LEGAL ADVISOR

A PilieroMazza Update for Federal Contractors and Commercial Businesses

How to Walk in the Valley of the Shadow of Death: Strategies for Mid-Tier Federal Contractors

By Cy Alba

It is a well-known fear of many small business federal contractors that, if you are too successful, it may be the death knell for the business. Every small business set aside is restricted to only those companies whose revenues or employees fall below the applicable size standard, some of which are quite small (only a few million dollars a year in some cases). As a result, small businesses that continue to win work soon find themselves classified as a large business and ineligible to bid on new set asides. These companies are then forced to compete with companies two, five, ten, or even a hundred times their size.

The immediate step up from small to large makes it very difficult for mid-sized firms, those generally with sizes of $25 million to $500 million in annual revenues, to succeed when competing with multi-billion dollar companies. Frequently in such scenarios, the mid-tier companies fail and close. If they are lucky and can survive a few years, they may fall back below the applicable size standards and rise like a small business phoenix from the ashes, or perhaps more accurately, they begin the Sisyphean labor of growing, exceeding the size standard, shrinking, and starting again—doomed to repeat the cycle like the cursed king of Ephyra.

While that all seems rather depressing, there are options to avoid this fate. A common strategy is to partner with a smaller firm that still falls below the applicable size standards in a mentor-protégé relationship, which allows the protégé to retain small business contracts. In such an arrangement, the large firm can continue to perform up to 60% of the work on set-aside contracts (through a joint venture with the protégé). The mentor-protégé regime allows mid-sized firms not only to work on small business contracts with their protégé but to acquire up to a 40% equity interest in that protégé without risk of affiliation. This means that the mid-sized firm not only has the ability to keep most of its incumbent work through the protégé, it also can keep up to 40% of the protégé's profits (as the mentor is treated like any owner and thus entitled to its share of the distributions). This incentivizes mentors to truly seek to have the small business succeed, as that then increases the value of the mentor's investment. This must be structured correctly of course, but it is a great option.

Another option that can work if the goal is to secure the first few full-and-open contracts is to form a joint venture with multiple other mid-sized firms. Unlike for set-aside contracts, on full-and-open contracts you can create a populated joint venture, where the employees who perform the work are employed by the joint venture itself without concern about affiliation. This not only means that, in most cases, you can use the experience and past performance of each joint venture member, but you also can take advantage of lower G&A costs that the joint venture itself may have, which closes the competitive price gap that may exist between a mid-sized firm and truly large federal contractors. Given that affiliation is not a concern for mid-sized firms, it may even be a viable strategy to form a permanent joint venture with a set of companies that all have complementary skills and experience to compete in the full-and-open arena.

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If you are seeking a longer-term solution, an acquisition may help, but it must be done carefully. This is especially the case if you still have legacy small business contracts due to the risk of recertification. Indeed, under SBA's rules, if a company with small business contracts acquires, is acquired, or merges with another firm, all the entities in the transaction must recertify on their respective contracts. If you are large (calculated after the acquisition), then the agency can no longer take small business credit for the work under the contract and, in rare cases, may terminate the work altogether. Thus, if you or the target firm have small business contracts, it is critical to investigate ways to structure the transaction to avoid recertification. While those strategies are not yet tested through case law—so there is some risk involved—for many mid-sized companies, that risk may well be worth it if it means they can continue to have the cushion of legacy contracts while leveraging the newly acquired work and experience.

Lastly, focused acquisitions in the commercial space, where the acquired target has all or most of its clients outside of the federal marketplace, can catapult a mid-sized firm into new industries. Such an acquisition can also allow a mid-sized firm to leverage its enlarged asset base, when compared to many of its small business competitors, to secure a competitive advantage in niche areas or unique or new marketplaces. PilieroMazza has helped a number of our mid-sized clients acquire new companies or assets in areas such as specialized camping gear, green energy, modular construction, and more. All of those acquisitions were made by government contractors who had grown out of their size standards, but had strategized and planned for the future prior to losing their small business legacy work. The companies used the revenues from the small business contracts to start investing in commercial technologies and marketplaces. Then, when the time was right, they moved to acquire the companies with which they had partnered in those same spaces. These transactions (1) can take the form of the acquisition of an entire company via stock purchase or merger, (2) can be structured as a strategic investment where the mid-sized firm takes a non-controlling interest in the other party, or (3) may involve the formation of a holding company, which allows the federal and commercial sides of the businesses to remain separate. The sky is the limit when size standards and affiliation are no longer of any concern.

As noted above, while it is certainly a legitimate fear of those in the small business federal market that runaway success can ultimately lead to failure due to the strict small business rules and size standards, there are options that can be deployed to prolong life, grow, and even thrive in what may appear to be a valley littered with the remains of once-great mid-tier companies.

About the Author: Cy Alba is a partner and is a member of the Government Contracts and Small Business Programs groups. He may be reached at ialba@pilieromazza.com.