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DOJ settlement underscores the significance of incorrect small business representations

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The Department of Justice ("DOJ") recently announced[1] a $5.2 million settlement with Numet Machining Techniques, LLC and affiliated entities (collectively, "Numet") concerning alleged misrepresentations of size and ownership in connection with pursuing U.S. Government contracts.

The Numet settlement is an important reminder to the contractor community that representations and certifications — particularly those concerning small business status — should be made with due caution and that the discovery of incorrect representations during M&A due diligence can be a significant finding. In this post, we explore the recent Numet settlement, examine the Small Business Administration ("SBA") size and affiliation rules, and offer guidance to companies assessing the significance of incorrect representations.

Numet: A warning and reminder

Numet manufactures and provides aerospace engine machined components for commercial and military purposes. According to the DOJ, Numet ceased to qualify as a small business in 2011 when it was acquired by another company. It nonetheless continued to claim small business status, and over the next five years, received 22 contracts that had been set aside for small businesses. Numet also incorrectly claimed to qualify as a women-owned small business.

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In 2019, Numet was up for sale again. In connection with that sale process, the company voluntarily disclosed its affiliation with other business entities, alerting the government that Numet had been ineligible to receive the aforementioned small business set-aside contracts.

That disclosure led to a government investigation, allegations of False Claims Act liability, and ultimately a civil settlement of over $5.2 million. The DOJ's press release indicates that Numet received credit in the settlement for voluntarily disclosing the matter and cooperating in the investigation.

Size status, affiliation, and M&A

The SBA maintains a table of size standards[2] for assessing whether contractors qualify as a small business. Most size standards rely on an entity's annual receipts or number of employees.

Affiliation issues can often become complicated and turn on nuanced considerations of ownership and control.

Determining annual receipts[3] and number of employees[4] requires consideration of the revenue and headcount of the contracting entity. But the analysis does not end there. The size calculation also must include a contractor's "affiliates."

In short, entities are affiliated[5] (and thus their revenue and employees counted together) if one entity has the ability to control the other or a third party has the ability to control both. In assessing whether control is present, the SBA considers usual factors, such as common ownership and common management, as well as less obvious considerations, such as negative rights that could allow an entity certain control over another (e.g., the ability to block a quorum of the Board or to veto matters related to officer compensation).

Although sometimes straightforward, affiliation issues can often become complicated and turn on nuanced considerations of ownership and control. Further, as the Numet settlement illustrates, application of these affiliation rules becomes particularly important in the context of an M&A transaction.

For example, when a contractor undergoes an ownership change, it must consider not only the revenue and employees of its immediate owner, but also whether that immediate owner has affiliates and the size of those affiliates. This analysis can be particularly complicated for members of a private equity portfolio, which may have little familiarity with the other companies in which their private equity sponsor has invested.

Practical considerations for assessing incorrect small business representations

In the context of M&A due diligence, it is not uncommon to discover that an acquisition target has made, or continues to make, an incorrect size status representation. The SBA's affiliation rules are confusing, and many contractors update their SAM.gov profile without a complete understanding of their affiliates.

This problem is further complicated by the fact that the responsibility for maintaining a SAM.gov profile — and in turn making a slew of representations and certifications about the registering entity — is often decentralized, without sufficient oversight within a company.

If an incorrect size status representation is discovered during due diligence, a potential acquirer and its legal counsel must use their judgment and experience to assess the likelihood and amount of potential liability, the advisability of disclosing the incorrect representations to the government, and whether it is appropriate (and possible) to allocate some of the potential liability to the seller.

It is important to consider, among other things:

- The scope of the incorrect representations (e.g., how long the representations have been incorrect; whether the representations are confined to SAM.gov or whether they extend to other settings, such as higher-tier contractor registration portals);
- What, if any, benefits the target has received from its incorrect representations (e.g., total or partial set-aside awards, accelerated payment terms, advantages in soliciting business from higher-tier contractors);
- The extent to which the target has fully investigated the circumstances surrounding the incorrect representations (e.g., whether there is a reasonable explanation that would withstand scrutiny from the government); and
- The ability of the target to sustain itself going forward without any further claim to small business status.

Conclusion

As Numet illustrates, incorrect representations as to size and ownership can have significant consequences. Numet had to pay millions of dollars to resolve allegations of procurement fraud, risk reputational harm, and most certainly expend considerable time and resources defending against a government investigation.

In the context of M&A due diligence, it is not uncommon to discover that an acquisition target has made, or continues to make, an incorrect size status representation.

The SBA's affiliation rules can be complicated, and misrepresentations may persist for years before being brought to light through M&A due diligence. The assessment of liability, proper remediation, and appropriate contractual protections is a fact-intensive inquiry that depends upon the specifics of each target company and transaction.

Ultimately, we advise both buyers and sellers in this space to carefully measure risks presented by an incorrect size status representation.

Notes

[1] *Connecticut Companies Pay $5.2 Million to Resolve Allegations of False Claims Act Violations Concerning Fraudulently Obtained Small Business Contracts*, U.S. Dep't of Just. (June 2, 2022), https://bit.ly/3nx7eg9.

[2] *Table of Size Standards*, U.S. Small Bus. Admin. (May 2, 2022), https://bit.ly/3absGUT.

[3] 13 C.F.R. § 121.104 (2022).

[4] 13 C.F.R. § 121.106 (2022).

[5] 13 C.F.R. § 121.103 (2022).

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