



PilieroMazza Webinar

Navigating SBA's "Present Effect" On Your Corporate Strategies

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About PilieroMazza

PilieroMazza PLLC is a full-service law firm with offices in Washington, DC and Boulder, CO. We are most well known as a 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.

Our primary practice areas are:

- Government Contracting
- Small Business Programs
- Labor & Employment
- Business & Corporate
- Litigation

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Overview

- Why size matters
- SBA's present effect rule
- Key corporate strategies and how they are affected by the present effect rule
- Tips to navigate SBA's "present effect" on your corporate strategies

Why Size Matters

- Small business status is the #1 eligibility requirement for all of the set-aside programs
- Being small also exempts you from certain requirements, such as reporting executive compensation, contractor code of ethics, and cost accounting standards
- SBA's "Presumed Loss Rule" increases the importance of verifying your small business status before you submit proposals for set-aside contracts
- For these reasons, if you participate in the set-aside programs, your small business status is one of your most important assets and you need to take steps to protect it

How Affiliation Impacts Size Status

- Small business status is determined by your:
 - Average annual receipts over your three most recently completed fiscal years; or
 - Average number of employees for each pay period during the past 12 months
- When you have an affiliate, your affiliate's annual revenues or employees are counted with yours to determine if you are a small business
 - This means you may be small on your own, but if you have affiliates, the combination of the affiliates and your firm may push you over the size standard, rendering your company “other than small”

Affiliation 101

- Affiliation is all about control
 - SBA's affiliation rules look to whether one firm has the power to control another, or a third firm has the power to control both
 - Control can be affirmative or negative
 - Does not matter if control is exercised, so long as the power to control exists
- An affiliate can be any business entity, whether for profit or non-profit, domestic or foreign
- In protests, SBA judges affiliation at a specific point in time, generally the date you submitted your initial proposal with price

Types of Affiliation

- Under 13 C.F.R. § 121.103, affiliation can arise based on:
 - Stock ownership
 - Common management
 - Newly organized concerns
 - Ostensible subcontractor arrangements
 - Identity of interest
 - Joint ventures
 - **Stock options, convertible securities, and merger agreements**
 - Franchise and license agreements
 - Totality of the circumstances

SBA's So-Called “Present Effect” Rule

- In determining size, SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a “present effect” on the power to control a concern
 - Present effect means SBA treats the stock options, convertible securities, and agreements in principle as though the rights granted have already been exercised
 - Therefore, SBA may treat a person holding stock options as an actual stock owner even before the person has exercised the stock option

Present Effect Can Cause Issues for Small Business Status

- New ownership or corporate structure may create affiliations that did not exist prior to treating the option, agreement in principle, etc., as if it was already exercised
- Example:
 - Company is 100% owned by a service-disabled veteran and qualifies as an SDVOSB
 - Company gives stock option or enters into an agreement in principle to sell 51% of the business to a large firm
 - If SBA gives present effect to the stock option or agreement in principle, it will view the large business as the Company's 51% owner
 - As a result, the Company will no longer be an SDVOSB even before the stock option is exercised or the sale transaction is closed

Exceptions to Present Effect Rule

- SBA will not give present effect to –
 - Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date
 - Stock options, convertible securities, and agreements to merge that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under state or Federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote
- The present effect rule only applies to stock options, convertible securities, and agreements to merge
 - SBA does not give present effect to agreement in principal for other purposes, such as an agreement in principal to revise an operating agreement

Only SBA Can Give Present Effect

- SBA can use the rule to give present effect to a stock option, convertible security, or agreement to merge
- However, companies cannot use stock options, convertible securities, or agreements in principle to divest control before actually doing so
 - **Example:** Company A is controlled by a large business, and the large business has an agreement to sell its interest at some point in the future. SBA will not give present effect to the large business' agreement to divest control in the future. Rather, SBA will treat the large business as controlling until it actually divests its ownership and control.

