

SUCCESSFUL PLANNING AND EXIT STRATEGIES FOR GOVERNMENT CONTRACTORS IN 2015 AND BEYOND

LEGAL UPDATE



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HOW TO POSITION YOUR BUSINESS TO REAP THE BENEFITS OF A LIQUIDITY EVENT

- ❖ Big Picture Perspective
 - Develop a “master strategic plan”
 - Chart a strategic path from the beginning, BUT, adjust it as needed going forward
 - For government contractors, portfolio of contracts and backlog = a big factor dictating potential buyer pool and driving terms of offer
- ❖ Minimize sale of the company as owners’ retirement nest egg
 - When possible, over time, take some chips off the table (money out of the company) for retirement planning/investing
 - Buyer’s valuation of company and offer is formulaic – it’s all about the numbers and value versus owners “lifestyle” valuation



HOW TO POSITION YOUR BUSINESS TO REAP THE BENEFITS OF A LIQUIDITY EVENT

- ❖ **Manage expectations**
 - Owners drill down on “what’s my company worth”
 - Recast financial statements – e.g., remove/adjust non-recurring or excessive items
 - Project revenue and earnings over next five years
 - Engage in a honest self-evaluation (know company’s strengths and weaknesses)
- ❖ **Plan Ahead**
 - Comprehensive due diligence checklist for an internal review and check-up
 - Importance of good business owners agreement (including buy-sell)
 - Develop a strong management team and key employee base



HOW TO POSITION YOUR BUSINESS TO REAP (INTERNAL REVIEW AND CHECK-UP)

- ❖ Use of comprehensive DD checklist for company internal review and check-up (in advance of a buyer doing the same)
 - Governing documents, corporate records and ownership records
 - Management
 - Assets
 - Financial (financial statements, debt, liens, security interests)
 - Contracts
 - IP
 - Labor/employment (employee benefit plans)
 - Taxes (federal and state tax returns, disputes)
 - Insurance
 - Litigation
 - Regulatory (licenses, permits)



HOW TO POSITION YOUR BUSINESS TO REAP (INTERNAL REVIEW AND CHECK-UP)

- ❖ Are the company's books and records in order and up to date?
 - Company complying with its articles and bylaws?
 - Shares issued in excess of authorized capital stock?
 - Operating agreement says member-managed but company manager-managed?
 - S-corporation but non-pro rata distributions to owners (tax issue)?
 - Ownership records showing clear chain of title?
 - Documentation on all prior stock issuances and transfers?
 - Financial statements reviewed or audited by independent auditors?
 - Makes lenders and buyers more confident in company's position and company's information
- ❖ What's the consequence of such deficiencies?
 - Could impair a company's ability to borrow money at a critical time
 - Could have a chilling effect on a buyer's interest in a transaction



STRATEGIC AND STRUCTURING CONSIDERATIONS (BUSINESS OWNERS AGREEMENT)

- ❖ A good business owners agreement = good business planning
 - Governance
 - Majority rule
 - Control over BoD; manager-managed vs. member-managed
 - Drag-along rights, tag-along rights
 - Deadlock provisions if no majority rule
 - Ownership
 - Specify ground rules for ownership
 - For example, ownership tied to active participation in company's day-to-day business and operations
 - Buy-out rights
 - Based on “triggering events” – death, disability, cessation of employment, disassociation



STRATEGIC AND STRUCTURING CONSIDERATIONS (BUSINESS OWNERS AGREEMENT)

- ❖ Hypothetical Scenario: Business Relationship among Owners Has Soured
 - 3 individuals form an LLC to perform government contracting work
 - One majority owner, two minority owners
 - Basic operating agreement – no dissociation and/or buy-out rights
 - For several years owners are in harmony, after that they differ on business development and corporate strategy matters
 - Relations deteriorate, company profitability and employee morale suffer
 - What possible remedies? Partial but not full remedies



STRATEGIC AND STRUCTURING CONSIDERATIONS (EMPLOYEE INCENTIVE COMPENSATION)

