

Small Business Size Determinations: Identifying and Avoiding Affiliation Traps

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11/15/12

- Understand and comply with requirements of contracting opportunities
 - Access to part of the large pool of contract revenue set aside for small businesses
 - Avoid penalties for misrepresentation of size
- Understand size status determinations – when and how
- Focus on affiliation issues:
 - Stand-alone tests and other “factors”
 - Exemptions: *e.g.*, mentor-protégé, ANCs
- Understand process and consequences of size protests

Agenda

- Why such scrutiny?
- When and how is size determined?
- What is “affiliation” and what does it mean for my company?
- What are the tests for determining affiliation (and their exceptions)?
- How do size protests occur and what are their consequences?
- Questions?

Purpose of the SBA

- The SBA was created to ensure that:
 - The Government assists and protects the interests of small businesses by “insur[ing] that a fair proportion of the total purchases and contracts or subcontracts for property and services for the Government . . . be placed with small-business enterprises. . . .”
 - 15 U.S.C. § 631(a) (Small Business Act of 1953).
- It is the “continuing policy and responsibility of the Federal Government to use all practical means to take such actions as are necessary” to foster the economic interests, growth, development, and competitiveness of small businesses.
 - 15 U.S.C. § 631a (citing Small Business Economic Policy Act of 1980).

SBA's Interaction with Contracting Agencies

- SBA negotiates annual procurement preference goals with each agency and reviews results
- SBA ensures that the statutory government-wide goals are met in the aggregate
- The statutory goals are:
 - SB's = 23%
 - SDBs = 5%
 - WOSBs = 5%
 - HUBZone = 3%
 - SDVOSBs = 3%
- Individual agency goals aggregate to meet or exceed government-wide goals

- In the past two years, SBA has focused on enforcement of the program's goals and regulations
- “The Small Business Administration has no tolerance for fraud, waste and abuse in any of our programs. Reflective of that commitment, over the last 18 months we've taken steps aimed at ensuring only eligible companies receive the benefits of our business development and contracting programs by strengthening our ongoing oversight and enforcement.”

--SBA Administrator Mills, 10/1/2010

- GTSI Suspension (key small business primes suspended as well)

False Certifications

- The Small Business Jobs and Credit Act of 2010 provides that an offeror's mere submission of a proposal for a small-business set-aside contract, or even its registration in a database to be considered for a set-aside, is to be considered an “**affirmative, willful and intentional**” certification that the offeror meets the small business size and status requirements

Size Protests

- Low threshold to file, short time frame to respond and response includes significant documentation and certified SBA Form 355
- May now also be filed by SBA OIG (in addition to CO, SBA Government Contracting Area Director, other eligible offerors)
- Teaming arrangements and subcontracting agreements will be scrutinized
- OIG may begin an investigation based on the results of the size protest

Unenforceable Subcontracts

- In *Morris-Griffin Corp. v. C & L Servs. Corp.*, a federal district court found a subcontract between small business prime and large business sub to be unenforceable because it violated SBA regulations and the limitation on subcontracting
- The court found that small business's size certification was "conceived in fraud" and that set-asides are "susceptible to finagling"

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What Is a Small Business?

- SB is independently owned and operated and is not dominant in its field of operation (market share / controlling influence nationally)
- SBA does not maintain a list of SBs
- Size requirements vary from industry to industry to reflect industry differences (either based on number of employees or annual receipts)
- SBA developed a table of size standards to match the North American Industry Classification System (“NAICS”) (13 CFR 121.201)
- NAICS code is identified in the solicitation
- Offeror certifies in ORCA/CCR that it is small for the size standard in that procurement (may be small for some procurements but not others)

When Is Size Determined?

- Size status determined as of date contractor submits self-certification that it is small to the procuring agency as part of an initial offer (or other formal response to solicitation) which includes price
- If solicitation modified so initial offers are no longer responsive, contractor must recertify when submitting a responsive offer including price
- 8(a), SDB, HUBZone applicants must qualify as small in the primary industry classification on date application submitted to SBA and on date of SBA certification
- If small when receive contract, then small for entire duration (even if grow beyond size standard)
 - But several key exceptions such as merger, acquisition, novation

Two primary ways to determine a business' size:

– Calculation of Receipts

- Total (gross) income plus cost of goods sold
- Does not include capital gains, sales taxes, or proceeds from transactions with affiliates
- Includes subcontractor costs, certain reimbursements, employee-based costs like payroll taxes, proportionate share in joint ventures
- Average of annual receipts for prior 3 completed fiscal years – different tests if in business <3 years
- Average annual receipts of each affiliate is added to that of the concern for entire period (former affiliates not included for entire period)

Two primary ways to determine a business' size:

– Calculation of Number of Employees

- Count all individuals employed full-time, part-time, or other basis as “one”
- Includes employees from a temporary, professional, or leasing organization
- Excludes volunteers
- Average employees for prior 12 calendar months (if in business less time – use completed pay periods)
- Average number of employees of each affiliate is added to that of the concern for entire period, including a proportionate share of joint ventures (former affiliates not included for entire period)

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What is “Affiliation”?

