of whether they are similarly situated. In furtherance of this section 3(c) and not in limitation thereof, the Administrator in its exclusive discretion may enter into nonuniform and selective Award Agreements.

(d) **Freedom of Action**.

(i) Nothing in the Plan or in any Award or Award Agreement limits or prevents any member of the Broader Group from taking any action that the member in its exclusive discretion determines is appropriate or in its best interest.

(ii) In furtherance of this section 3(d) and not in limitation thereof, and subject to any antidilution rule of any Applicable Requirement or any antidilution provision of any Award or Award Agreement, the Company may issue additional Shares of Common Stock and shares of other classes of stock on the terms that the Board in its exclusive discretion determines appropriate.

(iii) No Grantee will have any right or claim arising from or related to the decrease or fluctuation in the value of any Award or Shares issued under any Award as a result of the actions taken by the Board, a Committee, or the Company's Officers.

4. **Eligibility**.

(a) The Administrator may grant Awards of Nonqualified Stock Options and SARs to (i) Employees, Directors, and Contractors of the Company or a Related Entity if the Employee, Director, or Contractor primarily provides services to the Company or Related Entity on the Grant Date; and (ii) prospective Employees conditioned on their becoming Employees of the Company or a Related Entity.

(b) The Administrator may grant Awards of Incentive Stock Options to: (i) Employees of the Company, a Parent, or a Subsidiary if the Employee primarily provides services to the Company, a Parent, or a Subsidiary on the Grant Date; and (ii) prospective Employees conditioned on their becoming Employees of the Company, a Parent, or a Subsidiary.

(c) The Administrator may grant Awards of Restricted Stock to: (i) Employees, Directors, and Contractors of a member of the Broader Group if the Employee, Director, or Contractor primarily provides services to that member on the Grant Date; and (ii) prospective Employees conditioned on their becoming Employees of a member of the Broader Group.

(d) The board of directors or other governing body of the member of the Broader Group to which the Employee, Director, or Contractor primarily provides services on the Grant Date must have adopted the Plan on or before the Grant Date.

(e) The board of directors or other governing body of the member of the Broader Group to which the prospective Employee will primarily provide services must have adopted the Plan on or before the Grant Date.

(f) On the Grant Date of the first Award made to a Participant, and on the Grant Date of the first Award made to a Participant after the Plan has been amended, the Administrator shall deliver a copy of the Plan to the Participant.

5. **Provisions of Awards**.

(a) **Designation as Incentive Stock Option or Nonqualified Stock Option**. The Administrator shall designate each Option as an Incentive Stock Option or a Nonqualified Stock Option.

(i) To the extent that the aggregate Fair Market Value of Shares subject to Incentive Stock Options that become exercisable by a Grantee for the first time during a calendar year under all plans of the Company, any Parent, and any Subsidiary exceeds $100,000, these Incentive Stock Options will become Nonqualified Stock Options to the extent of the Shares that exceed this amount. The Administrator shall take the Incentive Stock Options into account in the order granted, and shall use the Fair Market Value of the Shares on the Grant Date of each Incentive Stock Option. If an Option is treated as an Incentive Stock Option in part and a Nonqualified Stock Option in part because of the limitations of this section 5(a)(i), the Grantee may desig-

nate which portion of the Option that the Grantee is exercising. In the absence of the Grantee's designation, the Grantee will be deemed to exercise the Incentive Stock Option portion first.

(ii) If within two years after an Incentive Stock Option's Grant Date, or within one year after the issuance of the Shares on exercise of an Incentive Stock Option, the Grantee makes a Disposition of Shares acquired on the exercise of an Incentive Stock Option, the Grantee shall notify the Administrator of the Disposition and the price realized on the Disposition. The Grantee shall notify the Administrator in writing within thirty days after the Disposition. For purposes of this section 5(a)(ii), "**Disposition**" means a disposition under Code Section 424(c) and Treasury Regulation Section 1.424-1(c).

(b) **Administrator's Determinations and Actions**. Subject to Applicable Requirements and the Plan, the Administrator in its exclusive discretion shall determine the provisions of each Award and Award Agreement.

(i) In furtherance of this section 5(b) and not in limitation thereof, the Administrator in its exclusive discretion may provide for one or more of the following in any Award or Award Agreement:

(A) antidilution provisions;

(B) forfeitures and clawbacks of Awards and the income and gain realized on the disposition of Shares received on the exercise or vesting of Awards;

(C) method of payment of the exercise or purchase price;

(D) method of payment of any Tax obligation triggered on the grant, vesting, or exercise of any Award, or on a Code Section 83(b) election;

(E) performance goals for the exercise and vesting of Awards;

(F) repurchase rights and obligations;

(G) rights of first refusal;

(H) Transfer restrictions; and

(I) vesting requirements.

(ii) In furtherance of section 5(b)(i)(E) and not in limitation thereof, nonexclusive criteria for the establishment of performance goals are:

(A) budget and expense management;

(B) cash flow, cash flow return on capital, free cash flow, and operating cash flow;

(C) completion of acquisitions or business expansion;

(D) earnings before interest, taxes, depreciation, and amortization;

(E) earnings per Share;

(F) gross margins;

(G) gross profit and gross profit growth;

(H) gross revenues;

(I) maintenance or improvement of profit margins;

(J) market share;

(K) net earnings or net income before and after taxes;

(L) net revenue and net revenue growth;

(M) operating income;

(N) operating margins;

(O) price of Shares, growth measures in the price of Shares, and total shareholder return;

(P) productivity ratios;

(Q) profitability of an identifiable business unit or product;

(R) ratio of earnings to assets or equity;

(S) return on assets, capital, equity, and sales;

(T) safety record; and

(U) working capital targets.

(V) The principle of *ejusdem generis* will not apply to the foregoing criteria.

(iii) With respect to performance goals, the Administrator in its exclusive discretion may:

(A) establish performance goals for corporate, division, group, subsidiary, or unit performance, or individual performance;

(B) use the performance criteria in section 5(b)(ii) to establish performance goals based on a comparison to the performance of a comparable group of companies, or to any published or special index;

(C) use the performance criteria under section 5(b)(ii)(O) based on a comparison to stock market indices;

(D) establish a schedule of payment or vesting corresponding to one or more levels of attainment of performance goals; and

(E) provide that partial attainment of performance goals will result in partial vesting.

(iv) For Awards subject to Code Section 162(m), to protect against the loss of deductibility under Code Section 162(m) the Director and Officer Committee in its exclusive discretion may decide to have one or more Awards satisfy the requirements for deductible performance-based compensation through the use of performance goals. If the Director and Officer Committee so decides, then within the first ninety days of a performance period, or if longer or shorter within the maximum period allowed under Code Section 162(m), the Director and Officer Committee shall make an Award subject to the attainment of one or more preestablished, objective performance goals for the performance period. Subject to Applicable Requirements and the Plan, the Director and Officer Committee in its exclusive discretion shall determine the performance goals and the performance period. If Applicable Requirements change to allow the Director and Officer Committee to exercise the discretion to change the performance goals without shareholder approval, the Director and Officer Committee in its exclusive discretion may do so.

(v) If the Director and Officer Committee uses performance goals under section 5(b)(iv), then to the extent permitted under Code Section 162(m) the Director and Officer Committee in its exclusive discretion may adjust performance goals to prevent dilution or enlargement of Grantees' rights on one or more of the following events:

(A) acquisitions or divestitures;

(B) asset write-downs;

(C) changes in Applicable Requirements or financial accounting standards that affect reported results;

(D) change in the Company's fiscal year;

(E) consummation of a Change-in-Control or Section 424 Corporate Transaction;

(F) extraordinary nonrecurring items under Accounting Principles Board Opinion No. 30, or in management's discussion and analysis of financial condition and results of operations in the Company's annual report to shareholders;

(G) any other unusual or nonrecurring event;

(H) foreign exchange gains and losses;

(I) impact of natural disasters;

(J) income from discontinued operations;

(K) judgments and settlements of litigation and other resolution of claims; and

(L) reorganization or restructuring programs.

(vi) If the Director and Officer Committee uses performance goals under section 5(b)(iv), to the extent permitted under Code Section 162(m) the Director and Officer Committee in its exclusive discretion may reduce or eliminate any Award for any performance period, but not increase any Award for any performance period. The Director and Officer Committee shall not vest any Award if the performance goals for the performance period have not been attained.

(vii) If the Director and Officer Committee uses performance goals under section 5(b)(iv), after the completion of the performance period the Director and Officer Committee shall determine and certify in writing: (A) the extent to which the performance goals have been attained; and (B) the extent of the vesting of the Awards subject to the performance goals.

(viii) The Administrator shall not grant any Option that on the exercise of the original Option entitles the Grantee to the automatic grant of additional Options without additional consideration of more than the exercise price of the underlying Option.

(ix) If the Administrator determines Fair Market Value for a Grantee's Award by an Appraisal, upon the Grantee's written request the Administrator shall provide the Grantee with a copy of the Appraisal. The Grantee shall keep the Appraisal confidential. In addition, the Administrator in its exclusive discretion may require that the Grantee enter into a confidentiality agreement satisfactory to the Administrator in its exclusive discretion before the Administrator provides the Grantee with a copy of the Appraisal.

(c) **Repurchase of Shares**. For each Award of Nonqualified Stock Options or SARs that contains a repurchase obligation for Shares, other than a right of first refusal, or contains a put or call right that is not a lapse restriction under Treasury Regulation Section 1.83-3(i), the purchase price will be the Fair Market Value of the Shares on the date of repurchase (disregarding lapse restrictions under Treasury Regulation Section 1.83-3(i)).

(d) **Acceleration of Exercise and Vesting Dates**. Subject to Applicable Requirements and the Plan, the Administrator in its exclusive discretion may:

(i) accelerate the exercise date of a portion of or an entire Award of Options or SARs, and the vesting date of a portion of or an entire Award of Restricted Stock;

(ii) extend the exercise date of a portion of or an entire Award of Options or SARs, and the vesting date of a portion of or an entire Award of Restricted Stock;

(iii) waive the attainment of any performance goal, any forfeiture condition, or any other restriction for any Award; and

(iv) adjust performance goals, vesting requirements, forfeiture conditions, and any other restriction in any Award in recognition of unusual or nonrecurring events, corporate reorganizations, changes in Laws, and changes in financial accounting standards.

(e) **Minimum Vesting Requirements**. Notwithstanding any other provision of the Plan, (i) for Awards that use time-based vesting, the Grantee will vest in the Award no earlier than in accordance with the following schedule: one-third of the Award after one year of service, an additional one-third after two years of service, and the final one-third after three years of service; and (ii) for Awards that use performance-based vesting, the minimum performance period is one year. The Administrator in its exclusive discretion may accelerate the minimum vesting on a Change-in-Control under section 8(a)-(d).

(f) **Term**. Except as otherwise provided in this section 5(f), the term of each Award will be the term provided in the Award Agreement. The term of an Incentive Stock Option cannot exceed ten years from the Grant Date. For an Incentive Stock Option granted to a Grantee who on the Grant Date owns stock with more than ten percent of the voting power of all classes of stock of the Company, a Parent, or a Subsidiary, the term cannot exceed five years from the Grant Date.

(g) **Transferability**.

(i) Only the Grantee may exercise Incentive Stock Options during the Grantee's lifetime.

(ii) Except as otherwise provided in this section 5(g)(ii) or section 5(g)(iv), a Grantee shall not Transfer Incentive Stock Options. A Grantee may Transfer Incentive Stock Options incident to divorce under Code Section 1041, or by domestic relations order. Upon Transfer, an Incentive Stock Option will automatically convert to a Nonqualified Stock Option.

(iii) Except as otherwise provided in this section 5(g)(iii) or section 5(g)(iv), a Grantee shall not Transfer Nonqualified Stock Options, SARs, and Restricted Stock. The Administrator in its exclusive discretion may permit a Grantee to Transfer Nonqualified Stock Options, SARs, and Restricted Stock: (A) by lifetime gift to members of the Grantee's Immediate Family; or (B) by domestic relations order to members of the Grantee's Immediate Family.

(iv) A Grantee may designate one or more beneficiaries on the Grantee's death to whom the Grantee's Incentive Stock Options, Nonqualified Stock Options, SARs, or Restricted Stock will be Transferred, or by whom any right will be exercised after the Grantee's death. A Grantee may designate beneficiaries contingently or successively. Each designation of beneficiary or beneficiaries must be in a written form prescribed by the Administrator, and will be effective only when the Grantee delivers the prescribed form to the Administrator. Each designation of beneficiary or beneficiaries will revoke any prior designation. In the absence of an effective designation of beneficiary or beneficiaries, the Grantee's estate will succeed to the Grantee's Incentive Stock Options, Nonqualified Stock Options, SARs, and Restricted Stock, and the exercise rights with respect to these Awards.

(v) At a reasonable time before the consummation of a proposed Transfer, the Transferor shall deliver to the Administrator written notice of its intent to transfer the Award, and a written statement in reasonable detail that enables the Administrator to determine whether the Transfer is permissible, and for any Transfer that requires the Administrator's permission, whether the Administrator will permit the Transfer.

(vi) Before consummation of any Transfer permitted under this section 5(g), the Transferee must agree in writing to be bound by the Plan, and the Award and Award Agreement governing the Award acquired by the Transferee. The Administrator in its exclusive discretion may also require that the Transferor and Transferee provide other instruments and certificates, and opinions of counsel, that the Administrator determines

are necessary or appropriate to consummate the Transfer.

(vii) Any attempt to Transfer an Award in violation of this section 5(g) will be void *ab initio*. Neither the Administrator nor the Company shall recognize, record, or give effect to such Transfer.

(viii) A Grantee's rights under an Award, Award Agreement, and the Plan will not be subject to the claims of the Grantee's creditors, or attachment, execution, or garnishment by the Grantee's creditors.

(h) **Stock Certificates for Restricted Stock**.

(i) Upon an Award of Restricted Stock, the Company shall issue stock certificates for the Shares registered in the Grantee's name (the "**Stock Certificates**"). The Company shall affix to the Stock Certificates any legend to reflect the restrictions in the Award or Award Agreement that the Administrator in its exclusive discretion determines necessary or appropriate. The Company in its exclusive discretion may direct the transfer agent to place a stop order against legended Stock Certificates.

