

PROTECTING YOUR SMALL BUSINESS STATUS: JVs, RESTRUCTURING & DIVERSIFYING

2016 NATIONAL HUBZONE CONFERENCE
OCTOBER 13, 2016



Presented by:

Jon Williams, Partner

jwilliams@pilieromazza.com

(202) 857-1000

Michael A. de Gennaro, Partner

mdegennaro@pilieromazza.com

(202) 857-1000



ABOUT PILIEROMAZZA

PilieroMazza PLLC is a full-service law firm located in Washington, D.C. We are most well known as government contracting firm and for 25 years we have helped our clients navigate the complexities of doing business with the federal government. We also provide a full range of legal services including advice on corporate, labor and employment, SBA procurement programs, and litigation matters. Our clients value the diverse array of legal guidance they receive from us and our responsiveness as we guide their growth and secure their success.

Sign up for our newsletters and blog at
www.pilieromazza.com

PM Legal Minute – our blog, written by all of PilieroMazza’s attorneys, provides trending insight to small and mid-sized businesses.

Legal Advisor Newsletter – our quarterly publication which addresses current issues that are of concern to federal government contractors and commercial businesses nationwide. The Legal Advisor articles focus on recent legal trends, court decision, legislative and regulatory rule-making as well as other newsworthy events.

Weekly Update – an email sent every Friday that provides an up-to-the minute recap of legislative and regulatory issues affecting small businesses.

Webinars on YouTube – all of our past webinars can be found on the PilieroMazza YouTube channel.

Follow us on:  @pilieromazza



PilieroMazza Channel



OVERVIEW

- ❖ **Why size matters**
- ❖ **Toolbox for maximizing your time as a small business (“SB”)**
 - **Tools that work**
 - **Tools you might think work, but generally do not**
 - **Tool of the future?**
- ❖ **Q&A**



WHY SIZE MATTERS

- ❖ **Being small is the essential ingredient of all federal small business contracting programs**
 - **Therefore, if you participate in SB programs, your SB status is one of your most important company assets**
- ❖ **Being small exempts you from certain federal requirements**
 - **Reporting executive compensation**
 - **Ethics awareness and compliance program under FAR § 52.203-13**
 - **Cost accounting standards**



HOW SBA DETERMINES SMALL BUSINESS STATUS

- ❖ Depending on your industry, SBA looks at your average annual receipts or total number of employees
- ❖ Your average revenue or employees must be less than the size standard for your industry's NAICS code
- ❖ How SBA calculates annual receipts
 - “Total income” plus “cost of goods sold,” per your tax returns
 - Limited exclusions, such as sales taxes and franchise taxes collected for and remitted to a taxing authority
 - SBA proposal earlier this year would include passive income in calculation of annual receipts
 - Short year: revenue divided by total weeks, multiplied by 52



HOW SBA DETERMINES SMALL BUSINESS STATUS

- ❖ Period of measurement:
 - Revenue-based: Average revenues from your three most-recently completed fiscal years
 - Employee-based: Average number of employees for each pay period over the past 12 completed months
- ❖ If you have affiliates:
 - Your size status = your average annual revenue or employees + your affiliates' average annual revenue or employees



TOOLBOX FOR PROTECTING YOUR SMALL BUSINESS STATUS



UNDERSTAND AND AVOID AFFILIATION

- ❖ **Affiliation can cause you to lose SB status**
- ❖ **SBA deems firms to be affiliated when one firm has the power to control the other, or when both firms are controlled by a third**
- ❖ **Examples of what can cause affiliation**
 - **Common ownership and management**
 - **Shared facilities and employees**
 - **Close family connections**
 - **Economic dependence**
 - **Newly organized concern**
 - **Totality of the circumstances**



UNDERSTAND AND AVOID AFFILIATION

- ❖ **Affiliation avoidance and mitigation tips:**
 - Proactively assess the potential for affiliation prior to corporate transactions
 - Be wary of corporate documents that give another party “negative control” over your business
 - Diversify your teaming partners and sources of revenue
 - Do not assume your family member’s business is unaffiliated with your firm
 - Make sure your website and marketing materials do not create an impression of affiliation with other firms
 - Structure your teaming and subcontract agreements carefully



GET YOUR HOUSE IN ORDER

- ❖ Your bylaws and shareholders' agreement, or operating agreement, may contain provisions that can wreck your SB status
 - Negative control in quorum and voting provisions
 - Transfer restrictions and rights of first refusal
- ❖ Your agreements with outside parties can also adversely impact your SB status
 - Employee leasing
 - Administrative services agreements
 - Bonding indemnification agreements
 - Teaming agreements and subcontracts
 - Joint ventures



UTILIZE JOINT VENTURES

❖ Manage revenue growth

- Joint venture revenue is attributed to the joint venture partners in proportion to their ownership interests in the JV
- By contrast, as a prime contractor, you get hit with 100% of the revenue even if you subcontract a significant portion

❖ Chase larger contracts

- Joint ventures often make it easier to pursue/win larger contracts
- Combined with SBA mentor-protégé, the joint venture can include a large business mentor
 - Coming soon: SBA mentor-protégé program for all SBs



