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Breakfast Seminar Series
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Strategic Business Planning
"Structuring Relationships"

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OVERVIEW

- Agreement Among Owners: Buy-Sell
- Incentivizing Employees
- Third Party Relationships
- Debt Financing Options in Order to Grow Your Business
- Investing in the Government Contracting Sector

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Buy-Sell Agreement

- **Outlines Relative Rights and Roles of Owners**
  - restricts transfers of owners' interests in the company
  - addresses effect of death, disability or retirement of owners
  - sets a purchase price or valuation method for owners' interests
  - sets payment terms (e.g., cash, promissory note, security)
  - details the rights of the company and non-selling owners vis-à-vis the selling owner
  - note: community property pitfall (get spousal waiver)

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Key Benefits of a Buy-Sell Agreement

- A pre-determined roadmap for dealing with challenging and/or turbulent times and events in the life cycle of a company
- *predictability and continuity of ownership* – prevents outsiders from acquiring an interest in the company by limiting transfers of owners' interests in the business (e.g., preserve S corporation status)
- *orderly transfer of ownership* – prevents owners who cease to participate in the business from continuing ownership in the company and avoids costly disputes (e.g., owner's death)

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Structure of Buy-Sell

- **Redemption** – the company has the right or obligation to redeem the owner's interest that is the subject of a transfer
- **Cross Purchase** – the other owners have the right or obligation to purchase the owner's shares that are the subject of a transfer
- **Hybrid -** the right or obligation to purchase the owner's interest that is the subject of a transfer is structured as redemption, in part, and a cross purchase, in part
  - The company may have the option to redeem a selling owner's interest, and if not exercised, the other owners may have the right purchase the selling owner's interest
  - **Cautionary Note:** if a corporation has the option to redeem, but the owners have an obligation to purchase the selling owner's interest if not redeemed, to the extent the corporation exercises the option it may be deemed to have made a dividend to the remaining owners (insofar as the corporation has relieved the remaining owners of their purchase obligation)
- Use of life insurance to fund the buy-sell right or obligation

Note: This presentation only lightly touches upon the tax aspects and benefits relating to redemption, cross purchase and hybrid agreements. In a subsequent session, one of our strategic partners may explore and explain these tax aspects and benefits in greater detail.

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Transfers

- **Definition of Transfer -** draft broadly to include, among other things, sale, exchange, assignment, transfer, gift, pledge, security interest, change-of-control (within an owner of an interest that is an entity) and other dispositions cover not only voluntary sales, transfers and other dispositions, but also involuntary transfers (e.g., bankruptcy/insolvency) and transfers by operation of law (e.g., divorce or creditor proceedings, including a secured party's retention of a pledged interest to satisfy a debt or sale of a pledged interest in a foreclosure sale)

- **Permitted Transfers** - notwithstanding general restrictions on transfer, owners are often permitted to transfer interests to controlled entities or for estate planning purposes (e.g., a transfer to a trust for the benefit of owner's spouse or children)

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Transfers (continued)

- **Right of First Refusal –** the right of company and/or non-selling owners to match any bona-fide arm's-length 3rd party offer to purchase a selling-owner's interest
- **Right of First Offer** – the selling-owner must first make an offer to sell the interest to the company and/or non-selling owners at a price and on terms set by the selling owner
- **Right of First Refusal versus Right of First Offer**
  - Right of first refusal triggered by 3rd party offer
  - The selling owner can trigger right of first offer before there is a 3rd party offer (forcing the company and/or non-selling owners to buy the selling owner's interest to prevent a transfer)
  - Primary concern of most buy-sell agreements is to restrict transfers, therefore the right of first refusal is more common

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Transfers (continued)

- **Drag-Along Rights/Tag-Along Right**
  - **Drag-Along:** typically, right of the majority owner, or in certain cases, an investor, to force ("drag along") the other owners to sell their interests alongside of the selling owner/investor (in the same proportion and on the same terms) to a 3rd party buyer
    - drag along right can be used instead of a right of first refusal, or alternatively, can be triggered after the expiration of a specified period of time)
  - **Tag-Along:** typically, right of minority owners to sell their interests ("tag along" if not dragged) alongside the selling owner/investor (in the same proportion and on the same terms) to a 3rd party buyer

