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

Episode 48: Section 280G Unpacked: Pitfalls and Planning for Tech Startups

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Megan Monson: Welcome to the Lowenstein Sandler podcast series. Before we begin, please take a moment to subscribe to our podcast series at Lowenstein.com/Podcasts, or find us on Amazon Music, Apple Podcasts, Audible, iHeartRadio, Spotify, SoundCloud or YouTube. Now let's take a listen.

Jessica Kriegsfeld: Welcome to the latest episode of *Just Compensation*. My name's Jessica Kriegsfeld, and I'm an associate in Lowenstein Sandler's Executive Compensation Employment and Benefits practice group. I'm joined today by two of my colleagues who I'll turn it over to introduce themselves.

Megan Monson: Hi, I'm Megan Monson. I'm a partner in Lowenstein Sandler's Executive Compensation Employment and Benefits practice group. Pleasure to be here.

Anthony Pergola: Hi Jessica. Hi Megan. I'm Anthony Pergola, the Vice Chair of the Firm's ECVC practice group, and I've spent the last 30 years at Lowenstein advising on merger and acquisitions.

Jessica Kriegsfeld: Section 280G is a section of the Internal Revenue Code that affects many companies undergoing or considering undergoing a change in control or sale process. Section 280G, if it applies, could put a significant portion of any compensatory payments you are receiving at risk for a 20 percent excise tax and the company losing a tax deduction. As a result, is it important to consider 280G and certain strategies for limiting the tax and addressing other pain points?

On a prior episode, we gave an overview of Section 280G, including how to determine who will be considered a disqualified individual and what types of payments will be considered in the 280G analysis. We will shift gears today to talk about common Section 280G challenges and frustrations, as well as strategies and planning opportunities to mitigate 280G issues or at least make the issues less painful.

As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if your company is undergoing or considering undergoing a change in control or sale process to understand the potential impact of 280G, as 280G is particularly complex and nuanced. To get us oriented, at a very high level, how does the company determine if section 280G is applicable and whether there will be a section 280G issue?

Megan Monson: Thanks, Jessica. So, while I'm not going to get into all of the specific details as it was addressed in a prior episode that will be linked to this episode, I'm going to briefly recap some of the key points just to level set. So as a threshold level, the first question you asked, is this transaction constituting a change of control? So, a change of control could be a change in control of ownership of the company, change in effective control of the company, although this is the least common change of control for 280G purposes, or a change in the ownership of a substantial portion of the assets. So even if you have an asset sale of at least a third of the assets, 280G might be implicated.

So, if you say yes to the first question, there is a change of control, the next question is are there any entities in the corporate structure undergoing the sale process that 280G applies to? So 280G is only going to be applicable to entities that are taxed as C corporations, including both public and private companies that are undergoing a change of control. And it can also include foreign entities, but that's a whole other set of complex topics that's outside the scope of this discussion.

So if, one, there is a change of control, and two, there are entities in the corporate structure that 280G would apply to, the next step is determining who is subject to 280G. 280G looks at people who are considered disqualified individuals, which again the analysis is very fact-specific, but it generally includes the top highest one percent compensated service providers of the company, one percent shareholders who are also service providers of the company, and officers of the company either by title or authority.

Once you've determined who's a disqualified individual, you'll perform specific calculations considering each individual's average compensation over the past five years multiplied by three to determine what their 280G threshold is, and then look at what various types of payment, including any compensatory payments in connection with the transaction that exceed their thresholds. Again these calculations are very in-depth and are discussed in more detail in our prior episode titled, "Change of Control: Golden Parachute Rules in the Sale Process."

Jessica Kriegsfeld: Anthony, what types of companies might be particularly affected by Section 280G?

Anthony Pergola: So, a theme of my comments today is going to be that tech companies are hit particularly hard by 280G, and tech management teams are particularly ill-suited and ill-prepared for the work and for the risks that 280G brings to their transactions. It's almost unfair, and they really hate it for good reason.

