

M&A Implications for Acquisitions of Small Business Government Contractors

By John Chierichella and Lucantonio Salvi

The US Small Business Administration ("SBA") recently amended its regulations to require government contractors to re-certify their "small business" designation, which is often critical to their ability to compete for government contracts, at the time the contractors acquire other companies or are themselves the target of an acquisition transaction. These amendments, which become effective on 30 June 2007, have significant implications for both government contractors and potential acquirers (including strategic purchasers and private equity groups ("PEGs").

Designation as a "small business" in the context of government contracting is important because it determines eligibility for certain prime contracts which are set aside for small business concerns. A company's "small business" status is also an important factor in the subcontractor selection process, as prime contractors routinely seek out effective suppliers that will assist the prime contractors in meeting their small business subcontracting program goals.

Other benefits available to "small businesses" include loans and development advice from the SBA, Small Business Innovation Research grants, and eligibility for the mentor-protégé program. "Small business" status also allows federal agencies to meet their annual small business prime contracting goals. A contractor that is owned by a larger company will not qualify for a "small business" designation because the parent company will be considered in the determination of size status under SBA rules.

Currently, a government contractor will certify itself as "small" as part of its offer for a government contract, and if the company is awarded the order, it is generally considered "small" for the life of the contract. Indeed, the designation remains the same even if the company grows or is acquired by a larger company/PEG and ceases to be "small" during the term of the government contract. This has critical implications for a company and a potential acquirer, since many government contracts have terms (with options to renew) that typically extend for many years and can be worth many millions of dollars.

Under the revised Small Business Size Regulations, government contractors that are registered as "small businesses" will have to re-certify their small business status within 30 days of an acquisition or merger transaction, including situations in which the contractor acquires another company, is acquired by a company or PEG, or is merged with another business.

The new rules apply to all contracts, including those signed before the rule becomes effective. If the contractor is no longer "small" as a result of the acquisition transaction, then the procuring agency is not permitted from that point forward to count those orders towards the fulfillment of its "small business" procurement goals. The re-certification process will not, however, affect the terms and

conditions of the initial contract; thus, for example, a company that was exempted from having a subcontracting plan because it qualified as a small business at the time of the award will not



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later be required to have a subcontracting plan if it becomes other than a small business. Nevertheless, if a company loses its small business designation as a result of an acquisition or merger, the contracting officer with the procuring agency has the discretion to decide whether or not to continue the relationship with the government contractor.

This has serious implications for the M&A market. Acquirers that are considering the purchase of an "emerging" small business will need to determine whether the procuring agency or critical prime contractors that drive a substantial portion of the "small business" revenue stream will likely replace the contractor because it will not receive small business credit for the continued performance of the firm. This means that strategic and financial acquirers will need to evaluate the potential loss of government contracts resulting from the re-certification requirements and adjust the purchase price of the business accordingly.

In the context of leveraged buyouts, purchasers will also need to assess whether sources of debt, such as banks and other lenders, will increase the cost of capital due to the higher risk on their investment (i.e., that a federal contract will lose its preferential status).

The increased risks associated with the new SBA rules should be considered carefully by both owners and investors in making investment decisions. Time will tell whether the new rules will inhibit small businesses from effectively developing a long-term marketing and growth strategy. But in the meantime, strategic players and PEGs should conduct thorough due diligence reviews of government contractors using experienced advisors and counsel familiar with this potentially explosive terrain.

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