Precise Systems, Inc. v. United States: A Case Study in Regulatory Inertia

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In *Precise Systems, Inc. v. United States*,[1] the United States Court of Federal Claims upheld the US Small Business Administration (SBA) Office of Hearings and Appeals' (OHA) "hardline approach" to the stock ownership requirements for service-disabled veteran-owned (SDVO) small businesses. The decisions of both the court and OHA raise some interesting questions about how the SBA will determine ownership not only for the SDVO program, but other small business programs such as the 8(a) business development and women-owned programs. The affirmed OHA decision appears to strictly circumscribe a small business's ability to issue different types of stock, while at the same time leaving open the possibility that differing state law could lead to disparate outcomes when ownership status is contested. Perhaps most interestingly, even while affirming OHA's decision, the court questioned whether the decision was in keeping with the spirit of the small business ownership requirements. The court's apparent skepticism is warranted, as a review of the regulatory history regarding small business ownership requirements reveals that OHA's decision is likely the result of regulatory accretion, not congressional or even agency intent.

OHA's "Hardline Approach"

A short review of the procedural history of *Precise Systems* is in order, as the case has had a somewhat lengthy path to the court's ultimate resolution. The case began with multiple size protests filed with the SBA challenging the SDVO status of Precise Systems, Inc., which alleged that Precise was ineligible for SDVO status because it was not directly and unconditionally owned by a service-disabled veteran. The SBA acting director of government contracting (AD/GC) sustained the protests, and Precise appealed to OHA. OHA affirmed the AD/GC's decision,[2] whereupon Precise appealed to the court. The court found that OHA had failed to provide a sufficient explanation for its decision, and remanded with orders that OHA provide greater clarity.[3] OHA then reaffirmed its decision in greater detail,[4] and Precise again sought review by the court. It is these last two decisions in particular that are discussed here.

Precise maintained what it termed two "series" of stock: Series A common stock and Series B convertible preferred stock. Notably, the Series A and Series B stock carried equal voting rights of one vote per share. There were, however, differences between them. Series B shareholders were entitled to cumulative preferential dividends and to convert their shares to Series A (there was no reciprocal conversion right for Series A shareholders), and only Series B shares were subject to redemption by the company.

The service-disabled veteran owner of Precise owned at least 51 percent of all stock outstanding, but all of his ownership was in Series A common stock, while employees of the company owned all of the Series B convertible preferred stock through an employee stock ownership plan. The question to be resolved was whether this ownership arrangement satisfied 13 C.F.R. § 125.9(d), which concerns the stock ownership requirements for an SDVO small business corporation:

> In the case of a concern which is a corporation, at least 51% of the aggregate of all stock outstanding and at least 51% of each class of voting stock outstanding must be unconditionally owned by one or more service-disabled veterans.

In particular, the question confronting OHA and the court was whether Precise satisfied the requirement that a service-disabled veteran own "at least 51% of each class of voting stock outstanding." Precise argued that because the Series A and Series B stock had identical voting rights, Precise had established a single class of voting stock, and moreover that the dividend rights accorded the Series B stock did not undermine the ownership rights of Precise's service-disabled veteran owner. As a service-disabled veteran owned at least 51 percent of Precise's voting stock, Precise argued that it satisfied 13 C.F.R. § 125.9(d). OHA disagreed.

Because the SBA's regulations do not define what constitutes a "class" of stock, the court in its initial opinion

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instructed that "the plain and ordinary meaning of the term applies."[5] Taking heed of that direction, OHA examined *Black's Law Dictionary*, finding that it defined the terms "class of stock," "common stock," "preferred stock," and "voting stock."[6] Because *Black's* stated that the term "class of stock" was used when "more than one type" of stock is issued, OHA concluded that "groups of stock with different characteristics constitute separate 'classes' of stock."[7] OHA further found that because *Black's* discussed "common stock" and "preferred stock" separately and defined each as a "class of stock," common stock and preferred stock were separate classes of stock.[8] Looking to the definitions of "common stock" and "preferred stock," OHA found that common stock has voting rights and a right to dividends subordinate to that of preferred stock, and that preferred stock may or may not have voting rights.[9] Consequently, OHA found, the salient distinction between common stock and preferred stock was the difference in dividend rights, not voting rights.[10] OHA further noted that *Black's* did not define "voting stock" as a "class of stock," and therefore concluded that even if two types of stock have the same voting rights, they are not necessarily the same class of stock.[11]

