PilieroMazza Webinar

Raising Capital – Options for Small Business Government Contractors

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About PilieroMazza

PilieroMazza PLLC is a full-service law firm located in Washington, D.C. 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.

Sign up for our newsletters and blog at www.pilieromazza.com

PM Legal Minute – Our blog provides updates and analysis of issues that our practice groups have encountered, as well as tips and practical advice for government contractors

Legal Advisor Newsletter – our quarterly publication which addresses current issues that are of concern to federal government contractors and commercial businesses nationwide. The Legal Advisor articles focus on recent legal trends, court decisions, legislative and regulatory rulemaking as well as other newsworthy events.

Weekly Update – An email sent each Friday that recaps any relevant actions taken by Congress, the administration, or the courts.

Webinars on YouTube – all of our past webinars can be found on the PilieroMazza YouTube channel.

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Overview

- Importance of Raising Capital
- Options for Raising Capital
  - Bank Financing
  - Factoring
  - SBA Loan Programs
  - Financing from Private Parties
- Affiliation Implications
- Small Business Investment Companies (SBICs)

Importance of Raising Capital

- Obviously, you need money to run and expand your business
- Government contractors have to manage "the float"
  - Upon winning an award will you have access to credit and working capital financing?
  - Can you weather sequestration or nature of billing and reimbursement cycles with government customer?
- Financial wherewithal is a factor in being considered a responsible contractor
- Also factors into likelihood of success for 8(a) eligibility and affiliation determinations

Options

- Debt vs. equity financing
  - Debt – getting loan without giving ownership
  - Equity – investor gets ownership
- Traditional lenders vs. private parties
  - Traditional lenders – banks, financial institutions
  - Private parties – individuals and entities
- Each has advantages and disadvantages
  - Particularly when viewed through the lens of a small business government contractor

Traditional Bank Financing

- Debt financing
- A loan or line of credit secured by the company's assets (i.e., asset based lending)
- Collateral used to secure the loan depends on the company's assets
  - Could be tangible or intangible assets including accounts receivable, inventory, equipment, and IP
- Bank loans are made to small business that are well established, have good credit, and assets
- Largely based on a company's "creditworthiness"

Advantages and Disadvantages

- Advantages
  - Fund strategic operations and growth
  - Maintain your equity
  - Generally, less risk of affiliation
- Disadvantages
  - Can be difficult to obtain, especially in the beginning – must be “bank ready”
  - Lien on your assets
  - Personal guarantees from owners may be required
  - Impact on other company debt – i.e., subordination

Tips When Pursuing Bank Financing

- Tell the company's story in a way that demonstrates strong creditworthiness (a good risk) by having:
  - Up-to-date corporate and ownership records
  - Complete financial statements
  - Strong management team
  - Solid business plan (show how company would achieve its goals with the loan)
  - Quality collateral
  - Financial resources of proposed guarantor

Tips When Pursuing Bank Financing

- Shop around for the right lender – choices and competition breed better terms
- Negotiate – lender is most flexible to negotiating when it is competing to secure a company's borrowing business
- Key terms:
  - Avoid being in automatic or near immediate default - make sure reps, warranties, covenants and events of default are liveable, feasible financial covenants
  - Have carve-outs for anticipated activities such as issuance of equity to employees and sales of assets not in core business
  - Right to prepay loan without penalties or early termination fees

Factoring

- Debt financing
- Also known as accounts receivable financing
  - Financial institution buys the borrower's accounts receivable
- Creditworthiness of the borrower not as strong
  - Financial institution instead looks at the creditworthiness of the customer (i.e., federal government)
- Not offered by all banks

Advantages and Disadvantages

- Advantages
  - Relatively quick way to obtain capital to fund a contract before you are “bank ready” for traditional financing
  - More attainable than traditional financing for contractors viewed as higher risk
- Disadvantages
  - You no longer own your AR
  - Must go through the Assignment of Claims Process
  - Can be more expensive

How Assignment of Claims Works

- Standard UCC grant of a security interest in government contracts is not permitted
- The Assignment of Claims Act (31 U.S.C.A. § 3727, implemented by FAR Subpart 32.8) process is used to buy AR of government contractors
  - With approval of government, the contractor assigns its right to payment on contract to the factor
  - A lock box account is set up at the bank to receive payments from the government
  - Note: some contracts expressly prohibit the assignment of claims (See FAR 52.232-24)

SBA Business Loan Program – At a Glance

- Debt financing
- SBA's 7(a) Loan Program
  - SBA's primary business loan program
  - Loan comes from a bank but with an SBA guaranty
  - Banks consider this option when the creditworthiness of borrower is not as strong
  - Not offered by all banks
- Regulatory restrictions on payment terms

Financing from Private Parties

- Could be from friends, family, minority owner, outside investors, business partner, “angel investor,” etc.
- May be debt and/or equity financing
- Terms and format can vary widely depending on the parties and circumstances

Advantages and Disadvantages

- Advantages
  - Can be faster and simpler than going through a bank
  - Greater likelihood of being able to negotiate favorable terms
  - May not matter if you are “bank ready”
- Disadvantages
  - Investor likely wants a say in how you run your business
  - If equity is involved, you have a new owner
  - Greater risk of affiliation

Structuring Options

- Debt with a promissory note
  - Should be arms-length, commercially reasonable terms
  - With customary interest rate and maturity date that are in line with normal business practices
  - Note could be convertible to equity
- Equity/ownership interest
  - How much ownership – valuation
  - What class of ownership – voting or non-voting?
  - What other rights are given to minority investor?
  - Is the equity pledged as security for repayment?

