Private Equity

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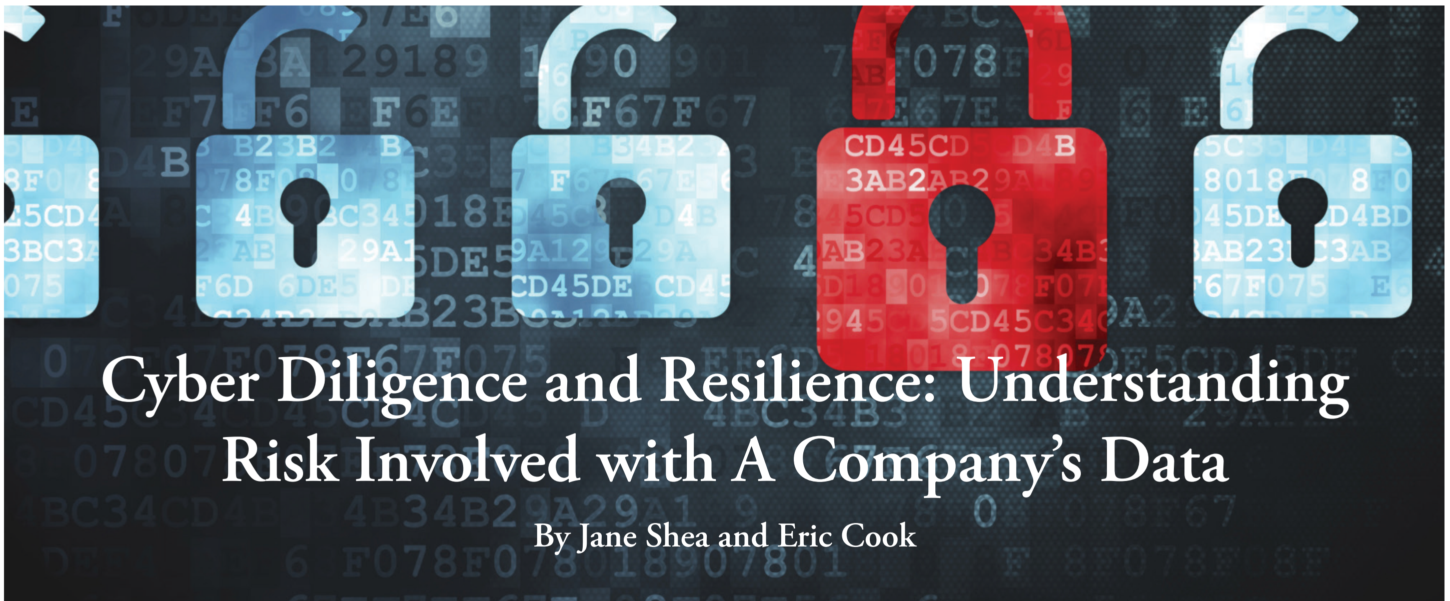


Cyber Diligence and Resilience: Understanding Risk Involved with A Company's Data

By Jane Shea and Eric Cook

The due diligence process in private equity transactions require that you as a buyer or seller conduct proper investigations into a prospective target's data security. Data breaches are inevitable. According to bitglass.com, data breaches of the three largest publicly traded companies over the past three years have resulted an average of $347 million in legal fees, penalties, remediation costs, and other expenses for each of these companies. In addition, these three large companies suffered an average decrease of 7.5% decrease in stock price leading to a market cap loss of $5.4 billion per company. Thus, there is a direct link between a company's valuation and the occurrence of a data breach.

Private equity firms are increasingly assessing the cyber health of their target companies as an essential component of the due diligence process. Key to this assessment is understanding what personal data the target collects and the systems it utilizes, the security processes it employs, the security incidents it has experienced, the responses to those incidents, and the programs it has in place for security, both internally for employees and externally for third party contractors.

Data Management

The types of personal data that a company maintains is important because it will help you determine what regulations apply to its business. More importantly, you will want to understand what kind of networks and systems are being used by the company and where the data is located on those systems (i.e. cloud).

- What types of data does the company maintain (e.g. financial, health, children's)? Where is the data located? What systems are the data located on?
- What networks and systems are being used by the company? Who maintains and has control over these networks and systems?

This knowledge will help you put into context the associated legal, technical, forensic, and administrative costs associated with complying with regulations in this industry, both to prevent data breaches and in dealing with a breach when it occurs.

