

LEGAL ADVISOR



A PilieroMazza Update for Federal Contractors and Commercial Businesses

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 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.

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/

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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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