

Preserving SBA Eligibility in Alliances With Government Contractors: Structuring Subcontracts and JVs

Maximizing Business Opportunities While Avoiding Affiliation and Loss of Small Business Status

TUESDAY, JANUARY 20, 2015

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

John E. McCarthy, Jr., Partner, **Crowell & Moring**, Washington, D.C.

Amy Laderberg O'Sullivan, Partner, **Crowell & Moring**, Washington, D.C.

The audio portion of the conference may be accessed via the telephone or by using your computer's speakers. Please refer to the instructions emailed to registrants for additional information. If you have any questions, please contact **Customer Service at 1-800-926-7926 ext. 10.**

Tips for Optimal Quality

FOR LIVE EVENT ONLY

Sound Quality

If you are listening via your computer speakers, please note that the quality of your sound will vary depending on the speed and quality of your internet connection.

If the sound quality is not satisfactory, you may listen via the phone: dial **1-866-961-8499** and enter your PIN when prompted. Otherwise, please send us a chat or e-mail sound@straffordpub.com immediately so we can address the problem.

If you dialed in and have any difficulties during the call, press *0 for assistance.

Viewing Quality

To maximize your screen, press the F11 key on your keyboard. To exit full screen, press the F11 key again.

Continuing Education Credits

FOR LIVE EVENT ONLY

For CLE purposes, please let us know how many people are listening at your location by completing each of the following steps:

- In the chat box, type (1) your **company name** and (2) the **number of attendees at your location**
- Click the SEND button beside the box

If you have purchased Strafford CLE processing services, you must confirm your participation by completing and submitting an Official Record of Attendance (CLE Form).

You may obtain your CLE form by going to the program page and selecting the appropriate form in the PROGRAM MATERIALS box at the top right corner.

If you'd like to purchase CLE credit processing, it is available for a fee. For additional information about CLE credit processing, go to our website or call us at 1-800-926-7926 ext. 35.

If you have not printed the conference materials for this program, please complete the following steps:

- Click on the ^ symbol next to “Conference Materials” in the middle of the left-hand column on your screen.
- Click on the tab labeled “Handouts” that appears, and there you will see a PDF of the slides for today's program.
- Double click on the PDF and a separate page will open.
- Print the slides by clicking on the printer icon.



**PRESERVING SBA ELIGIBILITY IN
ALLIANCES WITH GOVERNMENT
CONTRACTORS: STRUCTURING
SUBCONTRACTS AND JVs**

Amy O'Sullivan

aosullivan@crowell.com

John McCarthy

jmccarthy@crowell.com

Agenda

- The “Golden Ticket” of small business status
- Small business, big risks
- The affiliation “spider web”
 - Relationships
 - Layers
 - Related to core needs of a small business
- Broad definition of control
- Money matters – financing and equity interests
- Spin-offs, friends, and family
- Joint venture versus subcontract
 - When are JVs permitted
 - Allocation of workshare
 - Unique/counterintuitive requirements for JVs
- Common pitfalls in agreements and proposals
- New regulatory developments

The “Golden Ticket” of Small Business Status

- Goal-driven incentive at prime level with flow-down as subcontracting plan goals
- FY 13 SBA Scorecard:
 - **\$83,142,807,958** in prime awards to small businesses (23.39%)
 - **34%** of subcontracts to small businesses
- Protected space for small businesses to compete -- “set-aside” procurements
- High bar to challenge agency set-aside determinations (Rule of Two)
- Proposal evaluation advantages for utilization of small businesses – can be determinative factor