Breach and Disaster Response

Next, you will want to request information on any data breaches that have occurred and evaluate the target's breach response and business continuity plans.

- Does the target have a robust written information security program and breach response plan? Does the target conduct tabletop exercises to test its plan and its resilience in the event of a data breach?
- Does the target maintain a disaster recovery plan and business continuity plan? If so, have personnel been trained regarding their responsibilities?

Employee Training and Third-Party Contracts

A plan is only as good as the people who are implementing it.

Employees: You will want to know whether the target adequately trains its employees regarding data management and security.

- Does the company have a comprehensive data management and security program? Are the proper personnel knowledgeable about the program?
- How does the company train its employees regarding data security? Are exercises conducted annually to determine employees' knowledge of potential security threats (e.g. simulated phishing email)?

Third-Party Contractors: Companies should properly vet their vendors and other contractors that have access to the target's data.

- Does the contractor employ proper security measures for data that it exports from the target to its own systems?
- Do the service agreements indemnity the target in the event of a breach of the contractor's network?

Takeaways: Proper diligence regarding cybersecurity is crucial to assess the need for remediation of an acquired company's past data and security practices. And at the extremes this due diligence may help the PE firm avoid a potentially unwise and costly investment.

Dealing with Section 1061's Three Year Holding Period Requirement for Carried Interests

By Scott Dolson

Private equity professionals value the carried interest because it allows them to be compensated for their services at long-term capital gains rates. This article provides an update on the status of IRC § 1061 and discusses methods for avoiding its application.

Congress enacted IRC § 1061 during 2017. Reports indicate that during negotiation of the 2017 Tax Cuts and Jobs Act, White House economic advisor Gary Cohn campaigned to end the benefit of carried interests by taxing all income from carried interests as ordinary income, while Treasury Secretary Steven Mnuchin urged keeping the prior tax treatment with new limits. Mnuchin prevailed with the enactment of IRC § 1061.

How IRC § 1061 works. IRC § 1061 generally increases the holding period required for long-term capital gains treatment for the carried interests held by PE professionals from more than one year to more than three years. This article identifies some of the planning ideas available for dealing with Section 1061's three year holding period requirement. Additional planning ideas are discussed in an article found on the Frost Brown Todd website.

IRC § 1061 doesn't apply to a partnership interest issued in exchange for the contribution of capital or property. IRC § 1061(c)(4)(B) provides an exception to the three-year holding period rule for any interest that provides the right to share in partnership capital commensurate with the capital contributed to the partnership by the partner. The holder of a carried interest subject to IRC § 1061 might also hold a capital interest not subject to the reach of that statute. One planning basic should be to clearly keep the carried interest distinct from the capital interest for tax reporting purposes. Possible planning ideas include having the partnership distribute or loan funds to the service provider, who in turn then contributes those funds back to the partnership in exchange for the issuance of a capital interest. The parties would need to carefully consider whether any transaction as structured would be respected for tax purposes.

Planning idea – consider issuing equity compensation in a corporation. Bonus and equity compensation, including options and stock grants, by a C corporation do not fall within the scope of IRC § 1202. Given the reduction in the corporate tax rate from 35% to 21% and the potential availability of the tax benefits of IRC § 1202, many business owners and investors are considering the benefits of operating through a C corporation.

Planning idea – structure the economics to defer the triggering of taxes for the carried interest until the holder achieves the three-year holding period milestone. This strategy involves either the voluntary or mandatory deferral of allocation of profits during the initial three-year holding period for the carried interest. Once the three-year holding period is achieved, there can be make-up allocations and distributions to the carried interest holder. There are various technical issues and risks associated with using this planning idea that need to be carefully addressed by tax professions before this plan is implemented.

Additional planning ideas can be found in a full length article on **frostbrowntodd.com**.

Opportunity Zones and Kentucky's P3 Statute: Providing the Potential Solution for Some of Kentucky's Infrastructure Needs

By Chris Coffman and Michael Shull

With Kentucky's recent enactment of legislation permitting public-private partnerships (P3s), as well as unsolicited proposals to state and local entities, private equity can now propose privately funded improvements to the state's infrastructure needs. Infrastructure improvements that are already needed or located within an Opportunity Zone are choice targets for developers and investors.

Opportunity Zones: What are the Incentives?

The federal opportunity zone tax incentive offers tax benefits intended to encourage investors in qualified opportunity funds (QO Funds) to access unrealized capital gain from their appreciated assets through a sale or other disposition and then use that gain to reinvest in projects in economically distressed areas the U.S. Treasury and IRS have designated Opportunity Zones.

