Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 10 -
Change of Control: Golden Parachute Rules in the Sale Process

By Darren Goodman, Megan Monson, Taryn E. Cannataro
APRIL 2022

Kevin Iredell: Welcome to the Lowenstein Sandler podcast series. I'm Kevin Iredell, Chief Marketing Officer at Lowenstein Sandler. Before we begin, please take a moment to subscribe to our podcast series at lowenstein.com/podcasts. Or find us on iTunes, Spotify, Pandora, Google podcast, and SoundCloud. Now let's take a listen.

Megan Monson: Welcome to the latest episode of Just Compensation. I'm one of your hosts, Megan Monson, Partner in Lowenstein Sandler's Employee Benefits & Executive Compensation practice group, and I'm joined by two of my colleagues, Darren and Taryn, who I'll turn it over to introduce themselves.

Darren Goodman: Hi everyone. I'm Darren Goodman. I'm a Partner in the firm's Executive Compensation group.

Taryn Cannataro: Hi, I'm Taryn Cannataro. An Associate in Lowenstein’s Executive Compensation group.

Megan Monson: Thank you both so much for joining us today. Our discussion today will focus on a topic that affects many companies undergoing—or considering undergoing—the change of control or sale process, which is Section 280G.

In layman's terms, this is referred to as the golden parachute rules, the conversation is intended to be a high level overview of the types of individuals and companies that are impacted by Section 280G, what type of payments need to be taken into account, and how to mitigate issues in the private company context if you have any sort of 280G issue.

I'll preface this conversation with 280G is a very complicated section of the Internal Revenue Code. And so our discussion today is not intended to be a comprehensive in-depth discussion, but rather a high-level overview of some common questions that we see arise in this context.

And to put it on your forefront as something to consider, if your company is undergoing a change of control. As always application to your particular situation requires looking at individual facts and circumstances and we recommend that you reach out to your counsel, if your company is being sold, to understand how this may apply to you and how to navigate through these complicated rules. In this podcast, Darren Goodman, Taryn Cannataro, and I will touch on some items for consideration. With that let's dive right in. What Section 280G and when does it apply?

Taryn Cannataro: As you said, 280G is a complex set of tax rules that govern golden parachute payments. Golden parachute payments are payments a company makes to certain executives or key service providers that are contingent upon the sale of the company.

© 2022 Lowenstein Sandler LLP
The contents of this website contain attorney advertising. Prior results do not guarantee a similar outcome.

We will address a bit later in the episode, what types of payments that are looked at for this purpose. But, first, I think it's important to understand when it applies. So generally it applies to C Corporations and other entities taxed as C Corporations. For example, an LLC that is elected to be taxed as a C Corporation.

It does not apply to S Corporations. Or a C Corporation that's eligible for S-corporation status, even it has not elected to be an S Corporation. While 280G applies to both public and private corporations. This podcast will focus mainly on private companies.

Darren Goodman: The reason that we care about 280G is because if there's a 280G problem, there are two adverse tax consequences.

The first one is that the person who has the problem is hit with a 20% excise tax. On top of all of the federal state and local income taxes that they may pay. The second consequence is that 280G causes a loss of tax deduction. Normally compensation is tax deductible, but if a payment triggers 280G, it's not deductible.

So both the person receiving the payment and the company making the payment have a reason to be concerned about 280G.

Megan Monson: So Taryn and you mentioned which type of entities 280G applies to. Is it fair to say that if any of those types of entities are undergoing a sale transaction 280G is something that needs to be looked at?

Taryn Cannataro: Yes. I would say that if you are one of the entities that we mentioned earlier and you're undergoing a sale transaction, you should consider whether 280G applies and in general, it may be a good exercise for any company undergoing a change in control to just double-check whether 280G could apply.

Darren Goodman: Absolutely. Sometimes we have companies that sink to age you shouldn't apply, but once you look at their structure, you'll realize that it can apply.

Megan Monson: Great point. Now, in terms of kind of the purview of 280G, does it impact everybody who works for a company or does it only apply to certain individual?

Darren Goodman: It only applies to certain individuals. So there's three categories of people who could be impacted. The most important category is officers. It's not a bright line who is an officer and who isn't. So you have to look at each particular company. Certainly you would expect someone with a C-level title to be an officer for this purpose.

The next category is the 1% highest compensated individuals. So if a company has a hundred employees, who's the one highest paid person? Oftentimes it’s someone who's already an officer and you're already taking into account anyway, sometimes you'll have a company with a superstar salesperson or another person whose compensation is high enough to put them in the top 1%.

