PILIERO MAZZA PLLC
ATTORNEYS AT LAW

888 17th Street, NW, 11th Floor
Washington, DC 20006
Tel: 202-857-1000
Fax: 202-857-0200

PilieroMazza Breakfast Seminar

SMART MOVES FOR YOUR SMALL BUSINESS: AVOIDING THE 11TH HOUR CRISIS

MARCH 7, 2012

Presented by

Jon Williams
Dean Nordlinger

OVERVIEW

- Maximizing your time as a small business
- The small business lending market
- Compensating and retaining key personnel
- Developing an acquisition or sale strategy
- Succession planning
- Avoiding crises in corporate documents & agreements

HOW CAN YOU MAXIMIZE YOUR COMPANY'S TIME AS A SMALL BUSINESS?

- In federal government contracting, a small business' greatest asset is arguably its "small business" status
- Develop and work from a business plan that:
  - protects your company's small business status, and
  - promotes smart and controlled growth
- What are some key components of a business plan for smart and controlled growth?
  - good organizational documents

HOW CAN YOU MAXIMIZE YOUR COMPANY'S TIME AS A SMALL BUSINESS?

- Use Joint Ventures
  - JV revenue attributed to the JV partners in proportion to JV ownership interests
  - Shared resources and experience at prime contract level
  - JVs reduce contract revenue attributed to your firm, allowing your company to stay a small business longer, while still gaining experience at the prime contract level

HOW CAN YOU MAXIMIZE YOUR COMPANY'S TIME AS A SMALL BUSINESS?

- Proactively monitor your company's ties with 3rd parties to avoid affiliation:
  - Minimize common ownership and management
  - Minimize shared facilities and employees
  - Properly structure a newly organized concern
  - Prevent too large a percentage of your company's revenue coming from contracts with one company
  - Diversify teaming partners and joint venture partners

HOW CAN YOU MAXIMIZE YOUR COMPANY'S TIME AS A SMALL BUSINESS?

- Corporate planning and (re)structuring under the former affiliate rule
  - Does your company have operating divisions that are naturally separable or are otherwise operated on a segregated, stand-alone basis?
  - Plan early-on, if so, structure or restructure so that your company can be broken into parent/sub or sister companies
  - Sale of a subsidiary or affiliate– the former affiliate rule allows you to back out most recent 3 years average annual receipts of subsidiary or affiliate from your company's average annual receipts
  - Note: sale of a division of a company does not qualify

HOW CAN YOU MAXIMIZE YOUR COMPANY'S TIME AS A SMALL BUSINESS?

- Recent NAICS Code Increases

NAICS Sector	Description	Status
48-49	Transportation and Warehousing	Increases for 22 industries effective 3/26/12
51	Information	Proposed increases for 15 industries issued in 2011; final rule likely in late 2012
53	Real Estate and Rental and Leasing	Proposed increases for 20 industries and one sub-industry issued in 2011; final rule likely in late 2012/early 2013
54	Professional, Technical, and Scientific Services	Final increases for 34 industries and 3 sub-industries effective 3/12/12
56	Administrative and Support, Waste Management and Remediation Services	Proposed increases for 37 industries issued in 2011; final rule likely in 2012
61	Educational Services	Proposed increases for nine industries issued in 2011; final rule likely in late 2012/early 2013
62	Health Care and Social Assistance	Proposed increases for 28 industries issued in 2012; comments due 4/24/12; final rule likely in 2013
81	Other Services	Increase for one industry effective 3/12/12

How Can You Maximize Your Company's Time As A Small Business?

- Market your customers to assign different NAICS codes
  - Use meetings, letters, and white papers to contracting personnel to advocate for a different NAICS code that has a higher size standard
  - Challenge assigned NAICS codes to the SBA OHA
- Diversify and develop business under other NAICS codes
  - Use organic or acquisitive growth to build up capabilities to pursue work under different NAICS codes

HOW CAN YOU MAXIMIZE YOUR COMPANY'S TIME AS A SMALL BUSINESS?

- What can you do when you cannot hold on to your "small business" status?
  - Use mentor/protégé joint ventures
  - Subcontract with small businesses
  - Acquire other companies to grow
  - Position your company to be acquired

WHAT IS THE CURRENT STATE OF THE LENDING MARKET FOR SMALL BUSINESSES?

- Small business lending is experiencing a positive turnaround (for qualified borrowers)
- Due to increased competition among lenders and in order to win new business, lenders are making loans on increasingly borrower-friendly terms
- A bank's loan/no loan decision hinges largely on a company's "creditworthiness"
- Creditworthiness = a bank's financial and non-financial analysis of a company as being a "good" risk or a "bad" risk
  - Creditworthiness impacts the financial and non-financial loan terms

WHAT IS THE CURRENT STATE OF THE LENDING MARKET FOR SMALL BUSINESSES?