Temporary Deferral

Investors can defer recognizing the reinvested capital gain as income until the end of the 2026 tax year under certain criteria. They must reinvest the gain in a QO Fund within 180 days of when that gain must be recognized for tax purposes (generally, when the asset is sold). However, special timing rules apply in limited situations.

Reduction of Deferred Gain

Because an investor in a QO Fund is acquiring an equity interest in the fund using tax deferred gain, the investor's initial basis in the investment is zero. Investors who hold an interest in the QO Fund for at least five years receive a 10% increase in their basis and a 15% increase if they own the interest for at least seven years.

Permanent Exclusion of Appreciation

Investors holding an interest in a QO Fund for at least ten years can elect to exclude any appreciation in the value of their interest above the amount of the original QO Fund investment when the interest is sold.

What property can a QO Fund own?

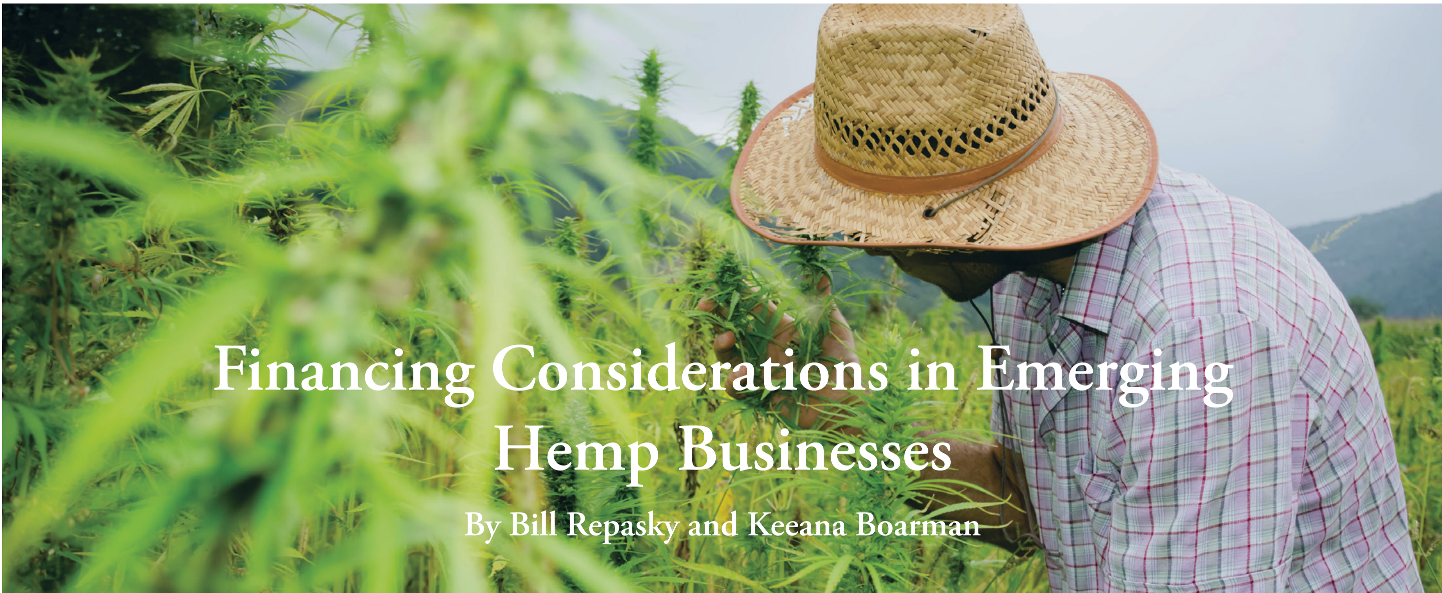
Whether partnership, LLC or corporation, a QO fund serves as a vehicle for investors to deploy capital into designated opportunity zones. At least 90% of the QO Fund's assets must consist of qualifying property—typically either an equity interest in a business operating in an Opportunity Zone (a QOZ Business) or tangible property used for trade or business activity in an Opportunity Zone (QOZB Property). At least 70% of the tangible property owned or leased by a QOZ Business must consist of QOZB Property.

If the original use of the qualified tangible property does not begin with the QO Fund or a qualifying business owned by the QO Fund, the fund or business is generally required to improve the property through capital investments exceeding the purchase price during the 30-month period after purchase.