- Generally, affiliation exists between entities when:
 - One controls or has power to control another
 - Or, a third party controls or has power to control both
 - It does not matter whether control is actually exercised
- A “totality of the circumstances” analysis, *i.e.*, numerous factors can be considered
 - Ownership, management, previous relationships or ties to another concern
 - Contractual relationships
- Affiliation may be:
 - Affirmative control
 - Negative control (*e.g.*, minority shareholder that can prevent quorum or otherwise block action by board or shareholders)
 - Direct or indirect (through a third party)
 - Domestic or foreign
 - For profit or not-for-profit

How Is “Affiliation” Determined?

- Several “stand-alone” tests, with certain exceptions
- “Totality of the circumstances” evidencing power to control
 - Case law provides guidance, but analysis is fact dependant
 - Focus on reality of control – substance over form
- Exceptions to affiliation coverage:
 - Most importantly, ANCs and mentor-protégé
 - Variety of other narrow exceptions

What Does “Affiliation” Mean for My Company?

- Affiliation affects a concern’s size for SB purposes
 - Employees/annual receipts of the SB and its affiliates
 - Eligibility for award of SB set-aside contracts/revenue – affects entire team!
 - Lost opportunities (prime and sub) and/or potential penalties if wrong
 - Possible subject of investigations, criminal sanctions
- This is an area where SBA devotes heightened scrutiny – don’t try to walk the line!!
 - “[SBA] will not close its eyes to the practical realities of business life, but will look to substance rather than form in determining the size of a concern. . . . Although no single factor alone may support a finding of power to control, consideration of all . . . factors together [may lead] to that conclusion.” *Size Appeal of Savini Construction Co.*, SBA No. 477 (1971).

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Why Is a Nuanced Understanding Important?

- SBA excels at finding attempts by contractors to bend the rules
- With size status and affiliation, grey areas are not safe
- For example:
 - Customers often request/prefer JVs, but
 - JV's = affiliation with certain limited exceptions (e.g. mentor-protégé program (13 C.F.R. § 124.520))
 - Large business can't form JV with SB unless mentor-protégé
 - Teaming agreement language can result in affiliation
- Critical to determining best teaming strategy for the procurement

- “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
 - Agreement designed to separate stock-voting power from beneficial ownership for the purpose of shifting control of a concern from the owner to avoid affiliation is not valid
 - Limitations on unanimous or supermajority voting requirements – 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

Affiliation: Common Management

- Affiliation arises when one or more officers, directors, managing members, or partners who control board of directors and/or management of SB also control the board of directors or management of one or more other entities

Common Management Exception

- Concerns owned and controlled by ANCs (NHOs, Indian Tribes, CDCs) are not
 - Affiliates of the parent organization
 - Affiliates of other held concerns because of their common ownership or management
 - Common administrative services (*e.g.*, bookkeeping or payroll) will not result in affiliation, so long as adequate payment is provided for those services
 - Affiliation may be found for other reasons

Affiliation: Identity of Interest (1)

- Affiliation may arise among two or more persons that have identical or substantially identical business or economic interests (e.g., family members, common investments, economically dependent through contract or other relationship)
 - When businesses are in the same line of business, dependence may be implied and affiliation found.
 - When “one or both of the concerns depends upon the other for a high percentage of its revenues.” *Size Appeal of Faison Office Products, LLC*, SBA No. SIZ-4834 (2007)
- Affiliation may also arise from repeat teaming or continuing contractual relationships. *Size Appeal of Taylor Consultants, Inc.*, SBA No. SIZ-5049 (July 2009)

Affiliation: Identity of Interest (2)

- The concerns are treated as one party and interests are aggregated
- SBA's determination may be rebutted with evidence showing that the interests are in fact separate
- Stand-alone affiliation test, or may be used to aggregate interests under other tests for affiliation

Affiliation: Stock Ownership (1)

