LEGAL ADVISOR

A PilieroMazza Update for Federal Contractors and Commercial Businesses

You've Decided to Sell Your Business—How to Be Prepared to Execute the Deal

By Dave Shafer

After years of building, growing, and investing in your business, there comes a point at which you start to think about an exit strategy. Perhaps your exit will be transitioning the ownership of your business to a family member or selling the majority of your ownership interest to an investor and taking a back seat going forward, or maybe it's selling the whole business enterprise. Regardless of the type of exit you contemplate, selling a business is not for the faint of heart. Preparing a business for sale can best be described as a second full-time job. Accordingly, it is prudent to start the process early, get truly comfortable with the idea of selling, build a team to assist, and be prepared for a curveball or two as the transaction progresses.

Teamwork is Key

The best course of action when approaching the sale of your business is to assemble a deal team to assist. The deal team should have two main components: (1) the Internal Team and (2) the External Team. The Internal Team should include a senior representative from each area of the company, notably accounting, operations, and human resources. While it is understandable that in the early stages you may want to keep a tight lid on any discussion related to the disposition of your business (after all, you want to preserve the ordinary course of business and wait for the right buyer at the right purchase price), it would be a mistake to shoulder the responsibility of managing the sale process on your own.

Special Corporate Issue

The External Team should include legal counsel, preferably versed in mergers and acquisitions, an accounting professional, and in some circumstances, an investment banker or broker. A seasoned mergers and acquisitions attorney can assist with sell-side diligence, as well as preparation of non-disclosure agreements and other documents that should be put in place before you allow a prospective buyer to view your business' proprietary information. Accounting professions can help identify any financial irregularities and provide insight into any tax issues that may arise. An investment banker or broker can assist with realistically evaluating your company's market valuation, as well as finding a qualified buyer.

Sell-Side Due Diligence

The term "Sell-Side Due Diligence" refers to a process by which the team you've assembled does a pre-sale, internal review of the key areas that a reasonable buyer would look to when determining whether to purchase the business. These areas are typically where the value of your business is found, and by understanding any issues in those value-generating areas and, to the

Continued on page 2

extent possible, correcting them, you are preserving the purchase price, maintaining leverage equality in negotiations, and ultimately speeding up the sale process.

Key Value Concerns

While the precise nature of the industry in which your business operates and the manner in which it has thrived may vary, there are certain areas that are typically the focus of a prospective buyer's scrutiny.

Employment Issues

In many businesses, there are key employees running the business, servicing a contract, or generally keeping the enterprise running smoothly. A prospective buyer will examine any and all agreements that are in place with such employees, particularly any invention assignments, non-competition, non-solicitation, and equity incentive agreements. They will also ask you if, to your knowledge, any of them intend to leave the company. The theme being, a reasonable buyer understands that the success of the business post-closing will depend on those key employees, so what tells the buyer that they will stick around? **Sarah Nash** gives tips on how to keep employment issues from holding up a sale in her article on page 6.

Intellectual Property

Again, depending on the business, intellectual property could comprise a significant amount of value in the company. If your business has trademarks, copyrights, patents, trade secrets, or other intellectual property assets, it is incumbent that you know and say with certainty that the company has taken all necessary steps to protect those assets and own them each outright.

Contracts

A reasonable buyer will want to review all of your material contracts and will pay special attention to make sure that they are in order. That means, among other things, that (1) the agreements are fully executed and copies are available for review; (2) amendments and term extensions have been properly documented; and (3) there are no prohibitions against assignment of change of control that are not waivable. For government contracts, this means an added layer of compliance with Federal Acquisition Regulations, registrations in government databases, and a novation package that may need to be presented to a contracting officer. **Katie Flood** addresses issues with novating GSA schedule contracts in her article on page 7 of this issue.

Litigation and Liens

Prior to a buyer's inspecting the books, records, and assets of your business, you will want to have comfort that the assets you own are not encumbered in any way. A great way to determine this is by conducting a lien, tax, litigation, judgment, and bankruptcy search in the jurisdictions in which the business is organized and those in which it has qualified to do business. Any erroneously filed liens should be identified and removed.

Structuring

Once the parties have materially progressed through the due-diligence stage, it is time to begin to draft the definitive agreement to consummate the transaction. The definitive agreement can take many forms, including (1) an asset purchase agreement; (2) a stock or membership interest purchase agreement; or (3) a merger agreement. There are various benefits to each party, depending on structure.