(ii) Immediately on the Grantee's receipt of the Stock Certificates, the Grantee shall deliver to the Company's Secretary or the Secretary's designee: (A) the Stock Certificates; (B) an assignment endorsed in blank separate from the Stock Certificates; and (C) an escrow agreement as determined by the Administrator in its exclusive discretion. The Company's Secretary or the Secretary's designee shall hold the Stock Certificates and the assignment in escrow under the escrow agreement until the Grantee vests in the Restricted Stock.

(iii) Once the Restricted Stock vests, the Company shall issue new Stock Certificates for the vested Shares without the restrictions of the Award or Award Agreement. The Company's Secretary or the Secretary's designee shall tender to the Company the Stock Certificates for the Shares subject to the restrictions for cancellation.

(iv) To the extent that the Restricted Stock is forfeited, the Company's Secretary or the Secretary's designee shall return the Stock Certificates to the Company for cancellation, and the Grantee shall no longer have any rights with respect to the Restricted Stock.

6. **Exercise or Purchase Price**.

The provisions of this section 6 govern the determination of the exercise or purchase price of an Award.

(a) For an Incentive Stock Option:

(i) granted to an Employee who on the Grant Date owns stock with more than ten percent of the voting power of all classes of stock of the Company, any Parent, or any Subsidiary, the per Share exercise price will not be less than 110% of the Fair Market Value per Share on the Grant Date except as otherwise provided in section 8(g); and

(ii) granted to an Employee other than an Employee described in section 6(a)(i), the per Share exercise price will not be less than 100% of the Fair Market Value per Share on the Grant Date except as otherwise provided in section 8(g).

(iii) Notwithstanding the provisions of section 6(a)(i)-(ii), the per Share exercise price of an Incentive Stock Option that is a Substitute Award may be less than the Fair Market Value per Share on the Grant Date as long as the substitution satisfies Applicable Requirements.

(b) For a Nonqualified Stock Option, the per Share exercise price will not be less than 100% of the Fair Market Value per Share on the Grant Date except as otherwise provided in section 8(f). Notwithstanding the provisions of the prior sentence, the per Share exercise of a Nonqualified Stock Option that is a Substitute Award may be less than the Fair Market Value per Share on the Grant Date as long as the substitution satisfies Applicable Requirements.

(c) For an SAR, the per Share exercise price will not be less than 100% of the Fair Market Value per Share on the Grant Date except as otherwise provided in section 8(f). Notwithstanding the provisions of the prior sentence, the per Share exercise of an SAR that is a Substitute Award may be less than the Fair Market Value per Share on the Grant Date as long as the substitution satisfies Applicable Requirements.

(d) For Restricted Stock, the per Share purchase price, if any, will be set forth in the Award Agreement.

7. **Exercise of Awards; Method of Payment; and Tax Withholding**.

(a) **Procedure; Rights as a Shareholder**.

(i) Upon vesting in an Option, a Grantee may exercise the Option by giving written notice of exercise to the Administrator and making payment of the exercise price. The Company shall issue the certificate for the Shares within thirty days after exercise, and shall issue separate certificates for the Shares acquired on the exercise of Incentive Stock Options and on the exercise of Nonqualified Stock Options. Until the Option's exercise, the Grantee will not have any right to vote or receive dividends, and any other rights as a shareholder. The Grantee will not be entitled to any dividends declared and paid on the Shares subject to the Option between the Grant Date and exercise.

(ii) Upon vesting in an SAR, a Grantee may exercise the SAR by giving written notice of exercise to the Administrator. If the Grantee is entitled to cash, the Company shall pay the cash within thirty days after exercise. If the Grantee is entitled to Shares, the Company shall issue the certificate for the Shares within thirty days after exercise. Until the SAR's exercise, the Grantee will not have any right to vote or receive dividends, and any other rights as a shareholder. The Grantee will not be entitled to any dividends declared and paid on the Shares subject to the SAR between the Grant Date and exercise.

(iii) Upon vesting in Restricted Stock, the Grantee shall pay any unpaid purchase price, and the procedures under section 5(h)(iii) for the issuance of Stock Certificates will apply. Until the vesting of the Restricted Stock, the Grantee will have the right to vote, but will not have any right to receive dividends or any other rights as a shareholder. The Grantee will not be entitled to any dividends declared and paid on the Shares between the Grant Date and vesting.

(iv) The Company shall not issue fractional Shares, and shall pay cash in lieu of fractional Shares in an amount equal to the Fair Market Value of the fractional Shares on the date of payment.

(b) **Method of Payment of Exercise or Purchase Price**. Subject to Applicable Requirements, any Award, Award Agreement, and the Plan, the Administrator in its exclusive discretion shall determine the method or methods of payment for the Shares to be issued on an Option's exercise, and the grant or vesting of Restricted Stock. For Incentive Stock Options, the Administrator shall set forth its determination on the Grant Date in the

Award Agreement. The Administrator may accept one or more of the following methods of payment:

(i) wire transfer;

(ii) bank cashier's check or certified check;

(iii) when the Shares are registered under the Exchange Act, the Grantee's tender of previously acquired Shares, or the Company's retention of Shares otherwise to be delivered on exercise of an Option or the grant or vesting of Restricted Stock. If the Grantee uses previously acquired Shares, the Administrator in its exclusive discretion may require the Grantee to have held the Shares for the length of time necessary to satisfy Applicable Requirements, and the requirements of financial accounting standards to avoid a charge to earnings. The Shares tendered or retained must not be subject to any encumbrance, or any forfeiture, repurchase, unfulfilled vesting, or similar requirements. The Shares must have a Fair Market Value on the date of tender or retention equal to the aggregate exercise price of the Shares for which the Option is exercised, or the aggregate purchase price of the Restricted Stock purchased; or

(iv) for Options, payment through a broker-dealer sale and remittance procedure by which the Grantee: (A) provides written instructions to a Company-designated brokerage firm to sell a sufficient number of the purchased Shares and remit to the Administrator from the sale proceeds available on the settlement date sufficient funds to pay the aggregate exercise price for the purchased Shares and any Tax withholding; (B) provides written instructions to the Administrator to deliver the stock certificates for the purchased Shares directly to the brokerage firm; and (C) bears the brokerage and other costs of this procedure (a "**Cashless Exercise**").

(v) Notwithstanding section 7(b)(iii)-(iv), if the Shares are traded on a Securities Market and the Administrator in its exclusive discretion determines that an Insider's method of payment may involve an extension of credit in violation of Section 402(a) of the Sarbanes-Oxley Act of 2002, the Administrator shall not allow the Insider to use that method of payment.

(c) **Tax Withholding**. The following provisions govern the Company's Tax withholding obligations:

(i) The Company in its exclusive discretion may deduct from any cash payment made to a Grantee under the Plan an amount that satisfies all or any portion of the Company's Tax withholding obligations.

(ii) The Company in its exclusive discretion may require the Grantee through payroll withholding, cash payment, or otherwise to satisfy all or any portion of the Company's Tax withholding obligations.

(iii) The Company in its exclusive discretion may retain from the Shares to be issued to a Grantee a number of whole Shares having a Fair Market Value equal to all or any portion of the Company's Tax withholding obligations. The Fair Market Value of any Shares retained must not exceed the minimum statutory Tax withholding obligations, or such lesser amount necessary under financial accounting standards to avoid classification of an Award as a liability or charge to earnings. The Shares retained must not be subject to any encumbrance, or any forfeiture, repurchase, unfulfilled vesting, or similar requirements.

(iv) The Company in its exclusive discretion may accept the Grantee's tender of a number of whole Shares having a Fair Market Value equal to all or any portion of the Company's Tax withholding obligations. The Administrator in its exclusive discretion may require the Grantee to have held the Shares for the length of time necessary to satisfy Applicable Requirements, and the requirements of financial accounting standards to avoid classification of an Award as a liability or charge to earnings. The Shares tendered must not be subject to any encumbrance, or any forfeiture, repurchase, unfulfilled vesting, or similar requirements.

(v) The Company in its exclusive discretion may satisfy its Tax withholding obligations through one or more of the methods under section 7(c)(i)-(iv).

(vi) The Company shall not issue Shares or pay cash to any Grantee until the Grantee satisfies the Company's Tax withholding obligations.

(vii) The provisions of this section 7(c) will apply on the vesting or exercise of an Option or SAR, the grant or vesting of Restricted Stock, a Grantee's Code Section 83(b) election, and the sale or other disposition of Shares received under an Award.

(d) **Exercise and Termination of Awards Upon Separation From Service**.

(i) [Alternative 1: Upon a Grantee's Involuntary Separation From Service for Cause, all unexercised Options and SARs, whether unvested or vested, will terminate, and all unvested Restricted Stock will be forfeited.] [Alternative 2: Upon a Grantee's Involuntary Separation From Service for Cause, all unvested Options and SARs will terminate, and all unvested Restricted Stock will be forfeited.]

(ii) [Alternative 1: Except as otherwise provided in an Award or Award Agreement, upon a Grantee's Separation From Service for Good Reason or Involuntary Separation From Service without Cause, the Grantee will fully vest in all Awards, and may exercise the Options and SARs for one year after the date of Separation From Service.] [Alternative 2: Except as otherwise provided in an Award or Award Agreement, upon a Grantee's Separation From Service for Good Reason or Involuntary Separation From Service without Cause within two years after the consummation of a Change-in-Control, the Grantee will fully vest in all Awards, and may exercise the Options and SARs for one year after the date of Separation From Service.] [Alternative 3: Except as otherwise provided in an Award or Award Agreement, upon a Grantee's Separation From Service for Good Reason or Involuntary Separation From Service without Cause (a "**GRWC Separation**"), the Grantee will fully vest in all Awards. On a GRWC Separation within two years after the consummation of a Change-in-Control, the Grantee may exercise the Options and SARs for three years after the date of Separation From Service. On all other GRWC Separations, the Grantee may exercise the Options and SARs for one year after the date of Separation From Service.] [Alternative 4: Except as otherwise provided in an Award or Award Agreement, upon a Grantee's Separation From Service for Good Reason or Involuntary Separation From Service without Cause (a "**GRWC Separation**"), the following treatment of Awards will apply:

(A) [Alternative A: The Grantee will fully vest in all Awards of Options and SARs, and may exercise the Options and SARs for one year after the date of Separation From Service.] [Alternative B: The Grantee will fully vest in all Awards of Options and SARs. On a GRWC Separation within two years after the consummation of a Change-in-Control, the Grantee may exer-

cise the Options and SARs for three years after the date of Separation From Service. On all other GRWC Separations, the Grantee may exercise the Options and SARs for one year after the date of Separation From Service.]

(B) [Alternative A: For all Awards of Restricted Stock that have not fully vested, the Grantee will be deemed to satisfy any solely service-based vesting requirements. For performance goals the satisfaction of which does not require the Grantee's continued service, the performance goals previously established for the one year following the date of Separation From Service will continue in effect, and their satisfaction will be determined without regard to the Grantee's Separation From Service.] [Alternative B: For all Awards of Restricted Stock that have not fully vested, the Grantee will be deemed to satisfy any solely service-based vesting requirements. Satisfaction of performance-based vesting requirements will be determined as follows: (I) for performance goals the satisfaction of which requires the Grantee's continued service, the Grantee's Separation From Service will be taken into account; and (II) for performance goals the satisfaction of which does not require the Grantee's continued service, the performance goals previously established for the one year following the date of Separation From Service will continue in effect, and their satisfaction will be determined without regard to the Grantee's Separation From Service.]]

(iii) Except as otherwise provided in an Award or Award Agreement, upon a Grantee's Separation From Service due to Disability, the Grantee will fully vest in all Awards. The Grantee, or in the case of a Nonqualified Stock Option or SAR, the Grantee's guardian or legal representative, may exercise the Options and SARs for one year after the date of Separation From Service.

(iv) Except as otherwise provided in an Award or Award Agreement, upon a Grantee's Separation From Service due to death, the Grantee will fully vest in all Awards. The Grantee's beneficiary or beneficiaries, or the Grantee's estate, may exercise the Options and SARs for one year after the date of Separation From Service.

(v) Except as otherwise provided in an Award or Award Agreement, or section 7(d)(i)-(iv), a Grantee may exercise a vested Option or SAR for three months after the date of Separation From Service.

(vi) Except as otherwise provided in an Award or Award Agreement, or section 7(d)(i)-(v): (A) all unvested Awards will terminate on the date of a Grantee's Separation From Service; and (B) acceleration of vesting of any Award under section 8 will not occur on a Change-in-Control or Section 424 Corporate Transaction consummated after the date of a Grantee's Separation From Service.

(vii) The provisions of section 7(d)(i)-(v) are subject to section 9(d).

(viii) Notwithstanding the provisions of section 7(d)(i)-(v), when the Plan or an Award or Award Agreement permits a Grantee to exercise an Option or SAR for a specified period after the Grantee's Separation From Service, the Option or SAR will terminate on the earlier of the last day of: (A) the specified period as extended under section 9(d); and (B) the Option's or SAR's original term without any extensions.

(ix) To the extent that Incentive Stock Options are not exercised within the time required by the Code after the Grantee's termination of employment from the Company and its Parents and Subsidiaries, the Incentive Stock Options will automatically convert to Nonqualified Stock Options. The Grantee may thereafter exercise the Nonqualified Stock Options for the period provided in the Plan, or the Award or Award Agreement. For purposes of an Incentive Stock Option, a Grantee's employment continues while the Grantee is on military leave, sick leave, or other bona fide leave of absence if the period of leave does not exceed three months, or if longer as long as the Grantee's right to reemployment is provided by statute or contract. If the period of leave exceeds three months, and the Grantee's right to reemployment is not provided by statute or contract, termination of employment will be deemed to occur on the first day immediately after the three month period.

(e) **Awards of Nonexempt Employees**.

(i) A nonexempt Employee under the Fair Labor Standards Act of 1938, as amended (the "**FLSA**") will not vest in and exercise in any Option or SAR, and will not vest in any Restricted Stock, until at least six months after the Grant Date.

