LEGAL ADVISOR

A PilieroMazza Update for Federal Contractors and Commercial Businesses

Business and Corporate Special Issue

We are excited to bring you this special edition of *The Legal Advisor* focused on our Business & Corporate Group. The articles in this issue highlight the diverse array of matters handled by our Business & Corporate Group, as well as how the group is fully integrated with our Government Contracts, Small Business, and Labor & Employment Groups to deliver practical, timely, and comprehensive solutions for our clients. Whether you are interested in forming a new business, bringing on an investor to an existing business, corporate governance, buying and selling assets or stock, or a myriad of other business issues, our Business & Corporate Group can help you develop and execute the right strategy and solution for your business.

Jon Williams, Editor

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Understanding the Impact of M&A on Pending Proposals

By Kimi Murakami

When our corporate team is working with a buyer or seller on an M&A transaction, we are often asked about what will happen to pending proposals. Specifically, clients often ask if pending proposals can be novated from the seller to the buyer. The short answer is no, a proposal cannot be novated. The Anti-Assignment Act, which prohibits the transfer of awarded government contacts from the original contract holder to a third party, is silent as to proposals. There is no parallel process for pending proposals as found in the novation regulations for the transfer of awarded contracts to a successor-in-interest.

That said, the fact that a pending proposal cannot be novated does not mean it cannot be included as a valuable asset in the M&A transaction. To maximize the value of pending proposals for buyers and sellers, steps should be taken to ensure the government will recognize the buyer as the successor-in-interest to the proposal. A common practice is to notify the customer and explain why the transaction will have no affect on the proposal. Ideally, you will be able to explain that all of the assets relied on in the proposal are transferring to the buyer so the government should feel comfortable that the pending proposal is unaffected by the transaction.

In transactions where the buyer is the complete successor-in-interest to the seller, the buyer should be able to confidently acquire the seller's pending proposal. This is because the U.S. Court of Federal Claims ("COFC") has held that a pending proposal remains viable when transferred to a buyer that is the complete successor-in-interest to the seller. See L-3 Communication Integrated Systems L.P. v. U.S., 84 Fed. Cl. 768 (2008) ("a bid or proposal may be assigned to an offeror's complete successor-in-interest").

However, the parties may have less confidence in the acquisition of a pending proposal when the buyer is

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not the complete successor-in-interest to the seller. The potential risk in this situation is shown in U.S. Government Accountability Office ("GAO") protest decisions. In Wyle Laboratories, Inc., B-408112.2 (Dec. 27, 2013), GAO found "there can also be no dispute that the substitution of a new prime contractor, in place of the original offeror, may well have a material effect on both the costs incurred and technical approach employed during contract performance." Additionally, in FCi Federal, Inc., B-408558.7 (Aug. 5, 2015), the proposal at issue relied on the resources of the offeror's parent company. As a result, when the offeror was sold and no longer had the same parent company, the offeror's proposal relying on the former parent "no longer reflected the manner in which the contract will be performed and the resources, experience, and past performance to be relied upon in the performance of the contract."

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A similar risk exists for a buyer in attempting to file a protest challenging an agency's failure to select a proposal acquired from a seller. In Universal Protection Service, LP v. U.S., 126 Fed. Cl. 173 (2016), after ABM Security Services submitted an offer it was acquired by Universal. Ultimately, a different contractor was awarded the contract and Universal filed a protest. The COFC held that Universal was not a successor-in-interest to ABM Security Services, and, therefore, Universal did not have standing to challenge the award.

Another potential consideration unique to small business contractors is whether the M&A transaction triggers the need to recertify size status for the pending proposal. Before last year, there was no rule requiring size recertification on pending proposals. But SBA added such a rule in 2016. The new rule states that, if a merger, sale, or acquisition occurs after offer but prior to award, the offeror must recertify its size to the contracting officer prior to award.

Small business contractors also have to be mindful of how an M&A transaction may affect pending proposals under SBA's affiliation rules. SBA's so-called "present effect rule," if triggered, will treat a pending transaction as if it has already been completed. Therefore, if you are considering starting an M&A transaction before submitting proposals for critical small business contracts, you need to consider whether the contemplated M&A transaction, if SBA gives it present effect, will have an adverse affect on those proposals.

The above is intended to demonstrate that proposals can be included in M&A transactions, but there are unique considerations that must be carefully considered to ensure the buyer and seller maximize the value and potential of those proposals in the transaction. Our Business & Corporate Group, working closely with our Government Contracting and Small Business Groups, regularly advises clients on this and many other aspects of M&A transactions.