Affiliation Implications

- Size matters
  - Being small is the essential ingredient of all federal small business contracting programs
- Affiliation can cause you to lose SB status
  - Firms are affiliated when one firm has the power to control the other, or when both firms are controlled by a third
  - When determining size, SBA combines the revenues or employees of the firm in question and all of its affiliates
- Circumstances giving rise to affiliation can also affect eligibility for other set-aside programs

Affiliation Through Loans

- Existence of loan, by itself, should not cause affiliation
- However, loan terms may create affiliation
  - Terms should be in writing, arms' length, and commercially reasonable
  - "Commercially reasonable" is not well defined
  - Affiliation could arise if the terms of the loan give the lender too much power to control the lendee, absent a default
- Security and stock pledge is generally permissible
  - But, could be problematic if the terms give too much control to the lender
  - Lack of security may be viewed as commercially <u>un</u>reasonable

Affiliation Through Loans

- Is the loan a "normal commercial practice"?
  - This is where a loan from a private party, particularly if it is from a business partner, close family member, or officer, may be viewed less favorably than a loan from a traditional lender
  - Size of the loan, compared to firm's revenues, is also considered
- What is the purpose of the loan?
  - One-time transaction, such as stock purchase: less risk
  - Ongoing financial assistance: greater risk

Economic Dependence

- Affects size and status eligibility
- Arises when one firm provides critical financial assistance to another firm, such as through loans or financial guarantees, or a firm generates a significant percentage of its revenue on contracts awarded to it by a second firm
- Key questions to ask:
  - Is another party providing critical financial assistance that you depend on to operate and that compromises your ability to exercise independent business judgement?
  - Would you be a viable, independent business without the financial assistance the other party is providing to you?

Negative Control

- Arises when a minority owner or director has the right to veto or block the majority owner or director from taking certain actions on behalf of the company
- Negative control can affect small business status as well as eligibility for the 8(a), SDVOSB, HUBZone, and WOSB programs
- May be lurking in quorum, voting, transfer, and other provisions of your operating documents

Negative Control

- Generally, negative control provisions are problematic when they pertain to day-to-day operations, such as unanimous consent requirements for:
  - Hiring and firing of executive officers
  - Setting executive compensation
  - Power to approve a board member
  - Veto power that gives control over board committees
- Negative control is less likely to be problematic when the unanimous consent requirements pertain to extraordinary actions, such as adding new owners or dissolving the company

Negative Control

- Be especially careful if you are an SDVOSB or WOSB
  - SBA case law indicates the veteran must control all decisions of the SDVOSB, so there is no wiggle room for negative control even for extraordinary decisions
  - Current SBA rules and case law make it very difficult for SDVOSBs and WOSBs to raise capital and bring on minority investors unless the investor is very flexible and willing to forgo customary investor rights

Stock Options and the "Present Effect" Rule

- Loans that carry an option to be converted to stock ownership may cause a size or status issue under SBA's "present effect" rule
  - 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
  - This means SBA treats such arrangements <u>as though the rights granted have already been exercised</u>
- SBA will not give present effect to an agreement when it is merely to open or continue negotiations, or when the conditions are extremely remote or unenforceable

Conditions on Ownership

- To qualify as an 8(a), HUBZone, SDVOSB, or WOSB, the majority owner must directly and unconditionally own at least 51% of all classes of ownership
- Transfer restrictions can be problematic
  - Generally, SBA does not want to see any restrictions on the majority owner's ability to transfer his or her ownership
- Rights of first refusal and tag along rights
  - Not permissible for WOSBs or SDVOSBs at SBA, but they should be permissible for SDVOSBs at VA
  - May be a little more flexibility for 8(a) firms

Ownership Changes

- Lender may require a minority ownership interest in your business in exchange for loan
- The ownership interest can create concerns about negative control, as discussed earlier
- Changing ownership itself also triggers notice and/or approval requirements
  - SBA must pre-approve ownership changes for 8(a) firms
  - SDVOSB firms certified by VA must notify VA of the ownership change
  - HUBZone firms should notify SBA of the material change
  - Self-certified WOSB should upload new ownership documents to www.certify.sba.gov

Using Mentor-Protégé

- SBA's new "All Small" Mentor-Protégé Program is open to all small businesses
- Financial assistance is one of the forms of assistance envisioned under SBA's mentor-protégé program
- SBA's program also permits the mentor to own up to 40% of the protégé
- An SBA-approved mentor-protégé relationship grants an exemption of affiliation between the mentor and the protégé for the assistance provided under the approved mentoring agreement

Small Business Investment Companies

- SBICs:
  - Unique public-private partnership between SBA and privately-owned and managed investment funds
  - Invest in small businesses meeting certain thresholds
  - Have invested over $20B in more than 11,000 domestic companies, including Whole Foods, Federal Express, and Costco
- SBA:
  - Makes available to SBICs up to 2x the amount of private capital raised through SBA-guaranteed securities
  - Provides affiliation exemption and unique 8(a) rules for small businesses owned by SBICs
- To learn more, please join us on October 25, 2017 for a webinar devoted to SBICs – sign up here

QUESTIONS?

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