Legal News & Data

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Protecting Small Business Status In Letters Of Intent

Law360, New York (August 10, 2012, 12:47 PM ET) -- Recently, there has been a noticeable uptick in mergers and acquisitions involving small business government contractors. The increased M&A activity has led to more questions, and case law, regarding when affiliation arises as parties negotiate a deal. Because small business status is one of the most important assets for a small business, protecting that asset by avoiding affiliation is vital as you negotiate a deal. This article focuses on protecting small business status when using a letter of intent (LOI), a common initial step in an M&A transaction that is fraught with the potential for affiliation.

An LOI is typically used toward the beginning of a potential transaction to memorialize the parties' initial agreements and understandings, and to set the stage for the negotiations and due diligence needed to finalize the deal. LOIs express the parties' hopeful intent of completing the transaction, so long as the conditions set forth in the LOI are satisfied. Given the number of conditions precedent in most LOIs, LOIs generally do not create legally enforceable rights to close the transaction. The LOI is, most often, the classic "agreement to agree."

Nevertheless, the U.S. Small Business Administration has found that an LOI is an "agreement in principle" to finalize a transaction when the terms of the LOI are sufficiently definite, include a price, and reflect the product of lengthy negotiations toward a deal that is ultimately consummated. The distinction between an agreement to agree and an agreement in principle is important in determining affiliation under the SBA's so-called "present effect rule." SBA regulations provide that "agreements in principle" will be given present effect, while "agreements to open or continue negotiations" will not. 13 C.F.R. § 121.103(d)(1)-(2).

If an LOI is considered to be an agreement in principle, the SBA will give it present effect in determining affiliation between the parties to the transaction. This means that the SBA will treat the contemplated transaction as if it has already been consummated as of the date of the LOI, even though significant due diligence and negotiations may remain. Thus, the LOI can jeopardize small business status by causing the transacting parties to be affiliated well before conditions are satisfied and the deal is closed.

The SBA's Office of Hearings and Appeals (OHA) has previously found that LOIs constitute an agreement in principle. However, two recent decisions suggest that the OHA may be taking a more business-friendly view of letter agreements used at the outset of negotiations for a deal. In Size Appeal of Nuclear Fuel Services Inc., SBA No. SIZ-5324 (2012), the OHA reversed the SBA's size determination finding the challenged firm to be other than small. The OHA concluded that an agreement in principle did not exist, despite the presence of an offer letter between the challenged firm and a large business.

The OHA began by stating that the mere existence of complex and time-consuming negotiations does not necessarily mean that an agreement in principle has been reached. Rather, there must be "tangible evidence" of an agreement in principle, such as an LOI. And in reviewing the offer letter, the OHA noted that the letter repeatedly stated that it was nonbinding and subject to numerous conditions, and, as such, the letter did not represent a definitive offer that the challenged firm could have accepted.

Further evidencing that the letter was not an agreement in principle was, as the OHA found, the fact that the negotiations between the parties continued for eight months after the letter was executed. Notably, the OHA also held that the inclusion of a proposed price in the letter merely marked the onset of more serious negotiations and did not establish that the parties had reached an agreement in principle.

In Size Appeal of The W.I.N.N. Group Inc., SBA No. SIZ-5360 (2012), the OHA affirmed the SBA's determination finding the challenged firm to be small because the offer letter at issue was not an agreement in principle. In concluding that the letter was not tangible evidence of an agreement in principle, the OHA began by noting that the letter's description of itself as "nonbinding" and its lack of a set price were indicators that the letter was simply an agreement to continue negotiations. Next, the OHA discussed how the letter was carefully conditioned on extensive further due diligence, including the large business' review of all contractual instruments, third-party and government audits, employee and contractor rosters, and financial documentation.

The presence of these conditions led the OHA to conclude that the large business had, in actuality, agreed to nothing at all. The OHA also cited a lack of evidence showing the challenged firm had accepted the large business's offer as further proof that the parties had not reached an agreement in principle. Finally, the OHA concluded that a series of email messages amounted to nothing more than ongoing negotiations between the parties and, if anything, demonstrated that no agreement had been reached.

The Nuclear Fuel and W.I.N.N. Group decisions are positive for small businesses considering M&A activity because the cases indicate a more practical interpretation of letter agreements used at the outset of M&A. The decisions recognize that, typically, such letter agreements are nothing more than agreements to agree and do not confer legal rights to consummate a deal.

That said, the affiliation analysis is performed on a case-by-case basis and will turn on the specific terms in an LOI. Consequently, when putting an LOI together, it is important to be mindful of how the letter is drafted to avoid creating a document that the SBA will give present effect, thereby creating an affiliation between the transacting parties at the LOI stage.

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