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Size Matters: Corporate Strategies for Maintaining Small Business Status

By John Shoraka

Through my experiences working with small businesses as the Associate Administrator of Government Contracting and Business Development at SBA, I have seen first-hand how a company's small business status can be a critical tool to develop as a contractor working with the federal government. And I have also seen how when companies grow beyond their size standard, many will fail because they are not ready to compete with the "big boys." So I really appreciate the importance of protecting your small business status. With PilieroMazza Advisory Services, one of the areas I am focusing on is working with the firm's corporate group to share strategies with our

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The *Legal Advisor* is a periodic newsletter designed to inform clients and other interested persons about recent developments and issues relevant to federal contractors and commercial businesses. Nothing in the *Legal Advisor* constitutes legal advice, which can only be obtained as a result of personal consultation with an attorney. The information published here is believed to be accurate at the time of publication but is subject to change and does not purport to be a complete statement of all relevant issues.

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clients to help them plan ahead and maintain their small business status.

One of the strategies that small businesses can employ when approaching their size standard is divesting a part of their business. If structured correctly according to SBA's rules, when a small business sells part of the business it will trigger SBA's "former affiliate" rule. The former affiliate rule says that "annual receipts of a former affiliate are not included if affiliation ceased before the date used for determining size. This exclusion of annual receipts of a former affiliate applies during the entire period of measurement, rather than only for the period after which affiliation ceased." 13 C.F.R. § 121.104(d)(4). This means that, by selling a "former affiliate," a small business concern can retroactively remove the former affiliate's last three years of revenue from the small business's revenue when calculating size. This can be a real win-win for the buyer and the seller. The buyer obtains valuable assets and the seller (which may have been approaching or even exceeding its size standard) can stay small or immediately become a small business again.

Of course, the success of this strategy depends on how the transaction is structured. The devil is in the details and it is important to be mindful of SBA's rules (and their thinking) when putting the deal together. That is how we work with the firm's corporate group to marry the SBA experience with our corporate expertise. Most importantly, we have to ensure there is a clear fracture between the seller and whatever was sold. To demonstrate clear fracture, all prior links between the small business and the former affiliate should be eliminated. That means you have to be mindful about ongoing connections between the seller and what was sold, including continuing guarantees on the line of credit, ongoing financial or administrative assistance, continued intermingling of management, ongoing contractual performance together, or continued sharing of facilities or other resources. We also have to be mindful of how the deal structure is impacted by the status of the former affiliate prior to the sale (i.e., was the former affiliate a distinct division or subsidiary of the seller, or was it indiscreetly intermingled within the seller?).

A separate strategy I have seen effectively used to manage and control small business revenue growth is to take advantage of joint ventures. In a traditional prime/sub relationship, the small business prime has to count 100% of the contract revenue toward its annual revenue, even if the small business ends up subcontracting a significant portion of the work. But, for joint ventures, revenues generated by a joint venture only count toward the size of a small business in proportion to the work performed by the small business in the joint venture. And, with SBA's new All Small Mentor-Protégé Program in place, all small businesses are able to enter into mentoring relationships and then joint venture with large businesses. Therefore, unlike a prime/sub relationship, entering into joint ventures will allow small businesses to avoid artificially inflating their revenue and stay small longer while still gaining experience at the prime contract level.

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SBA's Mentor-Protégé Program is also useful for small businesses that cannot avoid growing above their size standard. Even if a company grows above the size standard for its primary industry, the program will permit a small business to be a protégé in a secondary industry, as long as it is small in that industry and shows a business progression in that type of work. Additionally, the program permits a company to be both a protégé and a mentor at the same time. You may be able to soften the blow when transitioning to large business status through a mutually-beneficial relationship with a small business protégé.

In conclusion, sale by clear fracture of a former affiliate, joint ventures, and mentor protégé arrangements can all be used as weapons in a company's arsenal for protecting its valuable small business size status and continuing to play in the small business set-aside market place. Know that PilieroMazza Advisory Services is available to discuss any of these strategies.

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Tax Ramifications upon Exiting Your LLC

By David Medalia

Much has been written about the choice of taxable (as opposed to legal) entity in the context of government contractors. While there are certainly specific tax considerations that should be taken into account pertaining to business *formation*, it is equally important to consider the impact that the choice of taxable entity can have upon exiting the business. The tax election can lead to a wide variety of consequences, and has the potential to facilitate or impede a successful business sale.