Applying the *Black's* definitions, OHA found that "there is no dispute that the Series A and Series B shares have different dividend rights, different conversion rights, and different redemption rights. Thus, Series A and Series B are plainly different 'types of stock' and therefore separate classes of stock in accordance with the above definitions."[12] OHA allowed that it might be possible for two different types of stock to have differences that are not pertinent to the analysis whether they constitute different classes of stock, but found that even if that were true, Precise had established two classes of voting stock because Precise "identified its Series A and Series B shares as 'Common' and 'Convertible Preferred' respectively, and these two groups of stock differ, *inter alia*, in their associated dividend rights."[13]

OHA also found that the AD/GC's analysis, which had examined the substantive rights accorded to each series of stock to determine if they were "functionally equivalent," was consistent with OHA's plain meaning analysis.[14] Moreover, OHA found, that analysis was consistent with the law of Maryland, where Precise was incorporated. OHA's review of Maryland law revealed that "the boundaries of a 'class' of stock may be defined by any number of factors, including preferential dividends, redemption abilities, and conversion rights[,]" and that "Maryland law uses the terms 'class' and 'series' together—apparently as synonyms—throughout the provisions referring to corporate stock."[15] Because Maryland law was not conclusive, OHA concluded that the AD/GC was correct to look to the substantive rights of each series to determine whether they constituted different classes of stock.[16]

Having found that the Series A and Series B stock constituted separate "classes of voting stock," OHA concluded that Precise did not satisfy the ownership requirements of 13 C.F.R. § 125.9(d), as "the regulation specifically states that, if the concern is a corporation, a service-disabled veteran must own at least 51% of the aggregate of all stock outstanding *and* at least 51% of each class of voting stock."[17] Thus, despite the fact that Precise's ownership arrangement ensured that a service-disabled veteran had both ownership and control of Precise in any real sense, OHA found that Precise did not qualify for SDVO status based upon the plain language of the regulation.

Briefly, the court held that OHA's decision was rational and reasoned, as it was based on the plain meaning of the terms "class of stock," "common stock," "preferred stock," and "voting stock," and a further examination whether the Series A and Series B stock were "functionally equivalent."[18] The court rejected Precise's argument that OHA's "bright-line test skews in favor of finding any difference warrants treatment as separate classes," and that "even dissimilarities that materially *enhance* the interests of the service-disabled veteran may support a finding of separate classes."[19] While the court "[did] not disagree with these criticisms generally," it found that in light of the "real differences between Precise's Series A and Series B" stock, "[t]he two groups of stock are not interchangeable."[20] Accordingly, the court agreed that "while Precise is correct that it is hard to fathom what differences in rights, privileges, and limitations, for example, might exist among groups of voting stock that would not endanger functional equivalency, it is not inconceivable that such differences might exist."[21] Ultimately, while the court noted that "[n]othing in this opinion should be construed to hold that Precise's interpretation is contrary to law and not itself rational and adequately reasoned[,]"[22] it held that "OHA is within its discretion to adopt a hardline approach."[23]

Questions as to How the SBA Will Determine Ownership

Despite the apparent strictness of OHA's decision, it nevertheless leaves open questions about how small businesses can structure their capital arrangements without running afoul of ownership requirements in the SBA's regulations, and why such arrangements seemingly must be bound by determinations of what constitute separate "classes of voting stock." OHA's decision suggests that whenever a corporation issues "common" and "preferred" stock and accords different dividend rights to them, that is sufficient to declare them separate "classes" of stock. If those classes each have voting rights, then they are "classes of voting stock," each of which requires at least 51 percent ownership by a service-disabled veteran. On the other hand, OHA seems to permit the possibility that there may be more minor differences that will not render different groups of stock separate classes.[24] OHA's decision, however, provides no insight into what such differences might be. Indeed, as the court noted on its review,

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"it is hard to fathom what differences in rights, privileges, and limitations, for example, might exist among groups of voting stock that would not endanger functional equivalency[.]"[25] It remains to be seen whether the opening left by OHA can be captured in a small business's capital arrangement, or if it is purely theoretical.