- 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
- If 2 or more persons or entities each owns, controls, or has power to control
 - $< 50\%$ of SB's voting stock, and
 - Such holdings \approx and aggregate is large compared to any other holding, presume each person or entity has control or power to control
 - May be rebutted by showing power to control does not in fact exist

Affiliation: Stock Ownership (2)

- But, if voting stock is “widely held” and no block is large as compared to others, the Board, CEO or President are presumed to “control” the concern
 - “[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)
 - In determining whether a single block of voting stock is large compared to other holdings, SBA will consider prior decisions that contemplated similar percentages of stock
 - A block of 49% was considered large when compared to the next largest of 36%
 - *See Size Appeal of Novalar Pharmaceuticals, Inc.*, SBA No. SIZ-4977 (2008); *Size Appeal of H.L. Turner Group, Inc.*, SBA No. SIZ-4896 (2008)

“Present Effect” Rule

- SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on power to control
- Agreements to open/continue negotiations towards possibility of merger/sale of stock in future not given present effect
- Options, convertible securities, and agreement subject to conditions precedent incapable of fulfillment, speculative, or unenforceable (or if probability of transaction or rights is extremely remote) are not given present effect
- **None of these devices can be used to create an appearance of terminating control over an entity in order to avoid a finding of affiliation**

Affiliation: Newly Organized Concern (1)

- Purpose of the rule is:
 - “[T]o prevent circumvention of the size standards by the creation of spin-off firms which appear to be small, independent firms, but are really affiliates or extensions of large firms, even absent evidence the new firm was formed to circumvent the regulations” *Size Appeal of GSC Construction, Inc.*, SBA No. SIZ-4525 (2002)

Affiliation: Newly Organized Concern (2)

- Must meet all four factors to find affiliation:
 - Former officers, directors, principal stockholders, managing members, or key employees of a concern organize a new entity
 - New entity is in the same or related industry
 - Former officers, directors, principal stockholders, managing members, or key employees of concern serve as new entity's officers, directors, principal stockholders, managing members, or key employees
 - Concern is furnishing or will furnish new entity with contracts, financial or technical assistance, indemnification on bid or performance bonds, and/or other facilities, whether for a fee or otherwise
 - “Key employee” is an employee who, because of his or her position in the concern has a critical influence in or substantive control over the operations or management of the concern

Affiliation: Newly Organized Concern (3)

- It is possible (but difficult) to rebut a finding of affiliation between a spin-off and the large firm
 - Must show a “clear line of fracture” between the entities
 - When an officer continues to perform management duties for both business concerns, *i.e.*, “common management,” the SBA is unlikely to find a “clear line of fracture.” *See Priority One Services, Inc.*, SBA No. SIZ-4479 (2002)

Affiliation: Joint Ventures

- Understand difference between “teaming” and JVs
- JV may not be awarded more than 3 contracts in 2-year period – or affiliated for all purposes
 - Limit runs from date of initial offer including price
 - Same entities may create additional JVs
 - JV must be in writing and do business in own name; JV need not be populated or separate legal entity
- SBA may determine that a prime and subcontractor are a JV and affiliated in case of “ostensible subcontractor”

Joint Ventures: Ostensible Subcontractor (1)

- When a subcontractor is an “ostensible subcontractor” to the SB prime, they are treated as joint venture affiliates
- An “ostensible subcontractor” is:
 - *A large business subcontractor that is really the prime contractor*
 - A subcontractor that “performs primary and vital requirements of a contract,” or
 - A subcontractor “upon which the prime contractor is unusually reliant.”

Joint Ventures: Ostensible Subcontractor (2)

- Not just a percentage of work determination
- “All aspects of the relationship between the prime and subcontractor are considered, including, but not limited to”
 - Proposal terms (contract management, technical responsibilities, % of work subcontracted)
 - Agreements between prime and subcontractor
 - Whether the subcontractor is the incumbent and is ineligible to submit a proposal because of size
 - *See Size Appeal of TCE, Inc.*, SBA No. SIZ-5003 (2008)
- Requires counter-intuitive proposal writing
- Mentor-protégé relationships can resolve

Joint Ventures: Ostensible Subcontractor (3)

- Evidence of subcontractor acting as prime:
 - Will the sub manage the contract?
 - Are personnel commingled, or do the parties perform discrete tasks?
 - Does the sub perform more complex and costly contract functions?
 - Does the sub possess the requisite background and experience to carry out the contract requirements?
 - Did the sub collaborate extensively on the bid/proposal preparation?
 - Will the sub perform a greater amount of the work?
 - Did the sub chase the contract?
 - *Size Appeal of Fortier and Associates, Inc.*, SBA No. 4055 (1995)
- Other factors to consider: incumbent team members; personnel transfers; prime with a lack of qualifications or experience; teaming agreements; bonding or financial assistance from subcontractor
- More factors present, greater likelihood of affiliation