At the outset, it must be said that limited liability companies ("LLCs") provide the most flexible legal entity through which to operate a business from cradle to grave. An LLC allows its members both the limited liability of a C corporation, and the ability to elect a single layer of taxation, such as in a partnership. In fact, an LLC can elect to be taxed as a subchapter C or subchapter S corporation, or as a partnership. This is in stark contrast with an entity formed as a corporation, which can never elect to be taxed as a partnership, pursuant to Internal Revenue Code ("Code") § 7701(a)(2) and Treasury regulation § 301.7701-3(a). Given these parameters, this article focuses on the tax treatment upon exit from LLCs that elect to be taxed as partnerships and S corporations.

LLCs Taxed as Partnerships

When a member of an LLC taxed as a partnership decides to sell its interest in the business, and if the member sells

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less than a 50% interest in the partnership, then Code § 741 controls. That section grants the seller capital gains rates, except for certain unrealized receivables and inventory items taxed at ordinary rates under Code § 751. A seller is only taxed on the amount it receives above its outside basis in the partnership interest.

For example, let's consider the case of Anthony, who paid $50,000 for a 25% partnership interest in ABCD LLC ("ABCD"). Eleanor later buys Anthony's partnership interest for $100,000. At the time of Eleanor's purchase, Anthony had loaned ABCD $10,000, and had earned $75,000 of partnership income, $40,000 of which ABCD had distributed to him. Breaking it down, Anthony's outside basis would be his initial contribution of $50,000 plus the $10,000 he loaned ABCD, plus the $75,000 in partnership income he earned, minus the $40,000 of distributions he received. The total basis would be $95,000, meaning he would be taxed on $5,000 of capital gain (which would be long-term capital gain if he held the partnership interest for more than a year).

Alternatively, if a partnership interest of 50% or more is exchanged within a twelve-month span, a technical termination is deemed to occur pursuant to Code § 708(b). Using our example above, let's say Eleanor buys the partnership interests of Anthony, Bill, and Chris for $100,000 apiece. Further, each of the three selling partners holds a 25% partnership interest with adjusted outside bases of $95,000, $120,000, and $100,000, respectively. Anthony would have $5,000 of income taxable at capital gains rates to the extent the partnership interest did not involve unrealized receivables and inventory items; Bill would have a $20,000 loss, and would try to claim as much of the amount as possible was related to Code §751 items to obtain an ordinary loss, rather than a capital loss (which can only be offset against capital gains); Chris would break even.

The aggregate acquisition would trigger a technical termination of "old" ABCD, as more than 50% of the partnership would be acquired in a twelve-month span. That would entail old ABCD being deemed to contribute its assets and liabilities to "new" ABCD in exchange for an interest in new ABCD. Immediately thereafter, old ABCD would make a liquidating distribution of partnership interests to Anthony, Bill, and Chris for $100,000 apiece. The technical termination would cause ABCD's tax year to end at the time of sale, and would permit the company to make new partnership elections.

LLCs Taxed as S Corporations

The S corporation has a range of attributes that render it both tempting and dangerous for unsuspecting business owners. It offers limited liability and a single layer of tax, but there are negatives as well. S corporations may only have one class of stock, no more than 100 shareholders, and the IRS has placed limits on who those shareholders can be. Further, if an S corporation violates one of

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the aforementioned limitations, the IRS can impute C corporation taxation onto the entity, resulting in an unwanted second layer of taxation.

In liquidation, shareholders of an S corporation resemble both a partnership and a C corporation. Like a partnership, the shareholders of an S corporation include current year income in their basis, but unlike partners, S corporation shareholders cannot add liabilities assumed to their basis.

S corporation liquidations are subject to the rules of subchapter C. As such, Code § 331 applies to calculate gain or loss to shareholders on complete liquidation. That Code section provides that amounts received by a

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shareholder in a distribution in complete liquidation of a corporation shall be treated as full payment in exchange for the stock. For example, if Eleanor bought 100% of the shares of ABCD, an LLC taxed as an S corporation, for $6 million, each shareholder would be taxed as if he had sold all of his stock back to ABCD for cash. If Anthony had a basis of $1 million in his shares (25% of the company's total shares), which, on a pro rata basis were purchased by Eleanor for $1.5 million, Anthony would have $500,000 of capital gain.