> **"Regardless of the type of exit you contemplate, selling a business is not for the faint of heart. Preparing a business for sale can best be described as a second full-time job."**

There are also innumerable deal points to be negotiated among the business principals and legal counsel. Relating back to the diligence efforts of both parties, one of the points will likely be the extent, duration, and amount of indemnification obligations that the seller will incur for third-party claims and any breach of the agreement. Simply put, the more irregularities found during the diligence stage, the stronger the position

Continued on page 3

EXECUTE THE DEAL .... *Continued from page 2*

the buyer has for negotiating a higher indemnification obligation, or even an escrow of a portion of the purchase price that could tie up your sale proceeds for years. **Kathryn Hickey** discusses the different growth capital financing options in her article on page 4.

In sum, selling a business can be hard work, but with the right team in place and enough lead time, you can have a successful exit.

About the Author: Dave Shafer is an associate in the Business and Corporate group. He may be reached at dshafer@pilieromazza.com.

Welcoming the newest members of our Business & Corporate Law Group

Kathryn L. Hickey
Partner

khickey@pilieromazza.com • (202) 857-1000

PilieroMazza PLLC is pleased to announce the addition of Kathryn L. Hickey as Partner, and chair of our Business and Corporate Law Group located in our Washington, D.C. office.

Kathryn possesses a broad knowledge of general business, mergers and acquisitions, venture capital investments, and commercial contracting. She counsels companies on a wide range of legal issues, including entity formation and structure, corporate governance, employment issues, commercial leasing, licensing, and regulatory compliance.

Read Kathryn's article, Growing Pains: Growth Capital Sources and Considerations, on page 4 of this issue.

David T. Shafer
Associate

dshafer@pilieromazza.com • (202) 857-1000

We are also pleased to announce the addition of David T. Shafer as an Associate in our Business and Corporate Law Group located in our Washington, D.C. office.

Dave counsels clients on a variety of business, finance, and cybersecurity matters, including private equity transactions and mergers and acquisitions. He also assists with transactions and regulatory compliance in the government contracting industry.

Read Dave's article, You've Decided to Sell Your Business—How to Be Prepared to Execute the Deal, on page 1 of this issue.

Growing Pains: Growth Capital Sources and Considerations

By Kathryn Hickey

At a certain point in a company's life cycle, founders are likely to be faced with the financial pinch of requiring outside sources of funding to finance further growth and expansion of the business. Once bootstrapping ceases to be an option, there are two main avenues to pursue for growth capital: traditional bank debt or private equity investment. Both options present pros and cons, and they are not mutually exclusive. Ultimately, the route founders decide upon will depend on the objectives, limitations, and concerns specific to their organization. This article will map out a high-level overview of the characteristics and considerations of different growth capital financing options.

Debt Financing

One of the most attractive features of debt financing is its familiarity. Unlike the often unfamiliar complexity of venture capital investments, the basic outlines of a bank loan or line of credit are familiar to the average commercial consumer. Beyond this comfort level, the strongest argument in favor of traditional lending is the ability to avoid giving up ownership of the company and maintaining (nearly) absolute executive control. In most bank loan transactions, the lender will not require a board position or a role in company management. The debt will also be carried on the books of the company as a financial liability only and will not dilute the equity holders' ownership in the company. This can be attractive from a capitalization table perspective because it keeps the number of owners low and the ownership structure relatively simple (although beware of over-leveraging, which could diminish the interest of future investors). Typically, when taking on debt financing, the founders will retain the ability to direct and control decision-making for day-to-day operational decisions. Keep in mind, however, that banks often will require certain limited negative controls or negative covenants that limit the company's ability to engage in certain extraordinary transactions without triggering an event of default under the loan documents unless the lender's prior consent is obtained.

The primary drawback associated with traditional lending is that the debt will always have to be repaid. Unlike in venture capital deals, where return on investment is significantly contingent upon the success of the company, bank debt is an absolute liability with a maturity date. Collateralization requirements will put company assets at risk if payments on the loan are not made in a timely manner. Another key feature that can deter founders from seeking traditional debt financing is the potential that an institutional lender will require personal guarantees, which is especially common when the borrower is a relatively young company. Unless founders can successfully negotiate out of personally guaranteeing loans to the company, debt financings can be risky endeavors for those engaged in early-stage ventures.