(ii) Notwithstanding section 7(e)(i), a nonexempt Employee may vest in and exercise any Option or SAR, or vest in any Restricted Stock, before six months after the Grant Date upon: (A) the nonexempt Employee's death or Disability; (B) a Change-in-Control; (C) a Section 424 Corporate Transaction in which the Option or SAR is not assumed or substituted; or (D) the nonexempt Employee's Retirement. For purposes of this section 7(e)(ii), "**Retirement**" means retirement as defined in a then-effective agreement between the nonexempt Employee and the Company or a Broader Related Entity, or in a then-effective written policy of the Company or a Broader Related Entity that is binding on the nonexempt Employee.

(iii) The provisions of this section 7(e) are intended to exclude the income and gain realized or recognized on the vesting or exercise of any Award from the nonexempt Employee's regular rate of pay under the FLSA and Worker Economic Opportunity Act.

(f) **No Notice Obligation**. Subject to Applicable Requirements, neither the Administrator nor any member of the Broader Group will have any obligation to notify any Grantee of: (i) the time or manner of exercising any Option or SAR; (ii) any expiration or termination of any Option, SAR, or Restricted Stock; (iii) any period during which the Grantee cannot exercise an Option or SAR; or (iv) the Tax treatment of the grant and exercise of any Option or SAR, and the grant and vesting of any Restricted Stock.

8. **Change-in-Control and Section 424 Corporate Transactions**.

(a) **Vesting on Change-in-Control of Company**. On a Change-in-Control of the Company or a Related Parent of the Company, the Administrator or Board in its exclusive discretion may provide for one or more Grantees who provide services primarily to the Company on the date of the Change-in-Control for full or partial vesting in the Grantee's Awards, and the release from all or a portion of: (i) transfer restrictions other than the transfer restrictions on Incentive Stock Options; and (ii) repurchase rights and obligations.

(b) **Vesting on Change-in-Control of Related Entity**. On a Change-in-Control of a Related Entity or a Related Parent of the Related Entity, the Administrator or Board

in its exclusive discretion may provide for one or more Grantees who provide services primarily to the Related Entity on the date of the Change-in-Control for full or partial vesting in the Grantee's Awards, and the release from all or a portion of: (i) transfer restrictions other than the transfer restrictions on Incentive Stock Options; and (ii) repurchase rights and obligations.

(c) **Vesting on Change-in-Control of Broader Related Entity**. On a Change-in-Control of a Broader Related Entity or a Related Parent of the Broader Related Entity, the Administrator or Board in its exclusive discretion may provide for one or more Grantees who provide services primarily to the Broader Related Entity on the date of the Change-in-Control for full or partial vesting in the Grantee's Awards, and the release from all or a portion of: (i) transfer restrictions other than the transfer restrictions on Incentive Stock Options; and (ii) repurchase rights and obligations.

(d) **Vesting on Change-in-Control of Parent**. On a Change-in-Control of a Parent, the Administrator or Board in its exclusive discretion may provide for one or more Grantees who provide services primarily to the Parent on the date of the Change-in-Control for full or partial vesting in the Grantee's Incentive Stock Options, and the release from all or a portion of repurchase rights and obligations.

(e) **Cash-Out of Stock Rights**. [Alternative 1: With respect to any Change-in-Control under section 8(a)-(d), the Administrator or Board in its exclusive discretion may cancel all or any portion of the vested Options and SARs regardless of whether the Options or SARs vested before the consummation of the Change-in-Control or as part of the consummation of the Change-in-Control (the cancelled Options and SARs, the ''**Cash-Out Stock Rights**'') (the cancellation and payment under this section 8(e), the ''**Cash-Out**''). In exchange for the cancellation, the Company shall pay each holder of Cash-Out Stock Rights cash or stock, or any combination thereof, in an amount equal to the excess, if any, of the Change-in-Control Price over the exercise price of the Cash-Out Stock Rights (the ''**Cash-Out Amount**''). The Company shall pay the Cash-Out Amount within thirty days after the consummation of the Change-in-Control. For purposes of this section 8(e), ''**Change-in-Control Price**'' means the price per Share paid in the Change-in-Control in cash or property. The Administrator or Board in its exclusive discretion shall determine the fair market value of the portion of the Change-in-Control Price payable in property. If the Change-in-Control Price does not exceed the exercise price of the Cash-Out Stock Rights, on the consummation of the Change-in-Control the Company shall cancel the Cash-Out Stock Rights without the payment of any further consideration.] [Alternative 2: With respect to any Change-in-Control under section 8(a)-(d), the Administrator or Board in its exclusive discretion may cancel all or any portion of the Options and SARs that vested before the consummation of the Change-in-Control (the cancelled vested Options and SARs, the ''**Vested Cash-Out Stock Rights**'') (the cancellation and payment under this section 8(e), the ''**Cash-Out**''). In exchange for the cancellation, the Company shall pay each holder of Vested Cash-Out Stock Rights cash or stock, or any combination thereof, in an amount equal to the excess, if any, of the Change-in-Control Price over the exercise price of the Vested Cash-Out Stock Rights (the ''**CIC Cash-Out Amount**''). The Company shall pay the CIC Cash-Out Amount within thirty days after the consummation of the Change-in-Control. For purposes of this section 8(e), ''**Change-in-Control Price**'' means the price per Share paid in the Change-in-Control in cash or property. The Administrator or Board in its exclusive discretion shall determine the fair market value of the portion of the Change-in-Control Price payable in property. If the Change-in-Control Price does not exceed the exercise price of the Vested Cash-Out Stock Rights, on the consummation of the Change-in-Control the Company shall cancel the Vested Cash-Out Stock Rights without the payment of any further consideration. With respect to the Options and SARs that were unvested on the consummation of the Change-in-Control (the ''**Unvested Cash-Out Stock Rights**''), on the consummation of the Change-in-Control the Administrator or Board in its exclusive discretion may take one or both of the following actions: (i) cancel all or any portion of the Unvested Cash-Out Stock Rights without the payment of any further consideration; or (ii) allow the holders of Unvested Cash-Out Stock Rights to continue to hold all or any portion of the Unvested Cash-Out Stock Rights pending payment of the Post-CIC Cash-Out Amount. If the Administrator or Board elects the second alternative, the acquiror shall pay each holder of Unvested Cash-Out Stock Rights the applicable percentage of the Post-CIC Cash-Out Amount in accordance with the same vesting schedule established on the Grant Date of the Unvested Cash-Out Stock Rights. The acquiror shall pay the applicable percentage of the Post-CIC Cash-Out Amount within thirty days after each vesting date, and shall cancel the portion of the Unvested Stock Right that became vested. For purposes of this section 8(e), ''**Post-CIC Cash-Out Amount**'' means an amount equal to the excess, if any, of the Change-in-Control Price over the exercise price of the Unvested Cash-Out Stock Rights. If the Change-in-Control Price does not exceed the exercise price of the Unvested Cash-Out Stock Rights, on the consummation of the Change-in-Control the Company shall cancel the Unvested Cash-Out Stock Rights without the payment of any further consideration.]

(f) **Assumption or Substitution of Stock Rights in Section 424 Corporate Transaction**. The Administrator in its exclusive discretion may provide in an Award, Award Agreement, or Section 424 Corporate Transaction that the Administrator or Board in its exclusive discretion may take one or more of the following actions in a Section 424 Corporate Transaction: (i) all or any portion of a Nonqualified Stock Option or SAR will be assumed in accordance with the requirements of Treasury Regulation Section 1.424-1 (without regard to the requirement of Treasury Regulation Section 1.424-1(a)(2) that an eligible corporation be the holder's employer); or (ii) for all or any portion of a Nonqualified Stock Option or SAR an equivalent Nonqualified Stock Option or SAR will be substituted in accordance with the requirements of Treasury Regulation Section 1.424-1 (without regard to the requirement of Treasury Regulation Section 1.424-1(a)(2) that an eligible corporation be the holder's employer).

(i) Except as otherwise provided in this section 8(f), the requirements of Treasury Regulation Section 1.424-1 will apply as if the Nonqualified Stock Option or SAR were an Incentive Stock Option.

(ii) With respect to Treasury Regulation Section 1.424-1(a)(5)(iii), the Administrator may satisfy its requirements, or in lieu thereof will be deemed to satisfy

its requirements if the ratio of the exercise price to the Fair Market Value of the underlying shares immediately after the assumption or substitution is not greater than the ratio of the exercise price to the Fair Market Value of the underlying Shares immediately before the assumption or substitution.

(iii) For a transaction described in Code Section 355 in which the stock of the distributing corporation and the stock distributed in the transaction are both readily tradable on a Securities Market immediately after the transaction, the requirements of Treasury Regulation Section 1.424-1(a)(5) related to the fair market value of the stock may be satisfied by:

(A) using the last sale before or the first sale after the specified date as of which the valuation is being made, the closing price on the last trading day before or the trading day of a specified date, the arithmetic mean of the high and low prices on the last trading day before or the trading day of a specified date, or any other reasonable method using actual transactions in the stock as reported by the market on a specified date, for the stock of the distributing corporation and the stock distributed in the transaction, provided that the specified date is designated before its occurrence, and the specified date is not more than sixty days after the transaction;

(B) using the arithmetic mean of the market prices in section 8(f)(iii)(A) on trading days during a specified period designated before the beginning of the specified period, and the specified period is not longer than thirty days and ends within sixty days after the transaction; or

(C) using an average of the prices in section 8(f)(iii)(A) and (B) during the prespecified period weighted based on the volume of trading of the stock on each trading day during the prespecified period.

(g) **Assumption or Substitution of Incentive Stock Options in Section 424 Corporate Transaction**. The Administrator in its exclusive discretion may provide in an Award, Award Agreement, or Section 424 Corporate Transaction, that the Administrator or Board in its exclusive discretion may take one or more of the following actions in a Section 424 Corporate Transaction in accordance with the requirements of Code Section 424: (i) the assumption of all or any portion of an Incentive Stock Option by the successor corporation, or a parent or subsidiary of the successor corporation; or (ii) the substitution of all or any portion of an Incentive Stock Option with an equivalent incentive stock option by the successor corporation, or a parent or subsidiary of the successor corporation.

(h) **Assumption or Substitution in Section 424 Corporate Transaction and Change-in-Control**. Section 8(f)-(g) will apply to a Section 424 Corporate Transaction regardless of whether the Section 424 Corporate Transaction is also a Change-in-Control. Section 8(f)-(g) will not apply to a Cash-Out in a Section 424 Corporate Transaction.

(i) **Vesting, Exercise, and Cancellation of Stock Rights in Section 424 Corporate Transaction**. The Administrator in its exclusive discretion may provide in an Award, Award Agreement, or Section 424 Corporate Transaction, that the Administrator or Board in its exclusive discretion may take the following actions in a Section 424 Corporate Transaction: (i) contingent on consummation of the Section 424 Corporate Transaction, fully vest all or a portion of Options and SARs at least fifteen days before the reasonably anticipated date of consummation of the Section 424 Corporate Transaction (the ''**Section 424 Vested Stock Rights**''); (ii) require the Grantees who hold the Section 424 Vested Stock Rights to exercise them before consummation of the Section 424 Corporate Transaction; and (iii) immediately before consummation of the Section 424 Corporate Transaction, cancel the Section 424 Vested Stock Rights that have not been exercised without the payment of any further consideration.

(j) **Vesting, Exercise, and Cancellation of Stock Rights in Section 424 Corporate Transaction and Change-in-Control**. Section 8(i) will apply to a Section 424 Corporate Transaction regardless of whether the Section 424 Corporate Transaction is also Change-in-Control. In a Section 424 Corporate Transaction that is also a Change-in-Control in which the Administrator or Board exercises its discretion under section 8(i), section 8(a)-(d) will not apply to the Section 424 Vested Stock Rights.

(k) **Vesting, Exercise, and Cancellation of Stock Rights in Initial Public Offering**. Section 8(i) will not apply to an Initial Public Offering. Grantees may exercise vested Options and SARs payable in Shares immediately before an Initial Public Offering, and will be treated as holders of the Shares being acquired on exercise immediately on exercise. Grantees may exercise their Options in a Cashless Exercise and receive the number of Shares equal to the difference between: (i) the number of Shares as to which the vested Options are being exercised, minus (ii) the number of Shares having a Fair Market Value as of the date of exercise equal to the product of the exercise price of the vested Options multiplied by the number of Shares as to which the vested Options are being exercised. For purposes of this section 8(k), Fair Market Value will be the price of the Shares in the Initial Public Offering.

(l) **Treatment of Restricted Stock in Section 424 Corporate Transaction**. Except as otherwise provided in an Award, Award Agreement, or Section 424 Corporate Transaction, on a Section 424 Corporate Transaction that is not also a Change-in-Control, the Company's repurchase rights and obligations with respect to Restricted Stock, and all the Company's other rights with respect to Restricted Stock, will: (i) become the rights and obligations of any successor to the Company; and (ii) also apply to any cash, securities, or other property to which the Shares were converted into or exchanged for in the Section 424 Corporate Transaction in the same manner and to the same extent as they applied to the Shares subject to the Restricted Stock Award.

(m) **Administrator or Board Discretion**. Except as otherwise provided in an Award or Award Agreement, and subject to Applicable Requirements and the Plan, the Administrator or Board: (i) in its exclusive discretion shall determine the treatment, disposition, and terms of Options, SARs, and Restricted Stock in a Change-in-Control or Section 424 Corporate Transaction; and (ii) does not have any obligation to take the same action or actions for all or any portion of the Options, SARs, and Restricted Stock.

9. **Conditions on the Issuance of Shares**.

(a) Unless the grant of Awards or issuance of Shares satisfies Applicable Requirements, the Company shall not grant Awards or issue Shares on the exercise of an

Option or SAR, or the grant or vesting of Restricted Stock.

(b) The Company shall use reasonable efforts to obtain the approval from any Government Body or an applicable Securities Market for which the Company's counsel delivers a written opinion addressed to the Board that it is more likely than not that the approval is necessary for the grant of Awards or issuance of Shares. If, after reasonable efforts the Company does not obtain any necessary approval, the Company will not have any liability for not obtaining the approval or the inability to grant Awards or issue Shares. Notwithstanding the foregoing provisions of this section 9(b), the Company will not have any obligation to register the Plan, any Award, any Shares subject to an Award, or any Shares issued under an Award.