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Transfers (continued)

- **Put Rights/Call Rights:** can be used (i) to accommodate active versus inactive owners interests, (ii) as an exit for an investor, or (iii) to resolve deadlock among the owners

- **Put Right**: an owner can force the company or the other owners to purchase the owner's interest
  - put price could be liquidation value, or based on a formula or appraised value

- **Call Right**: company or owners can force another owner to sell that owner's interest back to the company or other owners

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Transfers – Triggering Events

- **Dissociation Events**
  - Death
  - Disability
  - Retirement
  - Termination of employment
  - Withdrawal

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Price

- Because the value of a business changes over time, typically a buy-sell agreement will provide a method for setting a price rather than specifying the price of owners' interests
  - **Agreed price**
  - **Stipulated price**
  - **Offer price**
  - **Formula**
  - **Appraised price**

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Payment Terms

- Cash, promissory note or combination
- Note - interest rate and term
- Security- interest being purchased
- Restrictions on business operations while note remains outstanding (e.g., no payment of dividends or distributions to owners until note has been paid)
- Personal guarantees of non-selling owners on note (if redemption by company)

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Payment Terms

- **Resolving claims between selling owner and the company**
  - General release – except selling owner to remain responsible for such owner's prior acts or omissions that later adversely impact on the company or its company's business and operations
  - Release from personal guarantees – company and other owners to use good faith efforts to cause third party creditors to release the selling owner from personal guarantees, and if that cannot be done, then company and/or other owners indemnify the selling owner from any future liability on company debt

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Covenants

- Non-compete
- Non-solicitation (customers, clients or employees)
- Non-disparagement
- Confidentiality

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Deadlock

- A critical purpose of a buy-sell agreement is to put in place procedures to prevent or break deadlocks over major business decisions
- Mechanisms to resolve deadlock
  - No Mechanism
  - Arbitration and Mediation
  - “Solomon’s Choice” Provision
  - Voluntary dissolution
  - Right to force a sale or merger
  - Put/Call rights

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Forms of Incentive Compensation

- Additional cash or noncash compensation beyond salary and benefits
- Tied to employee effort or company profitability
- Discretionary cash bonuses
  - taxable compensation to employee
- Stock Bonuses and Restricted Stock
  - award outright or subject to vesting
  - taxable compensation to employee → value-amount paid
  - generally speaking, deferral of income recognition if subject to substantial risk of forfeiture
- Stock Option Plans
  - Non-Qualified Stock Options (NQSOs)
  - Incentive Stock Options (ISOs)

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NSQOs

- Typically, granted with exercise price < FMV
- Typically, taxable compensation to employees upon exercise (and not grant)
- Sometimes, NSQO plans include provisions to pay a cash bonus to the employee to assist with the payment of tax on the income

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ISOs

- Typically, employee does not recognize any income upon grant or exercise
- Exercise price ≥ FMV
- Special rules apply to 10% employee-owner (e.g., exercise price greater than or equal to 110% FMV)
- ISOs must, among other things,
  - be granted to individuals in connection with employment by issuing company
  - be issued under a plan approved
  - be granted within 10 years of plan's adoption or approval
  - be exercised within 10 years of grant date
  - Exercise price ≥ FMV
- Favorable tax treatment (sale 2 years post-grant date, 1 year post-exercise)

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Securities Laws

- Stock and stock options are securities that are subject to federal and state securities laws; however
- For federal securities law purposes, these stock and stock options awards and/or issuances are generally exempted (Securities Act of 1933, Rule 701)
- For state securities law purposes, where the award or issuance is to a limited number of employees, a limited offering exemption is usually available under applicable state securities laws

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Stock Appreciation Rights (SARs) and Phantom Stock Plans

- SARs and Phantom Stock Plans - incentive compensation tied to the value of the employer's equity (e.g., stock or membership interests)

- SARs and Phantom Stock Plans are structured with the goal of incentivizing employees to use their best efforts to the value of the employer's business without the employer providing for such employees to acquire any actual equity (e.g., stock) ownership