Exponential Growth – Washington Technology's Fast 50 for 2013

Company	2008 Revenue	2009 Revenue	2010 Revenue	2011 Revenue	2012 Revenue	Compound Annual Growth Rate
OBXTek, Inc.	\$112,390	\$179,134	\$3,252,939	\$6,323,520	\$29,616,593	302.90%
Zantech IT Services, Inc.	\$240,000	\$4,390,288	\$4,590,138	\$17,834,495	\$22,366,748	210.70%
SHINE Systems & Technologies	\$90,624	\$387,977	\$1,257,517	\$2,837,490	\$5,857,472	183.54%
SAVA Workforce Solutions LLC	\$1,768,979	\$31,462,826	\$56,101,745	\$84,689,023	\$76,369,886	156.33%
ERP International	\$527,384	\$1,829,667	\$4,269,605	\$11,254,842	\$22,332,000	155.09%
Innotion Enterprises Inc.	\$993,079	\$4,126,526	\$15,043,068	\$35,755,461	\$41,462,734	154.20%
Rapier Solutions Inc.	\$146,000	\$198,120	\$802,854	\$3,555,839	\$5,947,062	152.63%
Streamline Defense LLC	\$179,258	\$268,357	\$613,929	\$5,031,837	\$6,269,633	143.19%
PCI Strategic Management LLC	\$781,389	\$6,846,620	\$16,260,331	\$21,984,172	\$26,902,492	142.23%
ESAC Inc.	\$253,680	\$615,312.	\$2,478,547	\$4,052,923	\$7,344,117	131.96%

What Is a Small Business?

- No “list” of small businesses, companies self-certify, and it’s a moving target
- Dramatic industry variations on “small” – NAICS Code:
 - Number of employees (50 to 1,500); or
 - Average annual receipts (\$750K to \$35.5M)
- Size status must include all “**affiliates**”
- Complex, changing regulatory requirements and detailed, fact-specific analysis

When Is Size Determined?

- Size determined on date contractor submits self-certification to agency as part of initial offer that includes price
- Nuances (relatively new) for multiple-award contracts
 - If small for contract, then small for orders, unless re-certification required for order
- 8(a), SDB, HUBZone applicants must qualify as small in the primary industry classification on date application submitted to SBA and on date of SBA certification
- If small when receive contract, then small for entire duration
 - Several exceptions such as merger, acquisition, novation
 - FAR re-certification requirement
- Large business subs should know these rules too

Small Business, Big Risks

- Continued crackdown on compliance and enforcement (SBA, IGs, Congress, and even the media (*i.e.*, MicroTech, GTSI))
- Increased regulations and reporting requirements (ensure SBs are true beneficiaries of set-aside work and SBA programs)
- Heightened tension between small and large businesses in tough economy – disputes over set-aside designations and workshare
- Size protest loss not limited to loss of contract – investigations, suspension, and debarment

Small Business, Big Risks

- Small business issues are frequent problems in due diligence/ M&A
- Risks relate to target's growth as well as its business relationships
- If status is not understood – red flag for other issues
- Liability for false size certification can be entire value of contract; mandatory disclosure obligations
- Directly impacts valuation in deal
- Buyer could insist on reserves or resolution of issues prior to closing