(c) The Company in its exclusive discretion may postpone the grant of Awards or issuance of Shares until satisfaction of the requirements of a Government Body or applicable Securities Market, or the requirements of registration of Shares.

(d) If the exercise period of an Option or SAR, other than its original term, would expire when the Grantee's exercise would violate federal, state, local, or foreign law, or would jeopardize the Company's ability to continue as a going concern, the Administrator shall extend the exercise period until thirty days after the first date that the exercise would no longer violate applicable law, or jeopardize the Company's ability to continue as a going concern. A provision of foreign law applies only to foreign earned income from sources within the foreign country that promulgated the law. Foreign earned income means income as defined under Code Section 911(b)(1) without regard to Code Section 911(b)(1)(B)(iv), and without regard to the requirement that the income be attributable to services performed during the period described in Code Section 911(d)(1)(A) or (B).

(e) Except as otherwise provided in section 9(f), as a condition to the exercise of an Option or SAR, or the grant or vesting of a Restricted Stock, the Administrator in its exclusive discretion may require a Grantee to do one or more of the following: (i) represent that the Shares are being acquired only for investment for the Grantee's account and without any present intention to sell or distribute the Shares; (ii) covenant that the Grantee shall not make any short sale, grant any option for the purchase, loan, pledge, or otherwise encumber or dispose of Shares for a specified time period; or (iii) indemnify one or more members of the Broader Group, one or more boards of directors or other governing bodies of one or more members of the Broader Group, each Committee, and each Director, Officer, and Employee who is a member of the Board or a Committee or who acts on behalf of any of the foregoing Persons, against all assessments, claims, costs, damages, expenses, fines, judgments, liabilities, losses, penalties, and reasonable accountant's, actuary's, and attorney's and paralegal's fees and disbursements arising from or related to the inaccuracy of the representation in clause (i), or the breach of the covenant in clause (ii).

(f) The provisions of section 9(e) will not apply if: (i) the Shares have already been registered under a then-effective registration statement under the Securities Act or Exchange Act; or (ii) the Company's counsel delivers a written opinion addressed to the Board that it is more likely than not that the issuance of Shares is exempt from the registration requirements of the Securities Act and Exchange Act, or that any action in section 9(e)(i)-(ii) does not have to be taken under Applicable Requirements.

10. **Adjustments of Awards on Equity Restructuring Events**.

(a) If any combination, consolidation, forward or reverse split, merger, recapitalization, reorganization, repurchase or exchange of stock, spin-off, split-off, split-up, stock dividend, or special and nonrecurring dividend or distribution (whether in cash, securities, or other property), liquidation, dissolution, warrants or rights offering to purchase Shares at a price substantially below Fair Market Value, or other equity restructuring event, affects the Common Stock so that an adjustment is necessary or appropriate to prevent the dilution or enlargement of Grantees' rights, then the following provisions apply. Subject to Applicable Requirements and section 10(c), the Administrator or Board [Alternative 1: in its exclusive discretion may adjust all or any portion of:] [Alternative 2: shall adjust all or any portion of one or more of the following as determined by the Administrator or Board in its exclusive discretion:]

(i) the number of shares and classes of stock available thereafter for Awards under section 2(a) in the aggregate to all Grantees and individually to any Grantee;

(ii) the number of shares and classes of stock available thereafter for Incentive Stock Options under section 2(b) in the aggregate to all Grantees and individually to any Grantee;

(iii) the number of shares and classes of stock available thereafter for Options and SARs under section 2(c) in the aggregate to all Grantees and individually to any Grantee;

(iv) the number of shares and classes of stock available thereafter for Options and SARs under section 2(d) per each individual Employee;

(v) the number of shares and classes of stock available thereafter for Awards under section 2(e) per each individual Employee;

(vi) the number of shares and classes of stock to be issued for outstanding Awards; and

(vii) the exercise price of any Option, SAR, or the purchase price of Restricted Stock.

(b) On a stock split (including a reverse stock split) or stock dividend the only effect of which is to increase or decrease on a pro-rata basis the number of Shares subject to Options or SARs, the Administrator or Board [Alternative 1: in its exclusive discretion may] [Alternative 2: shall] proportionally adjust the exercise price and number of Shares subject to the Options or SARs and maintain the aggregate exercise price after the adjustment at not less than the aggregate exercise price before the transaction.

(c) Except as otherwise provided in the Plan, the Administrator shall not make any adjustment:

(i) to the exercise price of an Option or SAR that causes the exercise price to be less than the Fair Market Value of the underlying Shares on the Grant Date and the loss of exemption from Code Section 409A;

(ii) to the exercise price of an Option or SAR that causes the exercise price to be less than the Fair Market Value of the underlying Shares on the date that a modification to the Option or SAR occurs under Code Section 409A, and the loss of exemption from Code Section 409A;

(iii) to an Incentive Stock Option that constitutes an extension, modification, or renewal thereof and results in the loss of Incentive Stock Option status;

(iv) that causes the loss of deductibility under Code Section 162(m); or

(v) that adversely affects the exemption under Rule 16b-3 of the Exchange Act.

(d) When the Administrator or Board makes an adjustment under this section 10 that affects the number of Shares subject to an Award, the number of Shares will be rounded down to the next whole number.

11. **Effective Date and Term**.

(a) Subject to Applicable Requirements and the shareholder approval requirements of section 13, the Plan will be effective on the earlier of: (i) its adoption by the Board; and (ii) its approval by Company's shareholders (the ''Effective Date''). Before the Company obtains shareholder approval, the Administrator may grant Awards conditioned on shareholder approval, but the Company shall not issue or deliver shares until the shareholders approve the Plan. If the Company does not obtain shareholder approval at or before the first annual meeting of shareholders to occur after the Board's adoption of the Plan, the Plan and any Award made thereunder will terminate **ab initio**.

(b) The grant of Incentive Stock Options is subject to approval of the Plan by the Company's shareholders no more than twelve months before, or no later than twelve months after, the Board's adoption of the Plan. Until the Company obtains shareholder approval a Grantee shall not exercise any Incentive Stock Options. If the Company does not timely obtain shareholder approval, the previously granted Incentive Stock Options will terminate **ab initio**.

(c) The Plan will continue in effect until the earliest of: (i) ten years after the Effective Date; (ii) all Shares available for issuance under the Plan have been issued and all restrictions on Shares have lapsed; and (iii) its termination under section 12(a).

12. **Plan Amendment and Termination**.

(a) The Board in its exclusive discretion may amend or suspend the Plan one or more times, and terminate the Plan at any time. To the extent required by Applicable Requirements or the Plan, the Company shall obtain shareholder approval of any amendment.

(b) The Administrator shall not grant Awards during any suspension of the Plan or after its termination.

(c) [Alternative 1: Any amendment, suspension, or termination of the Plan (a ''**Change**'') must not have a [Alternative A: Material] [Alternative B: Significant] adverse effect on: (i) outstanding Awards granted before the Change or outstanding Award Agreements executed before the Change; (ii) the Grantee's indemnification obligations under section 9(e) for representations and covenants made before the Change; (iii) the Company's indemnification obligations under section 18 for acts and omissions that occurred before the Change; or (iv) the Company's obligations under section 18 to pay Fees for Fees for indemnification obligations that accrued before the Change.] [Use Alternative 1 with Alternative 1 of section 3(b)(v)] [Alternative 2: Any amendment, suspension, or termination of the Plan (a ''**Change**'') must not have a [Alternative A: Material] [Alternative B: Significant] adverse effect on: (i) outstanding Awards granted before the Change or outstanding Award Agreements executed before the Change; (ii) the Grantee's indemnification obligations under section 9(e) for representations and covenants made before the Change; (iii) the Company's indemnification obligations under section 18 for acts and omissions that occurred before the Change; or (iv) the Company's obligations under section 18 to pay Fees for Fees for indemnification obligations that accrued before the Change. Notwithstanding clause (i), the Administrator may amend the Plan regardless of its effect on any Award or Award Agreement to maintain the status of an Option as an Incentive Stock Option, to satisfy the requirements of Code Section 409A or an exemption thereto, to protect against the loss of deductibility under Code Section 162(m), or to comply with any Applicable Requirement or financial accounting standard.] [Use Alternative 2 with Alternative 2 of section 3(b)(v)]

13. **Shareholder Approval**.

(a) If the listing requirements of an applicable Securities Market require shareholder approval of the Plan before the Plan becomes effective, the Plan will not be effective until the Company obtains shareholder approval in accordance with these requirements.

(b) If the listing requirements of an applicable Securities Market require shareholder approval of any material amendment to the Plan, the amendment will not be effective until the Company obtains shareholder approval in accordance with these requirements. For purposes of this section 13(b), the rules of the applicable Securities Market will determine whether an amendment is material.

(c) The Company shall obtain shareholder approval of any amendment to the Plan that: (i) increases the maximum number of Shares that may be granted through Incentive Stock Options (other than an increase that reflects a change in the number of outstanding Shares, e.g., a stock dividend or stock split); (ii) changes the designation of Employees or class or classes of Employees eligible to receive Incentive Stock Options; or (iii) changes the granting corporation or the stock available for purchase or award. The Company shall obtain shareholder approval no more than twelve months before or no later than twelve months after the date of the Board's adoption of the amendment.

(d) The shareholder approval under section 13(c) must comply with the applicable provisions of the Company's charter and by-laws, and Delaware Law prescribing the method and degree of shareholder approval required for the issuance of corporate stock or options.

(e) The Company in its exclusive discretion may obtain shareholder approval to the extent necessary to qualify an Award as deductible qualified performance-based compensation under Code Section 162(m) in accordance with the following requirements:

(i) For Awards of Options and SARs for which vesting is not subject to the attainment of one or more performance goals, the shareholders must approve: (A) the Plan; (B) the class of Employees to whom the Plan applies; (C) the exercise price or formula under which the exercise price is determined, e.g., Fair Market Value on the Grant Date; and (D) the maximum number of Shares per individual Employee for which grants of Options and SARs may be made during a specified period.

(ii) For Awards of Options, SARs, and Restricted Stock for which vesting is subject to the attainment of one or more performance goals, the shareholders must approve: (A) the Plan; (B) the class of Employees to whom the Plan applies; (C) the material terms of the

performance goal or goals under which the compensation is paid, and the business criteria on which the performance goal or goals are based; (D) the exercise price or formula under which the exercise price is determined, e.g., Fair Market Value on the Grant Date; (E) any other formula used to calculate the amount of compensation to be paid to an Employee if the performance goal or goals are attained; and (F) the maximum number of Shares per individual Employee for which grants of Options, SARs, and Restricted Stock may be made during a specified period.

(iii) For Awards described in section 13(e)(i), the shareholders must approve any increase in the maximum number of Shares per individual Employee for which grants of Options and SARs may be made during a specified period. For Awards described in section 13(e)(ii), the shareholders must approve any increase in the maximum number of Shares per individual Employee for which grants of Options, SARs, and Restricted Stock may be made during a specified period.

(iv) Shareholder approval must occur in a separate vote in which a majority of the votes cast on the issue (including abstentions to the extent abstentions are counted as voting under Delaware Law) are cast in favor of approval.

(f) Except as otherwise provided in section 8 or 10, if the Shares are traded on an applicable Securities Market, the Administrator or Board shall not: (i) cancel any outstanding Option or SAR and replace it with a new Award or cash without shareholder approval; or (ii) take any action that is a repricing under the shareholder approval rules of the applicable Securities Market without shareholder approval.

14. **Unfunded Status**. The obligations of each member of the Broader Group under the Plan and any Award or Award Agreement are unfunded and unsecured. Grantees will not have any interest in the assets of any member of the Broader Group, and no member of the Broader Group will have any obligation to segregate its assets for the benefit of any Grantee. Each Grantee will have only a contractual right to the benefits under the Plan and any Award or Award Agreement, and will be a general unsecured creditor of any member of the Broader Group.

15. **No Effect on Service Relationship**. Neither the Plan nor any Award or Award Agreement: (a) gives any Grantee any right regarding the Grantee's service; (b) limits any Grantee's right, or the right of any member of the Broader Group, to terminate the Grantee's service; or (c) limits the right of any member of the Broader Group to change the terms of the Grantee's service.

16. **No Effect on Other Plans**. Except as otherwise provided in a governing document of an Other Plan, the income and gain that a Grantee realizes or recognizes under any Award are not compensation for determining the contributions and benefits under any Other Plan. For purposes of this section 16, ''**Other Plan**'' means, with respect to any member of the Broader Group, any bonus plan, Change-in-Control plan, deferred compensation plan, disability plan, equity compensation plan, incentive plan, life insurance plan, retirement plan, severance plan, or any other welfare benefit plan.

17. **Payment of Expenses**. The Company shall pay the reasonable expenses of the Plan's administration incurred by the Board, each Committee, and each Director, Officer, and Employee who is a member of the Board or a Committee or who acts on behalf of the Board or a Committee.

18. **Indemnification**.

(a) The Company shall indemnify the Board, each Committee, and each Director, Officer, and Employee who is a member of the Board or a Committee or who acts on behalf of the Board or a Committee (each, an ''**Indemnitee**'') against all assessments, claims, costs, damages, expenses, fines, judgments, liabilities, losses, penalties, and reasonable accountant's, actuary's, and attorney's and paralegal's fees and disbursements arising from or related to any act or omission in the Plan's administration, other than an act or omission due to the Indemnitee's gross negligence or intentional misconduct (the ''**Indemnified Amounts**'').

(b) (i) The Company shall pay the Indemnified Amounts incurred by the Indemnitee in defending any administrative, civil, or criminal action, audit, investigation, proceeding, or suit (an ''**Indemnified Proceeding**'') in advance of its final disposition (the ''**Advanced Amounts**''). The Company's obligation to pay the Advanced Amounts applies to pending, ongoing, and threatened Indemnified Proceedings.