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SARs

- No option right to purchase equity
- Employee issued the right to the cash difference between the value of the employer's stock when the SAR was issued and the value at the time the SAR is exercised
- Like the stock option, frequently structured so that employee can choose when to exercise SAR
- Post-exercise employee has no further rights in the employer's stock or the stock's future appreciation
- SARs taxable compensation to the employee when exercised (and not issued), and there is no constructive receipt of income on any further appreciation of the SARs during the time period between issuance and exercise, even if the employee is fully vested in the SARs

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Phantom Stock Plans

- phantom stock plans are a form of deferred compensation (i.e., compensation for current services that is paid in the future)
- deferred compensation equal the performance of the employer's stock between the time the compensation is earned and the time it is paid
- employees are credited with units (much like equity) that represent a stated fraction (akin to an ownership percentage)
- units tracked and maintained in an employer maintained account
- units are frequently subject to a vesting schedule
- employees do not require rights in employer's stock
- issuance of phantom stock does not dilute ownership of existing owners (only an economic dilutive affect)
- taxable compensation to employee upon employee's retirement, death, disability or when the employee's employment is otherwise terminated

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SARs and Phantom Stock

- SARs and Phantom Stock are attractive to employer's for the fact that
  - Employees do *not* acquire rights in the employer's equity
  - The employer does not owe the employee any of the rights or protections that shareholders enjoy under applicable law
  - Rights to future payment based upon any increase in the value of the employer's equity
  - The issuance of SARs and Phantom Stock does not dilute the ownership of existing shareholders (only an economic dilutive effect)

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SBA

- As neither SARs nor phantom stock plans result in the issuance of any actual equity in the employer, this avoids employer's (such as 8(a) or SDVOSBs) having to worry about the ownership structure, on a fully diluted basis, running afoul of the 8(a) or SDV maintaining at least 51% ownership

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Teaming Agreements

- Due diligence of partner
- Agreement to join together to submit a proposal
- Must be specific to be legally enforceable (including as to subcontract terms)
- If you win execute a subcontract agreement

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Specific Terms

- **Avoid Ambiguities – Meeting of the Minds Common Causes**
  1. Identify the Requirement
  2. Establish why the Parties are Teaming
  3. No Affiliation – Independent Contractors
  4. Proposal support Resources
  5. Roles of the Parties during Proposal Preparation & Evaluation
  6. Proprietary Information
  7. Division of Work (Areas & Percentages)
  8. Assignment
  9. Termination
  10. Exclusivity/Noncompete
  11. Nonsolicitation / Hiring of Employees
  12. Disputes
  13. Governing Law

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Structuring of a Joint Venture

- Joint Venture Structures
  - General Partnership
  - Limited Liability Company
  - Corporation
  - Other Considerations:
    - Populated v. Unpopulated Joint Ventures
    - Limitations on Subcontracting

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Structuring of a Joint Venture

- What is a "partnership"?
  - A partnership (e.g., a general partnership or limited partnership) is an arrangement containing 5 elements: (1) an association, (2) of 2 or more parties, (3) to carry on as co-owners, (4) a business, (5) for profit
  - Partnership by agreement – arises when two or more parties enter into a relationship that has all 5 elements
    - **Note:** It is not necessary that the parties intend to form a partnership to create a partnership. The parties need only to have agreed to form a relationship containing *all* 5 elements

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Structuring of a Joint Venture

- What is a “partnership”?
  - If partnership is intended, a partnership agreement should clearly include all 5 elements of a partnership and a statement of intent to form a partnership
  - If partnership is not intended, and the parties intend to engage in business (e.g., through an LLC or otherwise) that contains partnership like features (e.g., sharing of profits), then the agreement should expressly provide that the arrangement is not intended to be a partnership and should expressly negate one of the 5 elements

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Debt Financing Options

- Overview
  - Generally speaking, businesses, whether in the start-up stage or more mature, require access to capital to survive and grow
  - 4 stages of a business
    - 1st stage: start-up
    - 2nd stage: products and services being developed, but no revenue generation from operations
    - 3rd stage: business plan in execution, products and services being produced and delivered, and initial revenue generation from business and operations
    - 4th stage: business has a significant track record and operating history and revenues

