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Small Business

Acquiring Small Business Government Contractors in a New Economic Reality: Opportunities for Growth Remain With Appropriate Due Diligence

BY JOHN R. PRAIRIE, WILEY REIN LLP

It is an exciting—and frightening—time to be in the government contracts industry. With the federal government, and the Department of Defense (''DOD'') in particular, facing the prospect of unprecedented budget cuts through sequestration in 2013, all companies are nervous about how this more restrictive spending environment will affect their bottom lines.

But opportunities for growth abound for firms in areas where spending is likely to be protected, or even increase—such as cybersecurity, counterterrorism, intelligence, unmanned systems and health information technology. Small businesses in these areas are particularly well-suited to prosper in the current environment, as they can more quickly adapt to changing government priorities through innovation and by leveraging technology and trimming excess costs. The government has also made a considerable effort to steer more and more government contracting dollars to small businesses, which have been touted as the ''job creators'' that can stimulate continued economic growth.

These circumstances also present opportunities for large companies looking to grow or diversify through the acquisition of small business government contractors. As with any acquisition, however, due diligence is critical to ensure that the buyer understands the potential risks and hidden liabilities of the target. This is even more true with the acquisition of small business contractors in today's budget climate, where a change in contractor size status coupled with shifting budget priorities may be just what an agency needs to justify terminating, rather than extending, an existing contract. Only through careful and comprehensive due diligence can a buyer have confidence that it is maximizing the value of its investment.

John R. Prairie is an associate in Wiley Rein's Government Contracts Practice in Washington, DC.

A. Federal Government Budget Climate Creates New Challenges and Opportunities for Small Business.

1. Less Funding is the New Reality. The industry has entered a new era of fiscal austerity. While in the decade after 9/11 contractors could count on year-after-year budget increases to support two wars abroad and economic stimulus initiatives here at home, contractors are now facing the strong likelihood of spending cuts in the near future. An increased focus on national spending, deficits and debt issues by both political parties in the run-up to the November 2012 election will likely mean a reduced government contracting spending pie for years to come regardless of the outcome of the election.

In the near term, automatic, largely across-the-board spending reductions will be triggered for Fiscal Year (FY) 2013 if Congress this year approves spending levels that exceed caps of the Budget Control Act of 2011 (''BCA''). To implement these budget cuts, the BCA calls for ''sequestration'' of discretionary and mandatory spending for FY 2013 through FY 2021, scheduled to commence on January 1, 2013 unless Congress acts (though President Obama has vowed to veto any attempts to change the BCA). Should sequestration occur, $1.2 trillion in reductions could be required in FY 2013 through FY 2021 spending. Approximately $100 billion of this total would come from reduced interest payments. The rest of the reductions would be split evenly between DOD and non-DOD accounts. The resulting $110 billion in cuts each year would create an ex-

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tremely challenging budget environment for government contracts.

2. Many Small Businesses Will Prosper in this Environment. Still, there are opportunities for growth in certain areas. Spending is likely to be protected and even increase in many of the following areas: intelligence, surveillance and reconnaissance (''ISR''); space systems; information and communication networks; cybersecurity/cyberspace defense; unmanned systems; counterrorism and countering weapons of mass destruction; health information technology; and energy efficiency.

Many of the companies leading the way in these critical areas are small businesses. There are hundreds, if not thousands, of small business contractors that are developing the latest technologies in these areas and serving as key subcontractors and suppliers to large business leaders in the field. Small businesses are also uniquely positioned to thrive in the current budget climate. Leaner, more streamlined organizations can be more flexible and can more quickly adapt to changing government priorities. Small businesses can also more easily cut excess costs in order to provide more competitive pricing, which will be increasingly attractive as the government inevitably shifts from favoring ''best value'' to ''good enough/low price'' solutions. Small business contractors that have developed expertise and qualifications in these areas present ideal acquisition targets for large businesses looking to leverage that expertise in the growth areas where spending is likely to be protected.

The government has also continued to make efforts to increase contracts awarded to small businesses. The Small Business Jobs Act of 2010 (''Jobs Act'') contained several provisions designed to increase opportunities for small business. Among other things, the Jobs Act increases loan opportunities available to small business, allows contracting officers to reserve orders for small business participation on contracts with multiple awards including the Federal Supply Schedule, and holds large prime contractors more accountable for complying with their small business subcontracting plans. The House Small Business Committee has also recently introduced a number of small business contracting bills designed to promote small business, including one bill that would raise from 23 percent to 25 percent the amount of federal contracts that must go to small businesses. The Small Business Administration (''SBA'') and the Department of Justice (''DOJ'') have also significantly increased oversight and enforcement efforts in this area to ensure that set-aside contracts are going to legitimate small businesses.

B. The Importance of Due Diligence in the Acquisition of Small Business Government Contractors. Performing appropriate due diligence is always important when acquiring a government contractor. But it is especially critical when acquiring a small business contractor, particularly when the target relies heavily on small business set-aside contracts and will become ''other than small'' as a result of the acquisition. While it would be a mistake for the buyer to assume that existing set-aside contracts will be unaffected by the acquisition, it would also be a mistake to assume that they will all be terminated. The buyer must carefully examine the circumstances surrounding each contract as part of the due diligence process in order to fairly assess its potential future value.

1. The Recertification Requirement. The general rule is that if a small business qualifies as ''small'' at the time it submits its original proposal, it will be considered small throughout the life of the contract. This is still generally true for companies that grow to become ''other than small'' through organic growth.