"The primary drawback associated with traditional lending is that the debt will always have to be repaid. Unlike in venture capital deals, where return on investment is significantly contingent upon the success of the company, bank debt is an absolute liability with a maturity date."

Finally, while some lenders have more appetite for risk than others, the terms of traditional bank debt are likely to be more conservative that those that may be available from some private investment funds.

Equity Financing

Private equity investments can be intimidating for many founders because it is a relatively foreign landscape. It is worth it, however, for founders to educate themselves on the basic principals involved in venture capital deals, as these can be valuable sources of financing to fund a company's leap to the next level. Minority investment venture capital deals can be employed at various stages of company growth. Typically angel round financing or seed round financings will come in without a fixed price. At this stage, an investor will likely take a convertible note or a SAFE (simple agreement for future equity). These instruments are similar in that they both involve the investment of funds with an agreement to roll that investment into the next round of equity financing of the company, often at some discount or capped purchase price for that future round. The primary difference between convertible notes and SAFEs is that convertible notes are true debt instruments that carry interest and will require repayment upon maturity if they do not

Continued on page 5

convert according to their terms. SAFEs, on the other hand, are not debt instruments and reflect the simple agreement between the company and the investor to convert the investment into future equity if and when another financing round occurs. SAFEs are generally considered more company-friendly, and it may be difficult to persuade a sophisticated investor to invest at an early stage via a SAFE rather than a convertible note, which offers more investor protections.

Once a company is considering a financing round beyond the seed funding stage (typically taking the form of an issuance of "series A" equity interests), there will be a pre-money valuation agreed upon between the investors and the company, which will set the price for the round and dictate the amount of dilution that the round will generate for the founders. Series A and later rounds typically feature various investor protections, which can include a liquidation preference and/or an accruing dividend on the initial investment amount, board seats and/or board observer rights, negative control protections, preemptive rights with respect to future rounds, rights of first refusal on transfers of equity, and anti-dilution protection. Private investors may also require the company to set an increased employee equity incentive pool pre-investment (to avoid dilutive grants post-investment) and/or impose restrictions or vesting requirements on existing founders' equity. At the end of the day, however, the right private investors can provide meaningful contributions as strategic partners with valuable management and executive leadership experience. And because private investor returns are primarily tied to company success, they are attractive in that repayment depends largely upon performance.

A Word of Caution for Small Business Contractors

It is important to note that many of the features typical of standard venture capital investments may be prohibited for companies that rely upon their status as small businesses because these investment deals, if not carefully structured, can result in undesired deemed affiliation with larger investment funds. Structuring concerns are of even greater importance for companies in the 8(a) program or other state-level set-aside programs, for which many standard venture capital investor control/voting rights are considered impermissible. Note that if your company fits into any of these categories, it is vitally important to consult with your legal advisors to determine what structuring options are available prior to seeking private financing.

About the Author: Kathryn Hickey is a partner and chairs the Business and Corporate group. She may be reached at khickey@pilieromazza.com.

Seller Beware: 5 Tips to Keep Bad Employment Practices from Holding Up a Sale

By Sarah Nash

Lawsuits and existing labor disputes are obvious impediments to the sale of your business. But short of these red flags, any number of ill-advised practices may slow down or even stop an acquisition from proceeding. Do not enter into serious talks about the sale of your company without first identifying and correcting poor employment practices. Follow these tips to avoid future headaches.

1 Ensure Employees Are Properly Classified

The Fair Labor Standards Act ("FLSA") requires that non-exempt employees receive at least a federal minimum wage and overtime for time worked over 40 hours a week. The rules governing which employees can be exempted from these requirements are strict, with non-compliance having the potential to open a business to tremendous wage and hour liability. When a potential buyer sees that employees have been misclassified, this may give them pause before proceeding and may indicate other risky employment practices. Prior to a sale, companies should evaluate employee job duties and responsibilities carefully and on a case-by-case basis to ensure compliance with the FLSA.