(ii) Before the Company pays the first Advanced Amounts to an Indemnitee for any Indemnified Proceeding, the Indemnitee shall provide the Company with a written undertaking to repay the Advanced Amounts and interest thereon if a Juridical Body determines in a final and nonappealable judgment that the Indemnitee is not entitled to indemnification. The Indemnitee shall pay interest on the repayment at the rate under Code Section 7872(f)(2)(A) from the date that the Company paid the Advanced Amounts to the date of repayment.

(iii) The Company shall pay the Advanced Amounts regardless of the Indemnitee's financial ability to make repayment, and regardless of whether the Company ultimately has an indemnification obligation.

(iv) The Company shall pay the Advanced Amounts within thirty days after its receipt of each statement from the Indemnitee describing the Advanced Amounts in reasonable detail and requesting payment thereof.

(v) Without diminution of the Indemnitee's rights under this section 18, the Company shall provide indemnification and advancement to the Indemnitee before and after Separation From Service at least to the same extent that the Company provides indemnification and advancement to its then-active senior executive officers.

(c) The Indemnitee shall notify the Company in writing of any claim made against the Indemnitee arising from or related to any act or omission in the Plan's administration. The Indemnitee shall notify the Company within ten days after learning of the claim. If both the Indemnitee and the Administrator or Company are named parties to the claim, the Indemnitee's failure to timely give the written notice will not relieve the Company of its obligations under this section 18, nor create any liability from the Indemnitee to the Administrator or Company. If the Indemnitee does not timely give the written notice in any other situation, this failure will not relieve the Company of its obligations under this section 18 except to the extent that the failure has Materially prejudiced the Administrator's or Company's rights.

(d) The Company in its exclusive discretion may assume the defense of any Indemnified Proceeding, and

the Indemnitee shall reasonably cooperate with the Company in conducting the defense. If the Indemnitee [Alternative 1: reasonably determines] [Alternative 2: determines in good faith] that there is an actual or potential conflict of interest between the Administrator or any member of the Broader Group and the Indemnitee in the defense of an Indemnified Proceeding, the Indemnitee shall give the Company written notice of the actual or potential conflict of interest. After giving the written notice, the Indemnitee shall obtain separate representation at the Company's expense by counsel selected by the Indemnitee. To the extent consistent with the Indemnitee's separate defense and representation, the Indemnitee's counsel shall cooperate and coordinate with the Administrator, the Administrator's counsel, and any member of the Broader Group's counsel in conducting a joint defense and in minimizing the expense of separate representation.

(e) The Company will not have any obligations under this section 18 for any settlement of an Indemnified Proceeding entered into by any Indemnitee without the Company's written consent.

(f) If an Indemnitee brings an action to recover on claims for any indemnification or advancement obligation of the Company under this section 18, the Company shall also indemnify the Indemnitee against all reasonable accountant's, actuary's, and attorney's and paralegal's fees and disbursements incurred by the Indemnitee in bringing the claims for indemnification and advancement on which the Indemnitee substantially prevails (''**Fees for Fees**''). The amount indemnified for the reasonable fees component cannot exceed the Maximum Fees, and the amount indemnified for the reasonable disbursements component cannot exceed the Maximum Disbursements. The Company shall indemnify the reasonable disbursements component regardless of whether the Indemnitee pays the disbursements directly, or the Firms pay the disbursements.

(g) For purposes of section 18(f), ''**Maximum Fees**'' mean the product of the average hourly rate for each group of personnel based in the United States (''**Personnel**'') in each group of Firms multiplied by the number of hours billed to the Indemnitee by the firm retained by the Indemnitee. The average hourly rate for each group of Personnel will be the average hourly rate for that group in: (i) the ten largest accounting firms with one or more offices in the United States as determined by the annual gross revenues of the office or offices in the United States; (ii) the ten largest actuarial firms (including without limitation the actuarial departments of accounting and consulting firms) with one or more offices in the United States as determined by the annual gross revenues of the office or offices in the United States; and (iii) the ten largest law firms with one or more offices in the United States as determined by the annual gross revenues of the office or offices in the United States (the ''**Firms**''). The classification of each group of Personnel will be by years of experience in the group's area of expertise as follows: one or more, five or more, ten or more, fifteen or more, twenty or more, twenty-five or more, and thirty or more.

(h) For purposes of section 18(f), ''**Maximum Disbursements**'' mean the reasonable costs and expenses customarily billed by each group of Firms to their clients in addition to the hourly rates of Personnel, including without limitation reasonable charges for court reporters, stenographers, and transcribers, electronic research services, expert witnesses, faxes, filing fees, investigators, lodging, meals, messengers, overnight delivery, overtime for support staff, photocopying, postage, preparation of exhibits, telephone calls, transcripts in any medium, translators, and transportation.

(i) The Company shall pay the Fees for Fees within sixty days after: (i) entry of a final and nonappealable judgment for an award of Fees for Fees; or (ii) execution of a final and nonappealable settlement agreement for payment of Fees for Fees.

(j) If the Company's obligation to pay Fees for Fees is triggered on an Indemnitee's Separation From Service, and if the Indemnitee is a specified employee under Code Section 409A(a)(2)(B)(i) on the date of Separation From Service, then the Company shall take the following actions. To the extent that the Fees for Fees are nonqualified deferred compensation under Code Section 409A, the Company shall withhold the payments to which the Indemnitee would be entitled from the date of Separation From Service through the end of the sixth month after the date of Separation From Service (the time period, the ''**Indemnitee's Fees for Fees Holdback Period**'') (the withheld amounts, the ''**Indemnitee's Fees for Fees Holdback Amounts**''). The Company shall pay the Indemnitee's Fees for Fees Holdback Amounts in a single lump sum on the first business day of the seventh month after the date of Separation From Service, or if earlier, within thirty days after the date of the Indemnitee's death after the date of Separation From Service (the ''**Indemnitee's Fees for Fees Delayed Payment Date**''). If the Company withholds the Indemnitee's Fees for Fees Holdback Amounts during the Indemnitee's Fees for Fees Holdback Period, the Indemnitee may pay any indemnified amount during the Indemnitee's Fees for Fees Holdback Period, and receive reimbursement on the Indemnitee's Fees for Fees Delayed Payment Date.

(k) The Company shall also pay interest on each Indemnitee's Fees for Fees Holdback Amount from the last day that each Indemnitee's Fees for Fees Holdback Amount would have been paid during the Indemnitee's Fees for Fees Holdback Period to the Indemnitee's Fees for Fees Delayed Payment Date. The interest rate will be the rate under Code Section 7872(f)(2)(A) as of the sixtieth day after the Indemnitee's date of Separation From Service. The Company shall pay the accrued interest on the Indemnitee's Fees for Fees Delayed Payment Date.

(l) The Company's payment of Fees for Fees during an Indemnitee's taxable year will not affect any other expenses eligible for reimbursement or in-kind benefits to be provided in any other taxable year.

(m) An Indemnitee's right to payment of Fees for Fees will not be subject to liquidation or exchange for another benefit.

(n) To the extent that any indemnified amount under this section 18 is nonqualified deferred compensation under Code Section 409A: (i) each separately identified amount will be treated as a separate payment; and (ii) any series of installment payments will be treated as a right to a series of separate payments, and not one of a series of payments treated as a single payment.

(o) The Company's indemnification and advancement obligations under this section 18 will apply from the date that an Indemnitee first has the right to act in the Plan's administration until expiration of the applicable statute of limitations as it may be tolled or ex-

tended for each claim to which the Indemnitee is entitled to indemnification, advancement, or the payment of interest (the ''**Claim Period**''). If a claim is made during the Claim Period, the indemnification, advancement, and payment obligations will continue beyond the Claim Period until the final and nonappealable resolution of the claim.

19. **Governing Law**. The Plan is governed by the Laws of the State of Delaware regardless of the Laws that otherwise apply under principles of conflict of laws.

20. **Compliance With Laws and Applicable Requirements**.

(a) With respect to Awards granted to Insiders when any class of equity security of the Company is registered under Section 12 of the Exchange Act, or any similar state, local, or foreign law:

(i) the Plan is intended to satisfy Rule 16b-3;

(ii) all transactions involving Grantees who are covered by Section 16(b) of the Exchange Act are subject to the provisions of Rule 16b-3 regardless of whether these provisions are set forth in the Plan; and

(iii) any provision of the Plan that conflicts with Rule 16b-3 does not apply to the extent of the conflict.

(b) If any provision of the Plan or any Award or Award Agreement conflicts with the requirements of Code Section 162(m) or 422 for Awards subject to these requirements, that provision does not apply to the extent of the conflict.

(c) The Administrator shall administer, construe, and interpret the Plan, and exercise its authority and discretion, to satisfy Applicable Requirements, and the requirements of Code Section 409A or any exemption thereto.

(d) Notwithstanding any other provision of the Plan, if as a result of the conversion of an Incentive Stock Option to a Nonqualified Stock Option, the Option held by an Employee of a Parent would not satisfy the requirements of Code Section 409A or an exemption thereto, the Incentive Stock Option will terminate on the date that it no longer qualifies as an Incentive Stock Option.

(e) Any reference to a statute includes the rules and regulations promulgated thereunder.

(f) Any reference to a statutory or regulatory provision includes the provision as amended, supplemented, or replaced.

(g) All the provisions of the Plan and each Award or Award Agreement are to be administered, construed, and interpreted so as to be enforceable under Law.

(i) If a Juridical Body with competent jurisdiction to determine the enforceability of any provision determines that a provision is unenforceable, then to the extent permitted by Law the Juridical Body is to revise the provision to the minimum extent necessary to make it enforceable, or disregard the provision to the extent that revision is not permitted by Law.

(ii) If a Juridical Body decides to revise or disregard an unenforceable provision, that decision will not affect the enforceability of any other provision, and the unenforceable provision will remain as written in all circumstances other than the ones in which the Juridical Body determines to be unenforceable.

(iii) If a Juridical Body declines to revise an unenforceable provision, that decision will not affect the enforceability of any other provision, and the unenforceable provision will remain as written in all circumstances other than the ones in which the Juridical Body determines to be unenforceable.

21. **Electronic Delivery and Signatures**.

(a) Any reference in an Award, Award Agreement, or the Plan to a written document includes without limitation any document delivered electronically or posted on the Company's or a Broader Related Entity's intranet or other shared electronic medium controlled by the Company or Broader Related Entity.

(b) The Administrator and any Grantee may use facsimile and PDF signatures in signing any Award or Award Agreement, in exercising any Option or SAR, or in any other written document in the Plan's administration. The Administrator and each Grantee are bound by facsimile and PDF signatures, and acknowledge that the other party relies on facsimile and PDF signatures.

22. **Headings and Captions**. The headings and captions in the Plan are used only for convenience, and do not construe, define, expand, interpret, or limit any provision of the Plan.

23. **Gender and Number**. Whenever the context may require, any pronoun includes the corresponding masculine, feminine, or neuter form, and the singular includes the plural and vice versa.

24. **Construction**. The terms ''includes,'' ''including,'' ''includes without limitation,'' and ''including without limitation'' are not to be construed to limit any provision or item that precedes or follows these terms (whether in the same section or another section) to the specific or similar provisions or items that follow these terms. The principle of *ejusdem generis* will not apply when any of these terms are used.

25. **Definitions**. The following terms have the following definitions:

(a) ''**Administrator**'' means the Board, the Director and Officer Committee, or the Regular Committee.

(b) ''**Applicable Requirements**'' mean the requirements for equity compensation plans or any Award under (i) federal corporate, employee benefits, employment, and securities Laws; (ii) the Code; (iii) state corporate, employee benefits, employment, securities, and tax Laws; (iv) the rules of an applicable Securities Market; and (v) the laws of any foreign jurisdiction.

(c) ''**Award**'' means the Options, SARs, or Restricted Stock actually granted, or the determination to make one or more grants of Options, SARs, or Restricted Stock.

(d) ''**Award Agreement**'' means the written agreement for an Award executed by the Grantee, the Company, and any other member of the Broader Group to which the Grantee primarily provides services on the Grant Date. An Award Agreement includes any amendments thereto.

(e) ''**Board**'' means the Company's board of directors.

(f) ''**Broader Group**'' means the Company and each Broader Related Entity, Parent, Related Entity, Related Parent, and Subsidiary.

(g) ''**Broader Related Entity**'' means: (i) a corporation that is a member of the same controlled group of corporations as the Company under Code Section 414(b). In applying Code Section 1563(a)(1)-(3), the language ''at least 50 percent'' is to be used instead of ''at least 80 percent'' each place it appears in Code Section 1563(a)(1)-(3); and (ii) a Person that is a member of the same group of trades or businesses under common control as the Company under Code Section 414(c). In applying Treasury Regulation Section

1.414(c)-2, the language ''at least 50 percent'' is to be used instead of ''at least 80 percent'' each place it appears in Treasury Regulation Section 1.414(c)-2. Whenever the Plan refers to a Broader Related Entity by reference to a Person other than the Company, that Person is to be substituted for the term ''Company'' in this section 25(g).