Affiliation Exceptions for Joint Ventures

- **Firms approved by SBA to be a mentor and a protégé (13 CFR 124.520)**
 - If protégé qualifies as small, and
 - For purposes of 8(a) sole source requirements, has not reached dollar limit in 13 CFR 124.519
- Two or more small businesses and the procurement (1) is a “bundled” requirement or (2) within the stated size limits
- Certain JVs with SBA 8(a) participants (must meet 13 CFR 124.513(b)(1))
 - 8(a) set-asides – SBA prior approval for JVs – leave time!! JV must be approved before contract award.

Totality of Circumstances: Other Considerations (1)

- A full range of types of financial and/or technical assistance provided to a SB could contribute to a finding of affiliation:
 - Loan guarantees and bond indemnification (*see Size Appeal of Inland Dredging Company, LLC*, SBA No. SIZ-4350 (1999))
 - Use of equipment at no cost (*see Size Appeal of Pointe Precision, LLC*, SBA No. SIZ-4466 (2001))
 - Extension of credit (*see Size Appeal of Frontier Applied Sciences, Inc.*, SBA No. 4316 (1998))
 - Clerical and office support services (*see Size Appeal of First American Tax Valuation, Inc.*, SBA No. 4206 (1996))
 - Supplying equipment and technical assistance (*see Size Appeal of Mingus Constructors, Inc.*, SBA No. 3115 (1989))

Totality of Circumstances: Other Considerations (2)

- SBA's Form 355 (Application for Small Business Size Determination) reveals additional information that could contribute to finding of affiliation, including:
 - “At the time of bid opening or application for assistance or at the present, have any services been performed by applicant for any of the alleged, acknowledged or possible affiliates, or vice versa?”
 - “In preparing the subject bid or application for assistance, was any assistance provided by an alleged, acknowledged or possible affiliate to the applicant or by the applicant to an alleged, acknowledged or possible affiliate?”
 - “Have there been any actual or proposed subcontracts between applicant and any of the alleged, acknowledged or possible affiliates?”

Totality of Circumstances: Other Considerations (3)

- Sharing common facilities could be factor in determining whether entities are affiliated
 - SBA, however, has recognized that if the two entities are located in separate executive suites in the same office building, this will not contribute to a finding of affiliation
 - *See Size Appeal of Gallagher Transfer & Storage Co., Inc.*, SBA No. SIZ-4295 (1998)

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Size Protests: Procedures

- Eligible offerors (not large businesses except if only 1 offer submitted), CO, and SBA may challenge size status
- File protest with CO; SBA Gov't Contracting Area Office decides; appeals to OHA
- Negotiated procurements –protest w/in 5 business days of notice award; awardee has 3 days to respond
- Size protest must relate to a particular procurement and be specific to be considered
- SBA to issue a size determination w/in 15 business days, “if possible”
- Burden of persuasion is with concern whose size is challenged
- Also status protests; NAICS code appeals (note unique procedures for each type)

Size Protests: Effect of Determination

- If a concern is found to be other than a small business
 - A CO shall not award a contract to the concern for the procurement in question
 - If the determination is received after award, the CO shall terminate the award if no appeal filed
 - If an appeal is filed, the CO must determine if performance can be suspended until an appellate decision is rendered
 - If the CO allows performance to proceed and the concern is found to be other than small on appeal, the CO shall either terminate the contract or not exercise the next option
- Once a concern is determined to be other than small
 - It cannot reduce its size to become eligible
 - Is ineligible for future procurements authorized for entities of that size or smaller unless SBA recertifies or OHA reverses
 - Recertification is not required if ineligibility was based only on affiliation due to joint venture (e.g., ostensible subcontractor) 42

Size Misrepresentations: Penalties

- The Small Business Act provides for severe criminal penalties for knowingly misrepresenting small business size status:
 - Fine of not more than \$500,000 or by imprisonment for not more than 10 years, or both
 - Subject to administrative penalties for Fraud
 - Be subject to suspension and debarment
 - Be ineligible to participate in any program or activity conducted by the SBA for up to 3 years
- May also be subject to:
 - Investigations
 - Civil or Criminal False Claims Act penalties

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