



Smart Growth in the Federal Market: How to Thrive in the Mid-Tier or Stay Small

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Cy counsels clients on a broad range of government contracting matters before government agencies and federal courts, which includes overall regulatory compliance with the Small Business Administration's (SBA) small business programs. He represents small and mid-sized government contractors looking to structure compliant teaming, joint venture, and mentor-protégé agreements. Cy also handles the prosecution and defense of small-business size and status protests; appeals before the SBA and the Office of Hearings and Appeals; as well as bid protests before the Government Accountability Office, the Court of Federal Claims, and the U.S. Court of Appeals for the Federal Circuit.

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Overview

- What Is the Mid-Tier?
 - The commercial sector vs. the public sector and why they are so different
- Risks / Challenges Companies Face
 - The difficulty of being stuck between the inability to go after incumbent work and inability to drop margins to win full and open work
- How to Mitigate the Risk of Growth
 - Smart growth OR
 - Staying small

What Is the Mid-Tier?

Defining the Mid-Tier

- The private sector has different definitions for “Mid-Tier” or “Middle Market”
 - \$10M-\$1B in Revenues
 - \$5M-\$30M in Revenues
 - 50-500 Employees
 - BUT: None of these matter for government contractors!
- In the federal market, if you are not small, you are large
 - There is no formal Mid-Tier program or benefits
 - Every procurement’s NAICS code dictates size
 - Once you outgrow the size standard you are seen as no different from Boeing / GDIT / etc.
- So some companies can “size-out” with just a few million in revenues and be forced to compete with billion-dollar entities
- Attempts to create a formal Mid-Tier program have failed
 - Other calls for a specific program by organization dedicated to mid-tier firms have also had no traction with Congress

What Are the Risks?

Toxic Success

- The 809 Panel recognized the problem of small businesses struggling to stay small, but no movement has been made toward rectifying the problem:
 - “Set-asides and other small business programs incent small businesses to make extraordinary efforts to remain small. Setting-aside all procurements under a certain dollar threshold does not encourage a small business to grow beyond that threshold, especially if that business relies on competing for procurements that are currently set aside for small business. Outgrowing the size standard makes those businesses ineligible to compete for the same contracts that, in many cases, were critical to the success of the small business....”
 - The 809 Panel itself recommend just removing small business set-asides entirely instead of helping with a path to growth

Inability to Re-compete for Incumbent Work

- Work must be set aside for small businesses if the “Rule of Two” is met
 - Two or more small businesses are capable of performing the work at a fair and reasonable price
- 8(a) work must stay in the 8(a) program
 - Agencies can remove things from the 8(a) program but it is very difficult
- Agency small business goals drives work onto “Best in Class” contracts with small businesses
 - Combined with Category Management it greatly reduces opportunities to bid
- New 5-year look-back for small business status makes it even harder to survive as you likely miss two full procurement cycles

Recertification Impacts on Existing Work

- Recertification required after 5 years on long-term contracts
 - If you cannot recertify as qualified no new orders may be placed
 - Many procurements have off-ramps
- If any member of a JV recertifies as large the entire JV is unable to bid for orders under existing work
- Contracting officers can request recertification at any time
 - Some COs believe that only companies that are small at the moment of a task order bid are “legitimate” small businesses – FALSE
 - COs are given limitless discretion to call for recertification – can be used to steer work to favored companies or away from “difficult” companies (note: many times “difficult” just means knowing their rights and standing up for themselves)

No Exit?

- Recertification is also required:
 - If a merger or acquisition occurs
 - Applies to both the acquiring company and the company being acquired
 - Not clearly defined in the rules what a “merger” or “acquisition” is
 - If a novation occurs
 - Applies to only the assets / contracts acquired
- Recertification prohibits easy sales of stock or assets
 - Any 8(a) contracts are required to be terminated for convenience
 - Small Business IDIQs become worthless
 - Outstanding proposals / bids are invalidated
 - Under the new SBA rules if an acquisition occurs within 180 days of proposal submission the offeror is ineligible, if it occurs after 180 the award can be made but the agency can no longer take small business credit

No Way to Stay Small?