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- Typically, the business stage influences if not determines what types of financing are available to the company
- As a company grows, it usually progresses through various stages of financing
  - For example:
    (1) the initial equity capital for a business is provided by its founders,
    (2) the first debt capital may be provided by owners in the form of unsecured long-term loans, and
    (3) the first line of credit may come from a bank or commercial finance company, for which the owners may be required to provide personal guarantees

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Financing Sources

- **Internal sources of funding**
  - **After-Tax Earnings:** a primary source of cash for businesses
  - **Sale of assets** - sale of assets no longer within company's core business operations
  - **Trade creditors** – business between suppliers and customers is usually done on a credit basis; "lean on trade" to temporarily defer payment and reduce its cash needs
  - **Owner loans** – most likely will have to be subordinated to any outstanding loans made by lending institutions

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Commercial and Government Lending Sources

- **Commercial banks** – engage in a wide variety of unsecured and secured financing activities
- **Commercial finance companies** – typically, these companies take greater risk and therefore charge higher interest rates than commercial banks
  - Greater risk – lower standards of borrower creditworthiness, longer term loans, lower collateral requirements, or less stringent loan-to-collateral ratios
- **Credit unions** – some credit unions do make small business loans, on terms and conditions similar to commercial banks (often these loans are part of the SBA's loan guarantee program)
- **Government financing** - SBA, among other government agencies, provides financing for businesses

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Commercial Lenders

- **Creditworthiness** – the lender's creditworthiness analysis of the company determines whether a company qualifies for a loan, and if it does, creditworthiness is a principal factor in determining the interest rate on the loan
- **Lender's creditworthiness analysis** – a lender will, among other things,
  (1) analyze a company's financial statements and tax returns,
  (2) assess the quality and experience of a company's management team,
  (3) review a company's business plan(s), and
  (4) inspect a company's physical facilities
- **Lender's inquiry tied to creditworthiness** – a prospective lender will further vet a prospective borrower by inquiring into, among other things,
  (1) the amount and purpose of the loan,
  (2) proposed repayment plan and the company's source of funds for repayment,
  (3) diligence on the company's business and operations, including near-term growth prospects,
  (4) financial resources of any guarantors,
  (5) diligence on company management, and
  (6) if a secured loan, the lender may conduct an objective valuation (e.g., appraisal) on the company's collateral (e.g., accounts receivable, inventory and equipment)

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Commercial Lenders (continued)

- **Unsecured loans** - commercial loans made by lender to borrower without the borrower having to provide collateral
- **Asset based financing (secured loans) -** commercial loans made by lender requiring collateral
  - e.g., accounts receivable financing - lender advances funds to company against the face value of company's "eligible receivables"
- **Factoring** - the factor (buyer) purchases all credit-approved accounts receivable at discount of the face value amount of the receivables

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Venture Capital

- Sophisticated financial investors, who provide equity capital in exchange for preferred equity (a class of equity with rights, privileges and preferences superior to common stock) and a role in management, or at least certain veto rights over material company actions

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Investing in Government Contracting Sector

- SBA – 8(a) and Service-Disabled Veteran (SDV)
  - 8(a) and SDV
    - must own 51% or more of the company *and* control it
    - must manage day-to-day business and operations
    - must be engaged full-time in the company's business and operations
    - must be the highest executive officer (e.g., President and/or CEO)
    - must be the most highly compensated individual among the company's directors, officers and employees

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Investing in Government Contracting Sector

- Negative Control - 8(a) or SDV not deemed to control and manage company's business and operations
  - Imposition of super-majority or unanimous voting requirements
  - Reservation of certain major business for super-majority or unanimous owner approval
  - Other factors (such as leasing or financing arrangements)

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Investing in Government Contracting Sector

Transfers

8(a) - Right of first refusal likely not a problem

Drag-along/tag-along rights structure should be acceptable

Can protect < 50% owners/investors with a put right (exit strategy)

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Investing in Government Contracting Sector

Transfers (continued)

SDV - Right of first refusal could call SDV eligibility into question (based on case law)

Drag-along/tag-along rights structure should be acceptable

Can protect < 50% owners/investors with a put right (exit strategy)

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