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An Overview of the Golden Parachute Payment Rules

Often, executives of private companies have certain rights and benefits that are triggered upon a change in control, such as accelerated vesting of equity awards and payments under a management carve-out plan. These payments may result in significant tax penalties under Section 280G of the Internal Revenue Code, or the "Golden Parachute Rules", unless appropriate action is taken by the company. Section 280G was enacted by Congress in an attempt to discourage the payment of significant compensation to executives of companies as "golden parachutes" in connection with an exit event, at the expense of other stockholders.

Who is covered: In general, 280G applies to officers, highly compensated individuals and 1% shareholders of a C-Corporation that undergoes a change in control. 280G does not typically apply to companies that are organized as an LLC or an S-Corporation, and also does not apply to any C-Corporation that is eligible to be treated as an S-Corporation.

Threshold: 280G is triggered when any covered individual receives payments in the nature of compensation in connection with a change of control in excess of 3 times his or her "base amount", which is defined as his or her average annual compensation over the previous five years (pro-rated for any partial periods). However, once this 3x threshold has been exceeded, the penalties under 280G apply to the "excess parachute payments", meaning all change in control payments in excess of one times the base amount.

Consequences: Excess parachute payments are subject to an additional 20% excise tax to the recipient (in addition to the ordinary tax rates that otherwise apply). Also, the amounts paid to the individual are non-deductible by the paying corporation.

Payments by Target within the scope of 280G: Payments to an individual from a target entity prior to or at the time of closing may include transaction bonuses (including payments under a management carve-out plan), severance benefits and the value of any accelerated vesting of options and restricted stock grants. 280G also presumes that any payment made to a covered executive pursuant to an agreement entered into within one year prior to a change of control is made in connection with the change in control. Payments are excluded, however, to the extent that they can be shown to be reasonable compensation for services provided.

Payments after Closing within the scope of 280G: Payments made after the closing of the transaction, such as a retention bonus or any severance upon separation of service, are generally also subject to 280G. Again, amounts paid by the buyer or surviving company post-closing can be excluded from the 280G analysis to the extent such payments are reasonable compensation for services provided post-closing.

Stockholder Vote: For executives whose aggregate change in control compensation is over the threshold, all is not lost. Generally, private companies may avoid the application of 280G by obtaining a shareholder vote approving the parachute payments. The vote must be approved by 75% in interest of all shareholders who are entitled to vote (excluding from the vote any persons who are receiving parachute payments in connection with such transaction). However, to receive this protection, an executive must first agree that if the shareholder vote fails, he or she will waive any right to any change in control compensation in excess of the 3x threshold. Additionally, if the corporation seeks a cleansing shareholder vote, 280G requires a disclosure of all material facts regarding the change in control payments to all stockholders who are entitled to vote.

This article is intended to provide a brief introduction to the Golden Parachute Payment rules. As the rules under 280G can be somewhat complex and technical, it is advisable to analyze any potential impact of 280G early in any potential M&A transaction.

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Top Considerations - Sale of Company

Selling a business can be a once-in-a-lifetime opportunity to reap the rewards for years of efforts spent successfully growing a company, but it is critically important that the business is positioned to achieve a successful exit and there are a number of initial steps to be taken to prepare for a successful exit.

1. **Keep the Trains Running on Time.** The sale of a company is not a sure thing. Many transactions don't close, which can be caused by a number of factors – lack of a meeting of the minds regarding deal terms; personnel issues; intellectual property concerns; or pending or potential litigation matters, to name just a few. As a result of these or other obstacles, many anticipated transactions can drag on for a period of 6 months to a year or more. With the potential for a deal to fail, business owners should make every effort to conduct "business as usual" throughout the sale process.

The vagaries of a transaction can feel overwhelming, but must not detract from the required laser-sharp focus making sure the business continues to meet its objectives.