(h) ''**Cause**'' means a Grantee's Involuntary Separation From Service for cause as defined in a then-effective written agreement between the Company or a Broader Related Entity and the Grantee, or in a then-effective written policy of the Company or a Broader Related Entity that is binding on the Grantee. In the absence of a then-effective agreement or policy, and except as otherwise provided in an Award or Award Agreement, Cause means an Involuntary Separation From Service when the following requirements are satisfied:

(i) The Company or Broader Related Entity to which the Grantee primarily provides services terminates the Grantee's service within two years after the occurrence of any of the following events:

(A) the entry by a trial court of a final judgment of conviction of the Grantee of a felony as defined in the jurisdiction in which the crime was committed. The entry of the final judgment may occur after trial or as a result of a guilty plea. Cause will exist regardless of whether the Grantee appeals the judgment;

(B) the Grantee's entry of a plea of nolo contendere to a felony as defined in the jurisdiction in which the alleged crime was committed, and regardless of whether the Grantee appeals the judgment;

(C) the issuance of a final award, judgment, or order by a Juridical Body that disqualifies or bars the Grantee from satisfying any [Alternative 1: Material] [Alternative 2: Significant] obligation to the Company or Broader Related Entity for more than sixty consecutive days, or sixty days in a 120 consecutive day period, regardless of whether the Grantee appeals the award, judgment, or order;

(D) the issuance of a final determination by a Juridical Body that the Grantee violated one or more securities Laws, regardless of whether the determination was made after a hearing or trial, or on consent without admitting or denying any allegation of wrongdoing, and regardless of whether the Grantee appeals the determination;

(E) the Grantee's intentional violation of any Law that causes or threatens to cause a [Alternative 1: Material loss to any business of the Company or any Broader Related Entity.] [Alternative 2: Significant loss to any business of the Company or any Broader Related Entity.] This provision does not apply to a violation subject only to a monetary fine not to exceed $5,000;

(F) the Grantee's violation of any Law governing any business of the Company or Broader Related Entity. This section 25(h)(i)(F) does not apply if the Grantee acted: (I) in accordance with the written direction or policy of the Board or governing body of the Broader Related Entity; or (II) in reliance on the written advice of the Company's or Broader Related Entity's counsel as requested by the Board or governing body of the Broader Related Entity;

(G) [Alternative 1: the Grantee is arrested or charged with a felony as defined in the jurisdiction in which the alleged crime was committed, and the arrest or charge results in substantial adverse publicity to the Company or any Broader Related Entity;] [Alternative 2: the Grantee is arrested or charged with a felony as defined in the jurisdiction in which the alleged crime was committed;]

(H) the Grantee's failure to obtain or maintain the professional qualifications necessary to perform the Grantee's service as determined by a reasonable person in the Company's or Broader Related Entity's position, including without limitation the licenses and registrations required by Government Bodies and self-regulatory organizations, and [Alternative 1: the Grantee does not cure the failure within thirty days after the Grantee's receipt of written notice from the Board or governing body of the Broader Related Entity specifying the failure and requesting the Grantee to cure it;] [Alternative 2: the failure continues for more than sixty consecutive days, or sixty days in a 120 consecutive day period;]

(I) the Grantee's failure, other than due to Disability, to perform satisfactorily any [Alternative 1: Material] [Alternative 2: Significant] duty on a regular basis. This provision does not apply solely to the Grantee's failure to attain one or more performance goals, or solely to the Company's or Broader Related Entity's economic performance;

(J) the Grantee's failure, other than due to Disability, to carry out the Board's or a Broader Entity's governing body's reasonable and achievable business directions that are consistent with the Grantee's position and Law;

(K) the Grantee's [Alternative 1: Material] [Alternative 2: Significant] violation of any policy, including without limitation the Company's or Broader Related Entity's code of conduct, that generally applies to the Company's or Broader Related Entity's employees, or to a group of employees that includes the Grantee, and the violation causes or threatens to cause a [Alternative 1: Material loss to any business of the Company or any Broader Related Entity.] [Alternative 2: Significant loss to any business of the Company or any Broader Related Entity.] This section 25(h)(i)(K) applies only if the Company or Broader Related Entity gave the Grantee written notice of the policy before the violation occurred;

(L) the Grantee's violation of any statutory or common law duty of loyalty to the Company or Broader Related Entity, and the violation causes or threatens to cause a [Alternative 1: Material loss to any business of the Company or any Broader Related Entity;] [Alternative 2: Significant loss to any business of the Company or any Broader Related Entity;]

(M) the Grantee's receipt of written notice from the Board or governing body of the Broader Related Entity requesting the Grantee's cooperation in any internal investigation, or investigation by any Government Body, into the business practices of the Grantee, Company, or any Broader Related Entity (an ''**Investigation**''), and the Grantee's failure to cooperate. Failure to cooperate includes without limitation the Grantee's refusal to be deposed or testify at a hearing or trial. Not-

withstanding the foregoing provisions of this section 25(h)(i)(M), the Grantee does not have any obligation to waive the attorney-client privilege for communications between the Grantee and the Grantee's counsel, or the Grantee's constitutional privilege against self-incrimination;

(N) the Grantee's intentional destruction, or intentional failure to preserve documents or other material known by the Grantee to be relevant to any Investigation;

(O) the Grantee's inducement or encouragement of any Person not to cooperate in any Investigation or produce documents or other material in any Investigation;

(P) any act or omission by the Grantee that results in any stock of the Company or any Broader Related Entity being delisted for trading on an applicable Securities Market;

(Q) (I) any act or omission by the Grantee that the Grantee intends to cause or threaten to cause a [Alternative 1: Material loss to any business of the Company or any Broader Related Entity;] [Alternative 2: Significant loss to any business of the Company or any Broader Related Entity;] (II) any act or omission by the Grantee that constitutes gross negligence and causes or threatens to cause a [Alternative 1: Material loss to any business of the Company or any Broader Related Entity;] [Alternative 2: Significant loss to any business of the Company or any Broader Related Entity;] or (III) multiple acts or omissions by the Grantee that constitute negligence and cause or threaten to cause a [Alternative 1: Material loss to any business of the Company or any Broader Related Entity;] [Alternative 2: Significant loss to any business of the Company or any Broader Related Entity;]

(R) the Grantee's appropriation of any business opportunity of the Company or any Broader Related Entity for the Grantee's personal benefit, the benefit of a member of the Grantee's Immediate Family, or the benefit of a Family Entity;

(S) the Grantee's intentional interference with any business of the Company or any Broader Related Entity, and the interference causes or threatens to cause a [Alternative 1: Material loss to that business;] [Alternative 2: Significant loss to that business;]

(T) (I) the Grantee intentionally falsifies any information given to a Director or Officer of the Company, or a member of the governing body or Officer of any Broader Related Entity; (II) the Grantee intentionally misleads a Director or Officer of the Company, or a member of the other governing body or Officer of any Broader Related Entity, regarding any [Alternative 1: Material matter;] [Alternative 2: Significant matter;] or (III) the Grantee intentionally provides a false certification to the Company or any Broader Related Entity pertaining to its financial statements; or

(U) any act by the Grantee directed against the Company or any Broader Related Entity of bribery, embezzlement, fraud, misappropriation of assets, or receipt of kickbacks. This section 25(h)(i)(U) will not apply to any good faith dispute involving the Grantee's claim for reimbursement of business expenses.

(V) In furtherance and not in limitation of this section 25(h)(i), a [Alternative 1: Material] [Alternative 2: Significant] loss includes without limitation the Company's or any Broader Related Entity's restatement of one or more of its financial statements for a completed fiscal period after the statement or statements were filed with the SEC.

(W) For purposes of this section 25(h), an act or omission is not intentional if: (I) the Grantee [Alternative 1: reasonably believed] [Alternative 2: believed in good faith] that the Grantee's conduct was in the best interest of the Company, or the Broader Related Entity to which the Grantee primarily provided services; (II) the Grantee acted in accordance with a resolution or resolution of the Board or the governing body of the Broader Related Entity to which the Grantee primarily provided services; (III) the Grantee acted in accordance with the instructions of the CEO or other officer senior to the Grantee; or (IV) the Grantee acted on the advice of counsel to the Company or counsel to the Broader Related Entity to which the Grantee primarily provided services; and

(ii) [Alternative 1: If the Board or governing body of the Broader Related Entity to which the Grantee primarily provides services determines that Cause exists under section 25(h)(i)(F), (I), or (J), the Board or governing body shall give the Grantee written notice specifying in reasonable detail the acts or omissions that establish Cause, and requesting the Grantee to cure the acts or omissions. If within thirty days after receipt of the written notice the Grantee cures the acts or omissions, Cause will no longer exist. During the cure period the Grantee will not vest in or exercise Options or SARs, vest in Restricted Stock, or purchase Restricted Stock.] [Alternative 2: If the Board or governing body of the Broader Related Entity to which the Grantee primarily provides services determines that Cause exists under section 25(h)(i)(F), (I), or (J), the Board or governing body shall give the Grantee written notice specifying in reasonable detail the acts or omissions that establish Cause, and requesting the Grantee to cure the acts or omissions. If within thirty days after receipt of the written notice the Grantee cures the acts or omissions, Cause will no longer exist. If as determined by a reasonable person in the Grantee's position more than thirty days is necessary to cure the acts or omissions, and if the Grantee commences performance of a cure within thirty days and thereafter uses reasonable diligence to complete the cure, Cause will no longer exist. During the cure period the Grantee will not vest in or exercise Options or SARs, vest in Restricted Stock, or purchase Restricted Stock.]

[Alternative 1: (i) ''**Change-in-Control**'' means a change in ownership or control of the Company effected through any of the following:

(i) one Person, or more than one Person acting as a group as determined under Treasury Regulation Section 1.409A-3(i)(5)(v)(B), acquires ownership of stock of the Company that, together with stock previously held by the acquiror, constitutes more than fifty percent of the total fair market value or total voting power of the Company's stock. If one Person, or more than one Person acting as a group, is considered to own more than fifty percent of the total fair market value or total voting power of the Company's stock, the acquisition of additional stock by the same Person or Persons acting as a group does not cause a change in ownership. An

increase in the percentage of stock owned by one Person, or Persons acting as a group, as a result of a transaction in which the Company acquires its stock in exchange for property, will be treated as an acquisition of stock;

(ii) one Person, or more than one Person acting as a group as determined under Treasury Regulation Section 1.409A-3(i)(5)(v)(B) and (i)(5)(vi)(D), acquires or has acquired during the twelve months ending on the date of the most recent acquisition, ownership of stock of the Company that, together with stock previously held by the acquiror, possesses thirty percent or more of the total voting power of the Company's stock. If one Person, or more than one Person acting as a group, is considered to own more than thirty percent of the total voting power of the Company's stock, the acquisition of additional stock by the same Person or Persons acting as a group does not cause a change in effective control. An increase in the percentage of stock owned by one Person, or Persons acting as a group, as a result of a transaction in which the Company acquire its stock in exchange for property, will be treated as an acquisition of stock;

(iii) a majority of the members of the Board is replaced during a twelve month period by directors whose appointment or election was not endorsed by a majority of the members of the Board before the date of appointment or election; or

(iv) one Person, or more than one Person acting as a group as determined under Treasury Regulation Section 1.409A-3(i)(5)(v)(B) and (i)(5)(vii)(C), acquires or has acquired during the twelve month period ending on the date of the most recent acquisition, assets from the Company that have a total gross fair market value equal to at least forty percent of the total gross fair market value of the Company's assets immediately before the acquisition or acquisitions. Gross fair market value means the fair market value of the Company's assets, or the fair market value of the assets being disposed of, without regard to any liabilities associated with these assets. Notwithstanding the prior provisions of this section 25(i)(iv), acquisitions of the Company's assets by the following Persons will not be treated as a change in the ownership of the assets: (A) a shareholder of the Company immediately before the acquisition in exchange for or with respect to the Company's stock; (B) a Person of which the Company owns stock with fifty percent or more of the total fair market value or total voting power of that Person's stock; (C) a Person, or more than one Person acting as a group, that owns fifty percent or more of the total fair market value or voting power of the Company's stock; or (D) a Person at least fifty percent of the total fair market value or voting power of which is owned by a Person or more than one Person acting as a group described in clause (C). Except as otherwise provided in the prior provisions of this section 25(i)(iv), a Person's status will be determined immediately after the asset transfer.

(v) In determining whether a Change-in-Control has occurred, the attribution rules of Code Section 318 will apply to determine stock ownership. The stock subject to a vested option will be treated as owned by the individual who holds the vested option, and the stock subject to an unvested option will not be treated as owned by the individual who holds the unvested option. If a vested option is exercisable for stock that is not substantially vested under Treasury Regulation Section 1.83-3(b) and (j), the stock subject to the option will not be treated as owned by the individual who holds the option.

(vi) Whenever the Plan refers to the Change-in-Control of a Person other than the Company, that Person is to be substituted for the term ''Company'' in this section 25(i).

(vii) Similar rules apply to determine whether a Change-in-Control of a noncorporate entity has occurred.]

[Alternative 2: (i) ''**Change-in-Control**'' means a change in ownership or control of the Company effected through any of the following:

(i) a Person or group of Persons, as defined in Section 13(d)(3) or 14(d)(2) of the Exchange Act, acquires or otherwise obtains beneficial ownership, as defined in Rule 13d-3 under the Exchange Act, on a fully diluted basis of [Alternative A: thirty percent or more] [Alternative B: fifty percent or more] of either the then-outstanding Shares of Common Stock, or the then-outstanding combined voting power of the Company's stock entitled to vote generally in the election of directors (the ''**Company Voting Stock**''). In determining the then outstanding Shares of Common Stock, the Shares issuable on the exercise of options and warrants, the conversion of convertible stock or debt, and the exercise of any similar right to acquire Shares, will be taken into account. Notwithstanding the prior sentence, the following acquisitions will not be a Change-in-Control: (A) any acquisition from the Company; (B) any acquisition by the [Alternative A: Company] [Alternative B: Company and its Broader Related Entities]; (C) any acquisition by any employee benefit plan or related trust maintained by the [Alternative A: Company] [Alternative B: Company and its Broader Related Entities]; (D) any acquisition by a Person in a transaction described in section 25(i)(iii)(A)-(C); (E) a reduction in the number of shares of Common Stock or Company Voting Stock in a transaction or series of transactions that is approved by a majority of the Board; or (F) with respect to any Award held by a Grantee, any acquisition by the Grantee, a member of the Grantee's Immediate Family, a Family Entity, any Person controlled by the Grantee, any group of Persons of which the Grantee is a member, or any Person controlled by a group of Persons of which the Grantee is a member. If a Person's beneficial ownership of the Common Stock or Company Voting Stock reaches or exceeds thirty percent as a result of a transaction described in clause (A), (B), or (E), and that Person subsequently acquires beneficial ownership of additional Common Stock or Company Voting Stock representing one percent or more of the Common Stock or Company Voting Stock, the subsequent acquisition will be treated as an acquisition that causes that Person to own thirty percent or more of the Common Stock or Company Voting Stock;

(ii) the individuals who are members of the Board as of the Effective Date (the ''**Incumbent Board**'') cease to be a majority of the Board. An individual who becomes a director subsequent to the Effective Date and whose election, or nomination for election by the Company's shareholders, was approved by a vote of a [Alternative A: majority] [Alternative B: two-thirds] of the directors then members of the Incumbent Board, will be treated as a member of the Incumbent Board. Approval will occur by a Board vote that specifically approves the election or nomination, or by Board approval

of the Company's proxy statement in which the individual is named as a nominee for director without any objection. Notwithstanding the prior provisions of this section 25(i)(ii), an individual will not be treated as a member of the Incumbent Board if: (A) a Person that has taken steps reasonably calculated to consummate a transaction described in this section 25(i) designates that individual as a director; or (B) an individual initially becomes a director or nominee for director as a result of an actual or threatened election contest for the election or removal of directors, or other actual or threatened solicitation of proxies or consents by or on behalf of a Person other than the Board (an ''**Election or Proxy Contest**''), including without limitation because of any agreement to avoid or settle an Election or Proxy Contest;

(iii) consummation of a consolidation, merger, reorganization, statutory share exchange, or similar transaction involving the Company or any of its Subsidiaries, a sale or other disposition of all or substantially all of the Company's assets, or the acquisition of assets or securities of another Person by the Company or any of its Subsidiaries (each, a ''**Business Combination**''). A Change-in-Control will not result from a Business Combination in which immediately after the Business Combination:

(A) all or substantially all of the Persons that were the beneficial owners of the outstanding Common Stock and outstanding Company Voting Stock immediately before the Business Combination beneficially own: (I) more than [Alternative A: fifty percent] [Alternative B: fifty-five percent] [Alternative C: sixty percent] of the then-outstanding shares of common equity securities (or for a noncorporate entity, the equivalent securities), and the combined voting power of the then-outstanding voting securities entitled to vote generally in the election of directors (or for a noncorporate entity, the equivalent governing body) of the Person resulting from the Business Combination, including without limitation a Person that as a result of the transaction owns the Company or all or substantially all of the Company's assets directly or through one or more subsidiaries; and (II) the securities in clause (I) in substantially the same proportions as their ownership immediately before the Business Combination of the then-outstanding Common Stock and the then-outstanding Company Voting Stock, as the case may be.

