



Understanding and Avoiding Affiliation Under Small Business Contracting Programs

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Peter advises government contractors and commercial businesses on a broad range of federal procurement matters. He is adept at navigating issues related to eligibility for, and continued participation in, small business programs such as SBA's 8(a) BD, SDVOSB, WOSB, and HUBZone programs and the VA's VetBiz VIP program. He represents clients in actions before OHA, GAO, and ODRA. He also counsels federal contractors on FAR and small business regulation compliance, which includes auditing clients for potential size and affiliation issues.

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We deliver results for our clients by implementing legal and business solutions that take the client's best interests into consideration. Moreover, PilieroMazza's efficient operational structure and lean approach to staffing matters translate into competitive pricing for our clients, while providing the highest standard of client service and legal acumen.

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Overview

- What is Affiliation?
- Why size matters
- How affiliation impacts small business status
- Overview of U.S. Small Business Administration’s (“SBA”) affiliation rules and exemptions from affiliation
- Tips to avoid/mitigate common affiliation pitfalls
- Q&A

What is Affiliation?

- FAR recognizes at least three different definitions of an Affiliate.
 - FAR 2.101 (definition of *Affiliates*) (for cost principles and general purposes)
 - FAR 9.403 (definition of *Affiliates*) (for suspension and debarment)
 - FAR 19.101 (definition of *Affiliates*) (FAR counterpart to the 13 C.F.R. small business rules)
- Small Business Rules definition of Affiliation
 - “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.” 13 C.F.R. § 121.103(a).

Why Size Matters

- Small business status is the #1 eligibility requirement for all the set-aside programs
 - Therefore, if you participate in set-aside programs, your small business status is one of your most important assets
- Being small also exempts you from certain requirements, such as cost accounting standards.
- SBA's Presumed Loss Rule increases importance of protecting and verifying your small business status
 - Creates a presumption of loss to the government from a size or status misrepresentation equal to the total amount expended on a contract obtained by misrepresentation

How Affiliation Impacts Small Business Status

- Small business status is determined by your: (1) average annual receipts over the five most recently completed fiscal years; or (2) average number of employees for each pay period during the past 12 months
 - Annual receipts include all income, including passive income
 - Small Business Runway Extension Act of 2018
- When you have an affiliate, your affiliate’s average annual receipts or number of employees are counted with yours to determine if you are a small business
 - You may be small on your own, but if you have affiliates, the combination of the affiliates and your firm may push you over the size standard, rendering your company “other than small”

Affiliation 101

- Affiliation is all about control
 - SBA's affiliation rules look to whether one firm has the power to control another, or a third firm has the power to control both
 - Control can be affirmative or negative
 - Does not matter if control is exercised, so long as the power to control exists
- Under 13 C.F.R. § 121.103, affiliation can arise based on:
 - Stock ownership: stock options, convertible securities, merger agreements
 - Common management: identity of interest
 - Newly organized concerns: joint ventures
 - Ostensible subcontractor arrangements: franchise and license agreements
 - Totality of the circumstances: SBA may find affiliation even though no single factor is sufficient to constitute affiliation

Affiliation 101, continued

- An affiliate can be any business entity, whether for profit or non-profit, domestic or foreign
- Affiliation can be ongoing or specific to one contract
- Affiliation is determined at a specific point in time
 - Generally, the date you submit your initial proposal, with price, or your application for an SBA procurement program
- There are exceptions to the affiliation rules for firms owned and controlled by Indian Tribes, Alaska Native Corporations, Native Hawaiian Organizations, and Community Development Corporations
- Affiliation rules for other SBA programs are found in other regulatory sections:
 - SBIR and STTR programs: 13 C.F.R. § 121.702
 - Business Loan, Disaster Loan, and Surety Bond programs: 13 C.F.R. § 121.301(f)