2. **Identify a Team and Map Out a Coordinated Effort.** A prospective seller should assemble a "deal team" from within the company including the CEO, a finance representative and a member of senior management with expertise regarding the company's operations and assets including intellectual property, contracts and personnel issues. Additionally, the company should identify an external team consisting of an investment banker, experienced mergers and acquisitions legal counsel and a financial (accounting) professional. The global deal team should discuss processes, tasks to be completed and roles and responsibilities. In many instances, business owners prefer keeping the internal deal team as small as possible to maintain confidentiality, but it is generally a mistake to exclude key executives as the transaction can easily monopolize the time of one or two key individuals which could have adverse consequences on ongoing business.

3. **Establish a Data Room.** Buyers will want to examine the corporate records of the company being sold – including financial information, contracts, corporate legal documents, personnel-related documents and intellectual property. Since assembling responses to due diligence requests can consume a great amount of time and effort, prospective sellers would be wise to address this issue before commencing the transactional process. An electronic data room is an excellent way to organize a company's records and, even if a potential transaction fails to close, it can be beneficial to have documents stored safely and securely in this manner.

4. **Make Sure Your Financial House is In Order.** It is a certainty that a potential acquirer will want to inspect a target's financial records including annual financial statements, interim financial statements, tax returns and possibly an operating plan. Prospective sellers should engage a reputable outside accounting firm (if they haven't done so already) to assist in the preparation of all financial statements. If the company has not prepared financial statements in the past, or has not had them prepared by a reputable accounting firm, the company could be left scrambling to do so according to the transaction's timeline. As one can imagine, last-minute preparation of proper financial statements can result in significant delays.

5. **Employment Issues.** One of the most important assets of a company is its human capital. In many instances, the hiring of key employees is a critical component of a prospective acquisition. Be sure to confirm that all agreements with existing and former employees have been properly documented (including employment agreements, non-disclosure, non-solicitation and confidentiality agreements, equity award agreements and separation agreements/releases).

6. **Intellectual Property Protection.** If intellectual property (patents, trademarks, copyrights and trade secrets) is a key ingredient of the seller's business, the seller should confirm that all necessary steps have been taken to protect its intellectual property. Among other tasks, prospective sellers should check with their IP counsel to confirm all necessary filings are up to date, and the seller and its counsel should be prepared to address forseeable IP due diligence questions.

7. **Confidentiality Agreements.** When engaging in a transaction, the selling company should proactively enter into confidentiality agreements with all interested purchasers. A transactional attorney can prepare and help negotiate the confidentiality agreement. Notwithstanding the presence of a confidentiality agreement, sellers are advised to be judicious in disclosing information to a potential acquirer; consider waiting until the last possible moment to disclose the "crown jewels" to a possible buyer.

8. **Review Your Contracts.** A purchaser will want to review all of the prospective seller's material contracts, and will want to confirm that contracts are properly in place with key customers, vendors and third parties. Additionally, the purchaser will assess the need for consents from third parties, the inclusion of indemnification obligations, restrictive covenants and other potentially problematic contract terms. Sellers should conduct their own assessment of the contracts prior to commencement of due diligence in order to identify and address potential concerns.

9. **Pre-planning (Tax and Estate Considerations).** Tax planning is integral to any transaction. Pre-transaction, the seller should confer with sophisticated personal and transactional tax counsel in order to understand the corporate and individual tax considerations of particular deal structures. There may be opportunities to address tax matters well in advance of a transaction. Similarly, individual sellers will want to consult trusts and estates professionals and wealth advisors to address estate planning opportunities before commencing the sales process.

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M&A Non-disclosure Agreements: Drafting Considerations for Buyers and Sellers

Selling a company can be a long and winding road with an inevitable exchange of confidential information between presumptive buyers and the selling company occurring throughout the course of a M&A transaction. Typically, the first document signed between a buyer and seller is a non-disclosure agreement (a "NDA") which is designed to place restrictions on what each party may do with confidential information shared by the other party during the course of the buyer's due diligence review of the seller. This article, while not exhaustive, will discuss important precautions and drafting considerations that buyers and sellers should bear in mind when negotiating a NDA.