The final category of people that take into account are 1% stock holders, including the value of vested options. Again, often overlap with the other two categories, but you can sometimes have people who come into 280G solely because of their stock holdings or because of their option holdings.

Megan Monson: So once you've already made the determination of who 280G applies to, and they're considered disqualified individuals, how do you determine whether those disqualified individuals actually have a 280G issue?

© 2022 Lowenstein Sandler LLP
The contents of this website contain attorney advertising. Prior results do not guarantee a similar outcome.

Taryn Cannataro: I'll preface my response with determining whether someone has a 280G issue involves an in-depth analysis. So it's important to really drill down details here. Everything is very facts and circumstances specific. However, typically the first step is to identify the disqualified individuals. As Darren just mentioned, once you identify the group that is going to be included in the 280G analysis, you collect W2's or 1099s for each of the disqualified individuals.

And you need W2's for the five years prior to the sale. So, for example, if a sale occurs in 2021, you'll need W2's or 1099 for years, 2016 to 2020 next, you calculate the average taxable compensation over that five-year period and multiply that result by three. For example, if someone's average taxable compensation over those five years is a hundred thousand.

You take three times, 100,000 or 300,000. Next, you calculate the aggregate amount of any compensatory payments each just qualified individual could receive that are contingent upon the sale. Also known as parachute payments. If the aggregate payments are less than three times the average compensation, in our example, less than $300,000, there will not be a 280G issue.

However, if the aggregate payments equal or exceed the Section 280G safe Harbor amount of $300,000 in our exam, Then all announced in excess of one time the individuals base amount may trigger the 20% excise tax and loss of tax deduction that we talked about earlier.

Darren Goodman: One trap that we see, especially with early stage startups, is that the officers, often the founder, are taking very little and possibly no compensation from the company because they just don't have the cash to pay it. What that means is that it really drives down their average. To take an extreme example, I've had situations where our founder wasn't paid anything. So when you do the calculations that Taryn mentioned three times zero is still zero.

So a single dollar that's included in the calculations will cause a 280G issue.

Megan Monson: And related to that, Darren mentioned earlier that 280G applies to 1% stockholders. Sometimes we see board members who are 1% stockholders and who have not actually received any other compensation from the company. So that's another scenario where there could be executives who have not had any compensation historically, and may have a 280G issue resulting from anything they're getting in connection with the deal.

You mentioned that 280G only applies to payments that are considered contingent on the sale. Can you provide a little bit more context of what type of payments this applies to?

Darren Goodman: So it can apply to a variety of payments, a sale bonus. You know someone gets a bonus if they're employed at the time of a sale that certainly will be included.

If someone's getting accelerated vesting, like someone has an option that vests over four years, but if the vesting is being accelerated on the sale. That's included. There's a presumption that anything new within the 12 months prior to a sale should be included. So if someone got a raise or someone got an increase in their bonus, the sale might've been the furthest thing from the company's mind but the IRS regulations say you presume that that amount should be included. And if there's any new agreements with the buyer that provide for increases in compensation; post-closing increase in base salary, an increase in bonus, a promise of an equity award—

© 2022 Lowenstein Sandler LLP
The contents of this website contain attorney advertising. Prior results do not guarantee a similar outcome.

that's included too. And then the rules also say that if someone's fired post-closing and they get severance that might need to be included.

So obviously you don't know at the time of the sale, whether someone's going to be fired post-closing in most instances. So, what normally is done is that people include the severance in an abundance of caution, just in case the person is fired at the severances triggering.

Megan Monson: So you both have provided a really helpful overview in terms of what 280G is when it applies and who it applies to as well as the type of payments that are considered and how you go through the analysis.

So once you've done kind of that whole process, what happens if you determined that there is in fact a 280G issue, is there any potential avenue that a company can take to avoid the tax consequences that were mentioned earlier?

Taryn Cannataro: Yes. So normally private companies can cleanse a 280G issue with a 280G shareholder vote, approving the parachute payment.

The 280G regulations are pretty clear. If more than 75% of the disinterested shareholders approve the payments 280G does not apply. And the tax consequences we discussed won't apply either. The individuals being voted on are not eligible to vote, which means they can't vote for themselves or anyone else who's being voted off.

The 75% approval requirement only requires approval of more than 75% of their remaining disinterested shareholders. The catch here is that before the shareholder approval can be sought, any individual who could trigger 280G must irrevocably waive their right to any of the payments being voted on.

In other words, if the vote failed, all of the payments they're putting into the vote are forfeited.

Darren Goodman: Generally in our experience, companies have a good sense of whether the vote will pass, whether there's a risk of failure before they even start the process. Many, many votes are approved without an issue.

