LEGAL ADVISOR

A PilieroMazza Update for Federal Contractors and Commercial Businesses

Small Business

SBA PROPOSES IMPORTANT NEW SMALL BUSINESS CONTRACTING RULES

By Patrick Rothwell

On December 29, 2014, the SBA published proposed amendments to its small business and socioeconomic set aside regulations. Although all of the proposed amendments are of interest to those involved in small business contracting, there are three specific proposed changes which are of heightened interest to many of our readers. They are: (i) clarifications regarding findings of affiliation based upon an identity of interest; (ii) expansion of small business joint venturing without affiliation; and (iii) when a concern must recertify size following a merger or acquisition. Each of these changes is briefly outlined below.

Affiliation Based Upon Familial Relationships

SBA regulations provide that concerns owned or controlled by family members have identical or substantially identical business or economic interests and may be found to be affiliated. 13 C.F.R. § 121.103(f). SBA's practice has been to find that such concerns are subject to a rebuttable presumption of affiliation simply by virtue of the familial relationship itself. Nevertheless, there has been ongoing confusion about the extent to which persons are treated as members of a family for purposes of an affiliation finding.

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In order to clarify this issue, SBA has proposed to amend its regulations such that firms owned or controlled by married couples, parties to a civil union, parents and children, and/or siblings are presumed to be affiliated with each other if they conduct business with each other. This presumption may be overcome by a "clear line of fracture" between the concerns. Importantly, the proposed rule also states other types of familial relationships, such as, presumably, cousin relationships, are not grounds for a finding of an affiliation based upon an identity of interest. By conducting business, the proposed regulations identify as examples, subcontracts, joint ventures, sharing or providing loans, resources, equipment, locations or employees with each other.

These changes, if made final, should provide small businesses some clearer lines as to the types of family relationships that could give rise to a finding of affiliation.

Affiliation Based Upon Economic Dependence

In addition to where there are familial relationships present, an identity of interest, and, therefore, an affiliation, between firms may be found where one firm is economically dependent upon the other firm. However, the extent to which the economic ties between two companies are so close that one firm is dependent upon the other has historically been difficult to determine and is the subject of constant litigation. Even though there is no fixed percentage of revenues in SBA's current regulations which would serve as the threshold for a finding of economic dependence, the SBA's Office of Hearings and Appeals (OHA) has held that economic dependence is present when one firm derives 70% or more of its receipts from another concern. However, even in such a case, OHA has found the 70% threshold not to be applicable in a case of a start-up firm.

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SBA has proposed to adopt OHA's precedent at least in part. The proposed rule provides that economic dependence of one firm upon another may be found if one concern derives 70% or more of its receipts from the other concern in the previous fiscal year. However, this new rule still leaves open many important problems in determining whether economic dependence is present. For instance, although the preamble to the new rule indicates that the presumption of affiliation can be rebutted for new firms that have only received a few contracts, it is uncertain whether the affiliation can be rebutted in other ways. It is also unclear to what extent a finding of affiliation may occur when a firm has earned a majority of its revenues from another firm but not 70%. Likewise, it is unclear from the rule whether receipts from other past fiscal years are relevant to an economic dependence analysis.

Joint Ventures

SBA has proposed a change in the joint venture rules which will significantly benefit small businesses. Currently, joint venture partners, combined, must meet the applicable size standard except for bundled or "large" procurements, where the partners will be eligible as long as each is small on its own. SBA is now proposing to allow small businesses to joint venture without affiliation on any contract as long as the businesses are each, on their own, considered to be small under the applicable size standard for the contract. This will open up more joint venture opportunities for small businesses and is welcome news to the small business contracting community.

Recertification of Size Following a Merger or Acquisition

Currently, there is a gap in SBA regulations regarding when a concern must recertify its size in connection with a merger or acquisition. The proposed rule closes this gap by requiring firms to recertify their size to the contracting officers on pending proposals where the merger or acquisition occurs prior to award.

While this proposed rule requires recertification prior to award, it is less clear what effect the recertification has on the pending proposal. If, after recertification, an offeror is no longer small under the applicable size standard, can (or must) the contracting officer still make award to that offeror if it was small at the time it submitted its initial proposal, including price? Thus, even if the proposed rule were to come into effect, there would still be some unanswered questions regarding the practical effect of a recertification prior to award. ❒

About the Author: Patrick Rothwell, an associate with PilieroMazza, practices primarily in government contracts and litigation. Mr. Rothwell advises clients in a variety of government contract matters, including size protests before the SBA and bid protests before the Government Accountability Office and the United States Court of Federal Claims. He can be reached at prothwell@pilieromazza.com.

