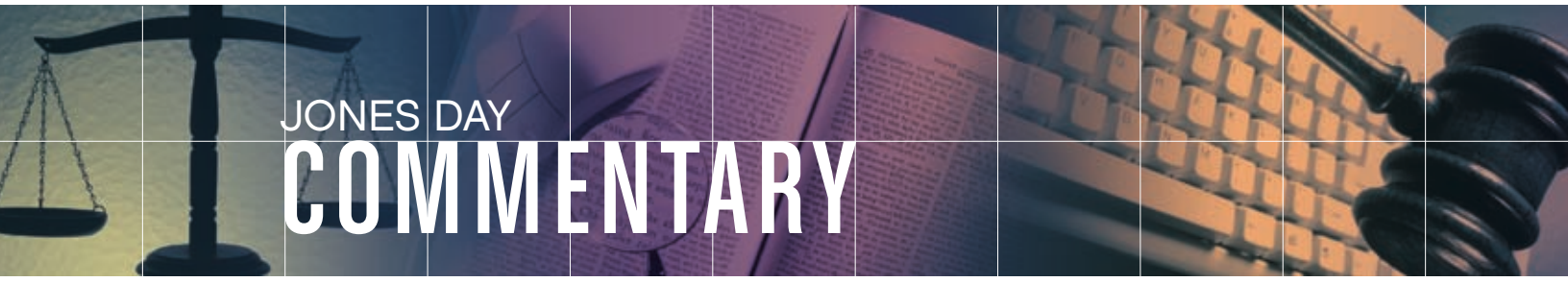
APRIL 2007



IRS ISSUES LONG-AWAITED FINAL SECTION 409A REGULATIONS

On April 10, 2007, the IRS and the Treasury Department issued the final regulations interpreting the basic provisions of Section 409A of the Internal Revenue Code. The final rules are complicated and voluminous.

The most significant aspect of the final rules is that they maintain the December 31, 2007, deadline for documentary compliance. Failure to properly amend deferred compensation plans and agreements prior to January 1, 2008, will subject employees to the potentially massive Section 409A penalties, including a 20 percent penalty tax and early inclusion in income upon vesting.

Most companies will need to start soon in order to meet the December 31, 2007, deadline.

Below are some of the key provisions of the final rules.

CERTAIN SEPARATION PAY ARRANGEMENTS EXEMPTED

Previous Guidance. The proposed regulations provided a limited exception for certain severance payments made on account of an involuntary termination where (1) the aggregate payments could not exceed $440,000 for 2007 (or, if less, two times the employee's annual compensation) and (2) all payments must be made by no later than the end of the second calendar year following the year of termination.

The proposed regulations also recognized that amounts paid upon an involuntary termination that did not meet the above specific exception could be structured so as to meet the general short-term deferral exception under Section 409A (*e.g.*, a lump-sum payment made within two-and-a-half months following the year of involuntary termination).

If severance payments satisfy either exception, they are exempt from all aspects of Section 409A, including the six-month delay on payments to "specified employees" (generally, the top 50 officers of a public company) made on account of a termination of employment.

Under the proposed regulations, however, it was unclear whether severance paid on account of a termination for "good reason" could qualify for either exception as a "constructive" involuntary termination. Indeed, some practitioners were concerned that the mere existence of a "good reason" provision in an arrangement would exclude such arrangement from being able to qualify for either exception.

Final Regulations. In a welcome move, the final regulations provide that where an employee is entitled to payment on account of a "good reason" event, the payment may be treated as payable upon an involuntary termination for purposes of either exception, provided that the facts and circumstances support the finding that the separation from service effectively is an involuntary termination. While, in such circumstances, qualification under the specific separation pay exception should be automatic (assuming satisfaction of the numerical requirements), qualification under the short-term deferral exception may require further analysis.