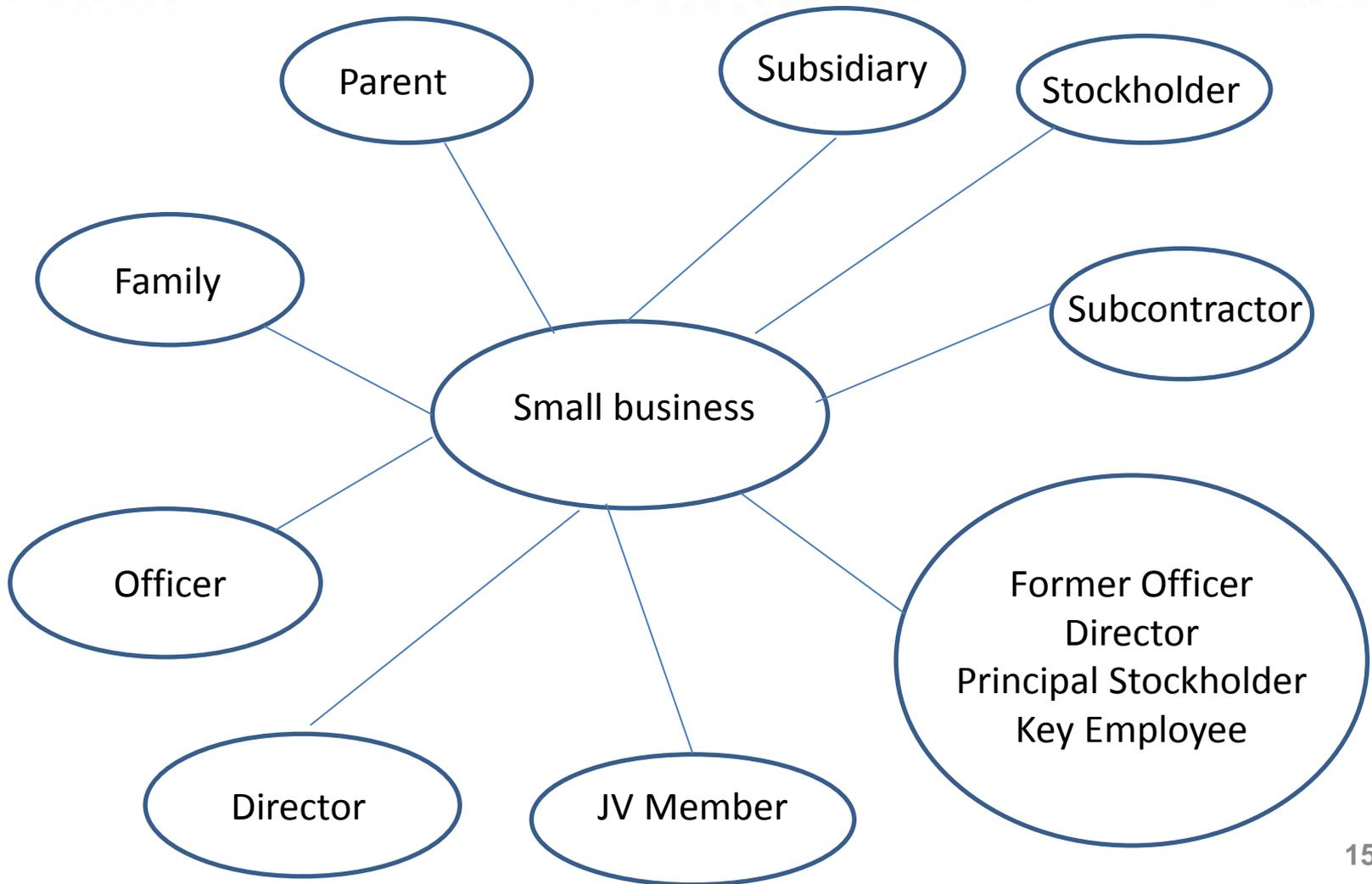
“Affiliation” – The Silent Killer of Small Business Status

- Generally, affiliation exists between entities when:
 - One controls or has power to control another
 - Or, a third party controls or has power to control both
- “Totality of the circumstances” analysis – so EVERYTHING is on the table:
 - Ownership, management, previous relationships or ties to another entity
 - Contractual relationships
 - Shared office space, equipment, office support, loans, common investments, etc.
- Corporate nuances – control can arise from:
 - Affirmative or negative control (quorum requirements, blocking rights, or supermajority voting rights)
 - Direct or indirect (through a third party)

