



Source: Federal Contracts Report: All Issues > 2009 > 08/25/2009 > Analysis & Perspective > Small Business: SBA Rules Continue to Impact Ability of Small Businesses to Raise Capital

92 FCR 152

Small Business

SBA Rules Continue to Impact Ability of Small Businesses to Raise Capital

By Keric B. Chin and Richard J. Vacura

During these turbulent economic times when small businesses are finding it extremely difficult with the tight credit markets to raise operating capital from banks and traditional lenders, the Small Business Administration rules raise even more barriers to obtaining capital for small businesses that are selling products and services to the federal government. In the private sector, venture capital and other investment funds have long provided essential operating capital that has sustained many small businesses and enabled them to grow into successful large businesses. When small businesses are pursuing federal government work, however, capital infusions by venture capital or other investment funds in a small business may change the status of the business to other than "small" as defined by the SBA rules, thereby making the business ineligible for opportunities that have been set aside by federal agencies for small businesses. In addition, losing the "small" size status may make a business less attractive to government prime contractors seeking to meet their small business subcontracting goals.

The effect of an investment on a small business concern's size status depends on a number of factors, including the relative size of the investment and management-related controls the investors typically insist upon to protect their investment. If an investor is deemed to have the power to control the small business concern, either because of the size of its shareholding or other factors, the two entities are considered "affiliates" and the investor's revenue and employee numbers are aggregated with the small business concern's numbers for size determination purposes. Notably, even minority shareholders can be, and often are, considered "affiliates" for determining the size status of the small business.

This article provides a general overview of the size eligibility provisions and standards under the SBA regulations, especially as they relate to investments by venture capital and other investment entities. As an initial matter, it is important to recognize that the small business size eligibility provisions and standards—particularly those related to affiliation—are complex and there are few bright lines to guide small businesses or investors. Each case must be examined on its own merits to determine the risks and benefits of the particular investment.

Small Business Administration Size Standards

The Small Business Act defines a small business concern as "one which is independently owned and operated and which is not dominant in its field of operation."¹ The Act goes on to provide that, in addition to this basic criteria, SBA may specify detailed definitions or standards by which a business concern may be determined to be "small." To this end, SBA has established size standards to determine whether a business is "small" and thus eligible for government programs and preferences reserved to small businesses.² The size standards vary by industry and are matched to the North American Industry Classification System ("NAICS") codes. The size standards are based on either numbers of employees or annual receipts, depending upon the industry involved. For example, SBA has established a size standard of 750 employees for Pharmaceutical Preparation Manufacturing (NAICS Code 32541) and a size standard of \$15 million for Satellite Telecommunication (NAICS Code 517410).³ In establishing the size standards for a particular industry, SBA seeks to ensure that any concern meeting the size standard is not "dominant in its field of operations."⁴

¹ 15 U.S.C. §632(a)(1).

² 13 C.F.R. §121.101(a).

³ In determining the number of employees, SBA counts all individuals employed on a full-time, part-time or other basis averaged over the preceding 12 calendar months. 13 C.F.R. §121.106. SBA calculates annual receipts for a concern based on the average total receipts over the concern's most recently completed three fiscal years. 13 C.F.R. §121.104.

⁴ 13 C.F.R. §121.102(b).

In practice, the contracting officer designates the NAICS code that applies to a particular procurement, and thus the size standard that applies to it. A company that meets the size standard for the designated NAICS code may represent itself as a "small" business for the procurement. Moreover, if the procurement has been set aside for small businesses, then only businesses that meet the size standard for the designated NAICS code are eligible for award.⁵ A company generally certifies its size status at the time it submits an offer or bid to the procuring agency,⁶ and the procuring agency may rely on the self-certification absent evidence to the contrary or a challenge by an interested party in a restricted procurement.⁷ Self-certification, however, should not be taken lightly. Section 8(d) of the Small Business Act provides severe penalties for knowingly misrepresenting the size status of a concern in connection with a procurement.⁸ In addition, there are separate certification processes for small businesses that wish to be certified as participants in the Section 8(a) Business Development Program, as small disadvantaged businesses, or as HUBZone small businesses.⁹

⁵ See FAR Subpart 19.5.