Affiliation Based on Stock Ownership

- There are three ways control can arise based on stock ownership:
 1. An individual or entity owns, controls, or has the power to control 50 percent or more of a firm's voting stock, or a block of stock that is large compared to other outstanding blocks
 - Example: Two individuals each own blocks of shares of Company A. One individual owns 46.67% of the business and the other owns 33.33%. The individual that owns 46.67% of the stock owns the largest single block, which is large compared to any other block, and therefore has the power to control the concern. This individual also controls Company B. There is affiliation between Company A and Company B.
 - Example: Company A owns 40% of the voting stock of Company B and the next largest share is 2%. Company A controls Company B due to the fact that it owns the largest block of voting stock of Company B compared to all other outstanding blocks of voting stock. Company A and Company B are affiliates. In addition, all other companies controlled by Company A will be considered affiliates of Company B.

Affiliation Based on Stock Ownership, continued

- . . . The other two ways control can arise based on stock ownership:
 2. Individuals or entities own, control, or have the power to control roughly equal minority holdings of voting stock, and the aggregate of the minority holdings is larger than any other stock holding
 - This scenario creates a rebuttable presumption that each person holding a minority interest has the power to control the firm
 3. If a firm's voting stock is widely held and no single block of stock is large, the Board of Directors and CEO or President will be deemed to have the power to control the concern in the absence of evidence to the contrary

Affiliation Based on Stock Options, Convertible Securities, and Agreements to Merge

- 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
 - Thus, SBA treats such arrangements as though the rights granted have already been exercised
 - Example: If Company A holds an option to purchase a controlling interest in Company B, the situation is treated as though Company A had exercised its rights and had become owner of the controlling interests in Company B. Company A and Company B are affiliates. In addition, all companies controlled by Company A will be considered affiliates of Company B.

Affiliation Based on Stock Options, Convertible Securities, and Agreements to Merge, continued

- However, SBA will not give present effect when:
 - The agreement is merely to open or continue negotiations towards the possibility of a merger or a sale at a later date
 - There are conditions precedent that are incapable of fulfillment, unenforceable, or extremely remote
 - Example: Company A and Company B are in discussion about a merger between the two of them. Both companies' representatives have met several times over the past two months. There is neither a formal nor informal agreement to merge. Unless the two companies have an agreement in principle, SBA will not find affiliation between the two companies based on these open and continuing discussions of merger alone. Discussions about the possibility of a future merger or buy-out, by themselves, are not sufficient to find affiliation.

Affiliation Based on Common Management

- Affiliation may arise 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 or management of one or more other concerns
- Size Appeal of Radant MEMS, Inc., SBA No. SIZ-5600 (2014)
 - Two firms found affiliated because the same individual served as president of both companies
 - SBA and SBA's Office of Hearings and Appeals ("OHA") rejected argument that president did not truly control one of the companies because that company's majority shareholder had the right to remove the president at any time

Affiliation Based on Identity of Interest

- This type of affiliation occurs when SBA finds that two or more firms have identical or substantially identical business or economic interests
- An identity of interest may arise based on:
 - Familial relationships: limited to married couples, parents, children, and siblings
 - Individuals or firms with common investments
 - Firms that are economically dependent based on contractual or other relationships
- Patterns of subcontracting, commingling of staff and/or facilities, or veiled attempts to disguise the true nature of the relationship may evidence an identity of interest
- In general, an identity of interest may be rebutted with evidence showing the interests thought to be identical or substantially identical are, in fact, separate
 - Key is whether there is a “fracture” in the relationship

Familial Identity of Interest

- There is a rebuttable presumption that close family members (e.g., father/daughter, husband/wife) have an identity of interest
- Familial identity of interest affiliation will only arise when the close family members control their respective firms
 - If a wife owns 100 percent of her firm, and the husband has a minority, non-controlling ownership interest in a separate firm, the two firms will not be affiliated based solely on the familial relationship between the husband and wife

