

Guidance Needed For ESOP Sole-Source Pilot Program

By **Kevin Barnett**

The National Defense Authorization Act for fiscal year 2022 includes a U.S. Department of Defense pilot program allowing businesses that are 100% owned by an employee stock ownership plan, or ESOP, to receive sole-source awards on follow-on contracts.[1]



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Although sole-source awards already exist for specific types of small businesses, this provision marked the first time that the government authorized a set-aside program for ESOPs.

Of course, the devil is in the details and this potentially historic provision merely authorized the program, but included few details.

ESOPs hoping to take advantage of this new authority have an opportunity to provide the DOD with early input to encourage the DOD to establish the pilot program and offer guidance on the pilot program's details.

Employee-Owned Stock Ownership Plans

ESOPs are employee benefit plans designed to invest primarily in shares of the sponsoring company.[2] Companies can be wholly or partially owned by the ESOP.

ESOPs provide numerous potential benefits, including favorable tax treatment, employee recruitment and retention, long-term wealth building, and improvements to employee culture and attitude.

According to the National Center for Employee Ownership, more than 14 million employees in the U.S. participate in ESOPs. The prevalence of ESOPs in government contracting is similarly widespread.

Between 2014 and 2017, the DOD obligated almost half of all contracting dollars to companies wholly or partially owned by ESOPs — awarding around \$563 billion to 622 different companies with ESOPs.[3]

Government contractors have long used ESOPs as an alternative to mergers and acquisitions. Traditional exit strategies, such as mergers or sales to third parties, raise complicated and nuanced questions about novation requirements, security clearances and assignment obligations.

Instead, an ESOP can buy the departing owner's shares — providing the owner an exit from the company on highly favorable terms — while maintaining continuity of operations.

For example, the company's board of directors would continue to oversee the company. In addition, ESOP transactions can be staged, so a small business owner can sell part of the company to an ESOP while retaining the requisite ownership to qualify for preferential status.

Fiscal Year 2022 NDAA ESOP Pilot Program Provision

Section 874 of the fiscal year 2022 NDAA authorized, but did not require, the DOD to implement a pilot program for sole-source awards to ESOPs for follow-on contracts.

The key provision reads:

Notwithstanding the requirements of section 2304 of title 10, United States Code, and with respect to a follow-on contract for the continued development, production, or provision of products or services that are the same as or substantially similar to the products or services procured by the Department of Defense under a prior contract held by a qualified business wholly-owned through an Employee Stock Ownership Plan, the products or services to be procured under the follow-on contract may be procured by the Department of Defense through procedures other than competitive procedures if the performance of the qualified business wholly-owned through an Employee Stock Ownership Plan on the prior contract was rated as satisfactory (or the equivalent) or better in the applicable past performance database.[4]

The provision imposes five discrete limitations on the authorized ESOP sole-source awards.

First, the sole-source award must be made to a 100% ESOP-owned business.

Second, the ESOP must have held a prior DOD contract for the same or substantially similar products or services.

Third, the ESOP must have received at least a satisfactory performance rating on the prior contract.

Fourth, the DOD can make only one such follow-on award to a company without the approval of a senior contracting official.

Fifth, the 100% ESOP-owned business must certify that no more than 50% of the contract payments will be expended on subcontracts, subject to reasonable and necessary waivers.[5]

Beyond those limitations, the 2022 NDAA also capped the duration of the pilot program at five years, ending Dec. 27, 2026.

In their respective committee reports, the House Armed Services Committee and the Senate Armed Services Committee explained their rationales for targeting 100% ESOPs for this unique benefit.

According to the House Armed Services Committee report on the 2022 NDAA, 100% ESOPs "are uniquely resilient during a financial crisis," so the committee empowered the DOD to determine whether their structure "enables them to successfully transition between experimental prototyping to full-scale development." [6]

Similarly, the Senate Armed Services Committee report on the 2022 NDAA reasoned the DOD "may benefit from the workforce talent attracted by businesses that are owned entirely by an ESOP." [7]

Open Questions for Implementation

Aside from the general contours described above, the historic NDAA provision provided few details about the pilot program, leaving numerous open questions about critical aspects of

implementation.

As an initial matter, the NDAA did not require the DOD to establish the program, but instead used the permissive "may" to allow the DOD to stand up such a pilot if it so chose.