Management teams of tech companies typically are underpaid from a market rate cash compensation standpoint, obviously less than they would get at larger companies. And sometimes founders and top management take very small or no salaries, notably in the early stages of a company's life. So even if a founder's comp is raised to market level in the year or two before a sale, because of that lookback period, you're typically reaching into time periods where founders and management were particularly underpaid versus market.

So since the 280G thresholds consider average cash compensation over the past five years, management of tech startups might have a very low 280G compensation in the earlier years, and therefore when you run the calculations, the base against which the deal compensation is measured is really understated and undervalued, and it can be challenging to explain to a management team why this is an issue. It's also obviously challenging to deal with the disclosure obligations and the vote needed, which we'll address in a minute, to cleanse 280G compensation problems.

These issues arise in the heat of the deal typically when there are lots of parallel processes going on that take the time, legal cost, and attention of management teams that are usually relatively thin, so this can become an emotional issue, as we'll get into.

Megan Monson: Yeah, and I'll just add one of the things that we try to do in educating our clients in this space, and we encourage others to do so as well, is making them aware of what 280G is throughout your time counseling the client so that if there are arrangements that you know, such as severance or change of control benefits that they could get on a future payout, making them aware of how 280G could have an impact on those payments and thinking about some planning opportunities that we'll get into later.

Jessica Kriegsfeld: Once a company determines that there might be a section 280G issue, how can a company mitigate the tax consequences I mentioned at the beginning of the episode?

Megan Monson: So, for the purposes of answering this question we're going to focus on private companies. Private companies are eligible to utilize a 280G cleansing vote whereby the shareholder base can approve these parachute payments. For a vote to be considered approved, 75 percent of the disinterested shareholders must approve those payments, so meaning that disqualified individuals cannot vote for themselves even if they are shareholders. So essentially, we remove those people from the numerator and denominator of determining whose vote is needed to reach that 75 percent approval threshold.

One of the key parts of the vote process is that you need to disclose material terms of all potential parachute payments to all shareholders eligible to vote. And so, as Anthony mentioned, that can be a point of contention and challenge to get management on board with if they do have a wide shareholder base and lots of employee shareholders.

Before the shareholder vote, all disqualified individuals who have excess parachute payments must sign and return a waiver letter. The waiver says that they are irrevocably waiving their right to any of the payments that are being voted on. So practically this means if the vote fails, the individual is forfeiting all of their payments being voted on and they have to sign a waiver before the vote can even happen. So, it's really important to explain to the disqualified individuals what they are waiving, what the vote process means, and getting them to understand how this all works.

Jessica Kriegsfeld: Anthony, in your experience, how do companies and disqualified individuals react to being asked to sign this waiver in advance of the 280G vote?

Anthony Pergola: The seven stages of grief, rejection, bargaining, all of them. You have to, again, put yourself into the point in the deal where this comes up. Yes, we would have explained what 280G is upfront. Yeah, we may have brought it up throughout the company's life in terms of different pieces of compensation, but none of that is retained by management teams in their active memory.

So, you're toward the end of the pre-signing process of the deal. You have a management team that's negotiated 500 different points of value and legal liability and other things with respect to the deal. There are members of the management team who are disqualified individuals who are in the know, and frankly members of the management team who are disqualified individuals who have just learned about the deal. They haven't been an active participant in part of the process, and you're asking them to sign something that says if this vote fails, you will not get these benefits. And some of the benefits are things, frankly, they've already received, an option grant made within a few months before the deal came about, change of control payments that they've negotiated and agreed to with the company, and some of them are specific to the transaction.

So, it's a frightening piece of paper to put in front of them. And they ask really good questions like "why," and "I don't understand how this technically works," and those are the questions that you can answer. We can explain the why. We can explain why it technically works. They'll question why when there are close calls or judgment calls to be made, why the buyer's team is taking such an expansive position that isn't necessarily required by the law because they will want to cleanse to the maximum extent possible. They'll do their own research. They'll go on ChatGPT. They'll read articles. They'll listen to this podcast. They'll do all the things to try to figure out why they don't have to do this thing that we want them to do.