Comparable Rule for 8(a) Eligibility

- An 8(a) firm performing an 8(a) contract must notify SBA in writing immediately upon entering into an agreement or agreement in principle (either oral or written) to transfer all or part of its stock or other ownership interest or assets to any other party
 - Such an agreement could include an oral agreement to enter into a transaction to transfer interests in the future
- Failure to notify SBA can lead to suspension or termination from the 8(a) program

Stock Option Equity Incentives

- Stock options granted to employees, executives, and investors
- Equity has not been purchased at time of grant of option
- Real equity/ownership occurs after options have vested and employee exercises option and buys the shares
- Typical triggers for the option:
 - At employee's discretion after certain period of time if still employed in good standing
 - Upon death or disability
 - Upon a sale event
 - Company has met certain financial objectives

Will SBA Give Your Stock Options Present Effect?

- This is a case-by-case determination based on the nature of the option and how it is triggered
 - The general rule is that SBA will give stock options present effect and treat them as if they have already been exercised unless the trigger for the option is too remote or the option is too speculative
- Questions to ask:
 - Is there an integrated and complete agreement?
 - How difficult is it to exercise the option?
 - How difficult is it to determine the amount of shares to which the person would be entitled upon exercising the option?
 - Is the option tied to an undetermined point of time in the future, or a financial measure that will not be known until the future?