⁶ 13 C.F.R. §121.404.

⁷ 13 C.F.R. §121.405.

⁸ 15 U.S.C. §645(d).

⁹ See 13 C.F.R. Parts 124 & 127, respectively.

Affiliation Rules

Determining whether a company qualifies as a small business concern is not always an easy task. This is mainly due to the complexity and ambiguity of the SBA affiliation rules and the myriad of business models and investment relationships among small businesses.¹⁰ For investors and small businesses, understanding the SBA affiliation rules and the risks inherent in them is critical.

¹⁰ 13 C.F.R. §121.103.

In calculating the size of a business concern, SBA aggregates the number of employees or annual receipts of the business concern with those of its affiliates. This, of course, requires SBA to determine which, if any, entities are affiliated with the concern. Affiliation is broadly defined as follows:

Concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists.¹¹

¹¹ 13 C.F.R. §121.103(a)(1).

The SBA affiliation regulations make clear that control can be either affirmative or negative. Negative control exists when a minority shareholder has the power to prevent a quorum or block ordinary actions by the board or shareholders.¹²

¹² *Size Appeal of EA Engineering, Science, and Technology, Inc.*, SBA No. SIZ-4973 (2008) (distinguishing between the power to block ordinary and extraordinary actions of the board or shareholders). *But see, Size Appeal of Dependable Courier Services, Inc.*, SBA No. SIZ-2210 (1985) (finding affiliation even though controls were characterized as limited to scenarios outside the normal course of business).

The SBA affiliation regulations identify certain circumstances under which affiliation will be presumed. In some cases, the presumption is rebuttable. In others, it is not. We have listed the circumstances that give rise to the presumption of affiliation and have indicated whether the presumption is rebuttable:

- **Affiliation based on stock ownership—single large block.** Affiliation exists where any individual, concern or other entity owns or has the power to control 50 percent or more of the voting stock *or* a block of voting stock that is large as compared to other outstanding blocks of voting stock.
- **Affiliation based on stock ownership—minority shareholder rule.** A rebuttable presumption of affiliation exists where two or more individuals, concerns or other entities each own or have the power to control less than 50 percent of a concern's voting stock *and* such minority holding are equal or approximately equal in size *and* the aggregate of these holding is large as compared to other outstanding blocks of voting stock.
- **Affiliation arising under stock options, convertible securities, and agreements to merge.** Affiliation may exist based on the ownership or control of stock options and convertible securities as well as agreements to merge, including agreements in principal. These instruments and agreements are given present effect by the SBA for determining affiliation.
- **Affiliation based on common management.** Affiliation exists where one or more officers, directors, managing members, or partners who control the board of directors and/or management of one concern also control the board of directors and/or management of one or more other concerns.
- **Affiliation based on identity of interest.** A rebuttable presumption of affiliation may arise where two or more individuals or firms have identical or substantially identical business or economic interests, such as family members, common investments, or economically dependent relationships through contract or otherwise.
- **Affiliation based on newly organized concern.** A rebuttable presumption of affiliation may arise where former officers, directors, principal stockholders, managing members or key employees of one concern organize a new concern in the same or a related industry *and* serve as the new concern's officers, directors, principal stockholders, managing members or key employees *and* the pre-existing concern furnishes or will furnish support to the new one.
- **Affiliation based on joint ventures.** Affiliation exists where an association of individuals and/or concerns engage in and carry out more than three business ventures in a two year period.¹³ With certain exceptions, this rule does not apply to: (1) a joint venture between two or more small businesses, each of which meets the designated size standard; or (2) two firms approved by SBA to be a mentor and protégé and the protégé qualifies as small under the designated size standard.
- **Affiliation based on joint ventures—ostensible subcontractor rule.** Certain prime contractors and their subcontractors are treated as joint venturers and affiliation exists where the subcontractor performs primary and vital requirements of the contract, or the prime contractor is unusually reliant on the subcontractor.

¹³ 13 C.F.R. §121.103(h); *Size Appeal of Weidlinger Associates, Inc.*, SBA No. SIZ-4846 (2007)(explaining that SBA could find affiliation between two concerns because they have formed so many joint ventures that the independent identity of one or both concerns has become blurred or non-existent).