- ❖ Key Question: have the owners positioned the company to access, recruit, retain and motivate the talent necessary to compete and succeed in this challenging environment?
- ❖ Use of employee incentive compensation to develop a strong management team and key employee base

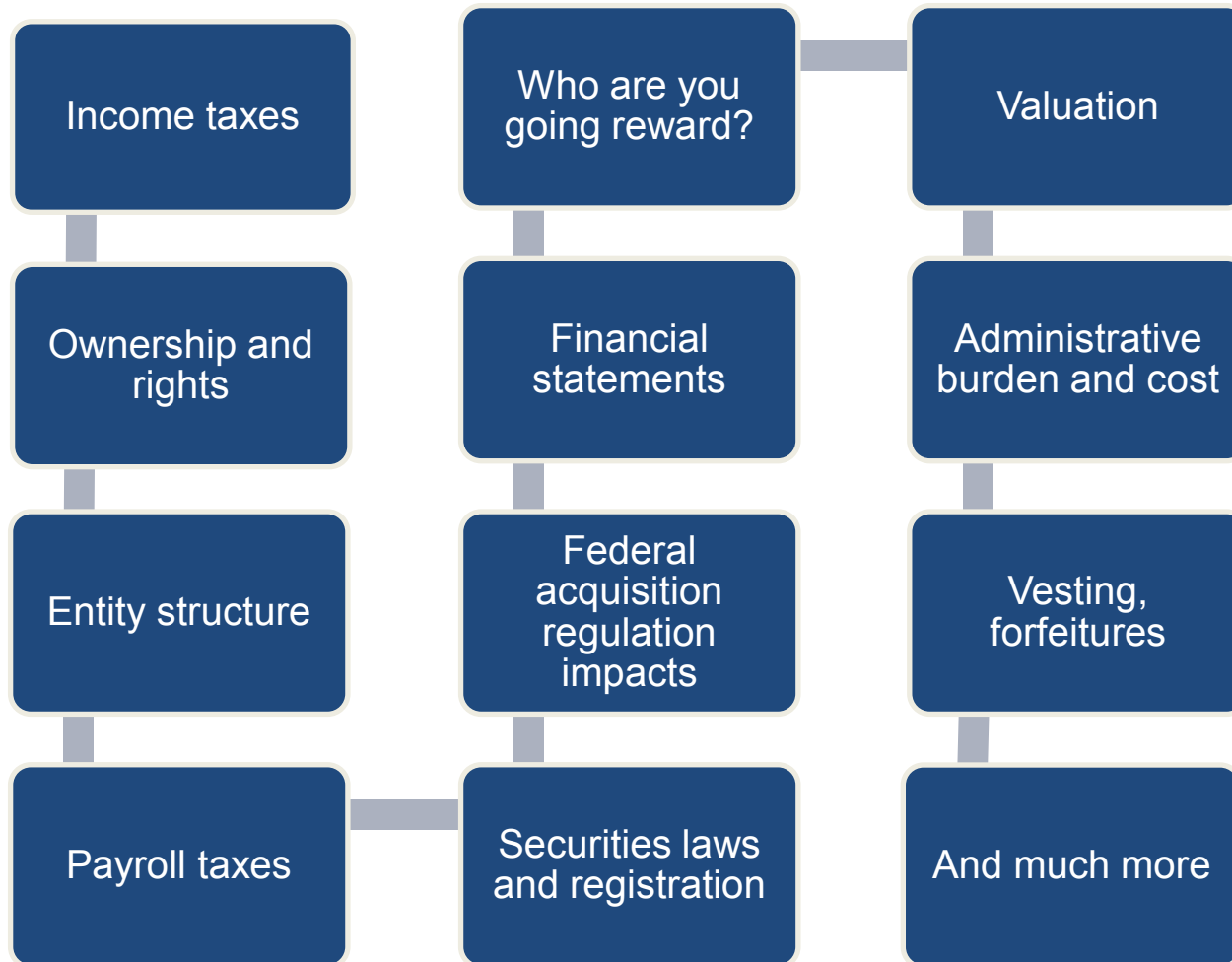


STRATEGIC AND STRUCTURING CONSIDERATIONS (EMPLOYEE INCENTIVE COMPENSATION)