Familial Identity of Interest, continued

- The presumption of affiliation may be rebutted by showing the family members are estranged or by demonstrating a clear fracture in the businesses
 - A family relationship standing alone, or in conjunction with minimal business contacts, generally does not create affiliation
- Rebuttable presumption of identity of interest affiliation through family relationships now exists for firms that conduct business with each other and are owned and controlled by persons who are married, parents and children, or siblings
 - Other family relationships not mentioned in the rule would not be grounds for identity of interest affiliation

Economic Dependence

- An identity of interest through economic dependence may arise when one firm provides critical financial assistance to another firm, such as through loans or financial guarantees
- Rebuttable presumption of affiliation through economic dependence when one firm derives 70 percent or more of its revenue from another firm over the previous completed fiscal year
 - May be rebutted when a firm is new or a start-up and has only received a few contracts or subcontracts
 - No affiliation between Indian Tribes, Alaska Native Corporations, Native Hawaiian Organizations, and Community Development Corporations, or a wholly-owned subsidiary of such an entity, and another concern owned by that entity based solely on the contractual relationship between the two concerns
- OHA has also found affiliation based on economic dependence where one concern is so dependent on another for contracts or business that its economic viability would be in jeopardy without that business

Newly Organized Concern Rule

- This rule is designed to prevent firms from circumventing the size standards by creating a “spin-off”
- Arises when the following four factors are met:
 1. Former officers, directors, principal stockholders, managing members, or key employees of one concern organize a new firm;
 - A key employee is someone in a position of critical influence or substantive control over a firm’s operations or management
 2. The new concern is in the same or related industry;
 3. The persons who organized the new concern serve as the new concern’s officers, directors, principal stockholders, managing members, or key employees; and
 4. The one concern is furnishing or will furnish the new concern with contracts, financial or technical assistance, indemnification on bid or performance bonds, whether for a fee or otherwise

Joint Ventures

- JV partners are considered to be affiliated for a contract, so a JV will qualify as a small business if the combined size of the JV partners meets the size standard for the contract
- JV partners can also be deemed affiliated for all purposes if the JV is awarded more than three contracts in a two-year period (known as the “3-in-2 Rule”)
- Exceptions to joint venture affiliation:
 - When each JV partner is small under the applicable size standard assigned to the procurement
 - Joint ventures between SBA-approved protégés and mentors (All-Small Mentor-Protégé program) when the protégé is small for the procurement

All Small Mentor-Protégé Program

- In 2016, SBA issued a final rule to create a mentor-protégé program for all small businesses
 - The mentor-protégé program provides the same joint venture affiliation exception previously available only to 8(a) firms, which allows all small business protégés to form joint ventures with their large business mentors
 - Mentor-protégé joint ventures qualify for all set-aside contracts for which the protégé is eligible

Ostensible Subcontractor Rule

- A contractor and its “ostensible subcontractor” are treated as a JV, and therefore are affiliated
- An ostensible subcontractor is a subcontractor –
 - That performs primary and vital requirements of a contract; or
 - Upon which the prime contractor is unusually reliant
- Ostensible subcontractor is a contract-specific form of affiliation
 - Whether ostensible subcontractor affiliation exists is based on the unique facts and circumstances of the solicitation in question and the parties’ approach to the project as reflected in their teaming agreement, subcontract, and proposal

Ostensible Subcontractor Rule, continued

- An SBA rule exempts “similarly situated” subcontractors from ostensible subcontractor affiliation
 - A similarly situated entity is defined at 13 C.F.R. § 125.1 and is a subcontractor that has the same small business program status as the prime contractor
 - Example: for a HUBZone requirement, a subcontractor that is a qualified HUBZone small business concern; for a small business set-aside, partial set-aside, or reserve a subcontractor that is a small business concern; for a SDVOSB requirement, a subcontractor that is a self-certified SDVOSB; for an 8(a) requirement, a subcontractor that is an 8(a) certified Program Participant
 - A similarly situated entity must also be small for the NAICS code that the prime contractor assigned to the subcontract the subcontractor will perform
- Since December 30, 2019, SBA can now make a determination concerning a small business program participant's overreliance on a non-similarly situated subcontractor as part of an eligibility or status protest determination.

