DETAILS OF THE "PRESENT EFFECT" RULE

In a long and detailed opinion, the Office of Hearings and Appeals ("OHA") of the Small Business Administration ("SBA") discusses many of the bases of the "present effect" rule which is found in the SBA rules at 13 CFR §121.103(d). *Size Appeal of Enhanced Vision Systems, Inc.,* SBA No. SIZ-5978, Dec. 13, 2018. The "present effect" rule states as follows:

(d)*Affiliation arising under stock options, convertible securities, and agreements to merge.*

(1) In determining size, SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.

(2) Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered "agreements in principle" and are thus not given present effect.

(3) Options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under state or Federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote, are not given present effect.

(4) An individual, concern or other entity that controls one or more other concerns cannot use options, convertible securities, or agreements to appear to terminate such control before actually doing so. SBA will not give present effect to individuals', concerns' or other entities' ability to divest all or part of their ownership interest in order to avoid a finding of affiliation.

The facts of the case are fairly simple, and OHA held that the present effect rule applied.

- Freedom Scientific, a subsidiary of VFO gained interest in acquiring Enhanced Vision Systems, Inc. in 2015, and VFO approached Enhanced Vision regarding a potential acquisition in May of 2017.
- On November 16, 2017, VFO sent Enhanced Systems a "Non-Binding Indication of Interest ("LOI") which required an expeditious execution of the purchase, exclusivity period (through July 31, 2017) and due diligence requirements. VFO and Enhanced Systems attempted to reach an agreement in good faith through December 2017.
- On December 7, 2017, Enhanced Vision submitted a proposal in response to a Department of Veterans Affairs solicitation that had been set aside entirely for small business, for closed circuit television systems. It is this solicitation and an award to Enhanced Systems that is at issue in the appeal
- Because of "softness" in Enhanced Systems' financial performance, VFO could not move forward with the agreement, and the parties were at an impasse at end-2017.

- VFO contacted Enhanced systems to restart negotiations, and a purchase agreement was reached on September 14, 2018.

OHA considered various facts concerning the purchase.

(1) Although the LOI was allegedly only an agreement to engage in exclusive negotiations, a revised LOI was mutually signed and executed on Nov. 17, 2017, and included an agreed on price
(2) The fact that the LOI included a previously negotiated definite price, without any conditions that would vary the price, supported a finding that the LOI is an agreement
(3) The fact that the LOI was not an agreement in principle because it was described as "non-binding" does not make it not an agreement in principle
(4) The fact that the LOI required a due diligence review before proceeding with a final transaction agreement does not negate finding the agreement as an agreement in principle
(5) Just because the LOI did not contain all the essential terms of a purchase agreement does not negate its being an agreement in principle.
(6) The fact that negotiations broke down does not negate the LOI's being an agreement in principle.

OHA held that the LOI between Enhanced Visions and VFO was an agreement in principle, which must be given present effect at the time of its execution. This means that the LOI agreement must be treated as if the merger took place on Nov. 17, 2017, the date the LOI was signed and executed. This meant that Enhanced Systems and VFO were affiliated as of Dec. 7, 2017, when Enhanced Systems submitted its offer, and this is the date on which its size must be determined. Based on the size standards, Enhanced Systems admitted it would be too large for this procurement, if it were found to be affiliated with VFO.

The Takeaway. If you engage in negotations and Letters of Intent for acquisition, be sure that they will not carry "present effect" by heeding the principles used by OHA as set forth above. (No stated price, make it crystal clear that there are many conditions precedent that could happen to negate the agreement, particularly those in due diligence, specify that there are numerous obstacles to making the agreement, explicitly stating that this is a not agreement in principle and should not be given present effect).