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From:
Sent: Monday, December 22, 2008 2:48 PM
To:
Cc:
Subject: RE: Option rollover / 409A issue

Rollover treatment is possible here. Arguably there is no disparate treatment where the executives with outstanding options receive substitute options that are the same economically. The regs at § 1.409A-1(b)(5)(v)(D) provide the standard for making this determination. The purpose of the substitution rules under this provision is to ensure that the substitute option has the same economic value (or less) as what they gave up. In addition, the spread isn't locked in because the substituted option's spread may fall in the future. [redacted] In the letter dated , Newco stated the following regarding the shares:

3. Rollover Share Certificates; Assumption and Adjustment of the Rollover Options. With respect to the Rollover Shares, you hereby authorize to take such action as may be necessary to cause the Rollover Shares to be rolled over.

You agree that you will not exercise the Rollover Options prior to the Closing. Newco agrees to assume the Rollover Options on their current terms and conditions, except that:

(a) the Newco Options will be fully vested at all times, except as provided in Section 7(b) below;

(b) the Newco Options will be exercisable for Shares;

(c) the exercise price per Share of each Newco Option will equal the lesser of (i) 25% of the fair market value of a Share, or (ii) the percentage of the fair market value of a Share that equals the ratio of the exercise price per share of such option to the Merger Consideration;

(d) the number of Shares underlying each Newco Option shall be as set forth in Schedule I; and

(e) at least 10 days prior to the termination or expiration of any Newco Option for any reason, if there is not a Public Market (as defined in the Stockholders' Agreement) for the Shares, Newco will permit you to exercise any such vested Newco Options through net-physical settlement (i.e., by delivery of Shares net of the number of Shares having a Fair Market Value (as defined in the Stockholders' Agreement, defined below) equal to the applicable exercise price and applicable withholding taxes at the minimum statutory rate), unless (i) Newco's independent auditors determine that net-physical settlement of any such Newco Options would produce less-favorable accounting consequences for Newco or its affiliates than if you paid the exercise price for any such vested Newco Options in cash (other than those that would have an immaterial effect) or (ii) Newco receives advice from counsel, in accordance with Section 10 below, that such net-physical exercise would result in a penalty under Section 409A of the Internal Revenue Code of 1986, as amended (the "Code"). If, in accordance with this paragraph, you are entitled to exercise Newco Options through net-physical exercise, Fair Market Value will be determined as set forth in the Stockholders' Agreement, including any right to an Outside Appraisal (as defined therein).

In particular, we question how paragraph meets the spread requirement under § 1.409A-1(b)(5)(v)(D). [redacted] If this requirement is not met, then the substitute options in Newco would be treated as new grants, which presumably would be discounted and therefore NQDC for purposes of § 409A.

Please let us know if we can provide further assistance.