To complicate matters even further, SBA will examine multiple levels of affiliation.¹⁴ Thus, for example, if Company A is affiliated through stock ownership, common management, an identity of interest, or otherwise with Company B, and Company B is affiliated with Company C, then Company A would be affiliated with both Companies B and C, and the number of employees or receipts of each affiliate would be aggregated for size determination purposes. For many venture capital and other

investment fund entities, the affiliation analysis typically is complex due to the number of individuals and business entities in their investment portfolios. Moreover, SBA may find affiliation based on the “totality of the circumstances” even though no single factor by itself would be sufficient to constitute affiliation.¹⁵

¹⁴ See, e.g., *Size Appeal of USA Jet Airlines, Inc.*, SBA No. SIZ-4867 (2007); *Size Appeal of Colt Defense, LLC*, SBA No. SIZ-4943 (2008).

¹⁵ 13 C.F.R. §121.103(a)(5).

To be sure, there are some exceptions to the affiliation rules, although they are quite limited.¹⁶ For example, business concerns owned in whole or in part by investment companies licensed, or development companies qualifying, under the Small Business Investment Act of 1958 are not considered affiliates of the investment companies or development companies. There are also exceptions pertaining to business concerns owned and controlled by Indian Tribes, Alaska Native Corporations, Native Hawaiian Organizations, and Community Development Corporations, as well as labor brokers and temporary employment agencies.

¹⁶ 13 C.F.R. §121.103(b).

Small Business Innovation Research

In addition to meeting the applicable size standards,¹⁷ small businesses that apply for and receive grants or contracts under the Small Business Innovation Research (SBIR) program must contend with yet another eligibility requirement.¹⁸ Under the SBA's SBIR regulations, a small business concern must be at least 51 percent owned and controlled by “natural persons” who are either U.S. citizens or permanent resident aliens of the United States, or be at least 51 percent owned by a *single* for-profit company that is, in turn, at least 51 percent owned and controlled by “natural persons” who are either U.S. citizens or permanent resident aliens of the United States.¹⁹ Notably, the SBA's SBIR regulations preclude multiple levels of corporate ownership; *i.e.*, a firm does not qualify under the regulation if it is owned by a single for-profit corporation, which corporation is in turn owned by another corporation.²⁰ It is also important to note that, for purposes of the SBIR program, size status is determined at the time of award rather than the date on which the entity submits its offer.²¹

¹⁷ The applicable size standard for firms participating in the SBIR program is 500 employees. 13 C.F.R. §121.702(b).

¹⁸ 15 U.S.C. §638.

¹⁹ 13 C.F.R. §121.702(a); *Size Appeal of Aspect Medical Systems, Inc.*, SBA No. SIZ-4567 (2003) (reaffirming that at least 51 percent of a concern's stock must be directly owned and controlled by natural persons who are citizens of the United States, or permanent resident aliens in the United States).

²⁰ *Size Appeal of Genex Technologies, Inc.*, SBA No. SIZ-4789 (2006).

²¹ 13 C.F.R. §121.704.

As a practical matter, the U.S. citizenship/permanent resident ownership requirement often makes it difficult for small businesses that are publicly traded companies to establish eligibility under the SBIR program.²² It also acts as a disincentive for small businesses going public.

²² On May 21, 2009, Representative Henry C. Johnson introduced a bill (H.R. 2568) which would exclude publicly traded companies and companies that are more than 50 percent owned by non-U.S. citizens from the definition of small business concern.