Another widespread issue involving employee misclassification relates to improperly classifying employees as independent contractors. Simply because a worker is subject to a contract or because classifying workers as independent contractors is standard industry practice does not mean that that worker is a non-employee under tax and labor law standards. The biggest factor in determining whether a worker is an employee boils down to a company's control over that worker's work product, direction, and financial success. If you have contractors who do not exercise independence in these areas, take another look to make sure they are properly classified.

2 Review Your Equal Employment Policies and Practices

Title VII of the Civil Rights Act prohibits discrimination on the basis of race, color, religion, sex, and national origin, and the Americans with Disabilities Act protects individuals with disabilities. State laws and federal contracting requirements may also oblige non-discrimination with respect to sexual orientation, gender identity, veteran status, genetics, and even height and weight. It is important to be familiar with the requirements where you operate and to capture these in well-drafted employee policies. Any complaints or pending claims will certainly be factored into a sale. The better your policies, the more you can reduce the likelihood of surprises as you get closer to a sale.

Do not forget to review your anti-harassment policies and non-retaliation policies while you are at it. In the #MeToo age, companies are even more diligent when it comes to ensuring that the companies they partner with have—and enforce—strong anti-discrimination and anti-harassment policies.

3 Confirm That Your Handbook Is Compliant with State and Federal Leave and Wage and Hour Requirements

Federal and state laws impose a number of requirements when it comes to employee compensation and benefits. For example, depending on a company's size, federal law provides several classes of employees with job-protected leave. Meanwhile, more and more states and localities are also requiring that employers provide paid sick leave. How you describe compliance (or non-compliance) with these laws in your company handbook matters. By way of example, few laws exist that require that a company provide its workers with paid vacation. That said, in many states, where a handbook promises paid vacation, the company is obligated to comply with this promise or else face a potential wage and hour liability.

The evolving matrix of laws relating to employee compensation can be complex, but stiff penalties for violations make it important to understand how the requirements apply to your workforce. A handbook can be a helpful guide to knowing whether the company is in compliance, so be sure to review and update your handbook on a regular basis. A handbook or practices

Continued on page 7

that demonstrate legal non-compliance will make a potential buyer question the deal, the purchase price, or, at very least, the strength of indemnification language in a purchase agreement.

4 If You Have a Unionized Workforce, Maintain a Healthy Relationship with Your Employees' Bargaining Representative

Employees who have unionized do not lose their unionized status simply because a company is sold. Assuming that business operations will continue in a substantially similar form (and that a majority of the workforce will remain employed), a buyer inherits the target company's bargaining obligations. In certain circumstances, the buyer may even end up bound by the same Collective Bargaining Agreement ("CBA") you signed.

> "The evolving matrix of laws relating to employee compensation can be complex, but stiff penalties for violations make it important to understand how the requirements apply to your workforce."

To the extent possible, it is important to keep union relations positive and productive. When considering a sale, make sure to comply with your CBA provisions and to notify or coordinate with the union before making any changes to terms and conditions of employment. A potential buyer is likely to shy away from the threat of a strike or unfair labor practice charges.

5 Make Sure Agreements with Key Employees Are Enforceable and Assignable

Often, the driving factor behind an acquisition is the information and trade secrets employees have acquired during their time with a target company. This appeal disappears if employees can simply leave the company at the time of sale and take their information elsewhere. To avoid having this risk dissuade a potential buyer, companies should review their employment agreements with key employees to make sure they have strong and enforceable non-disclosure, non-competition, and non-solicitation provisions. Be mindful that these provisions should be narrowly tailored to protect the business' interests and should have strong enforcement provisions. Non-compete requirements vary by state so, as always, it is important to review the specific law that applies to the agreement and working relationship. In some states, one bad term can undermine the enforceability of the entire provision.

Do not forget to draft the agreement in such a way that the rights and obligations may be assigned in the event of company sale. Omitting this broad assignment provision could prevent a future buyer from enforcing the agreement.

Whether a buyer is interested in purchasing the company assets or—if you are incorporated—the company stock, it is important to have all your ducks in a row when it comes to the above-listed employment practices.

About the Author: Sarah Nash is an associate in the Labor and Employment group. She may be reached at snash@pilieromazza.com.