The final regulations also provide a safe harbor under which a payment upon a "good reason" termination will be treated as providing a payment upon an involuntary separation from service. The regulations include a list of events that will constitute "good reason" (*e.g.*, material adverse change in base compensation or duties). In order to qualify for the safe harbor, the separation from service must occur within a limited period of time not to exceed two years following the initial event giving rise to the "good reason" condition. In addition, the final regulations require the employee to provide notice of the existence of the "good reason" condition within a period not to exceed 90 days of the initial event, and the employer must have at least 30 days during which to cure the event giving rise to the "good reason" condition.

We anticipate that many employment and severance agreements will be drafted to qualify for the safe harbor. The safe harbor, however, may not be suitable in some cases.

The final regulations also include the helpful rule where the aggregate payments exceed the dollar limit for the specific separation pay exception noted above that only the excess over the limit will be subject to Section 409A. The payments up to the applicable limit will not be subject to Section 409A, including the requirement that the payment be delayed for six months in the case of specified employees.

POST-TERMINATION OPTION/SAR EXERCISE PERIOD EXTENDED

Previous Guidance. The proposed regulations permitted the extension of the post-termination exercise period of an option or SAR only to December 31 of the calendar year in which the option or SAR otherwise would have expired (or, if later, the 15th day of the third month following expiration). This limited extension period was problematic in many cases.

Final Regulations. The final regulations provide that the extension of a post-termination exercise period generally will not cause a Section 409A problem if the exercise period is not extended beyond the earlier of the original maximum term of the option or 10 years from the original date of grant of the stock right. An extension also is permitted if the option is "underwater" at the time of extension. Extensions granted prior to April 10, 2007, may be amended to take advantage of the new rule.

DEFINITION OF SERVICE RECIPIENT STOCK EXPANDED

Previous Guidance. The proposed regulations provided that, in order to qualify for the exception for an option or SAR granted at fair market value, the option or SAR must apply to stock of the service recipient or a publicly traded affiliate. The proposed regulations restrictively defined "service recipient stock," especially where there were multiple classes of common stock.

Final Regulations. The final regulations liberalize the definition of service recipient stock to generally include any class of common stock. Preferential rights on liquidation are permitted, while preferred rights on dividends are not.

Buyback rights at other than fair market value, except to the extent they constitute lapse restrictions, are problematic. The existence of publicly traded affiliate stock is not relevant.

DECEMBER 31, 2007, DEADLINE FOR DOCUMENTARY COMPLIANCE RETAINED

Previous Guidance. Previous guidance established December 31, 2007, as the deadline for documentary compliance. Prior to January 1, 2008, good-faith operational guidance is sufficient. Also, prior to January 1, 2008, generous transitional relief provisions generally are available.

Final Regulations. The final rules maintain the December 31, 2007, deadline for documentary compliance and do not extend any of the transitional relief provisions that expire on December 31, 2007.

The final regulations generally provide that required plan provisions must be in writing and in effect at the time an amount is deferred. The six-month payment delay requirement applicable to specified employees must be set forth in writing at the time the employee becomes a specified employee.

Some practitioners had requested that the IRS publish model amendments that would satisfy the documentary compliance requirement. The IRS declined to provide such model amendments.

Finally, some practitioners had hoped that a general savings clause requiring compliance with Section 409A would be sufficient to satisfy the documentary compliance requirement. The final rules provide that a general savings clause will not work.

In short, companies should expect that full documentary compliance will be required by year-end 2007.

LAWYER CONTACTS

For further information, please contact your principal Firm representative or one of the lawyers listed below. General e-mail messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

Joni L. Andrioff
1.312.269.4170
jlandrioff@jonesday.com

John R. Cornell
1.212.326.8332
jrcornell@jonesday.com

Dennis B. Drapkin
1.214.969.4850
dbdrapkin@jonesday.com

Daniel C. Hagen
1.216.586.7159
dchagen@jonesday.com

Rory D. Lyons
1.404.581.8550
rlyons@jonesday.com

Manan (Mike) Shah
1.212.326.3986
mdshah@jonesday.com