What information is protected by the NDA?

In an effort to better understand the seller's business and the liabilities that the buyer will inherit in connection with its acquisition of the seller, the buyer typically delivers an extensive due diligence request list to the seller covering a wide array of areas including but not limited to financial information, intellectual property, customer contracts, human resources and pending litigation. Before delivering such confidential information or even engaging in a more informal dialogue with a presumptive buyer regarding the seller's business, it is important for the seller to confirm that the definition of "confidential information" in the NDA includes all such information, whether provided by the seller in written form or verbally in the course of meetings/conversations between the parties. Sellers should resist any effort by the buyer to require that information be specifically legended or identified as confidential in order for the information to be protected by the terms of the NDA; such an approach can be time consuming and inefficient and, depending on the care taken by the seller, may lead to the unintended disclosure of confidential information. Buyers should exclude from the definition of confidential information any information that they have independently developed or that is in the public domain. Sellers may consider the disclosure of particularly sensitive information (such as customer lists, trade secrets or source code) until later in the course of negotiations with the buyer and may also consider implementing special procedures and controls surrounding the sharing of this subset of confidential information.

What restrictions apply to protected information?

Once the universe of confidential information has been properly defined in writing, buyers and sellers next need to determine what restrictions will be placed on this shared information.

A seller will first and foremost want to ensure that the buyer will use the confidential information solely for the purpose of evaluating the acquisition opportunity and not for any other unrelated purpose. This restriction is particularly important in a situation where the buyer is a competitor of the seller; in such a case, a seller may consider implementing additional controls or procedures regarding the confidential information (such as limiting access to the confidential information to certain designated parties, redacting portions of the confidential information or allowing the buyer to view but not download/print confidential information). In addition, the NDA should make it clear that the seller is not providing the buyer or its representatives with a license to the confidential information or any of seller's intellectual property and that the seller makes no representation or warranty as to the accuracy or completeness of the shared confidential information.

In addition to placing restrictions on how shared confidential information may be used, a seller should also ensure that the buyer is prohibited from disclosing or revealing confidential information to any third party. Buyers and sellers alike should also take care to ensure that the very fact that they are engaged in discussions regarding a corporate transaction is confidential and shall similarly not be disclosed to third parties; this is particularly important in situations where one or both of the buyer and seller is a publicly traded company. Typically, an exception is made for disclosures to representatives of the parties (such as legal advisors or financial sponsors) who have a need to review the confidential information for purposes of evaluating the acquisition opportunity. Exceptions for court-ordered disclosures are also common although a seller is well advised to request the buyer's cooperation in seeking a protective order to limit any such compelled disclosure.

For how long do the restrictions survive?

A seller may argue that the non-disclosure agreement should not expire and, as a consequence, the buyer's non-use and non-disclosure restrictions should survive indefinitely, the rationale being that the confidentiality of certain shared information will not dissipate over time. In practice, however, buyers typically insist on limiting the term of the non-disclosure agreement; a survival period of 2-3 years is fairly typical although parties often agree to an extended survival period for trade secrets.

Who is subject to the restrictions?

It is important for sellers and buyers to specify which individuals and entities are subject to the aforementioned non-use and non-disclosure restrictions. Often, a seller will attempt to have the restrictions apply to not only the buyer but the buyer's affiliates and representatives as well; this is particularly important in a situation where the buyer is an investment fund with one or more portfolio companies that may be direct or indirect competitors of the seller. Buyers will typically resist this approach and ask that only representatives/affiliates with which confidential information is actually shared be subject to the restrictions; of course, it is difficult for sellers to verify this and so a safer approach is to insist on a more widespread application of the restrictions. Regardless of how this issue is ultimately resolved, a seller should insist that the buyer be held liable for any breaches of the restrictions by the buyer's affiliates/representatives.