Not So Fast: Practical Considerations Before Novating Your GSA Schedule Contract

By Katie Flood

The acquisition market for federal contractors is booming. Acquisition can provide a buyer the opportunity to target its growth strategically by acquiring the seller's past performance and experience, in addition to gaining the seller's personnel and resources. Of course, part of what makes a seller attractive is the contracts found in its portfolio. While the government does not officially condone the "buying and selling" of federal contracts, a contract may be novated after an acquisition if the buyer has acquired all of the seller's assets or has acquired the entire portion of the seller's assets involved in performing the contract. Novations are necessary after acquisitions where the seller (or acquired assets or division of the seller) will be merged into the buyer and not be held as a separate subsidiary, so the seller's contracts implicated by the acquisition can continue to be performed and administered under the buyer's name.

One of many ways that U.S. General Services Administration ("GSA") Schedule contracts differentiate themselves from other types of federal procurements is through a variety of unique issues arising in the novation process. Perhaps most significantly, GSA has taken the position that it will not novate task orders awarded

Continued on page 8

under a Schedule contract separately from the Schedule contract itself—the entire Schedule contract, including all task orders awarded thereunder, must be novated wholesale to a buyer. This makes it difficult for buyers to target the acquisition of a specific task order under a Schedule contract, no matter how large the dollar value of the task order or readily segregable its performance from the seller's remaining contractual portfolio.

To support this position, GSA relies on a case from the U.S. Government Accountability Office ("GAO"), AllWorld Language Consultants, Inc., B-411481.3 (2016). In AllWorld, GAO held that task orders issued under Schedule contracts "are not themselves stand-alone contracts" because the terms and conditions of the underlying Schedule contract govern the contractor's and government's rights and obligations with respect to the task order. Based on this principle, GAO found that the ordering agency's award was unreasonable in part because the awardee's Schedule contract was set to expire before all of the task orders' option periods could be exercised—option periods under a task order cannot be exercised without the underlying Schedule contract still being valid and effective.

Notably, the decision in AllWorld was not rendered in the context of a contract novation. Nevertheless, GSA has extended this concept from AllWorld for the proposition that it (GSA) cannot allow the novation of task orders separate from a GSA Schedule contract, even in a situation where the buyer has the same Schedule contract, with identical terms and conditions to the seller's. All of the task orders issued under the Schedule contract must be novated along with the Schedule contract itself, or no novation will be approved. But, GAO did not hold in AllWorld that a task order could not be novated from one schedule holder to another. In the case of a novation of a task order from one schedule holder to another, the task order will not exist independent of the Schedule—it will continue to exist tied to the Schedule of the buyer. Therefore, AllWorld does not prevent GSA from permitting novations of task orders from one schedule holder to another, but this is how GSA has interpreted it.

In practice, this policy poses problems for buyers acquiring specific assets without buying the seller's entire organization. For example, a buyer might want to acquire a distinct division of a seller that specializes in work performed with a specific federal agency. Even though this division might be otherwise segregable from the seller's other operations, GSA would not novate the Schedule task orders awarded to the seller and performed by this division unless the buyer acquired the seller's entire Schedule contract. This means that the seller would need to be willing to part with its entire Schedule contract, including other task orders awarded by different federal agencies that fall outside the assets it had initially targeted for acquisition, as the entire Schedule contract would need to be acquired by the buyer for GSA to approve the novation. This result inhibits the ability of a buyer to target a specific division or specific assets of a seller involved in the performance of task orders if its entire Schedule contract is not also being sold.

> **"Perhaps most significantly, GSA has taken the position that it will not novate task orders awarded under a Schedule contract separately from the Schedule contract itself—the entire Schedule contract, including all task orders awarded thereunder, must be novated wholesale to a buyer."**

Another issue that arises in the acquisition of Schedule contracts is the purchase of "empty" vehicles, where the seller has not been awarded any task orders. GSA has taken the position that it will not novate empty Schedule contracts because no "assets" of the seller are involved in contract performance—under the FAR, novation approval requires a buyer to acquire all of the assets involved in contract performance. This hinders sellers from capitalizing on otherwise valuable Schedule contract vehicles that they perhaps no longer need or have been unable to market to contracting agencies successfully.

As described above, GSA's novation policies present very real road blocks during the acquisition process. It is important for contractors to be mindful of these limitations when structuring their acquisitions, so an otherwise successful deal is not killed when GSA denies a novation after closing.

About the Author: Katie Flood is counsel in the Government Contracts group. She may be reached at kflood@pilieromazza.com.

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.