Labor & Employment Law

WHEN SNOW DAYS IMPACT GOVERNMENT CONTRACTS: BALANCING INCLEMENT WEATHER AND THE FLSA

By Julia Di Vito

Winter weather can be frustrating for all employers, but government contractors face some unique challenges. Employees who work in government facilities may be unable to work when the government closes its facilities, or employees may be unable to travel in to the worksite even when the worksite is open. In these situations, government contractors unexpectedly lose a day (or more) of work on the contract. Contractors often wonder what their obligations are to pay employees for a day when they are unable to bill the government. The answer depends on the applicability of the Fair Labor Standards Act (FLSA) to the contractor's employees.

Employees who are not exempt from the overtime requirements of the FLSA and who are paid on an hourly basis are paid only for hours they work. If the worksite is closed or the employee chooses not to come to work due to inclement weather, non-exempt employees do not need to be paid for those hours. Employers may choose to allow the employees to use personal or vacation leave, if provided by the employer, for the time they are absent. Thus, although winter weather may cause contractors to miss out on hours that could be billed to the government, they are not required to pay non-exempt employees when work is not being done.

However, the issue is not so simple when determining whether salaried employees, exempt from the overtime requirements of the FLSA, must be paid when work is missed due to inclement weather. The FLSA provides an exemption from the requirement to pay overtime for employees hired as bona fide executive, administrative, professional, and outside sales employees, as well as certain computer employees. To qualify for one of these exemptions, an employee must meet certain requirements based on his or her job duties and must be paid on a salary basis. To remain an exempt employee, an employee must receive his or her full salary for any week in which the employee performs any work, regardless of the number of days or hours worked.

When an exempt employee misses work because of inclement weather, whether an employer must pay the employee for the time missed depends on whether the employee's worksite is closed or whether the employee decides not to go to work because of difficult travel conditions. If a contractor's employee works exclusively at a government facility, and cannot perform work his or her work at the contractor's facility, then the employee's worksite is closed when the government is closed. Conversely, if the employee is able to work at the contractor's facility when the government facility is closed, or if the employee works exclusively at the contractor's facility, then the employee's worksite is considered closed only when the contractor is closed. Finally, even when the employee's worksite is open, he or she may choose to stay home due to the inclement weather.

If the employee's worksite is closed due to inclement weather, the FLSA considers the employee "ready, willing and able to work," even if he or she may not be able to travel in the inclement weather to the worksite. In this situation, a contractor may require exempt employees to use vacation or personal leave for the days the worksite is closed, even if using that leave will result in a zero or negative leave balance. However, no matter whether the employee has leave time available, the employer may not deduct anything from an exempt employee's salary if the worksite is closed for less than one workweek. Thus, to ensure an exempt employee continues to be an exempt employee, the employer must pay the employee for the time the worksite is closed if the worksite is open during other days that workweek. Note that if the worksite is closed for the entire workweek, the contractor may choose to not pay the employee for that week and still maintain the employee's exempt status.

Another common scenario during the winter is that the worksite is open for business, but the employee is unable to travel to work due to inclement conditions. As when the worksite is closed, the employer may require an exempt employee to use his or her vacation or personal leave time for the days he or she misses work because he or she cannot travel to the worksite. However, unlike when the worksite is closed, the FLSA allows employers to reduce an exempt employee's salary in full-day increments if he or she is absent for one or more full days for personal reasons, other than sickness or disability, and the worksite remains open. The Department of Labor has advised employers that an employee who is absent due to inclement weather is absent because of personal reasons. Thus, if the worksite is open, and an exempt employee does not work for a full day because of snow or other inclement weather, the employer may deduct from the employee's pay without jeopardizing the employee's status as an exempt employee, even if the employee works during other days that week.

If you have not already informed or reminded your employees of the company's inclement weather policies, now is a good time to do so. It is important to ensure compliance with inclement weather regulations because failure to comply could result in losing an exemption to the FLSA and gaining the requirement to pay overtime. Additionally, make sure any inclement weather policies set out in your employee handbook reflect the policies you put into practice. ❒

About the Author: Julia Di Vito, an associate at PilieroMazza, practices in the areas of government contracts, litigation, employment, and labor. She can be reached at jdivito@pilieromazza.com.

Business & Coporate Law

PLANNING AHEAD TO GET IT RIGHT FOR YOUR BUSINESS

By Dean Nordlinger

Many owners succumb to the understandable temptation to conserve capital and spend it only on those things that will directly grow and develop the business. This approach, however, comes with a cost – the failure to engage upfront in some good business planning on important issues that will promote smoother sailing for the business. The importance and effectiveness of planning ahead is illustrated through a few hypothetical scenarios discussed below.

