

MERGERS & ACQUISITIONS



Stuart Kane LLP

Blocking and Tackling – Earn-Outs in M&A

Earn-Out provisions in acquisition agreements allow the seller or owners of a business to receive consideration after the deal closes, in the form of additional payments which are contingent upon the future performance of the target business or the achievement of specified milestones, or both. Performance objectives are often expressed in financial reporting terms, such as total revenue, gross margin, cash flow or net income, while non-financial milestones may include a product launch, research and development achievements, FDA approval and the like. If the target business fails to achieve those objectives, or the specified milestones are not met, the seller's consideration is limited to the acquisition consideration paid up front at closing, and the seller is not entitled to receive the additional, contingent consideration.

“**Earn-Outs, however, are not for the faint at heart. An Earn-Out provision may create challenging conflicts of interest for seller management teams as they continue to operate the business after the deal closes.**”

Conventional wisdom tells us that Earn-Outs have become a useful tool to use to bridge a valuation gap, for example where the seller is convinced its business should be valued at a higher level than the acquiring company is willing to pay, or the seller is convinced that its business has the potential to attract that higher value. Small companies, privately held companies, and new or high-growth businesses can be particularly difficult to value with a high degree of “bi-lateral” accuracy. Buyers don't like to be told they paid too much for a business, while Sellers prefer not to leave anything on the table or to give up too much of the upside of the business they have built.

Sources of valuation-based uncertainty include the early stage of undeveloped products, volatile market and competitive conditions, lack of reliable financial information, limited historical operations, relatively inexperienced or under-developed management, and, well, the uncertainty of the times in which we live. Buyers (or their lenders and investors) might simply prefer additional time to finance the acquisition, and to allow the business to perform to its promise to validate the amount to be paid for the business, while sellers may anticipate synergies of the combined company and business integration efforts to drive achievement of post-closing objectives.



Vaughn

Rather than allowing a valuation disparity to block an otherwise sensible transaction, the Earn-Out, therefore, is a useful means by which buyers and sellers can bridge the gap.

Earn-Outs, however, are not for the faint at heart. An Earn-Out provision may create challenging conflicts of interest for seller management teams as they continue to operate the business after the deal closes. Sellers, having developed their own financial reporting and operating procedures, should be concerned about how an acquiring company will exercise control or support the operations of the acquired business after closing.

Post-closing disputes relating to Earn-Out provisions often involve allegations that a buyer failed to operate an acquired business in a manner consistent with the effort required to generate the potential Earn-Out. The litigation outcomes often turn on whether the parties included specific management provisions in the acquisition agreement. Did the buyer satisfy its contractual obligations, if any, to the seller relating to post-closing operations? If the acquisition agreement was silent on the post-closing operating standards, did the acquiring company have an implied obligation to maximize the seller's Earn-Out payments, or at least to avoid shortfalls? Or will the seller have to rely on an implied duty of good faith and fair dealing to achieve a favorable litigation outcome.

For these reasons, Earn-Out provisions should be crafted with great care to strike a delicate balance between allowing the buyer operating flexibility to carry on and invest in the acquired business as well as rewarding the seller for

post-closing performance and achievement consistent with valuation assumptions.

Post-closing Earn-Out disputes may ultimately be considered the can of a pre-closing valuation disagreement kicked down the road. But diligent drafting of Earn-Out provisions can be useful to avoid or narrow post-closing disagreements. Careful consideration of acquisition Earn-Out provisions can also be very useful in the pre-closing period to help the buyer's and seller's management teams agree on what steps will be taken to achieve their deal objectives. Sellers will need to anticipate the many risks that could impact their Earn-Out potential and seek contractual provisions to reserve or mandate some aspects of control over the acquired business. Buyers, in

contrast, are interested in maintaining control over the business, typically to achieve optimum long term operating results.

Drafting guidelines and key considerations for Earn-Out provisions:

- ▶ The amount of the potential Earn-Out payment(s) should be clearly stated, including any minimum amounts or caps, and whether each payment involves an all-or-nothing or graduated approach. The amount should be enough to properly reward the seller for potential value, while allowing the buyer to gain from the acquired business operations.
- ▶ If the acquired business is going to be integrated with the buyer's operations, the buyer may wish to exclude synergistic benefits from Earn-Out calculations, if they can be quantified, or if not, to operate the acquired business on a stand-alone basis during the Earn-Out period.
- ▶ Metrics should be defined with great specificity; all parties should carefully consider the extent to which application or interpretation of accounting principles can impact Earn-Out calculations.
- ▶ If the acquiring company is likely to acquire additional businesses during the Earn-Out period, how will future acquisitions impact measurements of operating results of the target business for purposes of determining Earn-Out payments? If the acquiring company itself is acquired by another company during the Earn-Out period, how will that event impact the seller's Earn-Out potential?
- ▶ Buyers and sellers need to carefully consider describing the standards by which a buyer's performance will be measured. Using terms such as “best efforts” or “commercially reasonable efforts” may create more uncertainty than expected, as they don't specifically indicate the buyer's obligations.
- ▶ The length of the Earn-Out period and frequency of payments should be clearly indicated in the purchase agreement. Will Earn-Out payments be made annually, quarterly or monthly, and over how many months or years? Do operating results in one Earn-Out Period carry over to the next, or is each period considered on its own merits? May Earn-Out payments be off-set against the seller's indemnification obligations to the acquiring company?
- ▶ How will contingent Earn-Out payment obligations be treated (or limited) under the acquiring company's credit agreements? Will the acquiring company's lender require Earn-Out payments to be subordinated to the lender's claims against the buyer?
- ▶ Federal and state tax and securities law considerations may also affect the nature and structure of Earn-Out provisions.

Until buyers and sellers find a better way to bridge valuation gaps, Earn-Outs are expected to remain a useful tool, and should be carefully designed and constructed to meet buyers' and sellers' objectives.

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Some Considerations on "Consideration"

by Jason Wisniewski, Partner, Dorsey & Whitney LLP

Recently, many non-public company buyers have begun issuing equity as consideration for the acquisition of target companies. Sellers have also been more receptive to accept equity in non-public company buyers. Using equity as purchase price consideration has many benefits for both buyers and sellers. However, issuing illiquid, non-public equity in connection with an acquisition poses unique issues to both the buyers issuing the equity and the seller's shareholders accepting the equity.

When structuring and negotiating acquisitions in which illiquid, non-public equity is being issued as consideration, buyers, sellers and their legal counsel should carefully consider and address these unique issues:

► **Indemnity.** Acquisition agreements should specify what effect indemnity claims will have on the shares of buyer's stock issued as purchase price consideration until all indemnity obligations have been satisfied. The parties should consider the right of buyer to hold stock in escrow and cancel or claw-back shares to satisfy indemnity claims. Sellers should also ensure that the methodology and timing for valuing the shares for indemnity purposes is clearly set forth in the agreement.

► **Post-Closing Ownership.** The parties should ensure that the obligations of the seller's shareholders receiving buyer stock are clearly documented in appropriate shareholder agreements, such as duties to keep information of buyer confidential, voting obligations, appropriate restrictions on stock transfers and repurchase rights. Having issued illiquid, non-public equity, the agreements should address rights to obtain liquidity for the buyer's shares before the buyer conducts an IPO, such as any "put rights" and the valuation to be used, or registration rights for the seller's shareholders in connection with an IPO.

► **Disclosure.** Issuing stock involves the issuance of securities under both federal and state securities laws, and the seller's shareholders making an "investment decision" when approving the transaction. Buyers will be liable for any material misrepresentations made to the seller's shareholders in connection with the issuance of the shares. Buyers should anticipate having to make enhanced disclosure to the seller's shareholders that are not customarily given in an "all cash" deal. The parties should also carefully analyze the status of seller's shareholders to determine what level of disclosure is required and the ability to issue such shares given the level of disclosure buyer anticipates providing.

► **Taxes.** Many transactions utilizing stock as consideration are structured as a "reorganization" for federal tax purposes, which is a primary benefit realized by the seller's shareholders. The amount and type of stock issued in a transaction are critical in determining if a transaction will qualify as a "reorganization". The parties should carefully review and limit any provisions in an acquisition agreement that could inadvertently cause the transaction not to qualify as a "reorganization," for example, provisions allowing the seller's shareholders to "elect" to acquire stock or cash.

Issuing illiquid, non-public equity as consideration in connection with an acquisition raises many issues for both buyers and sellers not customarily encountered in a typical "all cash" deal. Buyers and sellers must retain experienced legal counsel that understand these unique issues to ensure that each of their respective interests are protected.

Jason Wisniewski

Jason helps start-ups, emerging growth companies, and mature companies achieve key business objectives and unlock shareholder value by assisting them in various stages of financings, capital raising transactions and mergers and acquisitions. Contact Jason Wisniewski at wisniewski.jason@dorsey.com or 714.800.1456.