- ❖ All forms of incentive plans are helpful in recruiting employees
 - Not a one size fits all
 - Relevant and useful no matter stage of company life cycle
- ❖ Some incentive plans are more retention-oriented (e.g., RSUs or phantom stock)
 - “full elevator ride” in value
- ❖ Other incentive plans are more motivation-oriented (e.g., SARs plan or cash bonus plan)
 - Solely increase above floor value



DETERMINING THE APPROPRIATE “STARTING POINT”





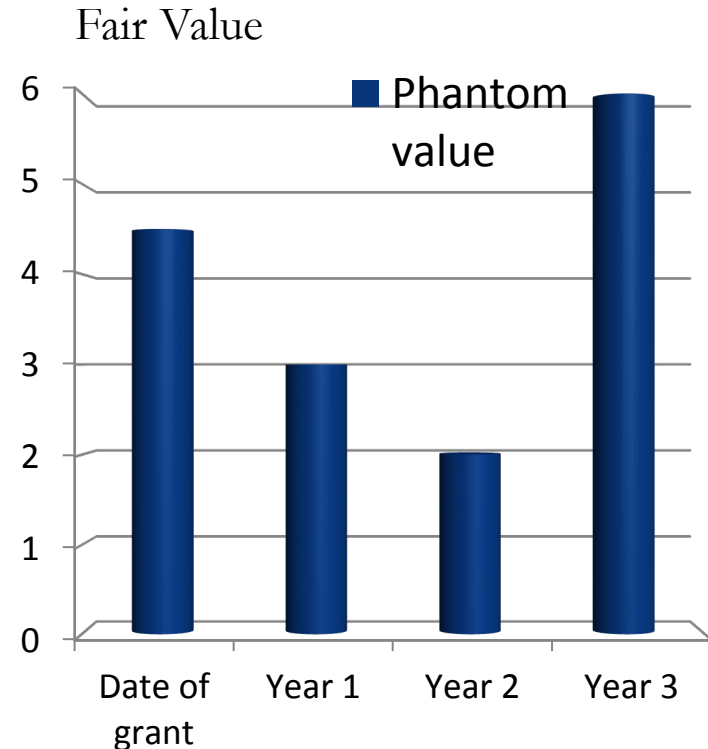
STRATEGIC AND STRUCTURING CONSIDERATIONS (EMPLOYEE INCENTIVE COMPENSATION)

- ❖ Does the company want to share real equity?
- ❖ How much of the company's equity or equity value is to be shared?
- ❖ Will awards be paid in stock or cash?
- ❖ Which employees will be eligible to participate (executive officers versus “rank and file”)?
- ❖ Will employees have to make a monetary contribution to get the equity value?
- ❖ How and when will liquidity events occur?
- ❖ How is the award earned and can the company take it away?