And of course as private company management, they're not used to having their personal compensation be publicly broadcast to their employee base, to their former employees, et cetera. And frankly, they'll ask a very nuanced questions, "Well, do we really have to send this notice to every stockholder?" And then they'll get into bargaining. "Well, what if we sent it to every stockholder, we sent it at 2:00 in the morning? Or what if we put it behind a firewall?" What if we did this and what if we did that

So, all those things are part of the legal discussion, but the emotional overlay is significant and tangible because you cannot say the two things that would make management teams get very comfortable. You cannot say, "Well, if someone votes against your compensation, they're really voting against the deal." Those things aren't tied together. They can't be, and so that presents the risk in a much starker way.

And the other thing that I can't say is that these votes always pass. They almost always pass. I can generally predict the circumstances in which there's real risk of non-passage. I can generally predict that institutional investors will vote yes for reputational reasons and just to be good corporate citizens. But I've been involved in situations where the vote has not passed and where we got into additional process to get the votes needed to make the deal happen. So, it's frightening because there is actual risk.

Jessica Kriegsfeld: How can Section 280G affect the timing of the deal?

Megan Monson: Well, as Anthony mentioned, I think a lot of this tends to come up when you've already negotiated a lot of points of the deal and you're pretty far along in the deal process. And gathering the information that's needed for the 280G analysis itself can be time-consuming because you already are using your resources on other aspects of the deal and now you have to go back and gather historic payroll information and other documentation. And some of the information gathering can't be turned on a dime, so it is something that we encourage companies to try to look at in the earlier stages of a transaction so it doesn't become almost like a backlog and a gating item when you're already chasing down the finish line to signing or closing.

Anthony Pergola: A hallmark of private tech M&A is keeping the team small who are in the know. M&A processes don't always work out. Secrecy is important. So, you typically have a very small group of senior executives and maybe a few less senior executives involved in the day-to-day process of the deal. That means if you have one or two people in your HR department or finance department who know the deal is happening, they're handling 72 different work streams, this being one of them. So, asking them to pull W-2s for years past, asking them to run analyses of the cap table to see how we'd get this 70 percent vote, when some of the information is in flux almost until the end is very challenging. And by in flux, I mean it's not always clear who the disqualified individuals are until nearly the last minute. You pretty much know the bulk of them, but there's always a couple on the edge that are last-minute items.

Megan Monson: And I'll also add, even if you know the group of disqualified individuals, often in these situations some of these people may be getting new comp for buyer and the terms of those compensation is not known and is being negotiated right up until the closing, and that can move the needle on whether somebody has a 280G issue or not.

Anthony Pergola: As a matter of fact, the compensation negotiations are almost always backloaded, and that's both for practical reasons and relationship reasons between buyer and seller, but also for legal and fiduciary reasons. There's a point at which the management team, the officers particularly, need to be focused on getting the deal done and not their own personal compensation. Obviously that switches at some point, and you have to make sure that they're comfortable with the deal.

Jessica Kriegsfeld: Since section 280G is so involved, what are some planning opportunities to avoid a 280G issue?

Megan Monson: So as I mentioned at the beginning, an individual's 280G threshold is based on their average compensation in the past five years. And as Anthony noted, startup founders often have low compensation in a company's early years. So, if a company is expecting to undergo a change of control or sale process in the coming years, one thing they could consider doing, if they have the cash to do so, is raising individual's compensation because ultimately the impact is that raises their 280G threshold to either avoid or lessen a 280G concern. So, if you're expecting that you're going to have a sale process in the next two or three years, it'll at least help mitigate some of that issue.

Another item to explore is that restrictive covenants can have a value attributed to them that can offset 280G payments. So, if you expect that you could be triggering 280G, consider the competing interests of entering into a restrictive covenants agreement that could lessen some of the 280G payments. Although the ability to enter into a restrictive covenant agreement will vary by state, and many startups are based in California, which severely limits certain restrictive covenants. Again, if you're a founder, you may not have these agreements in place, but it's possible a new buyer could require you to enter into these arrangements as part of the deal deliverables. So, considering the value of those restrictive covenants, again, it could be a way to reduce having a 280G issue.