- How does a small business position itself to tap into the improved credit markets?
  - Tell the company's story in a way that demonstrates creditworthiness
    - Complete and current corporate and ownership records
    - Financial statements, reviewed if not audited by a CPA firm
    - Strength and quality of management team's experience
    - Strong business plan (show how company would achieve its goals with the loan)
    - Quality of borrower's collateral
    - Financial resources of proposed guarantor(s)

WHAT IS THE CURRENT STATE OF THE LENDING MARKET FOR SMALL BUSINESSES?

- How does a company secure good loan terms?
  - Shop around for the "right" lender – choices and competition breed better terms
  - Timing is critical – negotiate the loan terms <u>before</u> signing a loan commitment letter
    - A lender is most flexible and open to negotiating when it's competing to secure a company's borrowing business (not once it's captive)

WHAT IS THE CURRENT STATE OF THE LENDING MARKET FOR SMALL BUSINESSES?

- What are the lender's and borrower's goals in entering into a loan agreement?
  - Lender: use loan agreement to control and monitor borrower's business to ensure the loan will be repaid
  - Borrower: a fair and reasonable loan agreement that allows the company to operate strategically and grow its business without too many restraints

- What is a "good" loan agreement?
  - One that is a negotiated compromise of borrower's and lender's goals
  - Borrower does <u>not</u> want to operate one step away from or on the edge of default

WHAT IS THE CURRENT STATE OF THE LENDING MARKET FOR SMALL BUSINESSES?

- What loan terms are important to a borrower?
  - Make sure reps, warranties, covenants and events of default are liveable
  - Materiality, reasonableness and knowledge qualifiers
  - Grace, notice and cure periods
  - Feasible financial covenants (avoid being in automatic or near immediate default)
  - Carve-outs for anticipated activities (e.g., issuance of equity to employees and sales of assets not in core business)
  - Right to prepay loan without penalties or early termination fees

WHAT IS THE BEST WAY TO COMPENSATE AND RETAIN EMPLOYEES?

- Provide forms of incentive cash and non-cash compensation (beyond salary and benefits) to motivate employee performance and minimize loss of employees
    - Tie incentive compensation to employee effort or company profitability

- Discretionary cash bonuses
    - Payable based on company's subjective evaluation of employee's performance
    - Payable under a target performance plan with objective benchmarks, which set amount the employee may be entitled to receive if employee hits the benchmark

WHAT IS THE BEST WAY TO COMPENSATE AND RETAIN EMPLOYEES?

- Equity compensation (leads to actual or potential ownership in company)
  - Stock bonuses
  - Stock options
    - Non-qualified stock options
    - Incentive stock options
  - Typically, subject to vesting
  - Potential impact of "present effect" rule
  - Taxable compensation to employees

WHAT IS THE BEST WAY TO COMPENSATE AND RETAIN EMPLOYEES?

- Equity-linked compensation (no actual or potential ownership)
  - Stock appreciation rights (SARs) and phantom stock – compensation tied to value of company's equity
    - How are SARS and phantom stock similar?
      - No right to purchase or acquire equity in company
      - Compensation tied to value of outstanding stock of company
      - Formulated based on company's outstanding equity
      - Tracked in a "special ledger" account
      - Typically, subject to vesting
      - Taxable compensation to employee

WHAT IS THE BEST WAY TO COMPENSATE AND RETAIN EMPLOYEES?

- How do SARS and phantom stock differ from one another?
  - SARS are (i) pegged to company's then current price per share on grant date AND (ii) a contractual right to cash difference between value of company stock on grant date and value at exercise date
  - Phantom stock provides for receipt of full value of company's stock (and not just appreciation in value after grant date)
  - Once vested, SARS are exercisable at employee's election
  - Once vested, phantom stock is exercisable only upon a "triggering event"
    - Death, disability, sale of the company, a specified future date

WHAT IS THE BEST WAY TO COMPENSATE AND RETAIN EMPLOYEES?

- Phantom stock is a form of deferred compensation plan (compensation for current services that is paid in the future)
  - Section 409A governs taxation of non-qualified deferred compensation such phantom stock plans
  - Want to avoid "constructive receipt of income" at time of grant and payment of interest and penalties
- Why would a company favor using SARS or phantom stock (as opposed to not stock compensation)?
  - Avoids providing actual ownership to employees
  - Stock triggers fiduciary duties, voting rights and information rights
  - Stock triggers compliance with securities laws
  - Facilitates an 8(a)'s, a WOSB's or SDVOSB's ability to avoid diluting ownership or profits share below 51% and violating applicable regulations

WHAT MAKES A GOOD ACQUISITION OR SALE STRATEGY?

- Formulate a business strategy and manage expectations
  - It's a journey and a process, not a sprint – a sale/purchase process can take up to 6 months from beginning to end
  - Plan ahead for future sale or acquisition - diversify contract base
    - Government contracts versus commercial contracts
    - 8(a)/small business set-aside/full and open
    - Seller: diversify contract base to be a more attractive target
    - Buyer: acquire other companies to acquire capabilities, past performance and/or diversify contract base

WHAT MAKES A GOOD ACQUISITION OR SALE STRATEGY?