The NDAA also qualified its data collection requirements by stating, "[i]f the Secretary of Defense establishes a pilot program under this section." This language choice stands in sharp contrast to the language used in other pilot programs authorized by the 2022 NDAA.

For example, the Section 231 pilot program on the use of private sector partnerships to promote technology transition, the Section 833 pilot program on acquisition practices for emerging technologies and the Section 834 pilot program to accelerate the procurement and fielding of innovative technologies all use the mandatory "shall" language.

Beyond this existential question, the NDAA's brief provision leaves other unanswered questions that the DOD will need to answer when establishing the program. The following are among those open questions.

Trigger Date for 100% ESOP Status

The provision requires companies to certify that they are 100% owned by an ESOP, but does not specify the applicable date.

In one section, the law states that it applies only to products or services provided "under a prior contract held by a qualified business wholly-owned through an [ESOP]," implying that the company needed to be 100% owned by the ESOP when it held the prior contract.

On the other hand, the law also requires the comptroller general to report on the number of businesses that became 100% ESOP-owned to benefit from the pilot program, suggesting that Congress envisioned the award date of the sole-source contract as the key date.

This timing question is significant for companies that are considering converting to an ESOP.

If one purpose of the legislation is to encourage defense contractors to adopt the more resilient 100% ESOP model, the pilot program should require the company to be a 100% ESOP at the time of the sole-source award — and not require the company to have been a 100% ESOP when the DOD awarded the prior contract.

Size of Follow-On Contract

The provision limits the subject matter of the follow-on contract to the "continued development, production, or provision of products or services that are the same as or substantially similar to the products or services procured by [the DOD] under a prior contract."

It is, however, silent on the size and performance period of a follow-on contract. Thus, a follow-on contract could be substantially larger or longer than the prior contract unless the law's implementing regulations somehow cap these features.

This opens the possibility for the DOD to use the pilot program to game the system by awarding a small contract under simplified acquisition procedures and following it with a large contract award.

At the same time, it also allows the DOD to effectively award full-scale development contracts to companies successfully completing prototyping contracts.

Date of the Prior Contract

Although this provision has been generally referred to as permitting follow-on contracts, the legislation itself requires only a prior contract. It does not state when the company needs to have held that prior contract for similar products or services.

This provides the DOD wide latitude to award sole-source contracts to 100% ESOP-owned companies that may not have active DOD contracts.

DOD Opportunity to Provide Early Inputs on 2022 NDAA

If the DOD intends to use this historic authority, it will need to provide more granular details about how the pilot program will work.

At a minimum, before it can use the pilot program, the DOD must provide the U.S. House of Representatives and U.S. Senate Armed Services Committees with a data collection and reporting strategy as well as a plan to meet the pilot program's requirements.

The DOD will likely issue proposed regulations for public comment at some point as well. In the meantime, the DOD has provided an opportunity to influence the scope of the ESOP sole-source pilot program as it is being developed.

On April 8, the DOD announced that companies can submit early feedback on the implementation of this — and other fiscal year 2022 NDAA provisions — by sending comments via email to osd.dfars@mail.mil.

The DOD touts this early engagement opportunity as a chance "for the public to provide early inputs on implementation of [the 2022 NDAA] within the acquisition regulations."^[8]

As a result, companies interested in the particulars of an ESOP sole-source pilot program can sketch out how those details should work and potentially influence if and how the DOD implements this pilot program. This gives those companies a chance to advocate for their preferred positions on the open questions identified above or other potential obstacles.

The deadline for providing such inputs is not yet clear because the DOD has not announced when it will stop accepting them, but it indicated that it would update the Defense Acquisition Regulations System website with that information.

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[1] National Defense Authorization Act for Fiscal Year 2022, Pub. L. 117-81, § 874.

[2] National Center for Employee Ownership, "What is Employee Ownership" (available

at https://www.nceo.org/what-is-employee-ownership#_Toc529288093).

[3] Government Accountability Office, "Defense Contracting: DOD Contracts with Companies Having Employee Stock Ownership Plans," Report GAO-20-514R (June 18, 2020).

[4] Fiscal year 2022 NDAA, § 874(b)(2).

[5] Fiscal year 2022 NDAA, § 874(c)(2).

[6] H. Rept. 117-118 at 196.

[7] S. Rept. 117-39 at 211.

[8] "Early Engagement Opportunity: Implementation of National Defense Authorization Act for Fiscal Year 2022," 87 Fed. Reg. 20,827 (Apr. 8, 2022).