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Column: Small business investors have rights, too

by Megan C. Connor, associate, PilieroMazza PLLC

With incredulity in his voice, a client recently asked me, "So you're telling me that the Small Business Administration has a different set of rules for corporations than the well-established corporate law in this country?"

My answer: "Yes."

And the primary reason behind my answer? Negative control.

SBA Regulations

Under the SBA's regulations, negative control is a minority owner's ability to block action by the majority owner.

If the status of the concern is based on the status of that majority owner (e.g., the woman owner and manager of a Women-Owned Small Business-WOSB) and a minority owner can block her action, then the majority owner may not be found to control her company.

In addition, if the minority owner is a large business, the majority owner's negative control may be the basis for a finding of affiliation between the concern and the large business.

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Negative control issues

Recently, our firm has encountered negative control issues arising frequently in the context of mergers, acquisitions, buy-outs and corporate restructuring.

A large firm recognizes the growth potential of a particular small business and wants to become a minority investor. But that large firm also wants to have some say over the operations of the small business in consideration for its investment. A seed of negative control is sown.

Corporate law vs. SBA

Simply put, certain rights of minority investors that are widely accepted in corporate law will not fly with the SBA.

For example, a minority owner might want a supermajority requirement on matters involving the borrowing of money and controlling operating budgets.

Outside the set-aside world, such a request is logical and allowable. However, in the small business federal contracting programs, it is not.

SBA's Office of Hearings and Appeals has recognized that ordinary actions--such as borrowing money, creating debt securities and controlling operating budgets--must be the province of the majority member. See, e.g., *Size Appeal of Carntribe-Clement 8AJV #1, LLC*, SBA No. SIZ-5357 (2012).

Ownership rights

So does this mean minority investors forgo all ownership rights when they invest in a small business pursuing set-aside contracts? No.

OHA also recognizes that if all minority ownership rights were disregarded, small businesses would stagnate without outside investment. Therefore, OHA allows a supermajority requirement for certain extraordinary acts, like amending the company's organizational documents, issuing additional shares of capital stock, and entering into a substantially different line of business. See *Size Appeal of EA Eng'g, Science, and Tech., Inc.*, SBA No. SIZ-4973 (2008).

The minority owner's ability to vote on these extraordinary acts is not an exercise of negative control. Rather, the approval of the supermajority of owners in these extraordinary circumstances protects the minority owner's investment.

Size protests

Importantly, these cases discussing minority investor rights

arise in the context of size protests. Firms participating in eligibility programs, like 8(a) and WOSB, must ensure that the individual upon whom the concern's status is based maintains all control over the company. Thus, providing for minority investor rights may still cause eligibility issues.

'Ordinary' vs. 'Extraordinary'

For other small businesses, however, the tricky part is discerning what qualifies as an "ordinary" act over which the majority owner must have unfettered control versus an "extraordinary" act in which minority investors are entitled to a vote.

OHA's decisions confirm there is a spectrum of gray between these two points.

Simply put, certain rights of minority investors that are widely accepted in corporate law will not fly with the SBA.

Therefore, before restructuring or negotiating an acquisition, small businesses would be well-served by consulting with an experienced government contracts attorney familiar with SBA's regulations and case law to vet whether they can achieve what the minority investor wants, without losing their valuable small business status.

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