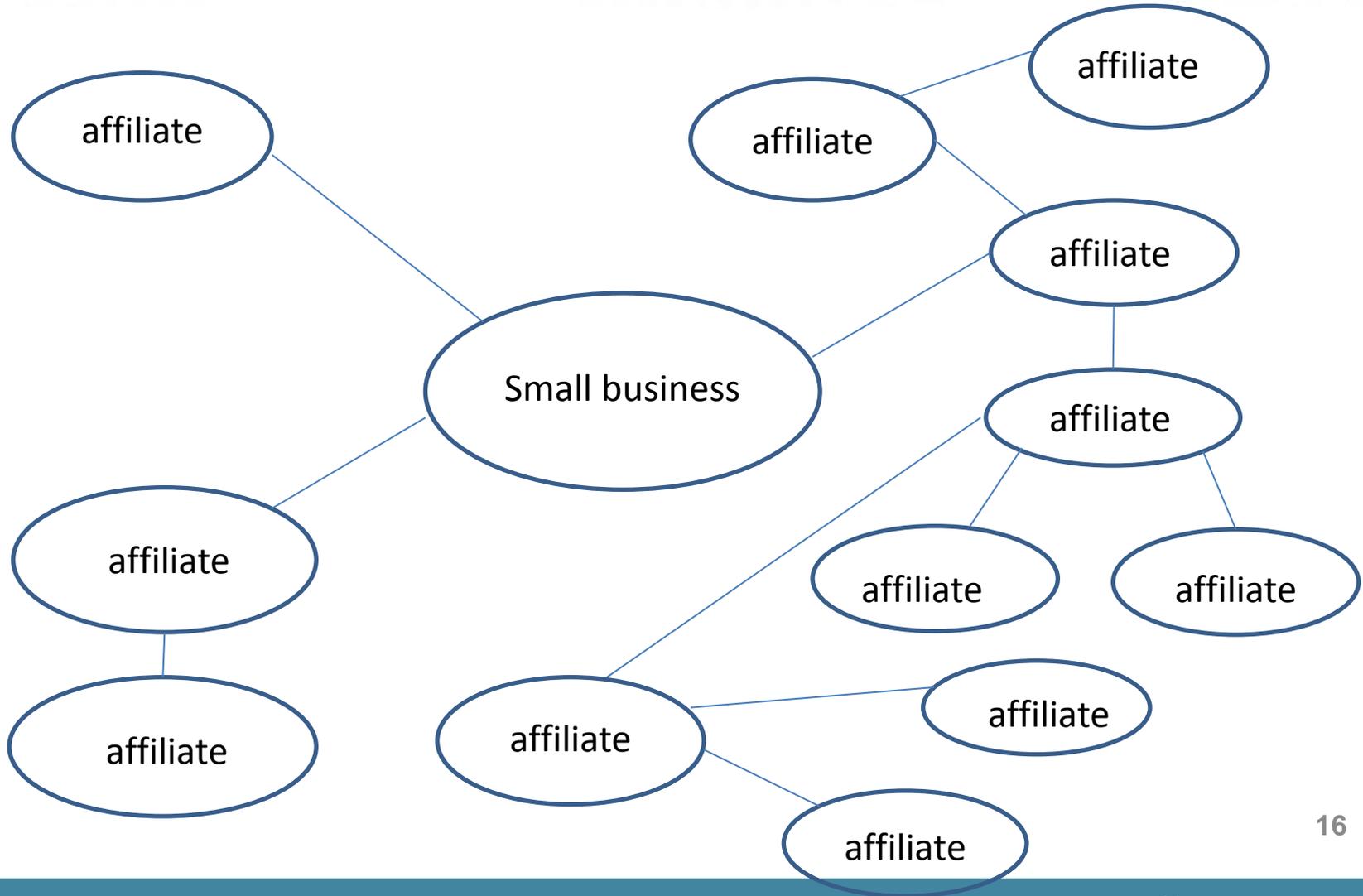
Affiliation: The Silent Killer of Small Business Status

- SBA's Form 355 reveals additional information that could contribute to finding of affiliation, including:
 - “At the time of bid opening or request for assistance, have any services been performed by business for any of the alleged, acknowledged or possible affiliate or vice versa?”
 - “In preparing the subject bid or request for assistance, was any assistance provided by an alleged or acknowledged affiliate?”
 - “Have there been any actual or proposed subcontracts between business and any of the alleged or acknowledged affiliates?”

The Affiliation Spider Web



The Affiliation Spider Web



How Is Affiliation Determined?

- Know the provisions in 13 CFR 121.103
- Several “stand-alone” tests, with certain exceptions
- “Totality of the circumstances” evidencing power to control
 - Case law provides guidance, but analysis is fact dependent
 - Focus on reality of control – substance over form
- Exceptions to affiliation coverage:
 - Most importantly, ANCs and SBA Mentor-Protégé (soon to expand)
 - Variety of other narrow exceptions
- Keep in mind size protest fire drill (shorter than bid protest) and be prepared!

Impact of Affiliation

Affiliation affects a company's size status

- Employees/annual receipts of the SB and its affiliates
- Eligibility for set-aside contracts/revenue – affects entire team!
- Lost opportunities (prime and sub) and potential penalties if wrong
- Possible subject of investigations, criminal sanctions, suspension and debarment

This is an area where SBA devotes heightened scrutiny

- “[SBA] will not close its eyes to the practical realities of business life, but will look to substance rather than form in determining the size of a concern. . . . Although no single factor alone may support a finding of power to control, consideration of all . . . factors together [may lead] to that conclusion.” *Size Appeal of Savini Construction Co.*, SBA No. 477 (1971).