(B) no Person, other than a Person resulting from the Business Combination, and other than any employee benefit plan or a related trust of the [Alternative A: Company] [Alternative B: Company and its Broader Related Entities] or the Person resulting from the Business Combination, beneficially owns [Alternative A: thirty percent] [Alternative B: fifty percent] or more of the then-outstanding shares of common equity securities (or for a noncorporate entity, the equivalent securities) of the Person resulting from the Business Combination, or the combined voting power of the then-outstanding voting equity securities of the Person resulting from the Business Combination, except to the extent that this ownership percentage existed before the Business Combination; or

(C) at least a majority of the members of the board of directors (or for a noncorporate entity, the equivalent governing body) of the Person resulting from the Business Combination were members of the Incumbent Board at the time of signing the initial agreement or Board action approving the Business Combination; or

(iv) approval by the Company's shareholders of a plan of complete liquidation or dissolution of the Company.

(v) Whenever the Plan refers to the Change-in-Control of a Person other than the Company, that Person is to be substituted for the term ''Company'' in this section 25(i).

(vi) Similar rules apply to determine whether a Change-in-Control of a noncorporate entity has occurred.]

(j) ''**Code**'' means the Internal Revenue Code of 1986, as amended, the final and temporary regulations promulgated thereunder, and the authorities that constitute substantial authority under Code Section 6662.

(k) ''**Committee**'' means the Director and Officer Committee or the Regular Committee.

(l) ''**Common Stock**'' means the Company's common stock.

(m) ''**Company**'' means ABC, Inc., a Delaware corporation.

(n) ''**Contractor**'' means any Person, other than an Employee or Director, who performs services as an independent contractor.

(o) ''**Director**'' means a member of the Board or the board of directors or other governing body of a Person.

(p) ''**Disability**'' [Alternative 1: means, except as otherwise provided in an Award or Award Agreement, that a Grantee is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be expected to last for a continuous period of at least twelve months.]; [Alternative 2: means, except as otherwise provided in an Award or Award Agreement, that a Grantee is: (i) unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of at least twelve months; or (ii) by reason of any medically determinable physical or mental impairment that can be expected to result in death or last for a continuous period of at least twelve months, receiving income replacement benefits for at least three months under an accident and health plan covering the Company's or a Broader Related Entity's employees. For purposes of determining the term of an Incentive Stock Option under section 7(d)(iii) and (ix), Disability means that a Grantee is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be expected to last for a continuous period of at least twelve months.] [Alternative 3: means, except as otherwise provided in an Award of Award Agreement, that a Grantee is unable to perform the duties of the Grantee's position of employment or any substantially similar position of employment due to any medically determinable physical or mental impairment that can be expected to result in death or can be expected to last for a continuous period of not less than six months. For purposes of determining the term of an Incentive Stock Option under section 7(d)(iii) and (ix), Disability means that a Grantee is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death, or that has lasted or can be

expected to last for a continuous period of at least twelve months.] [Use Alternative 3 with Alternative 2 of section 25(ww)(i) in the definition of Separation From Service.]

(q) ''**Employee**'' means a common law employee. An Employee does not include any person who is: (i) classified by a member of the Broader Group as working on discrete projects; (ii) classified by a member of the Broader Group as an independent contractor, as evidenced by its action in not withholding taxes from his or her compensation, regardless of whether the person is a common law employee; (iii) working for an organization that provides goods or services (including without limitation temporary employee services) to a member of the Broader Group and whom the member does not regard to be its common law employee, as evidenced by its action in not withholding taxes from his or her compensation, regardless of whether the person is a common law employee; (iv) a leased employee under Code Section 414(n); or (v) included in a unit of employees covered by a collective bargaining agreement (as so determined by the Secretary of Labor) between employee representatives and a member of the Broader Group.

(r) ''**Exchange Act**'' means the Securities Exchange Act of 1934, as amended.

(s) ''**Fair Market Value**'' means, as of any date, the fair market value of a Share determined as follows:

(i) If the Shares are readily tradable on a Securities Market, by the closing price of a Share on the date of determination. If a closing price was not reported on that date, then the arithmetic mean of the high and low prices at the close of the market on that date, and if these prices were not reported on that date, then the closing price on the last trading day on which a closing price was reported; or

(ii) If the Administrator in its exclusive discretion determines that the valuation method under section 25(s)(i) does not apply, then the Administrator shall determine Fair Market Value by one of the following methods as the Administrator in its exclusive discretion determines appropriate:

(A) an independent appraisal that satisfies the requirements of Code Section 401(a)(28)(C) as of a date within twelve months before the date of the action for which the appraisal is used, e.g., the Grant Date of an Award (the ''**Appraisal**''). If the Administrator in its exclusive discretion determines that the Appraisal does not reflect information available after the date of the Appraisal that may Materially affect the Company's value, then the Administrator shall determine Fair Market Value by a new Appraisal; or

(B) the reasonable application of a reasonable valuation method that takes into consideration in applying its methodology all available information Material to the Company's value.

(iii) The Administrator may use a different valuation method for each separate action for which a valuation is relevant as long as a single valuation method is used for each separate action. Once an exercise price or amount to be paid has been established, the Administrator shall not change the exercise price or amount to be paid through the retroactive use of another valuation method. Notwithstanding the foregoing provisions of this section 25(s)(iii), when after the Grant Date, but before the date of exercise of the Option or SAR, the Shares become readily tradable on a Securities Market, the Administrator shall use the valuation method in section 25(s)(i) for purposes of determining the payment at the date of exercise or purchase of the Shares.

(t) ''**Family Entity**'' means any Person in which: (i) the Grantee or Officer, (ii) one or more members of the Grantee's or Officer's Immediate Family; or (iii) any combination of the Persons in clauses (i) and (ii), owns an equity interest with at least five percent of the total combined voting power of the equity interests entitled to vote, or at least five percent of the total value of all classes of equity. In determining ownership, the rules of Treasury Regulation Sections 1.414(c)-3 and 1.414(c)-4 apply.

[Alternative 1: (u) ''**Good Reason**'' means a Grantee's voluntary Separation From Service when the following requirements are satisfied with respect to the Company or Broader Related Entity to which the Grantee primarily provides services:

(i) The effective date of Separation From Service occurs no later than two years after the occurrence of any of the following events, and the event occurs without the Grantee's consent:

(A) a Material diminution in the Grantee's base salary;

(B) a Material diminution in the Grantee's authority, duties, or responsibilities;

(C) a Material diminution in the authority, duties, or responsibilities of the supervisor to whom the Grantee is required to report, including a requirement that the Grantee report to a corporate officer or employee instead of reporting directly to the Board or governing body of the Broader Related Entity;

(D) a Material diminution in the budget over which the Grantee retains authority;

(E) a Material change in the geographic location at which the Grantee performs services; or

(F) any other action or inaction that constitutes a Material breach by the Company or Broader Related Entity of the agreement under which the Grantee provides services; and

(ii) The Grantee gives the Board or governing body of the Broader Related Entity written notice of the existence of the event described in section 25(u)(i)(A)-(F) no later than ninety days after its initial occurrence. Upon the Board's or governing body's receipt of the notice, the Company or Broader Related Entity does not cure the event within thirty days.]

[Alternative 2: (u) ''**Good Reason**'' means a Grantee's voluntary Separation From Service for good reason as defined in a then-effective written agreement between the Company or a Broader Related Entity and the Grantee, or in a then-effective written policy of the Company or a Broader Related Entity that is binding on the Grantee. In the absence of an agreement or policy, and except as otherwise provided in an Award or Award Agreement, Good Reason means the Grantee's voluntary Separation From Service when the following requirements are satisfied with respect to the Company or Broader Related Entity to which the Grantee primarily provides services:

(i) The effective date of Separation From Service occurs within two years after the occurrence of any of

the following events, and the event occurs without the Grantee's consent:

(A) [Alternative A: a Material diminution in the Grantee's base salary;] [Alternative B: a Material diminution in the Grantee's base salary other than as part of an across-the-board reduction in base salaries that applies in the same manner to the same group of Employees as the Grantee;]

(B) [Alternative A: a Material diminution in the Grantee's authority, duties, or responsibilities. In furtherance of this section 25(u)(i)(B) and not in limitation thereof, if a transaction or other event results in a change in any business, status, or structure of the Company or a Broader Related Entity, and this change causes a Material diminution, the Material diminution comes within this section 25(u)(i)(B). The principle of *ejusdem generis* will not apply in determining whether any event is a Material diminution under this section 25(u)(i)(B);] [Alternative B: a Material diminution in the Grantee's authority, duties, or responsibilities. In furtherance of this section 25(u)(i)(B) and not in limitation thereof, upon consummation of a Reorganization or Sale, whether a material diminution occurs will be determined by reference to the entire affiliated group of the Surviving Entity and its Broader Related Entities. The principle of *ejusdem generis* will not apply in determining whether any event is a Material diminution under this section 25(u)(i)(B);] [Alternative C: a Material diminution in the Grantee's authority, duties, or responsibilities. In furtherance of this section 25(u)(i)(B) and not in limitation thereof, upon consummation of a Reorganization or Sale in which more than fifty percent of the voting securities entitled to elect directors of the Surviving Entity is beneficially owned by a second entity (the "**Parent Entity**"), whether a Material diminution occurs will be determined by reference to the Parent Entity. The principle of *ejusdem generis* will not apply in determining whether any event is a Material diminution under this section 25(u)(i)(B);]

(C) [Alternative A: [Alternative I: a Material diminution in the authority, duties, or responsibilities of the person to whom the Grantee reports.] [Alternative II: a requirement that the Grantee report to an Officer of the Company or Broader Related Entity other than the CEO or President of the Company or Broader Related Entity.] [Alternative III: a requirement that the Grantee report to an Officer or employee instead of to the Board or governing body of a Broader Related Entity.] In furtherance of this section 25(u)(i)(C) and not in limitation thereof, if a transaction or other event results in a change in any business, status, or structure of the Company or a Broader Related Entity, and this change causes a Material diminution, the Material diminution comes within this section 25(u)(i)(C). The principle of *ejusdem generis* will not apply in determining whether any event is a Material diminution under this section 25(u)(i)(C);] [Alternative B: [Alternative I: a Material diminution in the authority, duties, or responsibilities of the person to whom the Grantee reports.] [Alternative II: a requirement that the Grantee report to an Officer of the Company or Broader Related Entity other than the CEO or President of the Company or Broader Related Entity.] [Alternative III: a requirement that the Grantee report to an Officer or employee instead of to the Board or governing body of a Broader Related Entity.] In furtherance of this section 25(u)(i)(C) and not in limitation thereof, upon consummation of a Reorganization or Sale, whether a Material diminution occurs will be determined by reference to the entire affiliated group of the Surviving Entity and its Broader Related Entities. The principle of *ejusdem generis* will not apply in determining whether any event is a Material diminution under this section 25(u)(i)(C);] [Alternative C: [Alternative I: a Material diminution in the authority, duties, or responsibilities of the person to whom the Grantee reports.] [Alternative II: a requirement that the Grantee report to an Officer of the Company or Broader Related Entity other than the CEO or President of the Company or Broader Related Entity.] [Alternative III: a requirement that the Grantee report to an Officer or employee instead of to the Board or governing body of a Broader Related Entity.] In furtherance of this section 25(u)(i)(C) and not in limitation thereof, upon consummation of a Reorganization or Sale that results in a Parent Entity, whether a Material diminution occurs will be determined by reference to the Parent Entity. The principle of *ejusdem generis* will not apply in determining whether any event is a Material diminution under this section 25(u)(i)(C);]

(D) a Material reduction in the budget over which the Grantee has authority;

(E) the relocation of the Grantee's principal office to a location more than [Alternative A: thirty-five geographic (not road)] [Alternative B: fifty geographic (not road)] miles from its location on the Grant Date of the Grantee's first Award, and more than [Alternative A: thirty-five geographic (not road)] [Alternative B: fifty geographic (not road)] miles from the Grantee's then-current principal residence;

(F) the Company's or Broader Related Entity's failure to provide an annual bonus opportunity equal to the average of the Grantee's annual bonuses for the three calendar years immediately before the then current calendar year. In determining the average of the Grantee's annual bonuses, the average includes a zero for any calendar year for which the Grantee was not entitled to an annual bonus. This section 25(u)(i)(F) will not apply to any clawback or forfeiture of an annual bonus resulting from the Grantee's violation of any agreement with the Company or a Broader Related Entity, any plan, program, or policy of the Company or a Broader Related Entity, or Law;

(G) the Company's or Broader Related Entity's assignment of travel obligations in a calendar year that are Materially more time-consuming than the Grantee's travel obligations in the prior calendar year; or

(H) an amendment of the Company's or Broader Related Entity's corporate governance documents that has a Material adverse effect on the Grantee's rights to indemnification and advancement; and

(ii) [Alternative A: The Grantee provides written notice to the Board or governing body of the Broader Related Entity specifying in reasonable detail the event described in section 25(u)(i) within ninety days after its initial occurrence. Upon the Board's or governing body's receipt of the written notice, the Company or Broader Related Entity does not cure the event within thirty days.] [Alternative B: The Grantee provides written notice to the Board or the governing body of the Broader Related Entity of the event described in section

25(u)(i) within ninety days after its initial occurrence, or, if later, within ninety days after the Grantee becomes aware of the event, or with reasonable diligence should have become aware of the event. Upon the Board's or governing body's receipt of the written notice, the Company or Broader Related Entity does not cure the event within thirty days, or if as determined by a reasonable person in the Company's or Broader Related Entity's position more than thirty days is necessary to cure the event, the Company or the Broader Related Entity does not commence performance of a cure within thirty days, or does not thereafter use reasonable diligence to complete the cure.]]