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Is CFIUS Biased Against China Investors?

by Daniel Anziska & Larry A. Cerutti, Troutman Sanders LLP

On September 13, 2017, President Trump took the unusual step of issuing an Executive Order blocking the China-backed investment firm Canyon Bridge Capital Partners Inc. from acquiring U.S.-based Lattice Semiconductor Corporation due to national security concerns. While this was only the fourth time during the past 30 years that a President has issued such an order, two of these orders have come in the past year.

The Committee on Foreign Investment in the U.S. (CFIUS) has the authority to block foreign investment in the U.S., or impose mitigation measures, when a transaction “threatens to impair the national security of the United States.” Parties to a covered transaction are not required to seek CFIUS pre-clearance before proceeding with the transaction. However, where parties elect not to seek pre-clearance, CFIUS may initiate its own review of the transaction, which could result in the divestiture of the acquired assets if there is a determination to block the transaction.



Recently, CFIUS has been exercising increased scrutiny over covered transactions involving prospective Chinese acquirers. In addition to the blocked Lattice transaction, CFIUS has recently challenged a number of China-initiated advanced technology transactions / investments including with respect to Inseego’s MiFi business, Global Eagle Entertainment’s in-flight services business, Aixtron’s chip equipment business, Philips’ Lumileds lighting business and Western Digital’s storage solutions business.

CFIUS’ recent scrutiny has also expanded into areas other than advanced technology. For example, CFIUS recently required China-based Oceanwide Financial to refile its CFIUS notification regarding its proposed acquisition of U.S. insurer, Genworth.

However, CFIUS has cleared a number of large acquisitions by China investors over the past few years including ChinaChem/Syngenta; Global Foundries / IBM; Beijing Jianguang Asset Management / NXP and Shuanghui / Smithfield Foods.

Based on these events, U.S. companies seeking China investors and/or acquirers should be sensitive to the following:

- ▶ The U.S. government appears committed to carefully scrutinizing prospective transactions that would result in a Chinese investor acquiring control of a business with U.S. technology or assets.
- ▶ CFIUS appears to be construing “national security” more broadly to include issues such as cyber-threats, access to data about U.S. citizens, food and agriculture supply chain threats and financial system risk.
- ▶ Proposed legislation is being considered that would broaden CFIUS’ jurisdiction to include overseas joint ventures, technology transfers and passive investments. It is difficult to predict the outcome of such legislative efforts, but bipartisan CFIUS reform is a distinct possibility.
- ▶ A substantive assessment of any transaction or investment that could implicate CFIUS should be considered before any agreement by a China investor is executed. The costs — both in fees and time— of CFIUS compliance can be significant and a failure to file could result in a CFIUS-led investigation and divestiture order.

For more information, feel free to contact us at larry.cerutti@troutman.com or daniel.anziska@troutman.com.

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Larry Cerutti is a partner in the firm’s Orange County office, where he is a senior member of the firm’s corporate section and managing partner of the Orange County office. His practice focuses on mergers and acquisitions, public and private securities offerings, corporate governance, and related corporate and securities counseling.



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Dan Anziska is a partner in the firm’s New York office, where he focuses his practice on antitrust and related regulatory issues. Over the past 15 years, he has participated in a wide range of antitrust lawsuits, on both the plaintiff and defense side.



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<p>Not Publicly Disclosed</p> <p>Acquisition by Douglas Elliman of California, Inc.</p>	<p>\$250,000,000</p> <p>Acquisition by Petrolia Inc</p>	<p>\$1,300,000,000</p> <p>Acquisition of Gland Pharma Ltd.</p>	<p>Not Publicly Disclosed</p> <p>Acquisition of Clarity Ventures, Inc.</p>
<p>\$1,000,000,000</p> <p>Acquisition by Windstream Holdings, Inc.</p>	<p>\$78,000,000</p> <p>Acquisition of Illinois Corn Processing, LLC</p>	<p>\$950,000,000</p> <p>Acquisition by EQT Infrastructure</p>	<p>\$34,007,000</p> <p>Acquisition by Western Digital Technologies</p>

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Quality of Earnings Report – Key Considerations for Entrepreneurs and Their Advisors

Entrepreneurs face complex issues and difficult decisions when contemplating growth or exit strategies for their business. Successful transactions require careful and thoughtful analysis to maximize value to a buyer or seller of a business. Seeking an advisor to assist with financial due diligence is a key factor that will help to promote deal success.

What is financial due diligence or a Quality of Earnings Report? Although the scope of work may vary from one M&A transaction to the next, financial due diligence is often described as providing a buyer (or seller) with an assessment of the unique risks and opportunities of a target company. Often the central focus with regard to financial due diligence is validating or confirming a target company's key financial metrics such as sales, gross margins, EBITDA (before and after adjustments – more to follow on this concept), operating cash flows and working capital requirements.