Don't rely on customer (procuring agency) requests and guidance – conflicting interests with SBA

Affiliation: Control

“Control” is construed broadly by the SBA and includes both affirmative and negative control

- Quorum requirement may be negative control
- Existence of one or more independent directors, does not preclude negative control by one or the other
- Agreement designed to separate stock-voting power from beneficial ownership for the purpose of shifting control from the owner to avoid affiliation is not valid
- Limitations on unanimous or supermajority voting requirements
 - look to case law guidance:
 - Can entity conduct business as it chooses?
 - Acceptable: approve the addition of new members, change board size, amend bylaws, issue additional shares of stock
 - Unacceptable: compensation of officers, choice of auditor, corporate budget, incentive plan, choice of accounting methods

Affiliation: Common Management

- Affiliation arises when one or more officers, directors, managing members, or partners who control board of directors and/or management of SB also control the board of directors or management of one or more other entities

Common Management Exception

- Concerns owned and controlled by ANCs (NHOs, Indian Tribes, CDCs) are not:
 - Affiliates of the parent organization
 - Affiliates of other held concerns because of their common ownership or management
 - Common administrative services (*e.g.*, bookkeeping or payroll) will not result in affiliation, so long as adequate payment is provided for those services
 - Affiliation may be found for other reasons

Financing and Other Start-Up Needs

- Smartly balance short term needs with long term goals
- Lending practices should also comply with ownership restrictions
- Huge contract awards may require influx of capital, internal controls, and infrastructure
- Be wary of strings attached and impact of “present effect” rule

Affiliation: Stock Ownership (1)

- Common mistake is not realizing there are several stock ownership tests – misperception that this is only about majority ownership
Tests are not just on percentage ownership, but relative percentage ownership
- Tests not limited to individuals, but also whether there are blocks (another tier of affiliation review – friends and family)
- Majority/Largest Minority Ownership: Person or entity that owns or has power to control
 - $\geq 50\%$ of SB's voting stock, or
 - A block of voting stock which is large compared to other blocks, controls or has power to control the SB
 - Case law: block 1.36 times larger than next block = large

Affiliation: Stock Ownership (2)

- No Single Block is Large: If 2 or more persons or entities each owns, controls, or has power to control
 - < 50% of SB's voting stock, and
 - Such holdings ≈ and aggregate is large compared to any other holding, presume each person or entity has control or power to control
 - May be rebutted by showing power to control does not in fact exist
- But, if voting stock is "widely held" and no block is large compared to others, the Board AND CEO/President are presumed to "control" the company
 - "[I]f stock in a corporation is freely traded and held by more than a few shareholders, it is reasonable to state that it is widely held." *MPC Computers, Inc.*, SBA No. SIZ-4806 (2006)

Spin-Offs: Newly Organized Concern (1)

- Purpose of the rule is:
 - “[T]o prevent circumvention of the size standards by the creation of spin-off firms which appear to be small, independent firms, but are really affiliates or extensions of large firms, even absent evidence the new firm was formed to circumvent the regulations” *Size Appeal of B.L. Harbert Int’l. LLC*, SBA No. SIZ-4525 (2002)

Spin-Offs: Newly Organized Concern (2)

Must meet all four factors to find affiliation:

1. Former officers, directors, principal stockholders, managing members, or key employees of a concern organize new entity
2. New entity is in the same or related industry
3. Former officers, directors, principal stockholders, managing members, or key employees of concern serve as new entity's officers, directors, principal stockholders, managing members, or key employees
4. Concern is furnishing or will furnish new entity with contracts, financial or technical assistance, indemnification on bid or performance bonds, and/or other facilities, whether for a fee or otherwise

Spin-Offs: Newly Organized Concern (3)

It is possible (but difficult) to rebut a finding of affiliation between a spin-off and the large firm – DIVORCE (without support):

- Must show a “clear line of fracture” between the entities
- When an officer continues to perform management duties for both business concerns, *i.e.*, “common management,” the SBA is unlikely to find a “clear line of fracture”

Friends and Family: Identity of Interest

- Affiliation may arise among two or more persons that have identical or substantially identical business or economic interests (*e.g.*, family members, common investments, economically dependent through contract or other relationship)
 - With family – rebuttable presumption of affiliation
 - When businesses are in the same line of business, dependence may be implied and affiliation found
 - When “one or both of the concerns depends upon the other for a high percentage of its revenues”
- Affiliation may also arise from repeat teaming or continuing contractual relationships.