Totality of the Circumstances

- SBA will consider the totality of the circumstances and may find affiliation even though no single factor is sufficient to constitute affiliation
 - SBA will examine whether the totality of the circumstances between the businesses is so suggestive of reliance as to render the businesses affiliates
- That said, OHA's preference is for SBA to first evaluate whether affiliation should be found under the independent grounds for affiliation (stock ownership; stock options, convertible securities, and agreements to merge; common management; identity of interest; newly organized concern; joint ventures) and to base a finding of affiliation on totality of the circumstances if no other ground is sufficient

Tip: Your Teaming Agreement is Key for Ostensible Subcontractor Affiliation

- Very popular size protest ground
 - Expect an ostensible subcontractor protest particularly when you subcontract to a large business incumbent
 - More agencies are requiring offerors to address ostensible subcontractor affiliation in the RFP
- To lessen vulnerability, your teaming agreement should make clear that the prime contractor is in charge of the project and performing key functions
 - What does the RFP define as the primary and vital requirements?
 - How specific is the scope of work in your teaming agreement?
 - Be discrete!
 - Do not simply assign percentages

What SBA Looks at in Ostensible Subcontractor Cases

- SBA used to look at seven factors, but the focus now is on totality of the circumstances, including consideration of:
 - What was the degree of collaboration on the proposal?
 - Is the subcontractor the incumbent contractor and ineligible to submit its own offer?
 - What are the more complex and costly contract functions, and which party will perform them?
 - Will the subcontractor perform discrete tasks or is there commingling of personnel and material?
 - Who possesses the requisite background and experience?
 - Who is providing the key management for the project?
- If you are **bidding** as a joint venture, the ostensible subcontractor rule does not apply

Who Prepared the Proposal?

- The extent of the subcontractor’s participation in proposal preparation is one factor considered in an ostensible subcontractor analysis
 - Too much control/influence over the proposal may be a factor in finding affiliation
 - That said, OHA has found no ostensible subcontractor affiliation even though the subcontractor “did the heavy lifting” in preparing the cost proposal
- Ostensible subcontractor inquiries are intensely fact-specific and depend on the unique RFP, teaming agreement, and proposal at issue
 - For example, in an LPTA procurement, proposal references to a subcontractor’s experience are less likely to create ostensible subcontractor affiliation because the subcontractor’s experience would not materially enhance the offeror’s prospects for award

Who is Providing the Key Personnel?

- Since 2011, OHA has held that hiring of incumbent personnel is not indicative of unusual reliance
 - Based on the 2009 Executive Order requiring successor contractors to offer a right of first refusal to certain incumbent personnel
 - However, since the President revoked the Service Contract Labor Standards right of first refusal with an Executive Order on October 31, 2019, this may be changing.
- However, wholesale personnel transfers from the subcontractor to the prime contractor, and particularly the hiring of key management personnel from the subcontractor, creates a significant risk of ostensible subcontractor affiliation
 - SBA will assess the extent to which the prime contractor had any key personnel of its own or was reliant on the subcontractor to provide it with all the necessary individuals, especially management

Tip: Use the Former Affiliate Rule in Corporate Restructuring

- SBA's rules do not say once affiliated, always affiliated
 - Affiliations can change/lessen over time
- Former affiliate rule allows you to back out the revenues/employees of a former affiliate from your revenues/employees—for the entire time period used to measure your size
 - Can be used effectively in corporate restructuring to sell a subsidiary or sister entity and reestablish the former parent and/or subsidiary as a small business

Tip: Be Careful with Letters of Intent (“LOI”)