In 2006, however, the SBA issued a new rule that requires small businesses to recertify their size status following an acquisition or merger. For ''standard'' contracts of five years or fewer, if the small business no longer qualifies as small following the acquisition, the agency cannot count additional options exercised or orders issued towards its small business goals. For ''long term contracts'' with durations of more than five years, the rule also requires small businesses to recertify their size status prior to the end of the fifth year of performance and prior to the exercise of any additional options thereafter. The purpose of the rule is to prevent agencies from continuing to take small business credit for set-aside contracts that are no longer being performed by small businesses.

An important distinction to note is that the rule does not necessarily apply to equity investments and the provision of financing to small business contractors. A small business can still accept funding without triggering the recertification requirement as long as the transaction does not result in the investor obtaining control over the small business. The firms must also ensure that they are otherwise in compliance with the SBA's affiliation rules. These issues are beyond the scope of this article, but should be examined in connection with any such transactions involving a small business government contractor.

2. Examine the Individual Circumstances of Each Contract. Not surprisingly, the recertification requirement has had a significant impact on merger and acquisition (''M&A'') activity in the government contracts industry, particularly with respect to small and middle market acquisitions. Large business buyers are often reluctant to purchase small business contractors that rely on a heavy dose of set-aside contracts because those contracts could potentially disappear immediately following the acquisition. But it would be a mistake for buyers to completely discount the value of set-aside contracts.

Many buyers mistakenly assume that small business set-aside contracts will end *automatically* if the small business contractor is acquired and becomes other than small. That is not the rule. It is true that the small business contractor must recertify its size status to the agency following the acquisition. But the agency has the discretion to continue exercising options and issuing orders to the contractor after the acquisition as long as the agency does not credit the value of the work towards its small business goals.

A number of factors can come into play in an agency's decision regarding whether to continue using a set-aside contract following a change in size status. Some of the more important factors that buyers should assess in analyzing the potential future value of set-aside contracts include:

- *Contract type.* If the contract is single-award, the agency likely will be more inclined to exercise the remaining options because it has no other alternative to perform that work. However, the government is increasingly moving to acquisitions through large, multiple award indefinite-delivery/indefinite-quantity (''IDIQ'') contracts that can have several dozen awardees. Under those set-aside contracts, an agency will be less likely to continue issuing orders to a contractor whose size status has changed because it has several other small businesses on contract through which it can order that same work *and* receive small business credit.

■ *Importance of the contract to the agency's small business goals.* Some agencies are better than others at meeting their small business goals. DOD, for example, historically has lagged behind the Department of Veteran Affairs, the Department of Commerce, and the General Services Administration in this area. If an agency is having trouble meeting its small business goals, it may be more inclined to stop using a set-aside contract after a change in the contractor's size status. In addition, all other things being equal, larger set-aside contracts are typically more important to an agency in terms of meeting its small business goals. Thus, the smaller the contract, the more likely it is that an agency may continue using it after an acquisition.

■ *Uniqueness of product or service provided by the contractor.* Many small businesses are market leaders in their field, having developed new technology or a niche service that other firms cannot provide. For many of their contracts, the small business credit earned by an agency is secondary. If the product or service being acquired by an agency is unique or particularly important to the agency's mission, it is more likely that the agency will continue using the contract after a change in size status.

■ *The agency's budget situation.* Some agencies will fare better than others in the coming budget cuts, and some will do a better job of managing through the uncertainty. For those that do not, a change in size status may be just the excuse they need to justify terminating a set-aside contract or allowing it to expire without exercising options or issuing new orders. In addition, in light of the pending budget cuts, agencies are more likely to continue using fixed price set-aside contracts for mature technology over developmental, cost-reimbursement-type contracts following an acquisition.

3. What Does the Contract Say? As a wise government contracts attorney once said, ''When all else fails, read the contract.'' Some contracts contain unique provisions that may dictate whether a small business contractor can continue performance following an acquisition. These provisions must also be reviewed and carefully considered.

For example, large multiple award IDIQ set-aside contracts increasingly contain ''off ramp'' provisions that require contractors to recertify their size status prior to the exercise of option periods and for every task order competition. Although these provisions are not mandatory for ''standard'' contracts of five years or fewer, agencies have begun to include them in IDIQ contracts to ensure that all contract dollars are spent with ''legitimate'' small businesses. If a small business target holds a contract with an ''off ramp'' provision, the contracting officer would not have the discretion to continue exercising options and issuing orders to the company following the acquisition, even if he or she wanted to do so.

Some agencies have also attempted to distinguish between companies that grow to become large through organic growth and those that become large as a result of an acquisition, and have taken the position that only the latter are ineligible for future orders under multiple award IDIQ set-aside contracts. It is unclear whether contracting officers have the authority to make such a distinction—both kinds of companies no longer qualify as ''small''—but it is another contract-specific provision that potential buyers should look for when reviewing a small business target's contracts. Contracts that are silent on these issues would revert to the default recertification rule, which allows the contracting officer to decide whether to continue using a contract without taking small business credit after a change in the small business contractor's size status.

Finally, investors should carefully examine all of the small business target's contracts to determine whether small business status could potentially affect the government's option renewal decision. Even in cases where a contract is not a small business set-aside, the agency may nevertheless take small business credit for that contract if it is being performed by a small business. In those cases, an acquisition may impact the Contracting Officer's decision regarding whether to exercise the remaining option periods even though the contract was solicited through full and open competition.

C. Conclusion. Although the industry is entering a time of increasing uncertainty, there is still an opportunity for growth through the strategic acquisition of small business government contractors. Potential buyers should perform thorough due diligence by carefully examining the circumstances surrounding each of the target's contracts to ensure that they are obtaining the maximum value for their investment.