Consistent with the mindset of mitigating costs, many owners move quickly to form their company as a corporation or a limited liability company (LLC), without thinking through which entity form is best to achieve their goals. Here, a little advance planning can go a long way to ensure your entity form is the most advantageous for how you will setup and operate your business.

Achieving a Priority Return of Capital

Take, for example, the common scenario where one owner (Owner 1) brings capital to the business (Company X) – a $1,000,0000 – another owner (Owner 2) brings substantially

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less capital – $250,000 – and a third owner (Owner 3) brings $10,0000 plus "sweat equity." Let's assume: (i) Owner 1, Owner 2 and Owner 3 form Company X as a corporation; (ii) Owner 1, Owner 2 and Owner 3 are 60%, 30% and 10% owners, respectively; and (iii) to be tax efficient the Owners elect to have Company X be taxed as an S corporation and therefore Company X has one class of common stock (S corporations can only have one class of stock).

Given the discrepancies in capital investments, it would seem logical and fair that Owners 1 and 2 would be able to get their initial investments back before the three owners share in the profits and losses of the company in a 60/30/10 ratio. However, as structured, Company X cannot provide Owners 1 and 2 a priority return of capital because an S corporation must allocate profits and losses and distribute net cash flow to the owners pro rata in accordance with ownership interests. In other words, Company X cannot prioritize or accelerate profits and distributions to Owners 1 and 2 to reward them appropriately for assuming greater financial risk in the business. In a sense, the capital invested by Owners 1 and 2 has been trapped in Company X, only to be returned in a slower and less than desirable fashion.

In an LLC, the profits and distributions can be sliced and diced to allow for a priority return of capital and once achieved subsequent profits and distributions can be allocated or made based on the specified ownership ratio.

It is worth noting that Company X could, to a lesser degree and in a more complicated manner, achieve some form of a priority in return of capital utilizing different classes of stock. But, Company X would have to be a C corporation, which is not a tax efficient structure. As a C corporation, Company X would be taxed at the corporate level (no pass-through treatment) and the owners would get taxed on any dividends issued to them by Company X.

On the other hand, if the owners formed Company X as an LLC, they could give owners 1 and 2 a priority return of capital. Generally speaking, an LLC offers more flexibility on these types of financial matters. In an LLC, the profits and distributions can be sliced and diced to allow for a priority return of capital and once achieved subsequent profits and distributions can be allocated or made based on the specified ownership ratio. And, this can be achieved in the LLC without comprising the LLC's tax-efficient structure.

Utilizing Equity Sharing Incentives

Now, let's take a look at how the choice of entity and tax structure could impact Company X's and the owners' choice of equity incentive plan to secure new talent once the company has operated for a few years and grown into multi-million dollar annual revenue. Having reached a revenue plateau, the owners recognize that to take the company to the next level, they have to attract new key employee talent using with some form of equity sharing incentive. And the owners envision awarding the equity sharing incentives to the key employees for current and future valuable services rendered, rather than requiring the employees to "buy in."

The owners feel they need to provide real equity to these key employees, and they intend to implement a restricted stock plan (meaning, issue common stock to the key employees that would "vest" over time). The owners landed on the idea of using a restricted stock plan because it was recommended to Owner 1 by a close friend who owns a company and a restricted stock plan has worked well for his company. In a continuing effort to control cost and in reliance on the recommendation of Owner 1's friend, Company X adopts a restricted stock plan and models it off of the one implemented by Owner 1's friend. Unfortunately, this approach will be disadvantageous to the owners. Let's see why.

Company X has significant value today. Company X will therefore be delivering to the key employees a valuable asset (restricted stock) which is likely to appreciate significantly over time. For certain tax efficiency reasons (which go beyond the scope of this article), Company X will presumably want to allow the key employees to accelerate and minimize the amount of ordinary income tax on the receipt of the restricted stock (by making and filing an 83(b) election) and to lock in all future income recognition if possible at capital gains rates.