- You cannot reduce revenues by the sale of assets
- You cannot reduce revenues by the sale of a full division
- You can only reduce revenues by the sale of a separate legal entity affiliate
- BUT: SBA rules prohibit 8(a), SDVSOB, WOSB, or EDWOSB firms from creating corporate structures that allow themselves to easily retain small business status under the rules
 - The SBA rules prohibit “indirect” ownership of these types of companies – as such, no contracts can be held in a separate legal entity subsidiary that requires these designations
 - SDVOSB/WOSBs may, in theory, be able to have a second (maybe 3rd) firm if in the same or similar line of business and you can convince the government having the two does not take away from your ability to work “full time” for each company (SBA does not buy “I work 80 hours a week”)

Unrestricted Competitions Are Very Difficult

- Large business success is based on volume – lower margins, higher price competition
 - But to get volume you need to win work!
 - Small businesses fail to learn to “sharpen the pencil”
- Or, highly specialized work
 - Often this work is not appropriate for small businesses so they have no experience in these areas
 - Much of the small business work is in standard areas where competition is even more intense at the unrestricted level (double whammy)

Option One: Stay Small

Plan Now

- Understand the rules (at least how they exist now)
 - Former Affiliate Rule: A company can eliminate revenues retroactively if it divests itself of a separate legal entity affiliate
 - Indirect Ownership Rules: “Vanilla” and HUBZone firms can be owned indirectly
 - Can you restructure your business to move work into a wholly owed subsidiary or set of subsidiaries?
 - The sooner the better as you (likely) can only retroactively remove the revenues going back to the date upon which the entity was created
 - Recertification Rules: There may be ways to restructure a company without triggering recertification
 - Use the “By Operation of Law Exception” to novations (not guaranteed to work)
 - Understand the JV Rules: Performing work through JVs reduces a firms revenues SUBSTANTIALLY

Use of Joint Ventures

- You only take on your books the revenues commensurate with the percentage of the JV's work you perform
 - As the qualified member you have to perform at least 40% of the work performed by the JV so then you would take 40% of the total contract dollars onto your books for size purposes
 - If you have a “similarly situated” member in that JV you can split the minimum 40% as well to reduce that amount
- With subcontracting you take 100% of the revenues
 - This is true even if you only do 50% of the work (as required for services)
 - For revenue purposes you do not split the revenues of a prime contract with a similarly situated subcontractor
- The JV allows to you stay small longer as a result of these rules

Shifting Your Business

- If you are a new company, applying for 8(a), HUBZone, CVE status (for SDVOSB), pick the largest possible NAICS code that fits your work and government needs
 - Check USA Spending, SAM, etc. to see what codes the government uses to buy the goods or services you sell, and pick the largest one
- For a mature company, review possible NAICS Codes for your work
 - Is there a code with a larger size standard that may fit the work you do or into which you could pivot?
- Review NAICS Codes placed on procurements
 - Make sure the procurements on which you are bidding have the correct NAICS code
 - Talk to the contracting officers about the possible higher NAICS Code
 - If you feel a larger code is more appropriate you can appeal that NAICS determination to SBA's Office of Hearings and Appeals

Structuring Your Company

- Depending on your set-aside designations, different strategies may have to be employed to allow for divestiture of revenues down the road
- HUBZone and “Vanilla” Small Businesses:
 - May want to form a holding company from the beginning and keep all actual work in subsidiary operating companies
 - Allows flexibility to divest certain work via stock sales of the subsidiaries
 - Can still use past performance and experience of affiliates in most cases
- 8(a)
 - May want to create subsidiaries (must be 100% wholly owned by the 8(a) firm itself) to hold non-8(a) work
 - Can create multiple wholly owned subsidiaries to hold HUBZone or “Vanilla” small business lines
- SDVOSB / WOSB:
 - May want to create a sister company for certain types of work
 - Can also create subsidiaries to hold HUBZone or “Vanilla” small business work

Corporate Law Considerations

- S-Corporations are VERY DIFFICULT to divest
 - Any acquisition by an entity will blow the tax status and create serious consequences
 - Often treated as a divestiture of all assets to the owner(s)
- JVs by contract (i.e., general partnerships) are not ideal
 - You cannot have a partnership of one
 - Thus, if only one JV member remains, the contracts have to be novated – if there is no work the novation may be denied and the contract terminated
 - No limitation on liability in a general partnership

Option Two: Smart Growth

What Do You Want?

