PilieroMazza Webinar

Identity of Interest Affiliation: Everything You Need to Know

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About PilieroMazza

PilieroMazza PLLC is a full-service law firm with offices in Washington, DC and Boulder, CO. We are most well known as a government contracting firm and for 25 years we have helped our clients navigate the complexities of doing business with the federal government. We also provide a full range of legal services including advice on corporate, labor and employment, SBA procurement programs, and litigation matters. Our clients value the diverse array of legal guidance they receive from us and our responsiveness as we guide their growth and secure their success.

Our primary practice areas are:

- Government Contracting
- Small Business Programs
- Labor & Employment
- Business & Corporate
- Litigation

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Overview

- Why size matters
- Overview of SBA's affiliation rules
- Drilling down on identity of interest affiliation
- Tips to avoid/mitigate identity of interest affiliation
- Q&A

Why Size Matters

- Small business status is the #1 eligibility requirement for all of the set-aside programs
- Being small also exempts you from certain requirements, such as reporting executive compensation, contractor code of ethics, and cost accounting standards
- SBA's "Presumed Loss Rule" increases the importance of verifying your small business status before you submit proposals for set-aside contracts
- For these reasons, if you participate in the set-aside programs, your small business status is one of your most important assets and you need to take steps to protect it

How Affiliation Impacts Size Status

- Small business status is determined by your:
  - Average annual receipts over your three most recently completed fiscal years; or
  - Average number of employees for each pay period during the past 12 months
- When you have an affiliate, your affiliate's annual revenues or employees are counted with yours to determine if you are a small business
  - This means 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
- An affiliate can be any business entity, whether for profit or non-profit, domestic or foreign
- Affiliation is determined at a specific point in time, generally the date you submit your initial proposal, with price

Types of Affiliation

- Under 13 C.F.R. § 121.103, affiliation can arise based on:
  - Stock ownership
  - Common management
  - Newly organized concerns
  - Ostensible subcontractor arrangements
  - Identity of interest
  - Joint ventures
  - Stock options, convertible securities, and merger agreements
  - Franchise and license agreements
  - Totality of the circumstances

SBA's Identity of Interest Rule

"Individuals or firms that have identical or substantially identical business or economic interests (such as family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships) may be treated as one party with such interests aggregated. Where SBA determines that such interests should be aggregated, an individual or firm may rebut that determination with evidence showing that the interests deemed to be one are in fact separate."

Identity of Interest Overview

- Affiliation arises when SBA finds that two or more firms have identical or substantially identical business or economic interests
- An identity of interest most commonly arises based on:
  - Familial relationships
  - Individuals or firms with common investments
  - Economic dependence based on contractual or other relationships
- But, identity of interest is not limited to only these three circumstances – it can arise when there is some connection outside the business in question that indicates identical or substantially identical business or economic interests

Identity of Interest Overview

- Example 1:
  - SBA found identity of interest between an individual and a business because the individual was a key employee of the business and they shared common investments
- Example 2:
  - SBA did not find identity of interest between Company A and Company B, even though Company A owned 49.5% of Company B, because outside of Company B the two firms' economic interests were not aligned

Identity of Interest Overview

- Identity of interest affiliation is rebuttable
  - You have to show the interests thought to be identical or substantially identical are, in fact, separate
  - Key is whether there is a “fracture” in the relationship

Identity of Interest in Size Protests

- Increasingly common
- Competitors will look on your website, simple internet searches, and other publically available information
- If your size is protested, you will have to provide a full response including an SBA Form 355, identifying:
  - All of company’s owners, officers, and directors
  - Other businesses owned by your owners, officers, or directors
  - Facilities, equipment, or personnel shared with alleged affiliate
  - Whether a family member of your owners, officers, or directors has an ownership interest in a potential affiliate
  - Actual or proposed subcontracts between potential affiliates

Identity of Interest in Size Protests

- If SBA finds an identity of interest between individuals and/or entities, SBA will combine their interests
  - Example 1: if two individuals have an identity of interest, and one individual controls Company A, and the other individual controls Company B, SBA will deem Company A and Company B to be affiliated
  - Example 2: if two individuals have an identity of interest, and one individual owns 30% of Company A, and the other individual owns 30% of Company A, SBA would view the two individuals as owning the controlling 60% stake in Company A
- If found to be affiliated, utilize revenue exclusion for inter-affiliate transfers, if applicable

Familial Identity of Interest

- Presumption of affiliation arises between two firms that are controlled by close family members
- Close family members are:
  - Married couples
  - Parties to a civil union
  - Parents, children, and siblings
- Presumption of affiliation does not arise through other family relationships (such as uncle and nephew)
  - That said, the family connection could still be a factor in finding affiliation depending on the other circumstances

Familial Identity of Interest

- There must be control
  - The presumption does not arise if one or both of the family members does not control their respective firms
- There must be a business connection
  - The presumption only arises if the family-owned businesses conduct business with each other, such as subcontracts or joint ventures, or share or provide loans, resources, equipment, locations or employees

Rebutting Familial Identity of Interest

- Demonstrate at least one of the family members does not control his/her respective firm
- Estrangement between the close family members
- Businesses are not in the same line of work
- Businesses are in different locations
- Clear line of fracture between the businesses
    - Avoid or minimize contracting between the firms
    - Do not share personnel, office space, back office functions, etc.

