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Best Practices for Structuring an M&A or Investment Transaction

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Why Are We Here?

Increased M&A Activity in the Sector

- OCI divestitures
- Consolidation in the industry

Emphasis on Revenue Generation

- Growth by Acquisition of Strategic Targets
- Maturation of the Private Equity Buyer

Shifting Government Purchase Model

- Greater emphasis on security, intelligence and information technology
- Proliferation of commercial technology in the government sector



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Key Components of Deal – Protecting Value



Due Diligence



Representations/Warranties



Indemnification



Consideration



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Shifting Diligence Landscape

Traditional Focus

- Valuation
 - EBITDA
 - Revenue waterfall
- Required approvals and novations
- Potential risks – audits, claims, investigations

New Focus

- OCI restrictions
- Valuation and viability
 - Backlog and program assessment
 - risks of termination or non-renewal of key contracts
 - margin sustainability and adequacy of business infrastructure
- Integration issues
- Deficiencies in business processes and policies
- In-sourcing risks



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Avoiding Data Room Disasters

- Competitively Sensitive Information
 - information that might give the Purchaser an unfair competitive advantage in future government procurements

OCI issues may arise even during diligence.

- Classified Material
 - May require customer consent to review
 - Timing of deal may dictate that completion of diligence on classified contracts be a closing condition.
- Export Controlled Material



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2015 Trends / 2016 Predictions

- More auction processes
- Indemnity caps are trending lower
- More pressure on deal timelines, means less time for diligence and integration planning
- Increased use of Transactional Risk Insurance
- Greater focus on “business” due diligence – continue to proactively monitor data room access



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Small Business = Big Issue in M&A and Investment Transactions

- Pipeline/valuation questions
 - Impact on current contracts/status
 - Ability to compete for future set-asides
 - Disclosure obligations or broken deal if serious problems identified
- Was status correctly certified pre- and post-transaction?
- For small businesses in need of investors – how can the transaction be structured to avoid defeating small business size status?
- Other issues: limitations on subcontracting/ostensible subcontractor; subcontracting plan compliance and goaling



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The “Golden Ticket” of Small Business Status

- Protected space to compete for business with “set-aside” procurements
- Federal Government “Goal” of 23% of prime contracts to be awarded to small businesses
- For FY15 – this was \$90.7 BILLION
- Similar goals imposed on large business primes to subcontract to small businesses
- Proposal evaluation advantages for utilization of small businesses
- Accelerated payment provisions



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Defining a “Small Business”

- No “list” of small businesses, companies self-certify, and it’s a moving target
- Dramatic industry variations what it means to be “small”:
 - Number of employees (100 to 1,500); or
 - Average annual receipts (\$750K to \$38.5M)
- Size status must include all “affiliates”
- Complex regulatory requirements and detailed, fact-specific analysis



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“Affiliation” – The Silent Killer of Small Business Status

- Generally, affiliation exists between entities when:
 - One controls or has power to control another
 - Or, third party controls or has power to control both
- “Totality of the circumstances” analysis:
 - Ownership, management, previous relationships or ties to another entity
 - Contractual relationships
 - Even shared office space, loans, common investments, etc.
- Corporate nuances – control can arise from:
 - Quorum requirements
 - Blocking rights or supermajority voting rights
- **Ownership misconception**: Affiliation can arise even if investor owns less than 50% of company



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Affiliation - Control

“Control” is construed broadly by the SBA and includes both affirmative and negative control

- Quorum requirement may be negative control
- Existence of one or more independent directors, does not preclude negative control by one or the other
- Limitations on unanimous or supermajority voting requirements – look to case law guidance:
 - Can entity conduct business as it chooses?
 - Acceptable: approve the addition of new members, change board size, amend bylaws, issue additional shares of stock
 - Unacceptable: compensation of officers, choice of auditor, corporate budget, incentive plan, choice of accounting methods



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Financing and Other Start-Up Needs

- Smartly balance short term needs with long term goals
- Lending practices should also comply with ownership restrictions
- Huge contract awards may require influx of capital, internal controls, and infrastructure
- Be wary of strings attached and impact of “present effect” rule



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Affiliation - Stock Ownership

- Common mistake is not realizing there are several stock ownership tests
 - Misperception that this is only about majority ownership
 - Tests are not just on percentage ownership, but relative percentage ownership
- Tests not limited to individuals, but also whether there are blocks (i.e., friends and family)
- Majority/Largest Minority Ownership: Person or entity that owns or has power to control
 - $\geq 50\%$ of SB's voting stock, or
 - A block of voting stock which is large compared to other blocks, controls or has power to control the SB
 - Case law: block 1.36 times larger than next block = large
 - Presumption of control CANNOT be rebutted

Affiliation - Stock Ownership

- No Single Block is Large: If 2 or more persons or entities each owns, controls, or has power to control
 - < 50% of SB's voting stock, and
 - Such holdings ≈ and aggregate is large compared to any other holding, presume each person or entity has control or power to control
 - May rebut by showing power to control does not exist
- But, if voting stock is "widely held" and no block is large compared to others, Board AND CEO/President presumed to "control"
 - "[I]f stock in a corporation is freely traded and held by more than a few shareholders, it is reasonable to state that it is widely held." *MPC Computers, Inc.*, SBA No. SIZ-4806 (2006)



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4.16% Interest = Control? YES.

Government Contracting Resources, Inc., SIZ-5706 (2016)

- 20 companies with equal 4.16% minority interest
- No owner could “create a quorum, prevent a quorum, cause any vote to pass, block any vote nor cast a tie-breaking vote”
- OHA: a concern must be controlled by at least one person or entity, so presumption of control NOT rebutted here
- **RESULT**: all 20 investors controlled through stock ownership



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Investor Tips

- Know which test will apply and if control can be rebutted
- Exercise caution if largest interests are equal/approximately equal minority investments
- Be prepared to rebut control presumption – vest decision-making authority in individual(s) with no affiliation concerns
- Do not ignore voting rights for minority investors

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