Legislative proposals currently before the House of Representatives and Senate would make it possible for venture capital companies to invest in small businesses without affecting their size status for purposes of the SBIR program.²³ The proposals would permit a small business that is majority owned by multiple venture capital companies to participate in the SBIR program so long as no single venture capital company owns 50 percent or more of the business. In other words, the venture capital

companies would not be considered affiliates of the small business for size determination purposes. There are, however, differences between the bills passed by the House and Senate that will need to be resolved in conference. Most notably, the Senate's version would restrict the amount of funds available under the SBIR program that could be allocated to small business concerns that are majority owned by venture capital companies. Under the Senate's version, the National Institutes of Health would be limited to allocating not more than 18 percent of its SBIR funds to such entities while all other agencies participating in the program would be limited to 8 percent of their SBIR funds.²⁴ By contrast, the House's version would not impose any limits.²⁵

²³ See SBIR/STTR Reauthorization Act of 2009, H.R. 2965, 111th Cong. (as passed by the House on July 8, 2009); Enacting Small Business Research and Innovation Act of 2009, S. 1233, 111th Cong. (as passed by Senate on July 13, 2009).

²⁴ S. 1233, 111th Cong. §108(a) (2009).

²⁵ H.R. 2965, 111th Cong. §102 (2009).

The proposed legislation would only affect the eligibility of small business concerns to participate in the SBIR program. In all other circumstances, the SBA affiliation rules would remain unchanged.

Consequences of Change in Status

In assessing potential investment opportunities, small businesses and venture capital or other investment fund entities must not only consider whether a contemplated investment will change the size status of the small business concern, but also what the consequences will be if the small business is deemed to be other than "small." There are two areas, in particular, where the small businesses might be negatively impacted. First, a change in status could impact future business opportunities by making the concern ineligible for contracts that are set aside for small businesses or less attractive to prime contractors who are looking to subcontract work to small businesses in order to meet their small business subcontracting goals. Second, a change in status could affect the small business concern's current contracts. This latter point is discussed in more detail below.

As a general matter, a change of size status does not alone necessitate termination of contract awards involving small business set-asides so long as the contractor met the size standard at the time it submitted its offer.²⁶ This means that the contractor will continue to perform under such contracts and may accept new orders under indefinite delivery indefinite quantity (IDIQ) type contracts. As a practical matter, however, with the intense pressure federal agencies are under to increase the procurement dollars going to small businesses, there is a risk that the contracting officer will make a new award to another small business and not exercise options or award further orders under the contract. The contracting officer could also terminate the contract for convenience, but this is less of a risk for companies with specialized expertise or products.

²⁶ Note, however, that a contract awarded under Section 8(a) of the Small Business Act (15 U.S.C. §637(a)) must be terminated for convenience if the 8(a) concern transfers ownership or control of the firm. 13 C.F.R. §124.515(a)(1); FAR 19.812(d).

Prior to June 30, 2007, there was no requirement for a contractor to notify the contracting officer of a change of circumstances that impacted its size status.²⁷ The contractor represented whether it was a small business concern at the time it submitted its offer and that was it. In 2006, however, the Federal Acquisition Regulation was amended to require notification upon the occurrence of certain events. Beginning June 30, 2007, a contractor that represented it was a small business concern before award of a contract is now required to re-represent its size status following: (1) the execution of a novation agreement; (2) following a merger or acquisition that does not require a novation agreement (*i.e.*, a stock purchase); (3) prior to the end of the fifth year of a long-term contract; and (4) prior to the exercise of any options thereafter.²⁸ The FAR amendment makes clear that "[A] change in size status does not change the terms and conditions of the contract, but the agency may no longer include the value of options exercised or orders issued against the contract in its small business prime contracting goal achievements."²⁹

²⁷ Note, however, that if the contract was awarded under Section 8(a) of the Small Business Act (15 U.S.C. §637(a)), the 8(a) contractor must provide notice to the SBA if it enters into an agreement to transfer all or part of its ownership interest. 13 C.F.R.

§124.515(g).

²⁸ FAR 19.301-2.

²⁹ 72 Fed. Reg. 36,852 (Jul. 6, 2007); *see also* 71 Fed. Reg. 66434 (Nov.16, 2006). Note that a contract awarded under Section 8(a) of the Small Business Act (15 U.S.C. §637(a)) must be terminated for convenience if the 8(a) concern transfers ownership or control of the firm. 13 C.F.R. §124.515(a)(1); FAR 19.812(d).