Public-Private Partnerships and Opportunity Zones

Although the number of P3 RFPs issued by state and local agencies has been less than what was hoped for, Kentucky has still seen a smattering of P3 projects over the past couple of years, in part because the P3 deal structure is already an attractive option for developers and investors.

With the refinement of Kentucky's P3 statute, savvy developers could take an already-attractive investment vehicle, add to it the potential benefits of Opportunity Zone tax incentives, and suddenly infrastructure projects previously thought to be incapable of finding financing may now suddenly be viable. Promisingly, this may solve the public's needs and provide excellent returns on private investment.



Financing Considerations in Emerging Hemp Businesses

By Bill Repasky and Keeana Boarman

Hemp-related business opportunities are exploding, particularly in Kentucky. Interested private equity backed investors will discover that the Commonwealth is at the national forefront in progressive legislation and support for the nascent industry, which by many measures is enjoying wide-spread and growing consumer demand.

Industrial hemp is not marijuana. While "hemp" and marijuana are derived from the same plant species, they are treated very differently under the laws. Hemp is specifically legal, thanks to the 2018 Farm Bill. Under this federal law and most states' laws, growing, processing and selling hemp-derived products is lawful so long as the products do not contain a concentration greater than 0.3% of THC, the chemical component that produces the infamous "high." Marijuana, which remains illegal at the federal level and in most states, has THC at higher concentration levels.

It is important for investors in this new legal industry to recognize that the industrial hemp marketplace involves much more than simply growing one of the three types of hemp plants. It includes businesses involved in transportation, warehousing, processing, manufacturing, distribution, financing and wholesale and retail sales.

Like every start-up business enterprise, developing the right mix of financing is essential to success. Traditional banks typically will be part of the mix due to their ability to offer depository accounts, loans and treasury management services, including credit card acceptance processing. However, despite passage of the 2018 Farm Bill, not all banks are accepting hemp-related businesses as customers. For B2C companies, close attention must be devoted to credit card payment services, which are proving problematic nationwide for retailers in this space.

Private equity buyers and financiers must understand the specific legal and regulatory scheme applicable to each business. This is a highly regulated industry and licensure varies depending upon where the business touches the stream of commerce. For example, CBD product producers and sellers are subject to different requirements than businesses using hemp in fiber production. It is noteworthy that important "business uncertainty" exists for those who manufacture or sell ingestible-type hemp products, as the Food and Drug Administration has only recently begun its investigation into whether it will exercise regulatory jurisdiction.

As with any emerging industry, there is little institutional history or past-practice formulas to rely upon in valuing a hemp business or its assets. This fact can be a source of reticence when interacting with traditional banks. Investor-owners must remember that hemp in the field is subject to all the laws of nature, just like all farm crops, but that crop insurance is currently unavailable. An additional financial risk is that hemp, whether in the field, at the warehouse or on a store shelf, can immediately become valueless if it tests "hot" because of an impermissible THC concentration.

The future appears bright for hemp-related businesses whose owners and investors can navigate these uncharted waters. Frost Brown Todd is uniquely positioned to advise PE firms interested in investing in this emerging industry. The firm and its government relations subsidiary have taken leadership roles in the creation and guidance of the hemp industry over the past decade, including presently serving as legal counsel for the U.S. Hemp Roundtable, the nation's leading business advocate for the industry. The firm's banking lawyers have worked with banks and hemp-related businesses in resolving the issues necessary to opening the Commonwealth's traditional banking infrastructure. Frost Brown Todd's M&A attorneys and PE industry team work closely with the firm's hemp industry group in connection with assisting clients entering or operating within the growing hemp industry.

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About Frost Brown Todd

Frost Brown Todd is a full-service law firm with offices in Indiana, Kentucky, Ohio, Pennsylvania, Tennessee, Texas, West Virginia and Virginia. With over 500 lawyers across our eight-state footprint, FBT offers a deep talented roster of legal professionals. Our services extend beyond our footprint, as we have attorneys licensed to practice law in 25 states and the District of Columbia. We serve a diverse client base, from global multinationals to small, entrepreneurial companies. Our attorneys integrate a powerful network of legal talent and business experience. We embrace a culture of innovation and implement the latest technology.

Private Equity in Franchising

By Jim Straus, Jason Williams and Nick Jones

Private equity ("PE") involvement in the franchising world has increased in recent years. Though historically PE firms have focused primarily on investment in franchisors, PE firms have in recent years increased their focus on franchisee-side investment. Understanding the franchisor's perspective on PE investment into its franchisee community can help PE firms more effectively negotiate their relationship with the franchisor.