- SBA will give present effect to an LOI that is too definite
- To lessen the chance of affiliation based on your LOI:
 - Carefully describe due diligence that has been completed and is yet to be done
 - Emphasize non-binding nature of the letter
 - Look for words that indicate the transaction is definite
 - Consider when the deal may be finalized and what set-aside opportunities may be on the horizon
 - Ask yourself if you even need an LOI

Tip: Check Your Corporate Records for Negative Control

- May be lurking in quorum, voting, transfer, and other provisions of your operating documents such as bylaws, operating agreement, or shareholders' agreement
- Negative control may arise through supermajority provisions that require a minority owner's approval for day-to-day operations, such as:
 - Hiring and firing of executive officers
 - Setting executive compensation
 - Power to approve a board member
 - Veto power that gives control over board committees
- However, negative control would be unlikely to arise from supermajority requirements for extraordinary actions, such as addition of new owners or changing the size of the board

Tip: Rebutting Control Based on Stock Ownership

- 50 percent stock = control is not rebuttable
- If no single owner holds 50 percent of the stock, SBA will presume that each owner controls the company, but you may be able to demonstrate otherwise
 - Will depend on ownership percentages
 - Are any of the owners passive investors, or are they all voting members of the board and officers involved with day-to-day operations?
 - To rebut presumption of control, you would need to clearly demonstrate, through your corporate documents and actual operations, that certain owners do not participate and have no ability to control the company

Tip: Do Not Put All Your Eggs in One Basket

- Economic dependence arises when you receive 70 percent or more of your revenue from another company, and can also occur at a lesser percentage depending on other factors
 - Applies when you are in the position of subcontractor, but not when you are the prime contractor
- You can fracture economic dependence if you show a downward trend in the percentage of revenue by the time of the relevant date for measuring size
- OHA recently stated that the revenue test must be carefully applied so it does not unfairly penalize start-ups
 - A firm should not be found economically dependent based on its first contract

What if My Family Member Owns a Business?

- How close is the family member?
- Does the family member control his/her company? Will depend on ownership percentages
 - If yes, there is a rebuttable presumption of affiliation
 - If no, there is no affiliation based solely on the family relationship
- Rebutting the presumption
 - Stop inviting them to Thanksgiving dinner
 - Keep the businesses separate
 - Helps if the industries and locations of the businesses are separate and distinct
 - Ideally no contracts together, sharing of personnel, facilities, ownership, etc.

Are You a New Concern?

- There is no black/white rule on definition of “new”
 - Less than three years is a good rule of thumb
- If your company is new, be mindful of where you previously worked, your position, and the extent to which your company has an ongoing relationship with your former employer
- All four factors must be present, so you can rebut affiliation under this rule if:
 - You were not an owner, officer, director, or key employee at your previous employer
 - Your company is not receiving any financial or other ongoing assistance from your former employer

Tip: Carefully Review Your JV Agreement

- To be eligible for the affiliation exception for JVs between a protégé and a large business mentor, you must ensure your JV agreement contains all required provisions
 - We have seen a number of JVs lose contracts recently because of relatively minor deviations from SBA's required provisions
 - Size Appeal of Kisan-Pike, A Joint Venture, SBA No. SIZ-5618 (2014): SBA and OHA rejected a mentor-protégé joint venture because the JV agreement did not clearly explain what each party would do in performing the contract
 - Other JVs have been rejected for incorrectly designating where the JV records will be kept, not identifying the project manager by name, and not specifying roles for contract negotiation and sources of labor

Summary

- Understand the various ways that affiliation can occur
- Proactively assess the potential for affiliation prior to corporate transactions
- Be wary of corporate documents that give another party “negative control” over your business
- Diversify your teaming partners and sources of revenue
- Do not assume your family member’s business is unaffiliated with your firm
- Make sure your website and marketing materials do not create a misimpression of affiliation with other firms

Questions?



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