EQUITY LINKED INCENTIVES: PHANTOM STOCK

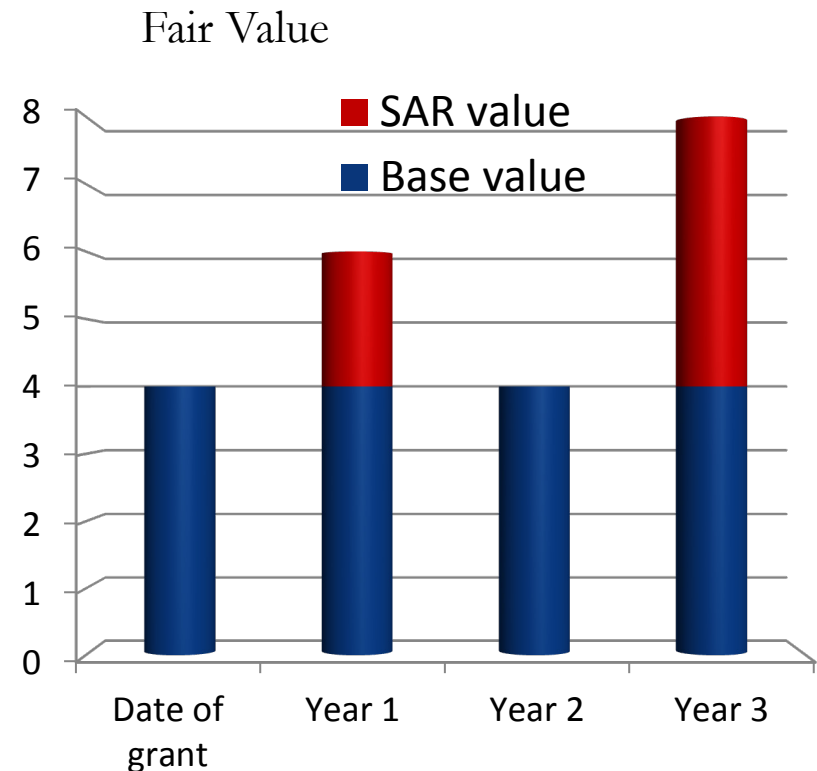
- ❖ Not real equity/ownership
- ❖ Typically no capital investment required
- ❖ Typically structured for immediate value
- ❖ Typically established to balance motivation versus retention
- ❖ Separate account to track increases and decreases
- ❖ Benefit = full elevator ride in value
- ❖ No appreciation = should **STILL PROVIDE BENEFIT**





EQUITY LINKED INCENTIVES: STOCK APPRECIATION RIGHTS (SAR/UAR)

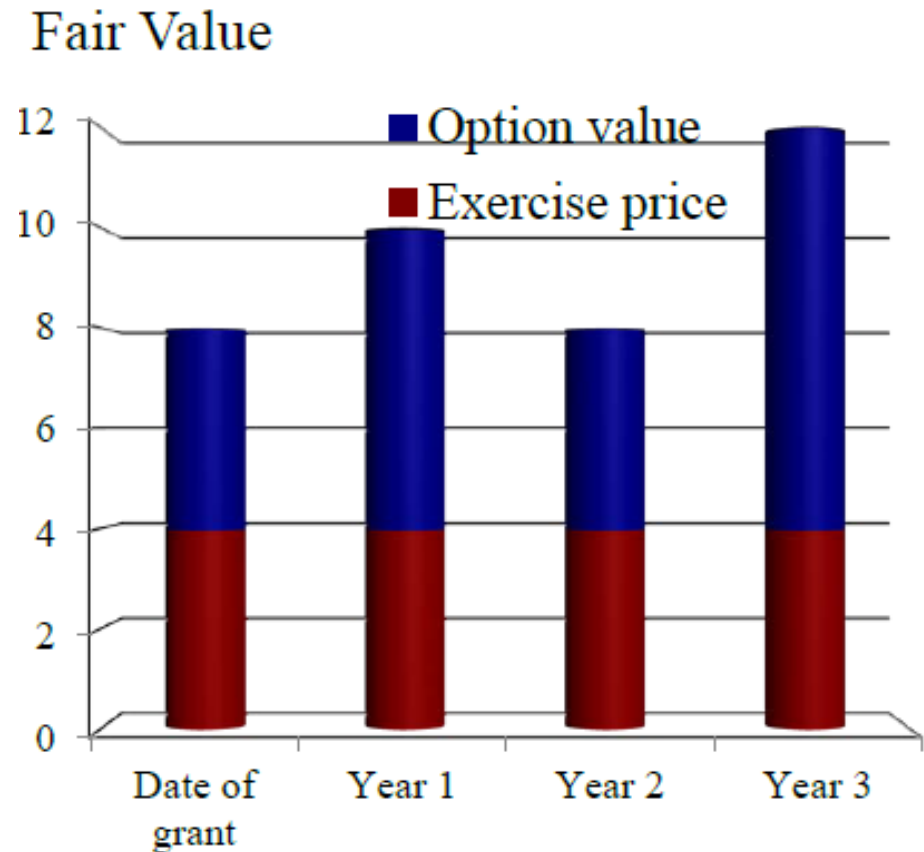
- ❖ Not real equity/ownership
- ❖ Base value fixed/set at date of grant
- ❖ No investment required
- ❖ Typically established to motivate increasing equity value (versus retention)
- ❖ Separate account to track increases and decreases
- ❖ Benefit = appreciation above floor value
- ❖ No appreciation = NO BENEFIT