Franchisors may be open to PE firms joining the franchisee community because PE investment can efficiently and aggressively grow a franchise system in a way that smaller franchisees cannot. PE firms typically have long-standing relationships with large lenders that can fund aggressive, multi-unit development. Franchisors also appreciate PE firms' focus on driving revenue and profit to produce returns for PE firm investors because that focus coincides with increased gross sales and therefore greater royalties for the franchisor. Franchisors also value the professionalism and sophistication that PE firms can introduce to the franchise system.

On the other hand, franchisors are often cautious of PE investment. PE-backed franchisees often make formidable adversaries when disputes arise within the franchise community. Large PE-backed franchisees have more leverage to push back on a franchisor's new system mandates and fees, potentially causing discontent in the wider franchisee community. Franchisors may also be uncomfortable with a PE firm's relatively short investment timeframe. Some PE-backed franchisees are ineffective operators when compared to smaller franchisees that view their investment in the brand as a life-long commitment or are second-generation franchisees. PE-backed franchisees sometimes have a tense relationship with smaller franchisees that feel they are being "crowded out" of the system or that too much of the franchisor's focus is on the needs and concerns of the larger PE-backed franchisees. PE investment in a franchisee community can introduce cultural shifts and tensions that represent a fundamental change in a franchise system.

Franchisors that are receptive to and see the advantages of PE investment in the franchise community are typically willing to negotiate certain of the standard franchise agreement terms and related requirements that have historically been non-negotiable. For example, franchisors may waive training requirements, particularly if the PE investment is in an existing franchisee that will continue to be managed day-to-day by the founding franchisee. Franchisors frequently waive requirements that franchisee owners personally guaranty the obligations of the franchisee entity, understanding that PE firms may be unwilling or unable (under governing or lending documents) to provide guaranties. Franchisors are often willing to forgo their right to control and approve franchisee financing arrangements when a sophisticated PE firm is involved. However, the franchisor may insist on a "relationship" agreement establishing certain ground rules for the relationship, such as requirements that the PE firm remain invested in the franchise for a certain period, that the PE firm (and the franchisee) will not go public, or requiring the PE-backed franchisee to maintain PCI and other technology compliance (if using its own IT infrastructure).

The members of Frost Brown Todd's Franchise and Hospitality Industry Team have significant experience guiding our clients through the legal and relationship issues of PE investments in franchise systems. Working closely with our FBT PE Industry Team colleagues, our Franchise and Hospitality Industry Team can help you navigate the legal complexities of investing in a franchise brand.

Successor Liability Presents A "Risky Gambit" to Private Equity Firm

By Jeremy Hayden and Edward Rivin

A Federal District Court recently called investments in private companies a "risky gambit" because of the potential for successor liability. Successor liability is the concept used to describe liability imposed on the purchaser of part or all an acquired company. Successor liability is often imposed by statute, case law, or other methods not contained in a purchase contract. Because the genesis of successor liability is often found outside of the purchase contract, these types of liabilities are sometimes called "hidden" liabilities. Importantly, these liabilities can sometimes spread to the purchaser's parent/sponsor entity and other affiliates such as other portfolio companies. Two exemplary types of successor liability are discussed below.

Withdrawal Liability

Employers use Multiemployer Pension Plans (MPPs) to provide employee benefits or are otherwise required to contribute to these plans due to participating in union organizations. Contributing to these plans creates joint and several liability for each entity affiliated with the contributing employer. A purchaser can assume this liability when it acquires a business. If the business attempts to partially or completely exit the MPP, then an exit penalty known as "withdrawal liability," is imposed on the business and can spread to other affiliates.

Two private equity funds formed by Sun Capital Partners, a private equity firm, were recently held liable for a company's withdrawal liability even though each fund's ownership separately fell below the applicable statutory 80% control threshold. The court imposed the withdrawal liability on both funds because the funds were deemed active investors and there was evidence of a joint venture between the two Sun funds. The Sun decision is currently on appeal, and Sun could potentially prevail but not without spending significant sums on attorneys' fees.

The Sun precedent poses a threat to acquirers. Firms should perform significant due diligence to ascertain the risk and exposure to withdrawal liability. There are at least 17 exceptions that reduce or eliminate withdrawal liability.