What remedies does a seller have if agreed upon restrictions are breached?

An impermissible disclosure of confidential information by a buyer can have dire consequences for a seller that often cannot be remedied by monetary damages alone. Accordingly, a seller will typically request an acknowledgement from the buyer that the seller shall be entitled to equitable relief (by way of an injunction or otherwise) in situations where the buyer breaches or threatens to breach provisions of the NDA.

Solicitation/employment of seller's employees

An area of particular concern for sellers is the solicitation of seller's employees by the buyer. In the course of the due diligence process, presumptive buyers will invariably be introduced to key personnel of the seller. Particularly in the case where a presumptive buyer is a competitor of the seller, sellers will understandably want assurances from the buyer that it shall not subsequently solicit the employment of these individuals (or otherwise contact these individuals) for a defined period of time that typically ranges from 1-2 years after the signing of the NDA. Buyers that are large organizations will often resist such a prohibition, citing the difficulty in tracking the organization's hiring activities. A typical compromise is to limit the prohibition to senior, management employees of the seller or to employees that were specifically introduced to the buyer or with whom the buyer otherwise had contact in the course of negotiations. In addition, buyers will typically seek to carve out indirect solicitations of the seller's employees that occur by virtue of general online or newspaper advertisements or via the use of a third-party search firm.

What happens if a deal is not consummated with a potential buyer?

Despite overtures to multiple interested parties, a presumptive seller may be unsuccessful in attracting a buyer on terms deemed acceptable to the seller. In addition, busted deals happen; parties may sign a letter of intent and start down the road to a potential acquisition only for the buyer or seller to get cold feet and discontinue discussions with the other party. In either of these situations, a seller will find itself in the situation of having disclosed sensitive, private information to one or more third parties with which the seller has not ultimately entered into a corporate transaction. To better protect disclosed confidential information, sellers will typically require a party that is no longer interested in an acquisition to return any shared confidential information or, alternatively, to certify that it and its representatives have destroyed such information. Presumptive buyers may request that they be able to retain a copy of shared confidential information for record keeping purposes; however, sellers may be leery of such an accommodation (and rightfully so in cases where confidential information was shared with a competitor) and may insist that any retained copies be kept in a secure file in the office of the presumptive buyer's legal counsel. Copies of confidential information that are made by way of routine technology backup pursuant to compliance, document retention or disaster recovery policies and procedures are typically excepted from the general rule that confidential information must be returned/destroyed.

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Attorney Profile: Joseph C. Marrow

1. Why a career in the law? Why M&A?

JCM: After college I knew that I wanted to pursue a graduate degree and felt that my skill set – critical thinking, writing and communications skills best fit with a legal career. In addition, my father worked for the NLRB. I enjoy the challenge and satisfaction of working collaboratively to structure and document deals. M&A transactions allow an attorney to consider a range of legal issues that often vary on a deal by deal basis.

2. What do you most enjoy about your job?

JCM: Client relationships and serving as a trusted advisor to C-level executives. I have had the pleasure of building long-lasting relationships with some very bright, entrepreneurial people.

3. What are you reading right now?

JCM: Hillbilly Elegy. An interesting portrait of many of the issues facing our country.

4. Best advice you've received?

JCM: In college, someone told me to pick the best teachers rather than focus on specific classes. Amazing teachers can make the material more compelling and bring more out of the students.

5. If you weren't a lawyer, what would you be doing instead?

JCM: Sportswriter. I enjoyed journalism. I wrote for several papers and had a sports talk show in college.

6. What's something people would be surprised to learn about you?

JCM: I am a huge Joe Namath fan.

The Morse Barnes-Brown Pendleton **Mergers & Acquisitions Practice Group** has extensive experience in complex M&A transactions, including private equity deals, representing both publicly traded and privately held buyers and sellers.

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