Companies can simply look at their cap table and they think that well, more than 75% of the stockholders would vote in favor, possible reasons that there could be a risk of failure include for example there's a lot of stockholders and the company is not really concerned about people voting “No.” They're concerned about finding all of them and getting enough of them to respond in favor, to get over the 75% threshold.

Sometimes there are disgruntled minority stockholders, and they might not have enough power to block a transaction, but they might have enough power to cause a 280G vote to fail. The last reason that shareholders might vote “No” is that they're unhappy with the sale price and asking them to approve payments to officers just could be viewed as adding insult to injury.

And the concern is that they just won't be happy with it and would vote “No.” An important point to be aware of is that when you're having the vote, the stockholders must know what they're voting on. So, what normally happens is a disclosure document is prepared and it lists the payments. It lists potential amounts.

© 2022 Lowenstein Sandler LLP
The contents of this website contain attorney advertising. Prior results do not guarantee a similar outcome.

It describes 280G. And this is a requirement of the regulations. There is no way to avoid giving that disclosure to every voting stockholder. And what it could mean for example, is that if a company has stock option grants and a rank and file employee has exercised option. That rank and file employee gets a disclosure document about what their CEO is getting paid in a sale.

Megan Monson: And I’ll just add that there are very technical requirements in terms of how the 280G process has to be handled in terms of the ordering of dispersing documents and what needs to happen. So it's something that you should always consult with your legal counsel on to make sure it's done properly. Otherwise the vote won't be valid.

Darren Goodman: Yeah, absolutely. The waiver has to be signed first. Then the vote happens. If you get that order wrong, the vote is ineffective.

Taryn Cannataro: I would just add also, as mentioned earlier, the waiver requires the disqualified individuals to forfeit payments. So if the vote is not done right or the vote fails, they are also putting their payments at risk.

Megan Monson: Well, thank you both so much for walking us through kind of all the technical aspects before wrapping up. Do you have any general tips for companies in terms of approaching a 280G shareholder vote more generally, or kind of navigating through this process?

Darren Goodman: I advise companies about 280G when they're entering into an arrangement that I know will have to be considered for 280G at the time of a sale.

So if a company is entering into a sale bonus agreement or putting in place a phantom equity plan, I advise about that right upfront so that no one's taken by surprise. There may be a limited ability to mitigate the scope of 280G. If there are some advanced planning done, there might also not be that ability, but I always wanted companies to know that this is something that will be coming down the road.

Taryn Cannataro: Exactly. And I would say get started early if you know that you have a sale coming or you're considering it start talking to your counsel about 280G and get things moving. So it's not holding up the deal at the end.

Darren Goodman: Absolutely. This is something that requires gathering information. So it's not something that can wait until a moment before closing and you just turn the 280G analysis. There just won't be time if you wait too long.

Megan Monson: Yeah. Especially on the W2 or 1099 aspects for some of the companies we counsel, they don't maintain those in-house. In particular, if they use like a PEO or another third-party provider, that part of the process just takes time and is integral to being able to complete the analysis.

So I can't agree more with what my colleagues said in terms of getting started early. So we've had a really great discussion today kind of talking about 280G and providing a really high level overview of how it works and when it applies well, the implications of Section 280G can seem daunting.

The good news is that because of the shareholder cleansing vote is often a non-issue for private companies and it's simply a corporate formality and process that needs to be looked at and gone through. However, as we mention, it's a good idea for companies to be aware of Section 280G early on, as Darren mentioned, so that they aren't taken by surprise when it's Section 280G analysis and vote is needed at the time of the sale, we encourage you to consult with counsel. If your company is

© 2022 Lowenstein Sandler LLP
The contents of this website contain attorney advertising. Prior results do not guarantee a similar outcome.

undergoing a sale or could be in the future, or if you are putting in place change of control arrangements so you understand what those implications could be at a later point.

Thank you so much for joining us today. We hope you found this discussion helpful, and we look forward to having you back again for our next episode of Just Compensation.

Kevin Iredell: Thank you for listening to today's episode. Please subscribe to our podcast series at lowenstein.com/podcasts, or find us on iTunes, Spotify, Pandora, Google podcasts, and SoundCloud. Lowenstein Sandler podcast series is presented by Lowenstein Sandler and cannot be copied or rebroadcast without consent. The information provided is intended for a general audience. It is not legal advice or a substitute for the advice of counsel. Prior results do not guarantee a similar outcome. The content reflects the personal views and opinions of the participants. No attorney client relationship is being created by this podcast and all rights are reserved.

© 2022 Lowenstein Sandler LLP
The contents of this website contain attorney advertising. Prior results do not guarantee a similar outcome.