Unpaid Taxes

One should be careful not to assume successor liability for a target's unpaid historical tax liabilities. In some cases, a purchaser can be liable for an unlimited amount – regardless of whether equity or assets are purchased and regardless of the purchase price or size of the deal. Thankfully, these liabilities can often be discovered during diligence through lien searches and tax clearance procedures. Where time, costs, or other constraints hinder performing adequate diligence, the purchaser should seek other protections such as indemnification enhanced by escrows, holdbacks, or guarantees when the selling entity will no longer exist or would not be left with sufficient assets to cover the indemnification. If an unpaid tax liability is overlooked, tax amnesty and voluntary disclosure programs can serve to limit the look-back period and to abate interest and penalties.

In the end, care must be taken to mitigate the chance that these and other successor liabilities do not come back to spoil the deal.

Avoid Buying Big Labor & Employment Law Risks

By Jennifer Asbrock and John Lovett

Savvy buyers must be on the lookout for "surprise" labor and employment law risks that can exceed the protection of traditional "reps" and "warranties." Examples that can ruin a deal include exposure to wage-hour class actions, harassment claims against key employees, and entanglement with unions and multi-employer pension plans.

Wage-hour class and collective actions typically carry exposure and litigation expenses measured in millions, not thousands. Total lawsuits and settlements dipped in 2018, but we see middle market companies increasingly becoming targets. Wage-hour problems are inherited in stock sales, and thanks to labor and employment successorship exceptions to general corporate liability principles, they can also plague asset sales. A seller's existing wage-hour violations may go unnoticed and continue in effect after the sale, until litigation ensues. But if handled properly, sales can be a strategic opportunity to fix wage-hour problems without calling attention to them; add "safe harbor" provisions to personnel policies; and obtain arbitration agreements with class/collective action waivers as a condition of employment with the new owner.

Harassment allegations involving key employees can also inflict a lethal blow to M&A deals. If the worth of a business depends on key executive leadership, personalities identified with the brand, critical salespeople with close client relationships, or irreplaceable creative/technical/market experts, then traditional due diligence is simply not enough. Buyers should review past harassment/discrimination complaints, anonymous reports, or "hotline" calls—no matter how old, if they focus on a key employee. They should also ask to see any settlement agreements disposing of harassment/discrimination claims, especially those purporting to be "confidential."

The sale of a company with a unionized workforce presents a whole new set of challenges. In a stock sale, buyers are stuck with the existing union and labor agreement, but in exchange, they enjoy a higher degree of labor stability. In an asset sale, buyers end up with the union only if they continue the seller's line of work and hire a majority of its union employees, but this is hard to avoid. Despite inheriting a union, it is still possible for buyers in an asset sale to avoid inheriting existing labor agreements under certain circumstances, but this can result in low morale and labor unrest. Perhaps the scariest legal "landmine" in a union setting is the prospect of getting trapped in multi-employer pension plans, many of which are gravely underfunded and carry the ever-looming threat of multi-million-dollar withdrawal liability.

In short, savvy buyers should not only review all threatened and pending litigation during their M&A due diligence. They should also identify less obvious labor and employment issues that can carry big dollar exposure. Some of these risks can be mitigated if they are identified and addressed as part of the sale. Others, however, may make a deal not worth doing. In all events, buyers should go into any purchase with their eyes wide open.

Typical Minority Ownership Issues Facing Rollover Participants

By Scott Dolson

PE buyers and target company owners are rightfully focused during the M&A process on the terms of the purchase. Often the tax structure receives careful attention, particularly where a tax-free rollover requires sellers during an M&A transaction are rightfully on M&A transaction that includes a rollover component. Less frequently a center of attention during the negotiations but of equal importance are the rules governing the ongoing relationship between the buyer and the rollover participants.

The following issues list is viewed from the perspective of the rollover participant but can provide useful background information for buyers trying to get deals over the goal line:

1. **Mandatory tax distributions.** The inclusion of a mandatory tax distribution is critical to minority owners of a pass-through LLC who don't have any control over whether permissive distributions will be approved by management.

2. **No involuntary additional capital contributions.** A minority owner doesn't want to be forced to make involuntary capital contributions.

3. **No involuntary loans or personal guarantees.** A minority owner doesn't want to be forced to make loans to the company or have an open-ended requirement to guarantee company obligations.

4. **Understanding the potential for dilution.** A minority owner benefits from pre-emptive rights and an understanding of when and how dilution can occur. Typical exceptions to pre-emptive rights include the issuance of equity compensation and the redemption of equity in connection with the reissuance of shares to new investors.