Teaming v. Joint Ventures

Teaming Relationships:

- One party leads and will serve as prime contractor
- Other teammates will serve as subcontractors
- Relationship begins with a teaming agreement/NDA (prior to proposal submission) and joint proposal effort
- Parties enter into subcontracts (post award) if team wins contract

Joint Ventures:

- Parties form and jointly own and manage a new legal entity (or de facto partnership)
- Parties may contribute assets, technology, and personnel to JV
- JV seeks contract and will serve as prime contractor
- JV itself may perform contract in whole or in part
- JV may subcontract performance to JV partners or other contractors

Teaming – Advantages and Disadvantages

Possible Advantages:

- Generally easier and quicker to arrange than a JV
- More familiar approach to many organizations
- Reduced need to arrange chains of command
- No need to create separate organization or allocate resources
- Quantifiable costs and known lines of responsibility at the RFP stage
- Leads to a prime-sub relationship – a common and generally well understood structure
- If the prime, will have more control over customer relationship and contract performance

JVs – Advantages and Disadvantages

Possible Advantages:

- Maximum ability to pool resources and strengths
- May result in a more competitive bidder
 - Stronger past performance history
 - Broader scope of experience
 - May be able to offer more competitive pricing through lower costs
 - Can incorporate best practices from all JV partners
 - Can offer a single point of contact and more experienced centralized management team
- Enhanced coordination and organization
- Meet unique customer requirements
- **LIMITED CIRCUMSTANCES WHEN PERMITTED ON SMALL BUSINESS SET ASIDE**

Affiliation: Joint Ventures

- Understand difference between “teaming” and JVs
- JV may not be awarded more than 3 contracts in 2-year period – or affiliated for all purposes
 - Limit runs from date of initial offer including price
 - Same entities may create additional JVs
 - JV must be in writing and do business in own name; JV need not be populated or separate legal entity
- SBA may determine that a prime and subcontractor are a JV and affiliated in case of “ostensible subcontractor”

Subcontracting Risk: Ostensible Subcontractor (1)

- When a subcontractor is an “ostensible subcontractor” to the SB prime, they are treated as JV affiliates
- An “ostensible subcontractor” is:
 - *A subcontractor that is really the prime contractor*
 - A subcontractor that “performs primary and vital requirements of a contract,” or
 - A subcontractor “upon which the prime contractor is unusually reliant”

Subcontracting Risk: Ostensible Subcontractor (2)

- Not just a % of work determination (common mistake)
- “All aspects of the relationship between the prime and subcontractor are considered, including, but not limited to”
 - Proposal terms (contract management, technical responsibilities, % of work subcontracted)
 - All agreements between prime and subcontractor
 - Whether the subcontractor is the incumbent and is ineligible to submit a proposal because of size
- Requires counter-intuitive proposal writing
- Mentor-Protégé relationships can resolve

Subcontracting Risk: Ostensible Contractor (3)

- Evidence of subcontractor acting as prime:
 - Will the sub manage the contract?
 - Are personnel commingled, or do the parties perform discrete tasks?
 - Does the sub perform more complex and costly contract functions?
 - Does the sub possess the requisite background and experience to carry out the contract requirements?
 - Did the sub collaborate extensively on the bid/proposal preparation?
 - Will the sub perform a greater amount of the work?
 - Did the sub chase the contract?
- Other factors to consider: incumbent team members; prime with a lack of qualifications or experience; teaming agreements; bonding or financial assistance from subcontractor
- More factors present, greater likelihood of affiliation

Mentor-Protégé Program

SBA's Mentor-Protégé (M-P) Program - currently limited to 8(a) Protégé but FY13 NDAA provisions for expansion....