EQUITY (OWNERSHIP) INCENTIVES: STOCK OPTION PLAN

- ❖ Real equity/ownership occurs upon exercise
- ❖ Typically some capital investment required (exercise); Recipient has financial investment at risk
- ❖ Can be structured for immediate and/or future value
- ❖ Benefit = full elevator ride in value, share in ownership rights
- ❖ No appreciation = may still provide benefit (non-statutory option)





TO PUT IT IN PERSPECTIVE...

A HYPOTHETICAL CLIENT SCENARIO

Company Background:

- Single owner, S corporation
- Owner inclined to not issue equity
- 7 year anniversary of company's existence
- Revenue \$10 million
- FMV of stock is \$5 per share value
- Culture: cash oriented

Goals:

- Planning for exit strategy (“sale of the company”) within 5 to 7 years
 - **Reward** 2 key longstanding employees
 - **Recruit** someone in the healthcare IT space
 - **Motivate** company's employee base
 - **Retain** key personnel through the closing of a “sale of the company” transaction



HYPOTHETICAL CLIENT SCENARIO (CONT'D)

Possible Solution:

- Retain/Reward: Long term incentive agreement
 - Cash or phantom stock
- Motivate/Recruit: SARs plan
 - Management group or key employees
- Cash Bonus Plan
 - Select employee pool – business development and sales people



MAXIMIZING THE VALUE OF “SMALL BUSINESS” STATUS

- ❖ “Former Affiliate” Rule
- ❖ Joint Ventures
- ❖ Mentor Protégé



USE THE FORMER AFFILIATE RULE IN CORPORATE PLANNING AND RESTRUCTURING

- ❖ SBA's rules do not say once affiliated, always affiliated
 - Affiliations can change/lessen over time
- ❖ Former affiliate rule: allows a company to back out the revenues/employees of a former affiliate from the company's revenues/employees – for the entire time period used to measure its size



ABOUT JOINT VENTURES

❖ Main Characteristics:

- Co-management
- Sharing profits and losses
- Limited duration

❖ Competing as a Joint Venture:

- Joint Ventures should be formed before submitting offer
- Agreement should provide for contract performance
- FAR requires disclosure in the proposal

❖ Forms of Joint Venture

- Partnership
- Limited Liability Company
- Corporation



JOINT VENTURES

- ❖ JV Revenue versus Prime-Sub Relationship
- ❖ Default Rule in JVs: JV partners are generally affiliated for a contract
 - JV will, therefore, be considered a small business only if the combined size of the JV partners meets the size standard for the contract
- ❖ JV partners can also be deemed affiliated for all purposes if the JV is awarded more than 3 contracts in a 2-year period
- ❖ Exception to JV affiliation:
 - When each JV partner is small under the applicable size standard and either:
(1) the procurement is bundled or consolidated (rare situation); or (2) the procurement exceeds one-half the size standard (revenue based) or \$10 million (employee-based)
 - Joint Ventures between 8(a) protégé and SBA-approved mentor



Business & Corporate Law Group

- We represent clients on business and corporate matters in all phases of their business life cycle, from start-up to sale of the company. We advise clients on entity formation and structure, draft documents that serve as the backbone for clients' companies as they grow, and assist with all aspects of an exit strategy.

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Limited Liability Companies

Joint Ventures

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Employee Incentive Plans

- Stock Option Plans
- Equity Linked (Stock Appreciation Rights, Phantom Equity)



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Weekly Update – an email sent every Friday that provides an up-to-the minute recap of legislative and regulatory issues affecting small businesses.

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