Based on the foregoing, the mere fact that a venture capital or other investment fund entity invests in a small business may not trigger the rerepresentation requirement, even when the investment impacts the size status of the concern. A contracting officer may, nevertheless, require the small business to recertify its size status at any time, including in response to a solicitation for an order under a contract, such as a Multiple Award Schedule, Multiple Award Contract, or Government-wide Acquisition Contract. ³⁰ In addition, a small business with a long-term contract must recertify its size status at the end of the fifth year of the contract and each option year thereafter.

³⁰ 13 C.F.R. §121.404(3)(v).

Mitigation Strategies

To mitigate the potential impact of an investment on a small business concern's size status, venture capital other investment fund entities should limit their ownership and control of the concern's voting stock, including stock options and convertible securities. The more control an investor has over a small business concern, the more likely it will be found to be an "affiliate" of the concern. This in turn will trigger an examination of the investment entity's portfolio of companies and other entities to determine whether those entities are also "affiliates." In structuring investments, it is important to recognize that affiliation is more than just a numbers game. SBA considers the totality of the circumstances, including, but not limited to, whether an entity or entities own or have the power to control blocks of voting stock that are individually or collectively large when compared to other blocks of voting stock. Small businesses and investors must consider the implications of shareholder voting agreements, corporate charters and bylaws, common management, and mutual business or economic interests, among other things. Unfortunately, there are no bright lines or clearly delineated safe harbors to guide small businesses and investors. Simply put, an investor that owns more than a relatively small percentage of a concern's voting stock runs the risk of being considered an "affiliate" of that concern.

There are factors that small businesses and investors should consider when structuring the investment relationship to avoid triggering "affiliation." The SBA Office of Hearings and Appeals (OHA) generally distinguishes between controls that limit *ordinary* actions by the board of directors or shareholders, *i.e.*, management decisions that affect the daily operations of the business, and those that limit *extraordinary* actions pertaining to the protection of ownership stakes. ³¹ For example, OHA has held that supermajority voting requirements for amending the corporate charter or bylaws, issuing additional shares of capital stock, or entering into any business substantially different from the company's normal business did not constitute negative control for purposes of triggering affiliation. ³² The types of actions, however, that OHA considers to be extraordinary are quite limited. OHA has held that decisions related to the following types of actions are important to business operations and an entity's ability to block them would constitute negative control for affiliation purposes: (1) setting compensation; (2) hiring and firing corporate officers; (3) declaring or paying dividends; (4) creating debt; (5) alienating or encumbering assets; (6) amending or terminating lease agreements; and (7) purchasing equipment. ³³

³¹ *Size Appeal of EA Engineering, Science, and Technology, Inc.*, SBA No. SIZ-4973 (2008).

³² *Id.*

³³ *See Size Appeal of Novalar Pharmaceuticals, Inc.*, SBA No. SIZ-4977 (2008)(declaring or paying dividends); *Size Appeal of Eagle Pharmaceuticals, Inc.*, SBA No. SIZ-50233 (2009) (creating debt and paying dividends); *Size Appeal of Firewatch Contracting of Florida, LLC*, SBA No. SIZ-4994 (2008)(establishing compensation or hiring or firing officers); *Size Appeal of Dependable Courier Services, Inc.*, SBA No. SIZ-2210 (1985) (alienating or encumbering assets, amending or terminating lease agreements, and purchasing

equipment).

Conclusion

The foregoing suggests that small businesses and investors should adopt a minimalist approach when structuring the investment relationship, assuming size status is important to the value propositions of the small business concerns. Because the very act of investing in a small business concern can change its size status, it is critically important to consider all facets of the prospective relationship between the investor and the small business. Moreover, given the complexity and uncertainty inherent in the SBA affiliation regulations, we would highly recommend that small businesses and investors consult legal counsel before finalizing small business investments.

Richard Vacura is a partner, and Keric Chin is of counsel, in the Northern Virginia office of Morrison & Foerster LLP.

Contact us at <http://www.bna.com/contact/index.html> or call 1-800-372-1033

ISSN 1523-5696

Copyright © 2009, The Bureau of National Affairs, Inc.. Reproduction or redistribution, in whole or in part, and in any form, without express written permission, is prohibited except as permitted by the BNA Copyright Policy. <http://www.bna.com/corp/index.html#V>