5. **Board representation.** Depending on the percentage of equity represented by the rollover participants' holdings, rollover participants may have board representation (in addition to a seat for a rollover participant continuing as the company's president/CEO) or observer rights.

6. **Governance issues and management fiduciary duties.** The buyer entity's governance documents, particularly when the entity is an LLC, often requires owners to waive the fiduciary duties of care and loyalty otherwise applicable to the financial buyer's board representatives or managers. In many cases, the documentation will go further and provide that the financial buyer and its representatives are permitted to approve decisions that further their interests rather than making decisions based on what is best for the LLC or the rollover participants.

7. **Supermajority voting rights.** Rollover participants with a substantial ongoing stake in the portfolio company should consider negotiating for supermajority voting rights on key decisions. In many cases, however, buyers will not be willing to grant the rollover participants a meaningful vote on matters other than consent rights associated with a PE firm conflict of interest transaction. Some key issues that might be the subject of a supermajority consent requirement include: (i) amending the buyer's organizational documents; (ii) the making of a non-pro rata distribution to owners not contemplated in the LLC agreement; (iii) the making of non-pro rata redemptions (other than upon termination of employment); (iv) the dissolution or liquidation of the buyer entity; (v) increasing or decreasing the number of directors; (vi) equity redemptions not contemplated in the buyer's LLC agreement; and (vii) consent rights with respect to asset purchases or sales exceeding agreed-upon threshold.

8. **Sponsor fees.** PE firms typically receive 20% carried interest (profits interest) and pursuant to a support and services or management fee an annual management fee equal to 1.5% to 2% of committed capital. There may be other fees, including directors' fees, acquisition and disposition fees, and monitoring fees.

9. **Information and inspection rights.** Rollover participants usually have a right to periodic financial statements and typical equity holder information rights, but careful attention should be paid to any restrictions on those rights set out in the LLC operating agreement or a separate equity holders agreement.

10. **PE firm repurchase rights upon termination of employment.** Most rollover equity is subject to repurchase rights upon termination of employment. In most deals, the repurchase right is based on some reasonable fair market value calculation, but the terms of the repurchase should be carefully reviewed.

11. **Registration rights.** Many PE firms include the granting of securities (demand and piggyback) registration rights in their investor documents.

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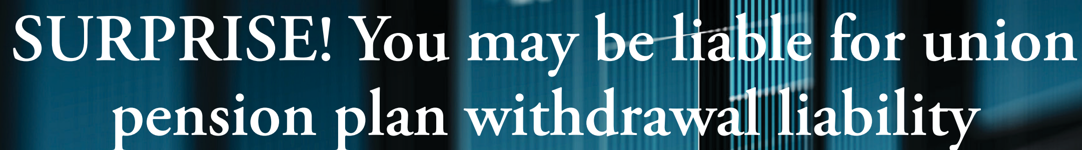

SURPRISE! You may be liable for union pension plan withdrawal liability

By Michael Bindner

When a participating employer stops contributing to, or no longer has an obligation under a collective bargaining agreement (CBA) to contribute to, an underfunded multiemployer (union) pension plan, the employer may be liable for “withdrawal liability” even though it always paid its required annual contributions to the pension plan. Withdrawal liability can be triggered when an employer has a significant union workforce reduction (a partial withdrawal), a complete union workforce reduction (a complete withdrawal), or a withdrawal of all employers from the pension plan (a mass withdrawal).

The employer is primarily responsible for paying the withdrawal liability, but other businesses which have common ownership with the employer will also be liable. Shareholders of an incorporated business, partners in a partnership, or an alter ego or successor business may also be responsible for withdrawal liability if the participating employer does not pay the withdrawal liability to the pension plan.

The following is an explanation of the potential liability of certain entities, other than the employer, when the participating employer becomes insolvent and can’t pay the withdrawal liability.

Liability of Commonly Owned Businesses

All entities which are considered under common control (i.e., a parent-subsidiary group or a brother-sister group) as determined by Internal Revenue Service regulations are jointly and severally liable for the withdrawal liability if the participating employer does not pay the liability.

Successor Employer Liability

A purchaser of assets generally does not acquire a seller’s liabilities, but some federal courts have found a buyer of assets liable for the seller’s withdrawal liability as a successor business. Successor businesses to entities which are assessed withdrawal liability have been found liable for unpaid withdrawal liability if they:

- had notice of the liability and
- continued the business of the predecessor entity (typically referred to as a “continuity of operations”) after purchasing the assets of such entity.