❖ Factor impact of acquisition on size of seller and buyer - would acquisition cause seller or buyer to bust through its own NAICS code size standard

- Procuring agency not required to terminate existing contracts (of buyer or seller)
- BUT
  - Can no longer receive credit as a small business award
  - May choose not to exercise options on contract
- Cannot bid on new contracts as a small business

WHAT MAKES A GOOD ACQUISITION OR SALE STRATEGY?

- ❖ Implement a strong management team (seller)
  - Ability to run business in absence of the owner
  - May need to incentivize management team to stay
- ❖ Consider engaging an investment banker or broker
  - Seller: for best packaging and presentation of company and creating competition among potential buyers
  - Buyer: to cast efficient and wide net for quality targets that would further company's business/growth plan
  - Engagement letter
  - Confidentiality agreement

WHAT MAKES A GOOD ACQUISITION OR SALE STRATEGY?

❖ Sale or Acquisition Process

- Due diligence
- Letter of intent
  - Transaction structure (stock sale, asset sale or merger)
  - Pay attention to "present effect" rule and risk of affiliation
- Definitive sale agreement and other agreements
  - Employment agreement, non-compete agreement, loan agreement & promissory note and security or pledge agreement
- Novation of contracts (asset sale & merger (non-surviving company contracts))
- Small firms must recertify
  - Stock purchase: within 30 days of (after) closing
  - Asset purchase or merger: within 30 days after novation

WHAT SHOULD A COMPANY CONSIDER IN DEVELOPING A SUCCESSION PLAN?

- Board of directors has a fiduciary duty to address major business risks, including the loss of senior executives
- In dealing with succession planning, the board of directors must:
  - Act in good faith,
  - With diligence, and
  - In the best interests of the company

WHAT SHOULD A COMPANY CONSIDER IN DEVELOPING A SUCCESSION PLAN?

- Address potential gap in senior leadership due to:
  - Anticipated winding down of incumbent CEO and/or other key executives, and
  - An emergency disruption of current senior leadership (e.g., CEO's sudden death or disability)
- Include a senior management development plan
  - Focus on systematically developing executives and training them to handle higher levels of responsibility
  - Leads to an expansion of the pool of internal leadership candidates for standard succession and emergency succession planning

AVOIDING CRISES IN YOUR CORPORATE DOCUMENTS

- Negative Control
  - Board of Directors/Management Committee Provisions
  - Quorum Provisions & Supermajority Voting Rights
- Conditions on Ownership
  - Transfer Restrictions
  - Rights of First Refusal
- Community Property States
  - Transmutation Agreement
- Commercial Agreements
  - Employee Leasing & Sharing
  - Administrative Services Agreements
  - Bonding Indemnification Agreements

AVOIDING CRISES IN YOUR TEAMING AGREEMENTS, SUBCONTRACTS & JOINT VENTURES

- Teaming Agreements
  - Tailored to a specific federal procurement – not open-ended
  - Avoid ostensible subcontractor affiliation by clearly assigning discrete tasks to subcontractors and ensuring you perform the "primary and vital" tasks
  - Follow the performance of work requirements
- Subcontracts
  - Small business prime must manage the project
  - Pay when paid
  - Flow down prime contract obligations
- Joint Ventures
  - "3 in 2" rule, as modified
  - Check the size of the JV partners – is mentor-protégé necessary?
  - For SDVOSB projects through the VA, JV must be verified on VetBiz.gov

Any Questions?

Thank you for attending.

Your opinion is very important to us.

Please take a moment and complete the yellow survey in your folder

PILIERO MAZZA
ATTORNEYS AT LAW PLLC

SMART MOVES FOR YOUR SMALL BUSINESS
AVOIDING THE 11TH HOUR CRISIS
March 7, 2012

Overall how would you rate this seminar?
☐Excellent ☐Good ☐Fair ☐Poor

Please rate the following aspects of the seminar presentation.

	Excellent	Good	Fair	Poor	Comments
Relevance of the seminar topic	☐	☐	☐	☐	
Quality of the presentation	☐	☐	☐	☐	
Speakers' delivery	☐	☐	☐	☐	
Did the speakers include the right level of detail	☐	☐	☐	☐	
Amount of time for Q&A	☐	☐	☐	☐	

Based on your experience at this seminar, how likely are you to attend future seminars?
☐Very Likely ☐Somewhat likely ☐Not likely

How did you hear about this seminar?
☐Direct Mailing ☐Legal Advisor ☐Website ☐Word of Mouth ☐Other________

Was this the first time you attended a PilieroMazza seminar? ☐Yes ☐No

Any other suggestions or comments to help us improve future seminars?

Are there any topics you would like to see us offer in a future seminar or webinar?

Name: __________
(Optional)