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Common financial accounting and business issues include the following:

1. Has the seller understated income historically for income tax purposes?

- Common example is under-reporting inventory
- Making adjustments for this can sometimes be more of an "art" than a "science"

2. Working capital adjustments gone wrong

- Are the accounting policies and methods consistently applied?
- What is included and not included in working capital?

3. Earn-outs ("contingent consideration")

- Should the earn-out be based on revenue or earnings?
- How are earn-outs accounted for under the latest GAAP rules?

4. Personal/Owner expenses

- Common examples are airplanes, condos, country club dues, travel
- Where are the expenses recorded in the books and records?

5. Poor internal accounting and lack of internal controls

- Has the target company had annual audits and reviews?
- Diligence is often focused on interim financial statements, how do the monthly financials differ from the annual financials? (The results of this diligence can affect

representations and warranties, in addition to purchase price)

6. Non-recurring revenues/expenses

- Are they really one-off?
- How should they be quantified?

7. Out of period income or expense

- Has the target company released accruals and reserves on the balance sheet to inflate income?
- Do current year financials include charges that should have been recognized in prior periods? (for example switching from cash to accrual or setting up reserves for the first time)

8. Key executives/employees leaving the business

- How much does the business depend on the skills, relationships, and overall leadership of the selling shareholder or key executive? (Consider having seller retain an ownership post-close)
- Who owns the key customer relationships?

9. Concentration risk (customers/vendors)

- What are the chances a key customer or vendor could be lost? (Most buyers will contact key customers during due diligence)

10. Unrecorded liabilities

- How will they be identified?
- What are the EBITDA implications?

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Mike Thielman

Mike Thielman is an audit partner and oversees the firm's audit department in Orange County. Mike co-founded the firm's M&A group and leads the financial due diligence team. Visit HCVT's website at www.hcvt.com. Contact Mike directly at miket@hcvt.com or 714.361.7666.

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The Seaworthy Seller: Preparing for the M&A Voyage.

By: James J. Scheinkman, Partner - Snell & Wilmer



To expand upon a quote from JFK, a rising tide lifts all boats, but not all boats are seaworthy. Similarly, while the longstanding favorable M&A market of the last several years has benefited many owners of midmarket businesses, many other owners who have not prepared for the M&A process have found themselves unable to sail off into the proverbial sunset.

Business owners who focus on the following four most important tasks in advance of the sale are much more likely to be satisfied with the outcome:

1. **Prepare** to execute (get the deal done).
2. **Prepare** to demonstrate the sustainability of future increasing cash flows.
3. **Prepare** to demonstrate mitigation of risk to the buyer.
4. **Prepare** to maximize net proceeds from the sale.

Here's why these four steps are so important:

- *Most buyers evaluate a business based on the risks associated with the ability to generate sustainable and increasing cash flows.* In order to convince a buyer to pay more, the successful seller will have evaluated the ongoing risks to the business in the same manner as the buyer and will have proactively reduced those risks. The successful seller will have also established that the company has the infrastructure and programs in place to sustain future increasing cash flows.
- *Sellers must know their business well enough to survive the due diligence gauntlet.* To evaluate the risks to, and confirm the likelihood of, future sustainable and increasing cash flows associated with the business, many buyers engage accountants, lawyers, internal diligence and integration teams, insurance experts, environmental consultants, and others, to perform "due diligence" on all aspects of the business. To the extent 1) a seller has not performed diligence on his or her own business, 2) is not prepared to answer questions and provide in-

formation and documents satisfactorily and on a timely basis, or 3) does not understand his or her business better than the buyer does, the more risk there is of the deal not closing at the purchase price originally negotiated or not closing at all.

- *Time is the seller's enemy.* Once a letter of intent is signed, it is not uncommon for the purchase price to go down and very rare for it to go up. A seller needs to be prepared to execute the transaction quickly. If there are delays because a seller cannot execute on a timely basis – say due to disagreements or issues among the multiple owners of the business, incomplete corporate organizational documents, pending employee issues or litigation, unidentified approvals from third parties to sell the business or a host of other reasons – the risk of an unsuccessful sale outcome dramatically increases.
- *It's the net purchase price proceeds, not the gross purchase price proceeds, which matter the most.* The lesson that many of us learned when receiving our very first paycheck also applies to

the sale of a business: It's not just how much you make; it's also about how much you get to keep. Take for example the organizational form and tax status of your business. If the business is organized as a corporation and taxed as a "c corporation," a deal structured as an asset sale may be problematic, and a stock deal may not be palatable to the buyer.