Liability of Private Equity Investors

A private equity fund that owns an interest in an operating entity (sometimes referred to as a “portfolio company”) can be responsible for withdrawal liability that is originally assessed to the operating entity if the private equity fund’s involvement in the operating entity is sufficiently active as to render the private equity fund a “trade or business” (i.e., not a passive investor) in common control with the operating entity.

In the ***Sun Capital Partners*** cases, federal courts determined that two Sun Capital funds were not merely “passive investors,” but “trades or businesses” because they operated and managed the operating entity and were provided a direct economic benefit that an ordinary passive investor would not derive. Because the two Sun Capital funds owned enough of the operating entity (100%) to be in common control with such entity, the Sun Capital funds were liable for the bankrupt entity’s liability. The courts applied what is referred to as the “investment plus” test (i.e., the owner is more than just a passive investor) in making the determination that the Sun Capital funds were “trades or businesses”.

The Sun Capital Partners decision has been appealed again to the U.S. First Circuit Court of Appeals by Sun Capital.

Addressing The Impact Of The Golden Parachute Rules In M&A Transactions

By Scott Dolson and Carl Lammers

A "golden parachute" is defined as an agreement between an employer and employee that triggers a significant compensation payment as a result in a merger, M&A transaction or other change-in-control event. Regulatory concerns over excessive change-of-control payments dates back to the 1990s when Congress added provisions to the Internal Revenue Code limiting an employer's deduction for excess golden parachute payments and imposing an excise tax on the employee. Roll forward to 2019 and the threat of a 20% additional tax imposed on the management team's excess golden parachute payments ranks high on their list of concerns during a sale process.

The best time to begin planning for minimizing the tax impact of excess golden parachute payments is when compensation packages are first structured and negotiated. Later when a sale process is looming or underway, the management team and owners can often take steps to mitigate the potential impact of IRC §§ 280G and 4999. Although the golden parachute excise tax has the greatest impact on management team, the provisions also impact the target company and the buyer.

M&A Transaction Planning

There are several strategies available to reduce the potential impact of Section 280G prior to and during a sale process:

- **Increase pre-sale annual compensation.** An effective strategy is to increase an executive's compensation during the five-year period prior to triggering a change in control. The higher the compensation base amount, the less likely there will be excess parachute payments.

- **Obtain shareholder approval.** A private company can avoid the impact of Section 280G by obtaining shareholder approval of the excess parachute payments. Shareholders holding at least 75% of the target company's voting equity must approve the compensation payments immediately prior to the applicable Section 280G triggering event (e.g., sale of assets or stock). Shareholder approval must not be automatic or a condition of the sale transaction. Prior to the vote, the target company must adequately disclose the material facts concerning the payments and benefits along with the adverse tax consequences to both the affected individuals and the target company. There can be no advance agreement to lock up votes in favor of shareholder approval. Finally, and most significantly, the affected employees must agree in advance of the vote to waive the excess parachute payments if shareholder approval is denied. Understandably, pursuing the shareholder vote option can be a bit nerve racking for the employees. As a practical matter, shareholders generally understand that an important aspect of a successful sale is a happy management team, and as a result for shareholders to withhold their approval of the excess parachute payments.

Typical Provisions in M&A Agreements

A buyer purchasing a C corporation's stock (i.e., inheriting the C corporation's tax and compensation obligations) wants to avoid a situation where the acquired company is obligated to make nondeductible compensation payments or is obligated to gross-up an executive's compensation to cover the 20% excise tax. As a result, most definitive agreements will include representations confirming that there will be no excess parachute payments triggered by the sale transaction and/or a covenant requiring the target company and its executives to seek shareholder approval of the excess parachute payments. Since employees must agree in advance to waive the excess parachute payments if shareholder approval is denied, the buyer knows that whether or not shareholder approval is obtained, the Section 280G problem has been eliminated. The definitive agreement should not include a closing condition specifically requiring a favorable shareholder vote, but there can be a closing condition requiring that shareholders consider approval of the excess parachute payment, which effectively means that at closing either the excess parachute payments will have been approved or waived by the affected employees.

The target company's owners also benefit from obtaining shareholder approval of the excess parachute payments, since purchase agreements can include an offset against the purchase consideration for the value of lost tax deductions due to Section 280G or a purchase price reduction for any gross-up obligations.