- You must decide if you want a “lifestyle” company or if you want to sell your business in the future (be honest)
- If you want to continue running a successful small business or a lower middle market company who works with small business partners or as a subcontractor you can be very successful and do well
 - BUT: the strategies for that are different than growing for a sale or massive growth
- If you want to sell your business or grow into the solid or upper mid-market you need to sacrifice now for the possibility of future pay-offs (know that most do not succeed, but if you do, it can be worth while)
 - Plan for 5-10 year future cycles, emerging technologies / needs, be first to market while competition is low
 - It will cost time and money and you will make LESS now than you otherwise could

Invest for the Long Term

- You know how to run a successful small business, but you need help to build a large business
 - Recruit key management from larger firms who understand the full and open environment or who can help build a pipeline years in advance of your “graduation” from your small business status
 - Find the personnel who have connections and can help you build relationships with key customers
 - Network with government officials closely to determine the long-term goals of the key agencies you work with and plans and focus on those areas with hires, technology or IP creation, IP acquisition, etc. – this creates value that is more than the revenues from contracts
- Determine if there is any way to leverage your government experience in the commercial space
 - This allows you to increase revenues without all the restrictions
 - Are there completely new areas you can invest in to take current profits to take a shot at larger growth? - Does not have to be related to your current work.

Growth by Acquisition – Key Issues

- Recertification
 - Growth by acquisition puts current work at risk!
 - If you acquire the equity of another company you must recertify on all of your work and the work you acquired
 - If you acquire another company to grow your business you must recertify, taking into account the revenues and employees of the acquired company
 - If you acquire less than “all or substantially all” of the assets of another company and novate the contracts, you have to recertify only as to those contracts, not all of your own work
- Possible ways to avoid recertification?
 - The rules are not entirely clear and this is not tested, but it seems to be indicated that, if a natural person acquires the stock of another company and keeps it separate, that does not require recertification for either firm

Mentor / Protégé Program

- Find new or very small firms to be your protégé
 - You can take a 40% ownership interest in them – if they are new the value will be low and you can invest for a relatively small amount
 - You can form JVs for all of your small business work that is expiring and go after the renewal with the MP JV
 - You can then get 60% of the total work back, plus you get 40% of the profits from the protégé as a 40% owner
 - Giving you roughly an 78% stake in the business flowing through the JV
 - Note: 8(a) firms have distribution limitations but the value/cash will still be yours just has to stay within the company until graduation of the firm from the program
- You can have up to 3 protégés at any time (if you can show SBA you are capable of supporting that many)
 - It may be difficult to have more than one if they are in the same industries, so you should look to diversify

Should You Exit?

Plan Now (But Differently)

- Exit Timing for a Small Business:
 - Small businesses need to sell when they are not close to their size standard because you need a small business buyer to be able to recertify and keep your work
 - Sell off assets
 - not as tax advantageous and usually at a lower value
 - Novation of a “naked” contract is difficult
 - Some agencies will reject those attempts – GSA rejects most of the time
 - Anti-Assignment Act Violations

Plan Now (But Differently)

- Exit Timing for a Mid-Tier Business:
 - Take all the steps noted above to GROW
 - If you succeed, your firm will be far more valuable than when it was reliant upon small business contracts
 - Try and get as much unrestricted work as possible
 - You must commit: if you fail and are both a large business and have little to no unrestricted work, it will be very difficult to sell your business
 - Be prepared for the long haul, not just a few years
 - If you want to retire and really cannot continue the grind, it may be possible to sell to an employee using a seller note, but that can be very risky
 - An ESOP sale may be possible, but those are complicated and very costly

Questions?



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