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Buying or selling a small business government contractor? Draft the letter of intent carefully to avoid immediate affiliation

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Buying a small business government contractor may not be as simple as a standard acquisition. This is particularly true if the small business wants to continue to qualify for federal small business set-aside and sole-source awards during negotiations. The U.S. Small Business Administration ("SBA") treats stock options, convertible securities, and agreements to merge (including agreements in principle), as having a "present effect" on the power to control a concern.

Affiliation can lead to a number of concerns for both entities — including loss of business, potential criminal liability, or liability under the civil False Claims Act.

So if a letter of intent is sufficiently firm to be considered an agreement in principle, the SBA's regulations require such agreements be given "present effect" on the power to control a concern — deeming the two entities are immediately affiliated. In other words, the small business likely is no longer small (and, if it is a specialty small business concern, like woman-owned or service-disabled veteran-owned, it is likely ineligible for those programs as well) before the deal even is done.

On the other hand, agreements to open or continue negotiations towards the "possibility of a merger or a sale of stock at some later date" are not considered agreements in principle, and are not given present effect. In practice what this means is that a letter of intent must be carefully drafted to ensure that it does not trigger the present effect rule before the parties are ready or willing to be considered affiliated.

A small business is considered affiliated with another business if there is an agreement to merge, including agreements in principle — such as a definitive letter of intent. When a small business and another business have a close relationship or share control, they may be considered "affiliated."

Generally, affiliation exists when one business controls or has the power to control another or when a third party controls or has the power to control both businesses. SBA considers affiliates to be a single entity when calculating a small business's size.

In other words, if the applicable size standard is 1,000 employees and the small business has 600 employees but a potential buyer has 900 employees, the small business is considered to have 1,500 employees for size purposes and is not "small" for the procurement.

Affiliation can lead to a number of concerns for both entities — including loss of business, potential criminal liability, or liability under the civil False Claims Act — so vigilance is key in monitoring relationships and how they impact a small business' status.

Whether a letter of intent is deemed an agreement in principle that is given present effect, or merely an agreement to open or continue negotiations, is a question that the SBA will address through a fact-specific inquiry based on the totality of the circumstances.

Affiliation can also put the prime and subcontractors at risk of civil and criminal fraud violations as well as suspension or debarment from federal contracting based on a false certification.

Generally, a letter of intent will be given present effect if it has sufficiently definitive terms such as the price of the acquisition, tax and legal structure (asset or stock sale, etc.), exclusivity, limited due diligence, and/or prohibitions on withdrawal.

On the other hand, if the letter of intent does not have definitive terms — if the price is not settled, the deal structure is unknown, the parties are not negotiating exclusively, the deal is contingent on extensive due diligence, and/or the parties may withdraw at any time — it is likely there is merely an agreement to open or continue negotiations; this kind of letter of intent is not given present effect.

As a practical matter, this means that both the buyer and the small business seller entering into an exclusive letter of intent will need

to balance the benefits of exclusivity against the need to allow the small business to maintain its status to be eligible for federal awards.

This question is not purely academic. Though the question of present effect and the resulting affiliation may impact the seller's business pipeline, disqualifying it from future business, but perhaps more notably, affiliation can also put the prime and subcontractors at risk of civil and criminal fraud violations as well as suspension or debarment from federal contracting based on a false certification.

It would be shame if the parties' zeal to move forward with the transaction resulted in expensive down-stream liabilities that both parties could have avoided by crafting the letter of intent more thoughtfully.

Under the SBA regulations, a small business's size typically is determined at the time that it submits its initial offer which includes price. The company then, generally, is deemed small throughout the life of the contract. Perversely, a small business could enter into a letter of intent deemed to have a present effect, disqualifying it from a competition, only to ultimately have the deal fall through.

For this reason alone many businesses scoff at this rule when informed of the potential impact of the present effect rule — "The deal's not done until it's done." Makes sense, right? But SBA has determined that the risk of a deal falling through is not outweighed by the risk of a small business with a veritable "done-deal" otherwise qualifying for a small business set-aside.

It is important that a small business seller's pending bids and proposal are considered during the negotiation process as well, as the small business may be disqualified from pending offers due to a unique look-back provision, which was added to the SBA regulations in October 2020. If a merger or acquisition occurs after the proposal, but before the award, the offeror must recertify its size to the contracting officer before award.

But if a merger or acquisition (including agreements in principle and/or a definitive letter of intent) occurs within 180 days of the date of the proposal, and the offeror is unable to recertify as small, then the offeror is not eligible as a small business to receive the contract award. If the merger or acquisition (including agreements in principle) occurs more than 180 days after the date of an offer, however, award can be made, but it will not count as an award to a small business.[1]

SBA regulations require that within 30 days of a merger, sale, or acquisition where novation is not required, the business must either recertify as small or inform the agency that it is no longer small. In the latter scenario, where the business is considered large for the acquisition, the agency can no longer count the options or orders issued under the contract, from that point forward, towards its small business contracting goals.

The present effect rule is an often surprising, and unwelcome, tangle in the already complex negotiations related to buying a small business government contractor. But it is important that the parties know the potential impact of a letter of intent or other agreement to merge — even though the deal is not final, it may be treated as such by the SBA and contracting agency, and the business may lose its "small" size status immediately.

It certainly is possible to draft a letter of intent to avoid it being given present effect, giving it less "firm" and more "conditional" language. But though a looser letter of intent may avoid affiliation, it may allow other unwanted consequences such as courting other potential buyers or withdrawal from negotiations without consequences that may outweigh the present effect rule.

If that is the case, the parties need to have all the facts before them to weigh the present effect rule against the risks of a less definitive letter of intent.

Notes

[1] *See* 13 C.F.R. § 121.404(g)(2)(iii).

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