(v) ''**Government Body**'' means: (i) the government of any country or the government of any political subdivision of any country (a ''**Government**''); (ii) any instrumentality of a Government; (iii) any other Person authorized by Law to perform any administrative, executive, judicial, legislative, military, police, or regulatory functions of a Government; (iv) any intergovernmental organization; and (v) any successor to the entities described in clauses (i) through (iv).

(w) ''**Grant Date**'' means the date on which the granting corporation or corporations complete the corporate action necessary to create the legally binding right in the Grantee to the Award. A corporate action is not complete until the date on which the maximum number of Shares that can be purchased or received under the Award is fixed or determinable, the minimum exercise or purchase price is fixed or determinable, and the class of stock subject to the Award and the Grantee's identity are designated.

(x) ''**Grantee**'' means an Employee, Director, or Contractor of a member of the Broader Group who receives an Award of Options, SARs, or Restricted Stock, or any Person who holds an outstanding Award of Options, SARs, or Restricted Stock.

(y) ''**Immediate Family**'' means a: (i) child; (ii) stepchild; (iii) grandchild; (iv) parent; (v) stepparent; (vi) grandparent; (vii) spouse; (viii) former spouse; (ix) domestic partner; (x) former domestic partner; (xi) sibling; (xii) niece; (xiii) nephew; (xiv) mother-in-law; (xv) father-in-law; (xvi) son-in-law; (xvii) daughter-in-law; (xviii) brother-in-law; (xix) sister-in-law (the individuals described in (i) through (xix), the ''**Family Individuals**''); (xx) person sharing the Grantee's or Officer's household, other than a tenant or an employee; (xxi) trust in which one or more Family Individuals, whether separately or together with the Grantee or Officer, own more than fifty percent of the beneficial interests; (xxii) foundation for which one or more Family Individuals, whether separately or together with the Grantee or Officer, control the management of its assets; and (xxiii) any other Person in which one or more Family Individuals, whether separately or together with the Grantee or Officer, own more than fifty percent of the total voting power or the total equity interests by value. Family Individuals are those individuals who have a relationship described in this section 25(y)(i)-(xix) by birth or adoption.

(z) ''**Incentive Stock Option**'' means an Option intended to qualify as an incentive stock option under Code Section 422, and that the Administrator designates as an incentive stock option under Code Section 422 on the Grant Date.

(aa) ''**Initial Public Offering**'' means the first underwritten offering or listing of Shares of the Company or any successor to the Company when the Shares are offered pursuant to an effective registration statement under the Securities Act.

(bb) ''**Insider**'' means an Officer, member of the Board, or any other Person whose transactions in Shares are subject to Section 16 of the Exchange Act or any similar state, local, or foreign law.

(cc) ''**Involuntary**'' means a Grantee's involuntary Separation From Service as defined in a then-effective written agreement between the Company or a Broader Related Entity and the Grantee, or in a then-effective written policy of the Company or a Broader Related Entity that is binding on the Grantee. In the absence of an agreement or policy, and except as otherwise provided in an Award or Award Agreement, Involuntary means a Separation From Service due to the independent exercise of the unilateral authority of the Company or Broader Related Entity to which the Grantee primarily provides services to terminate the Grantee's service when the Grantee is willing and able to continue performing services. A Separation From Service is also Involuntary when the Company or Broader Related Entity to which the Grantee primarily provides services does not renew a contract when the contract expires, and the Grantee is willing and able to execute a new contract that provides terms and conditions substantially similar to those in the expiring contract and to continue to perform services. A Separation From Service is not Involuntary when it is due to the Grantee's implicit or explicit request.

(dd) ''**Juridical Body**'' means a court, single arbitrator or panel of arbitrators, Government Body, or self-regulatory organization.

(ee) ''**Law**'' means an administrative decision on which Persons other than those to whom the decision was issued can rely, a judicial decision on which Persons other than those to whom the decision was issued can rely, ordinance, regulation, rule, or statute.

(ff) ''**Material**'' means a level of importance that would have affected the decision of a reasonable person in the position of the Person subject to the provision of the Plan requiring that the act, omission, or event be Material. An act, omission, or event that is Material is also Significant.

(gg) ''**Nonqualified Stock Option**'' means: (i) an Option not intended to qualify as an Incentive Stock Option and that the Administrator designates as a nonqualified stock option on the Grant Date; or (ii) an Incentive Stock Option that no longer satisfies the requirements of Code Section 422 after the Grant Date.

(hh) ''**Officer**'' means an individual who is an officer of the Company or a member of the Broader Group under Rule 16a-1(f) promulgated under Section 16 of the Exchange Act.

(ii) ''**Option**'' means an Incentive Stock Option or Nonqualified Stock Option to purchase a specified number of Shares under an Award Agreement.

(jj) ''**Parent**'' means any corporation, other than the Company, in an unbroken chain of corporations ending with the Company, if on the Grant Date each corporation, other than the Company, owns stock with at least fifty percent of the total combined voting power of all classes of stock in one of the other corporations in the chain.

(kk) ''**Person**'' means a business trust, corporation, estate, general partnership, individual, limited liability

company, limited liability partnership, limited partnership, sole proprietor, trust, or other entity.

(ll) ''**Plan**'' means the ABC, Inc. Equity Compensation Plan as it may be amended.

(mm) ''**Related Entity**'' means any corporation or other entity, other than the Company, in an unbroken chain of corporations or other entities beginning with the Company in which each corporation or other entity has a controlling interest in another corporation or other entity in the chain, and ending with the corporation or other entity to which the Grantee provides services on the Grant Date. For a corporation, a controlling interest means ownership of stock with at least fifty percent of total combined voting power of all classes of stock, or at least fifty percent of the total value of all classes of stock. For a partnership or limited liability company, a controlling interest means ownership of at least fifty percent of the profits interest or capital interest of the entity. In determining ownership, the rules of Treasury Regulation Sections 1.414(c)-3 and 1.414(c)-4 apply.

(nn) ''**Related Parent**'' means any corporation or other entity in an unbroken chain of corporations or other entities, in which each corporation or other entity owns more than fifty percent of the total fair market value and total voting power in one of the other corporations or entities in the chain, and ending with the entity to which the Grantee primarily provides services.

(oo) ''**Reorganization**'' means a consolidation, merger, statutory share exchange, exchange offer combined with a consolidation or merger, or similar transaction.

(pp) ''**Restricted Stock**'' means a specified number of Shares issued to a Grantee for a specified purchase price, if any, and subject to the transfer restrictions, repurchase rights and obligations, rights of first refusal, vesting requirements and schedules, performance goals for vesting, and other provisions that the Administrator in its exclusive discretion determines appropriate.

(qq) ''**Rule 16b-3**'' means Rule 16b-3 promulgated under the Exchange Act.

(rr) ''**Sale**'' means a lease, sale, or other disposition of all or substantially all of the Company's or Broader Related Entity's consolidated assets, including without limitation by a series of transactions, or by a consolidation, merger, or stock sale or similar transaction.

(ss) ''**SAR**'' means a stock appreciation right that entitles the Grantee to Shares or cash, or any combination thereof, as provided in the Award or Award Agreement, in an amount equal to the product of the number of Shares subject to the stock appreciation right being exercised multiplied by the excess of the Fair Market Value of a Share on the exercise date over the exercise price.

(tt) ''**Section 424 Corporate Transaction**'' means the occurrence, in a single transaction or a series of related transactions, of any of the following: (i) a sale or other disposition of all or substantially all of the consolidated assets of the Company and its Subsidiaries; (ii) a sale or other disposition of more than fifty percent of the outstanding stock of the Company; (iii) the consummation of a consolidation, merger, or similar transaction after which the Company is not the surviving corporation; (iv) the consummation of a consolidation, merger, or similar transaction after which the Company is the surviving corporation but the Shares outstanding immediately preceding the consolidation, merger, or similar transaction are converted or exchanged by reason of the transaction into other securities, property, or cash; or (v) a distribution by the Company (other than an ordinary dividend or a stock split or stock dividend under Treasury Regulation Section 1.424-1(e)(4)(v)).

(uu) ''**Securities Act**'' means the Securities Act of 1933, as amended.

(vv) ''**Securities Market**'' means: (i) a national securities exchange that is registered under Section 6 of the Exchange Act; (ii) a foreign national securities exchange that is officially recognized, sanctioned, or supervised by a Government Body; or (iii) any over-the counter market that uses an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers that regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets that are prepared and distributed by a broker or dealer in the regular course of business and that contain only quotations of that broker or dealer.

(ww) ''**Separation From Service**'' means the Grantee's separation from service as an Employee, Director, and Contractor of the Company and its Broader Related Entities when the Grantee dies, retires, or otherwise terminates service as follows:

(i) Employment will be treated as continuing while the Grantee is on military leave, sick leave, or other bona fide leave of absence, as long as the period of leave does not exceed six months, or if longer, as long as the Grantee's right to reemployment with the Company or a Broader Related Entity is provided by contract or statute. [Alternative 1: A leave of absence will be bona fide only if the Company or Broader Related Entity and Grantee reasonably expect that the Grantee will return to perform services for the Company or a Broader Related Entity. When the period of leave exceeds six months and the Grantee's right to reemployment is not provided by contract or statute, the Grantee's employment will be deemed to terminate on the first business day immediately after the six month period;] [Alternative 2: A leave of absence will be bona fide only if the Company or Broader Related Entity and Grantee reasonably expect that the Grantee will return to perform services for the Company or a Broader Related Entity. When the period of leave is not due to Disability and exceeds six months, and the Grantee's right to reemployment is not provided by contract or statute, the Grantee's employment will be deemed to terminate on the first business day immediately after the six month period. When the period of leave is due to Disability and exceeds twenty-nine months, and the Grantee's right to reemployment is not provided by contract or statute, the Grantee's employment will be deemed to terminate on the first business day immediately after the twenty-nine month period;] [Use Alternative 2 with Alternative 3 of section 25(p) in the definition of Disability.]

(ii) A Director or Contractor will have a Separation From Service upon the expiration of the contract, and if there is more than one contract, all contracts, under which he or she performs services as long as the expiration is a good faith and complete termination of the contractual relationship; and

(iii) If the Grantee performs services in more than one capacity, the Grantee will have a Separation From Service when the Grantee separates from service in all capacities as an Employee, Director, and Contractor.

Notwithstanding the prior sentence, if the Grantee provides services both as an Employee and a Director, the services provided as a Director will not be taken into account in determining whether the Grantee has a Separation From Service as an Employee under a nonqualified deferred compensation plan in which the Grantee participates as an Employee and that is not aggregated under Code Section 409A with any plan in which the Grantee participates as a Director. In addition, if the Grantee provides services both as an Employee and a Director, the services provided as an Employee will not be taken into account in determining whether the Grantee has a Separation From Service as a Director under a nonqualified deferred compensation plan in which the Grantee participates as a Director and that is not aggregated under Code Section 409A with any plan in which the Grantee participates as an Employee.

(iv) Whenever the Plan refers to the Separation From Service of an Indemnitee, the term ''Indemnitee'' is to be substituted for the term ''Grantee'' in this section 25(ww).

(xx) ''**Share**'' means a share of Common Stock, par value $0.01 per share.

(yy) ''**Significant**'' means important enough to merit the attention of a reasonable person in the position of the Person subject to the provision of the Plan requiring that the act, omission, or event be Significant. Significant has a lesser level of importance than Material.

(zz) ''**Subsidiary**'' means any corporation, other than the Company, in an unbroken chain of corporations beginning with the Company, if on the Grant Date each of the corporations, other than the last corporation in the chain, owns stock with at least fifty percent of the total combined voting power of all classes of stock in one of the other corporations in the chain. For purposes of the definition of a Change-in-Control, a corporation's status as a Subsidiary will be determined without regard to the grants of any Awards.

(aaa) ''**Substitute Awards**'' mean awards granted upon assumption of, or in substitution for, outstanding awards previously granted by, or held by employees of, any Person or business acquired by the Company or with which the Company combines.

(bbb) ''**Surviving Entity**'' means in a Reorganization, the entity resulting from the Reorganization, and in a Sale, the entity that acquires all or substantially all of the Company's or a Broader Related Entity's assets.

(ccc) ''**Taxes**'' mean federal, state, local, and foreign employment, excise, income, and payroll taxes.

(ddd) ''**Transfer**'' means, whether involuntarily by operation of law or voluntarily, to assign, encumber, exchange, pledge, sell, transfer, or otherwise dispose of.