- SBA's M-P Program as affiliation exception for JVs and up to an additional 40% equity interest in Protégé
- Eligibility requirements for Mentor and Protégé
- Generally 1 Protégé permitted – max. of 3 (if demonstrate they will not be competitors), conduct due diligence before selection
- Types of assistance offered pursuant to M-P agreement should be as broad as possible yet achievable (umbrella to avoid affiliation) but avoid commitments Mentor is unwilling to provide
- Leave adequate time for SBA approval!
 - SBA approval of M-P agreement
 - SBA approval of JV agreement
 - Must receive approval of JV BEFORE award can be made

Key Mentor-Protégé JV Requirements

- Track 13 CFR 124.513 to address all issues and ask local office for THEIR templates
- SBA regularly expects JV agreement as separate from Operating Agreement and does not understand/care about most standard corporate provisions/rights
- Protégé as managing venturer and supply project manager
- Not less than 51% of net profits of JV must be distributed to Protégé for separate legal entity
- Differing workshare restrictions depending on JV structure – in addition to limitations on subcontracting
- Each party obligated to ensure performance of the contract even if member withdraws
- SBA must approve changes to JV

Mentor-Protégé JV Requirements

- Protégé must maintain control over JV
 - Majority voting rights
 - Caution with quorum, blocking rights, and supermajority requirements
 - Control can also be affected through economic dependence (loans, bonding support, etc.)
- Limited exceptions to prohibition on unanimous/supermajority voting requirements:
 - Amending or terminating JV agreement or certificate of formation
 - Issuing additional membership interests or admitting another JV member
 - Changing the JV's business

Common Pitfalls in Agreements

- Templates for teaming agreements and subcontracts for set-asides are different
 - Communication with customer
 - Workshare
 - Proposal preparation responsibility
 - Payment control
 - Exclusivity limitations
- Assume all agreements could be reviewed in size protest
- Mentor must accept loss of control in JV and limited exit strategies
 - more than a marriage
- Understand what SBA prefers in JV agreements (different from standard corporate documentation)
- Track timing for JV approval
- Remember application of the “present effect” rule

Common Pitfalls in Proposals

- JVs – fewer issues, but may require steps in advance of proposal submission (GSA schedule, facility clearance, set up of legal entity, SBA Mentor/Protégé approval)
- Added risk in hiring incumbent that is now too large to compete as prime
- SB prime controls proposal preparation – or use a proposal consultant
- Clearly track compliance (using correct test) with limitations on subcontracting
- Now OK to refer to as “team” but provide clean division of functions and ensure SB responsible for most of more complex functions – organizational charts
- Key Personnel – most, and most senior should be SB’s employees
- Hiring of incumbent personnel now common (and often required)
- Past performance should include SB prime’s experience
- TIP: Include section summarizing ostensible subcontractor factors and demonstrates why no affiliation

New Regulatory Developments

December 29, 2014 – Proposed Revisions to SBA Regulations Implementing Some of the 2013 NDAA Provisions

- Limitations on subcontracting
 - Revise calculation to amount paid to prime in comparison to amounts expended on subcontractors
 - Includes exception for “similarly situated” subcontractors at any tier – no longer limited to first-tier consideration
 - Certificate of compliance now required
- Clarification on affiliation based on identity of interest
- Exemption of affiliation for joint venture members if they individually qualify as small
- New recertification if merger/acquisition post-proposal submission but before award
- Revisions to non-manufacturer rule waivers – with new provisions on applicability of rule to software
- Subcontracting plans – additional sanctions for failure to comply with goals/implement corrective action
- Expansion of mentor-protégé program – *still waiting*

QUESTIONS?

John McCarthy

(202) 624-2579

jmccarthy@crowell.com

Amy O'Sullivan

(202) 624-2563

aosullivan@crowell.com

Q&A

To ask a question from your touchtone phone, press *1.

To exit the queue, press *1 again.

You may also use the Chat function to ask questions, or email questions to lawquestion@straffordpub.com

CLE CODE: TLBGVA

Tell us how we did!

After you complete a brief survey of this program, we'll send you a **free \$5 Starbucks Gift Card**.

Look for our 'Thank You' email (which you should receive shortly) for details and the survey link!

Thanks.

Please join us for our next legal conference, “Corporate Governance and FCPA Compliance: The Board's Duties and Obligations - Meeting Duty of Care Requirements, Facilitating Effective Oversight, and Minimizing FCPA Risks,” scheduled on February 18, 2015, starting at 1pm EST.

Strafford Publications, Inc.
1-800-926-7926
www.straffordpub.com