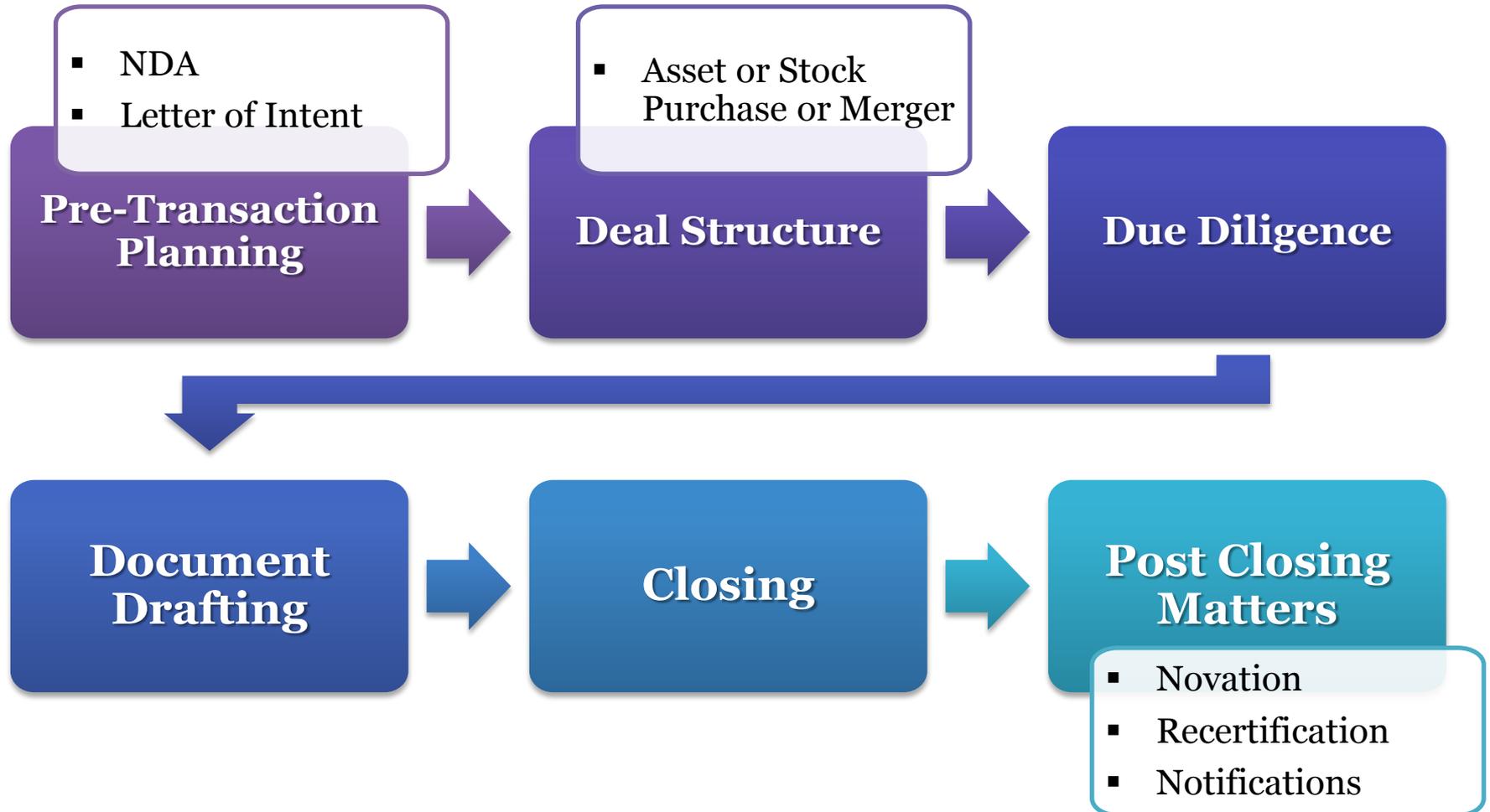
Workarounds for Stock Options

- Use triggers that are more remote
- Provide stock options in a different class of stock or non-voting stock
 - For affiliation, control is based on voting stock
 - For other set-aside programs, control may need to include all classes of stock
- Cash bonuses
- Quasi-equity
 - Stock Appreciation Rights (SARs) plan
 - Phantom stock plan
 - Restricted stock units

Agreements to Acquire or Merge

- Asset purchase
 - An asset purchase involving government contracts will require novation
 - Cannot acquire a federal contract without additional related assets
- Stock purchase
 - Generally should not require novation
- Agreement to merge
 - Statutory process whereby one company is dissolved (non-surviving) when it is merged with and into another company (surviving company)

Stages of M&A Transactions



Letters of Intent (LOIs)

- Typically entered into toward the beginning of discussions
- Goal of the LOI is to provide a roadmap for material deal terms, transaction structure, and due diligence/negotiations
- LOI terms are non-binding, but certain terms should be specified as binding such as:
 - Confidentiality
 - Exclusivity
 - Conduct of seller business
 - Access to seller
 - Deal subject to financing (if applicable)

When Do You Have an “Agreement in Principle”?

- Unfortunately, SBA’s rules are not clear and this presents protest risk
- Questions to consider:
 - How quickly will the deal close after the initial NDA/LOI phase?
 - Does the agreement include a set price, or a potential price range?
 - How much due diligence is already done vs. remains to be done?
 - Mere negotiations are not enough – is there a formal document memorializing negotiations and next steps?
 - Is the merger essentially done and signed up, but for final shareholder approval and regulatory filing – or does substantial work remain to be done?
 - Do the parties have big/easy ways to get out of the agreement?

LOIs Can Cause Affiliation Problems

- May not matter to SBA that the LOI is nonbinding if the LOI indicates:
 - Significant work has already been done
 - A set price
 - Significant commitments toward the success of the deal
 - However, merely agreeing to negotiate exclusively should not be a problem by itself
- SBA will look at how soon the deal closes after you sign the LOI
 - Closing < one month after LOI may be problematic
 - Closing > eight months after LOI should not be problematic

Workarounds for LOIs

- Be careful with the terms
- Assess transaction timeline against upcoming set-aside proposal deadlines, contract renewals, SAM re-certification, etc.
- Ask yourself, is an LOI necessary?

Convertible Securities

- A convertible security can start as either:
 - debt (such as a note, bond, or debenture)
- OR
- a security (such as preferred stock)
- In either case, it can convert into true equity such as common stock
- As with stock options, this is a pathway to true ownership and if outstanding can be given present effect thereby triggering potential affiliation issue when determining size

Convertible Debt

- Convertible debt such as a convertible note, for example, commonly used for initial “seed” financing for start-ups
- Where the holder has the option to convert the note into a security of the issuer (e.g., common stock) at some future date upon certain trigger events such as sale of company, new round of equity financing, or upon reaching maturity
- Because of the conversion right, generally, for convertible debt:
 - the interest rate is lower than the rate on straight debt
 - it will be unsecured and have a relatively short maturity
 - can be done as an unregistered offering, i.e., without being subject to securities laws

Impacts of and Workarounds for Convertible Securities

- Similar to the workarounds for stock options set forth above

Key Takeaways

- Be aware that SBA may treat stock options, convertible securities, and agreements to merge or acquire as if they have already been exercised
- SBA will not give present effect if the trigger points are too remote or speculative, or if the parties have not reached an agreement in principle
- If considering use of stock options, convertible securities, and agreements to merge or acquire, then give such scenarios present effect (as if options have already been exercised or the deal has closed) and analyze the impact on your ownership, control, upcoming proposals, and future activity in the set-aside programs

Questions?

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