This is just the tip of the S corporation iceberg; the subchapter has a myriad of confusing rules that can thwart uninformed investors. It is important for prudent business owners to take the time to understand the tax consequences of their entity selection on the front end, to ensure they obtain a positive result when it is time to sell.

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For any questions or concerns about this issue, or to submit a guest article, please contact our editor, Jon Williams, at jwilliams@pilieromazza.com or 202-857-1000

Considerations When Bringing on a New Owner

By Peter Ford and Meghan Leemon

The attorneys at PilieroMazza's Colorado office frequently assists businesses in drafting, amending, and negotiating their operating agreements, bylaws, and shareholders' agreements. When this exercise involves a government contractor, it is a good marriage of our government contracts and corporate practices because we can navigate the corporate governance issues with an eye toward applicable federal requirements. That is especially important when the company is bringing on a new owner, which affects the corporate structure and may trigger notification and/or approval requirements with the federal government.

Whatever the reason for bringing on a new owner, it is critical to carefully assess the impact on the company's operating agreement and its contracts with federal customers. For example, the ownership change may trigger a notification requirement to federal customers. If the owner is a foreign entity, this may raise other issues depending on the nature of the company's business. And, if the company participates in small business programs, the government may need to approve of the new owner. The point is that there are many important considerations when you take the plunge and bring on a new owner. This article focuses on how an ownership change can impact federal contractors that participate in small business programs, and how to plan for a smooth exit strategy ahead of time through so-called "business divorce" provisions.

From a small business perspective, the operating agreement must comply with the regulations governing the SBA's contracting programs – e.g., 8(a), SDVOSB, or WOSB. These regulations require the qualifying individual to have unconditional ownership and control of the company. For ownership to be unconditional, the qualifying individual must be able to transfer his interest in the company whenever he wants, to whomever he

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wants. Thus, the operating agreement should not contain transfer restrictions, such as rights-of-first-refusal or tag-along rights, that apply to the qualifying individual.

To unconditionally control the company, the qualifying individual needs to possess the day-to-day management and long-term decision-making authority for the company. In the case of a limited liability company, this means that the qualifying individual must serve as the managing member, with control over all company decisions, and, in some cases, this requires giving the qualifying individual the right to unilaterally amend the agreement. Similarly, the operating agreement cannot provide the new owner with veto rights, meaning there should not be any unanimous consent provisions.

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In addition to these small business considerations, it is equally important to plan ahead so that the company and qualifying individual are protected if things go awry. While, at the outset, the qualifying individual likely has a strong relationship with the new owner, there is always the possibility that the relationship will have to be severed down the road. Thus, from a corporate perspective, the operating agreement should contain a business divorce section.

The business divorce section gives the company and/or a member the right to buy out the other member's interest in the event he is dissociated from the company. Events that trigger dissociation generally fall into one of two buckets – controllable and uncontrollable. Examples of controllable triggering events include a member's termination for cause and bankruptcy of a member. Conversely, uncontrollable triggering events include a member's death, disability, or termination without cause. With respect to a "termination for cause," this should be a defined term in the operating agreement. Defining the term with certainty would help to avoid disputes down the road about what constitutes for cause. Alternatively, the definition could reference examples of cause which would give the parties flexibility to have a termination for cause that is not specifically mentioned in the operating agreement.

In addition, the business divorce section should address how the buy out price is determined when the member's dissociation is due to an uncontrollable triggering event versus a controllable triggering event. For an uncontrollable triggering event, the purchase price could be the fair market value of the membership's ownership interest, whereas the purchase price for a controllable triggering event might be the book value of the ownership interest or a fraction of the fair market value, perhaps 50% or 75%. Furthermore, the operating agreement should provide for a third-party appraiser who will determine the fair market value of the ownership interest in the event that parties cannot reach an agreement on the value, and it is a good idea to identify an appraiser by name in the operating agreement so that this issue is not up for debate if and when the sale/purchase of a dissociated member's ownership interest comes into play. Likewise, the operating agreement should set forth the payment terms for the purchase price. The payout could be in the form of cash, a promissory note, or a combination of both. The payment terms should be specific, but also flexible in case the company or the other member is not in a financial position to make a lump sum cash payment at the time of purchase.

In closing, there are a number of issues to consider when deciding to bring on a new owner. You can successfully manage the ownership change and gear your re-tooled company for success by providing a roadmap in your operating agreement or bylaws and by ensuring you are on top of any implications for your federal contracts.

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