THE “FORMER AFFILIATE” RULE

- ❖ According to SBA’s “former affiliate” rule, your affiliate’s average annual revenues or employees are not included in determining your SB status if the affiliation ends before the date used to determine your size
 - And, your affiliate is excluded for the entire period used to measure your size

- ❖ Example:
 - 2012-2014: A (avg. \$20M) is affiliated with B (avg. \$20M), meaning A has avg. total revenue of \$40M and is not small
 - On 11/1/15, A and B fracture affiliation
 - A submits proposal on 11/2/15 and can certify as small based on avg. revenue of \$20M between 2012-2014



THE “FORMER AFFILIATE” RULE

- ❖ To be a “former affiliate,” the entity must first be an affiliate
 - SBA rules state that an affiliate is a “concern,” which SBA defines as a separate legal entity, such as a partnership, sole proprietorship, LLC, corporation, etc.
 - SBA will not treat a firm as a separate business concern if a substantial portion of its assets and/or liabilities are the same as those of a predecessor entity – in that case, SBA will consider the predecessor entity’s annual receipts or employees in determining size
 - What about a division or business unit?



SELL AN AFFILIATE

- ❖ **Goal is to trigger the “former affiliate” rule and remove the affiliate’s revenues retroactively**
- ❖ **Questions to ask:**
 - **Does your business naturally fall into distinct groups or units?**
 - **Are you currently utilizing a subsidiary or sister entity structure?**
 - **Do you see yourself moving into a new direction that might lend itself to a separate structure from your current business?**
 - **What is the market?**
 - **How much time do you have?**



SELL AN AFFILIATE

❖ Novation

- Required for asset purchases
- Should not be required for stock purchases
- Could be avoided for corporate reorganizations

❖ Size recertification

- A SB must recertify its size on set-aside contracts and proposals when it is the acquiring or the acquired entity
- Same for participants in joint ventures
- For multiple-award contracts, if a firm certified itself as large, the firm may recertify as small for a subsequent option period
- Also applies to acquisitions by affiliates



SELL AN AFFILIATE

- ❖ Sale must result in a “clean” break
 - Ongoing ties could result in finding that the affiliation was not sufficiently fractured and therefore the affiliate does not qualify as a former affiliate
 - What could trip you up:
 - Legacy financial commitments such as guarantees on your company’s line of credit
 - Former corporate representatives still listed on corporate paperwork
 - Ongoing financial or administrative assistance
 - Continued intermingling of management
 - Continued sharing of facilities and/resources



FRACTURE A BUSINESS RELATIONSHIP

- ❖ Selling an affiliate requires finding a buyer, which could be difficult
- ❖ An easier (and faster) option may be to fracture an existing business relationship that is causing affiliation
- ❖ Fracture means breaking the ties between two companies that are causing affiliation
 - Restructure ownership and management
 - End sharing of resources, facilities, and personnel
 - Cancel administrative services agreements and other joint undertakings
 - Again, key is to show a “clean” break



CHANGE NAICS CODES

- ❖ Using organic growth and/or acquisitions, diversify into new industries that have higher size standards
 - For SBA programs, your primary industry is generally determined based on the NAICS code in which you earn the most revenue
- ❖ Market your customers to assign a different NAICS code with a higher size standard
 - The assigned NAICS code is supposed to best describe the “principal purpose” of the solicitation
 - Use meetings, white papers, etc. to customers to advocate for a different NAICS code with a higher size standard
 - Challenge assigned NAICS codes to the SBA’s Office of Hearings and Appeals



EXAMINE YOUR TAX RETURNS

- ❖ Prevent accidental inclusion of items that should be excluded (such as sales taxes and franchise taxes) and could overstate your average annual receipts
- ❖ Find errors in your tax returns and amend the returns before you submit a proposal relying on the corrected tax return figures



“TOOL’S GOLD”

- ❖ Start a new company
- ❖ Change your fiscal year
- ❖ Delay submission of invoices and/or cashing checks



WAIT OUT SIZE STANDARD INCREASES

- ❖ SBA has reviewed and increased many industry size standards over the last several years
- ❖ SBA also implemented an inflation adjustment for size standards in July 2014
 - SBA is supposed to examine inflation every 5 years
 - Another inflation adjustment around 2018/19?



BRING ABOUT SIZE STANDARD INCREASES?

- ❖ **Contractors may soon be able to challenge SBA's size standards**
 - **2016 National Defense Authorization Act includes provisions permitting contractors to challenge a size standard to SBA's Office of Hearings and Appeals**
 - **Law requires challenge to be filed within 30 days after the proposed size standard increase is published**
 - **Law makes clear that SBA appeal option does not prevent a contractor from taking SBA to court**
 - **However, OHA has ruled that contractors cannot use this new appeal mechanism until SBA rules are implemented**



Questions?

Jon Williams

jwilliams@pilieromazza.com

(202) 857-1000

Michael A. de Gennaro

mdegennaro@pilieromazza.com

(202) 857-1000