And as Anthony mentioned before, one thing that we see often is that buyers want to be conservative in the payments that are included in the 280G analysis. So as part of the discussions with buyer and their counsel, sellers can try to rebut, let's say, some of the more conservative assumptions and try to back out certain payments from being included in the 280G analysis.

So, for example, one argument that can be made is that certain payments are reasonable compensation for services rendered, and if there's clear and convincing evidence to support that, you might be able to take out some of the payments that Anthony mentioned that you wouldn't expect to be considered change of control type payments. An example could be a salary increase or a bonus you received in the past 12 months completely unrelated to the deal, but in an abundance of caution, buyers want that included. So that may be an opportunity where you can try to negotiate and back out some payments from being considered for 280G purposes. Now this won't work for every type of payment, but again it could be helpful for somebody who's on the cusp of triggering to avoid them having an issue.

Anthony Pergola: And often when you're looking at people who are on the cusp of being disqualified individuals or not, you're dealing with a group of people who are probably below the C-level status and therefore there might be others of the same title or same job role who have received comp at the same time that can bolster an argument that the comp is reasonable. Because if you paid all your vice presidents a bonus of X, the fact that this vice president got a bonus of X is probably not part of the deal, and you could argue for that.

Another planning opportunity is to know your cap table and know your voting stock ownership really well. The times when there are real risk to the vote failing are when you've got a large chunk of voting power who are not active in the company for some reason and who would be unhappy or upset to see current management receive payments that are not for the stock that they own.

So if you've got a company where a new management team was brought in the last one or two years and they don't have the kind of equity that a founder management team would have and need to be compensated in an M&A deal in a way that is dislocated from their equity ownership, you need to start looking at, well, who's got voting control over the other 75 percent? Do we have former management who might cause trouble?

Another thing to think about is when there are economic differences from voting. So, if you've got preferred stock with a multiple liquidation preference or with accruing dividends getting paid out in a deal, they're taking a larger chunk of the deal proceeds than their percentage ownership, and therefore there might be folks lower down on the cap table who could be looking for ways to put more money back into the deal for them. So those are scenarios where it's really important to have someone think through before an M&A process begins how you would go about getting the vote.

Jessica Kriegsfeld: Are there any other 280G considerations to make companies aware of?

Anthony Pergola: Yeah, I mean, I think there are basically two things that need to be addressed when talking about 280G with management teams. One is the disclosure piece. And the disclosure piece, the disclosure statement, the information statement that gets sent out to all stockholders is going to land in the inboxes of former employees who have exercised their options, current employees, investors who haven't thought about the company in years, and the founder and management team's personal financial business is going to be disclosed for all to see.

While this is always uncomfortable, it sometimes could be really damaging for morale. You may have folks who are at the same level as some of the disqualified individuals seeing that their compensation is lower than those disqualified individuals. You may be seeing folks who are supervisors of a disqualified individual seeing compensation that they might not be aware of, so you can have interpersonal issues and employee morale issues.

The other issue to be careful about is avoiding surprises. We've talked throughout this podcast about dealing with this issue early and often. It can sometimes be the case where you can't do that with a disqualified individual, where you need to bring that disqualified individual over the wall at the very last minute, and you need to have prepared the company's CEO typically, or head of people, to really be part of the discussion about why this is an issue for that person, what we're doing to help that person with this issue, and what the risks are. And it almost always works out. It almost always works out that the person ultimately signs the waiver, and the vote happens, and the vote was successful, and there's no harm, no foul, but prepare yourself for 18 hours of pain and angst.

Jessica Kriegsfeld: As you heard today, Section 280G can present challenges and its complex provisions can lead startup managements grappling with these challenges during the rush of other deal-related considerations. With careful planning and consultation with legal experts, seller management teams can be prepared and armed with strategies to navigate the complexities of Section 280G and take steps to mitigate the adverse tax consequences. This episode is intended to be a high-level overview and is not an exhaustive discussion. Thanks for joining us today. We look forward to having you back for our next episode of *Just Compensation*.

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