Common Investments

- SBA may consider individuals or firms with common investments as having identical or substantially identical business or economic interests
- Requires more than a single joint investment
  - Common investment in only the challenged firm is not enough
- But, two common investments may be sufficient to find affiliation
- SBA focuses on whether the investments are “substantial, either in number of individual investments, or in total value”

Rebutting Identity of Interest Through Common Investments

- Again, you have to provide evidence that the interests are separate
- Limit the number of shared investments
- Avoid shared control of common investments
- Demonstrate that joint investments are not substantial for at least one of the common investors

Economic Dependence

- Arises when a firm provides critical financial assistance to another firm, such as through loans or financial guarantees, or a firm generates a significant percentage of its revenue on contracts awarded to it by a second firm
- 70% test
  - First developed in case law and then added to SBA's rules in 2016
  - SBA may presume an identity of interest based upon economic dependence if one firm derives 70% or more of its revenue from another firm
  - Judged over the firm's three most recently completed fiscal years

Exceptions to Economic Dependence

- Does not typically arise when the small business is the prime contractor
  - Economic dependence arises when the small business is a subcontractor, receiving at least 70% of its revenue from one prime contractor
  - However, even when the small business is the prime contractor, an affiliation could still arise with a subcontractor if the relationship with the subcontractor (either for a particular project or on an ongoing basis) gives the subcontractor the ability to control the prime
- Firms owned by Tribes, ANCs, and NHOs will not be found affiliated solely based on contractual relations

Exceptions to Economic Dependence

- Beyond the 70% revenue test, an economic dependence could arise based on the following factors between your firm and another business:
  - In the same or similar line of business
  - Minority ownership interest
  - Financing arrangements
  - Seat on board of directors
  - Contracts for exclusive dealing
  - Subcontractor relationships
  - Supply of raw materials
  - Co-location
  - Strategic relationship or ability to exert influence

Rebutting Economic Dependence

- New businesses may rebut the presumption
  - Example 1: Firm A has been in business for nine months, has received two contracts, and over 70% of its revenue is on a contract from Firm B. Absent other circumstances, no affiliation because Firm A is a new business.
  - Example 2: Firm A has been in business for five years, has received 200 contracts, 195 of the contracts are from Firm B accounting for more than 70% of Firm A's revenues. SBA would very likely find affiliation absent a compelling rebuttal.
  - Where do you fall on this spectrum?

Rebutting Economic Dependence

- Diversify your revenue sources and business development efforts
- Point to positive trends
  - Trend during the relevant three-year period shows reduction in the number of contracts and revenue with the alleged affiliate, or a complete cessation of the business relationship
  - Positive trend continuing into the current fiscal year may also help, if it shows the continuation of a positive trajectory away from 70% of your revenue from one firm
  - But, to be most effective, the trend has to indicate you are now below the 70% revenue threshold, not simply headed in that direction

Rebutting Economic Dependence

- Demonstrate why, despite the contractual relations, your firm is not solely dependent on the other firm
  - How would you be a viable firm without the other business?
  - Are the contracts with the alleged affiliate not significant enough to support your firm financially?
  - How are you otherwise an independent business?

Rebutting Economic Dependence

- Examples of when a protested firm successfully rebutted the presumption of affiliation:
  - During relevant three-year period, over 70% of the firm's revenues came from the alleged affiliate – but the revenue from alleged affiliate had dropped to 18% by the time of the size determination
  - Over 85% of the firm's revenue came from the alleged affiliate during the relevant three-year period, but the firm demonstrated business development opportunities that led to new sources of revenue and the revenues from alleged affiliate were not sufficient to sustain the firm's business operations

Rebutting Economic Dependence

- Examples of when a protested firm was unable to rebut the presumption of affiliation:
  - Revenues from affiliate decreased from 100% to 70% over three-year period; business could not establish that it would remain viable without the revenues from the affiliate
  - Revenues from affiliate were approximately 70% over five years; company had a “strategic alliance” with affiliate; shared locations with affiliate; affiliate had 45% ownership in business

Questions?

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