But, this will lead to some other somewhat thorny and unintended consequences for Company X and the owners. First, in awarding restricted stock, the key employees will, at the time of a sale of the company event, share in the full value of Company X (and not just the part tied to their efforts to take Company X form level x to level y). Second, the Section 83(b) filing and payment of taxes will, for tax purposes, make the key employees full shareholders in Company X right away; regardless, of the fact that they would not yet have vested to and therefore would not truly own any of the restricted stock. Because Company X is an S corporation, it can only have one class of stock. As noted above, this means the owners and the key employees must be treated the same and have the same financial/economic rights. Going forward, any time Company X makes pro rata tax or other distributions to the owners, it must make matching pro rata distributions to the key employees. Moreover, any efforts by Company X and the owners to condition the key employees' receipt of discretionary distributions until they vest to the stock (for example, by depositing the distributions into an escrow account) could be viewed as creating a second class of stock, which could jeopardize Company X's S corporation tax status. It is likely that some form of equity-linked plan (such as a stock appreciation rights plan) as opposed to an equity plan, would have better matched to and achieved Company X's goals and objectives.

What these hypothetical scenarios show is that it is better to spend some money upfront to address and hopefully avoid situations like these, and others like them. This is true for several reasons. At the beginning of a business relationship, the owners' collective interests are generally aligned. Over time, the owners' interest may start to diverge and there may be resistance to going back and reworking the terms of the business relationship, even if only to correct and lock in the original business intent and terms. And, while many things can be fixed or resolved at a later date, often the fix or solution comes with a hefty price tag. ❒

About the Author: Dean S. Nordlinger is a partner with PilieroMazza and heads the Business and Corporate Law Group. He represents companies, private equity firms, entrepreneurs and other clients on a variety of corporate matters across varied industries. He can be reached at dnordlinger@pilieromazza.com.

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SBIC INVESTMENT, A POTENTIAL SOURCE OF CAPITAL FOR GOVERNMENT CONTRACTORS

By Linh Phu

Owners of privately held businesses generally finance their businesses with their own capital, augmented with bank loans. An additional source of funding for government contractors is available from Small Business Investment Companies (SBICs).

The Small Business Investment Company Program was established by Congress in 1958 to supplement the long term capital, both debt and equity, available to small businesses. The SBICs are privately owned and managed investment funds, but regulated and licensed by the U.S. Small Business Administration (SBA). With the SBIC licenses, SBICs can raise public funds at low cost by issuing SBA guaranteed debentures and are allowed to leverage up to three times the private capital they are able to raise. Despite certain SBA requirements for investment, working with an SBIC is not much different from working with any other private equity firm or mezzanine lenders.

To be eligible for SBIC investment, the business must have a tangible net worth of no more than $18 million and an average of $6 million or less in net income over the previous two years at the time of investment. A business may also be deemed "small" based on its industry using SBA Size Standards. Moreover, a government contractor wholly owned or substantially owned by an investment company that is licensed under the Small Business Investment Act of 1958 such as an SBIC is not considered affiliated with the SBIC. This is a major difference between SBIC investment and traditional investment as the former does not create hurdles for the government contractors with small business set-aside contracts or plans to continue to compete in this space.

SBIC provides capital in one of three forms: loans, debt with equity feature, and equity. According to the SBA quarterly update on the SBIC program, the majority of SBIC financings use the first two forms. However, the majority of financing for government contractors with median annual revenue of $14 million use debt with equity feature which is also known as mezzanine debt. This form of debt is subordinate to bank loans and is based on the business cash flow. Mezzanine debt provided by SBICs offers the government contracting business owners an additional source of funding for acquisitions, change of ownership or recapitalization.

In addition to the cost benefit, using mezzanine debt in a capital structure provides the necessary capital for a company to grow with little to no dilution to the business owners.

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- **Secure More Capital**: Financing with a Bank loan is often limited by available collateral. Mezzanine debt with its subordination feature, interest-only period and sometimes deferred interest payments or payable in kind interest (PIK) is treated as equity from banks' perspective; for this reason, the proposed bank loan amount could be higher with this additional equity-like capital. In the end, the company is able to obtain more capital to finance its strategic objectives.

- **Retain the Control and Ownership**: Mezzanine lenders' investment horizon is typically up to five years; their goal is not to be a long term shareholder. Whether there is an equity feature such as a warrant or not, a typical mezzanine lender wants to achieve a target return over some specified time and payback the SBA guaranteed debenture that was used to fund the investment.

The most important criterion for the SBIC mezzanine investor is the ability of its client to generate the required cash flow. This means the mezzanine investment applicant must have an established business with a competent management team, proven past performance, a strong contract backlog and potential pipeline. If these criteria describe your business, layering mezzanine debt with bank loans in your capital structure may provide the necessary funding to meet your strategic objectives. ❐

About the Author: Linh Phu is a commercial lender with the Government Contractor Lending Group at Access National Bank, headquartered in Reston, VA. The Group provides various financing solutions to meet the business goals of government contractors from $1 million to $100 million in annual revenue. She can be reached at lphu@accessnationalbank.com or 703-871-7361.

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