"...we have helped many business owners navigate the most important transaction they will ever enter into; that being, the sale of their businesses."

There are multiple legal and business questions to consider in order to successfully accomplish the four tasks listed above.

As lawyers at a full-service business law firm with more than 400 attorneys and a very active M&A practice, we have helped many business owners navigate the most important transaction they will ever enter into; that being, the sale of their businesses. Bon Voyage!

For a more expansive discussion of transitioning your business, please see the Business Transition Checklist co-authored by Jim Scheinkman at www.swlaw.com/Business-Transition-Checklist.

Jim Scheinkman is a practice group leader with Snell & Wilmer's Corporate and Securities Group. His practice focuses on assisting mid-market companies and their owners in mergers and acquisitions, financings, joint ventures, corporate governance and shareholder dispute resolution, securities offerings, technology development and transfers, executive compensation and other corporate and commercial matters. Jim also serves as general outside counsel for a variety of mid-market businesses. Reach Jim at jscheinkman@swlaw.com or 714.427.7037.

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Restricted Stock: Should You Pay Tax Now or Later?

by Curtis Campbell, CPA, MST

For companies involved in mergers and acquisitions, equity-based compensation is a powerful tool for retaining, as well as attracting, executives and other key employees. If you receive an award of restricted stock or purchase shares subject to vesting, consider making an election under Internal Revenue Code Section 83(b) to accelerate taxable income associated with the stock.

Two Ways Sec. 83(b) Reduces Taxes

Accelerating income may seem counterintuitive but if the stock's growth prospects are strong and the risk of forfeiture is low, a Sec. 83(b) election can generate significant tax savings. Ordinarily, restricted stock isn't subject to tax until it vests. At that time, however, you're subject to tax at ordinary-income rates on the stock's vesting-date value (less the purchase price you paid, if any). This can result in a substantial tax bill if the stock has appreciated significantly in value.



A Sec. 83(b) election can reduce your taxes in two ways:

1. If the stock's value increases, the election minimizes ordinary-income taxes by allowing you to pay the tax on the grant or purchase date value rather than on the vesting date value. If you purchase the stock at its fair market value, you'll recognize *zero* income on the purchase date.
2. It accelerates the start of the one-year long-term capital gains holding period to the grant or purchase date rather than the vesting date. Remember, long-term capital gains rates are lower than ordinary-income rates.

Bear in mind that you can't take too long to decide whether to make the election: You have only 30 days from the award or purchase date.

A Sec. 83(b) Election in Action

Let's say Patricia's employer grants her 10,000 shares of restricted stock with a fair market value of \$1 per share. When the stock vests one year later, its value has grown to \$10 per share. Patricia sells the stock a year after the vesting date

for \$25 per share. Assume that Patricia is in the 35% tax bracket and that her long-term capital gains tax rate is 15%. (To keep things simple, we'll ignore state and payroll taxes.)

If Patricia doesn't make a Sec. 83(b) election, no tax will be due when the stock is granted. When the stock vests, however, Patricia will recognize \$100,000 in ordinary income ($10,000 \times \$10$), resulting in a \$35,000 tax bill. When Patricia sells the stock a year later, she'll recognize a long-term capital gain on the stock's additional appreciation of \$15 per share, resulting in a \$22,500 tax bill ($10,000 \times \$15 \times 15\%$). Patricia's total tax liability is \$57,500.

Now, let's assume that Patricia files a timely Sec. 83(b) election when the stock is granted. She'll pay tax on \$10,000 in ordinary income as of the grant date (\$3,500), but when she sells the stock two years later, all of its appreciation in value (\$24 per share) will be treated as a long-term capital gain, resulting in a \$36,000 tax bill ($10,000 \times \$24 \times 15\%$). Her total tax liability is \$39,500. By making the election, Patricia enjoys \$18,000 in tax savings.

Consider the Risks

Be aware that a Sec. 83(b) election isn't risk-free. If you forfeit the stock (because, for example, you leave the company before it vests) or the stock declines in value, you'll have paid tax on income you didn't receive. You also might end up paying more tax than necessary if tax rates go down. Your tax advisor can help you weigh the pros and cons.

Curtis Campbell

Curtis Campbell, CPA, MST is a partner at HMWC CPAs & Business Advisors (www.hmwccpa.com), one of Orange County's largest local accounting firms. Contact him at 714.505.9000 to discuss how your company or client could benefit from HMWC's services.



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