It is also noteworthy that OHA appears to have sanctioned use of the law of a company's state of incorporation to determine whether groups of stock are "functionally equivalent" and therefore part of the same class. Small business owners must ask, to the extent that a state's corporations law might permit differing dividend rights within the same class of stock, will that overcome OHA's plain meaning analysis? That raises the specter of disparate outcomes depending on the relevant state law. OHA's decision, however, does not indicate whether that is a concern. The court did not suggest that it raised any concerns, either, and in fact found it reasonable for OHA to look to state law.[26] Interestingly, OHA also distinguished its decision from a prior holding in *Matter of Precision Analytical Laboratory, Inc.*,[27] which OHA found related only to the question whether two classes of stock were both "voting stock," not whether they were different "classes of voting stock."[28] While OHA noted that the decision in *Precision Analytical* rested on the finding that "because the voting rights associated with one of the classes of stock were so meager, there could be no valid policy rationale for requiring" ownership of at least 51 percent of each class,[29] OHA did not mention that those "meager" voting rights were required by state law, as the *Precision Analytical* decision recognized.[30] Thus, both *Precise* and *Precision Analytical* indicate that the SBA may look to state law to find some measure of flexibility in the regulatory ownership requirements.

Why Require Ownership of Each Class of Voting Stock?

While the Court of Federal Claims upheld OHA's decision, it appeared to do so reluctantly. Among several indications of displeasure with OHA's "hardline approach,"[31] the court found that OHA's "narrow interpretation" of *Precision Analytical* as relating only to whether a group of stock is voting stock "seems handily to circumvent *Precision Analytical*'s broader principle[.]"[32] The court noted, "Hypothetically, if *Precision Analytical* were precedent, the OHA would have had to disregard any distinctions in Precise's Series A and Series B that were not meaningful (that is, did not adversely affect or dilute the service-disabled veteran's ownership or control of the entity)."[33] As the court recognized, OHA found itself constrained by the plain language of the regulations, as "'the requirement to own at least 51% of each class of voting stock is imposed *in addition* to the other ownership and control criteria.'"[34] Thus, despite the fact that in any real sense, Precise was both owned and controlled by a service-disabled veteran, the court acknowledged that OHA's decision was consistent with the plain language of 13 C.F.R. § 125.9(d), which OHA held required it to find that Precise did not satisfy the ownership requirements.

This raises the most significant question to come out of *Precise*. The SDVO program, as set forth in 15 U.S.C. § 657f, is designed to ensure the award of contracts to small business concerns "owned and controlled by service-disabled veterans." The language of 13 C.F.R. § 125.9(d) would seem to cover both the ownership and control requirements. Ownership would be satisfied by § 125.9(d)'s requirement that a service-disabled veteran own at least 51 percent of all outstanding stock. Control would be satisfied by § 125.9(d)'s requirement that a service-disabled veteran own at least 51 percent of each class of voting stock outstanding. There is a separate provision for control, however, in 13 C.F.R. § 125.10(e), which contemplates certain stock ownership and board membership requirements. So what does ownership of *voting* stock have to do with ownership of the corporation if the regulations already require at least 51 percent ownership of *all* outstanding stock? The answer lies in the history of the regulations governing the SBA's 8(a) business development program.

The SBA promulgated the ownership and control requirements found in 13 C.F.R. §§ 125.9 and 125.10, respectively, in 2004, noting that it had patterned those requirements after the corresponding requirements for the 8(a) business development program.[35] Indeed, provisions closely similar to 13 C.F.R. §§ 125.9(d) and 125.10(e) appear in the 8(a) regulations at 13 C.F.R. §§ 124.105(d) and 124.106(d). Notably, however, the 8(a) regulations did not always bifurcate the ownership and control requirements.

Prior to a 1986 revision, the 8(a) regulations combined the ownership and control requirements into a single provision, which required:

> (2) *Ownership and control* . . . (A) In the case of an applicant concern which is a corporation, 51 percent of all classes of voting stock of such corporation must be owned by an individual(s) determined to be socially and economically disadvantaged.[36]

Thereafter, the 1986 revision broke the ownership and control requirements into separate regulatory provisions.[37] The new regulations retained the old ownership and control language with respect to ownership, stating:

> In the case of an applicant concern which is a corporation, 51 percent of all classes of voting stock must be owned by an individual(s) determined to be socially and economically disadvantaged.[38]

The new, separate control section contemplated control of a corporation partially in terms of ownership of voting stock:

> [A]n applicant concern's management and daily business

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> operations must be controlled by an owner(s) of the applicant concern who has been (have been) determined to be socially and economically disadvantaged, and such owner(s) must own a greater percentage of the business entity than any nondisadvantaged owner, or in the case of a corporation, more voting stock than any nondisadvantaged stockholder.[39]

Thus, despite recognizing that ownership of voting stock was critical to establishing *control* of a corporation, the post-1986 regulations continued to define *ownership* of the corporation solely by ownership of each class of voting stock.

The SBA next amended the 8(a) regulations in 1989.[40] Of note, this amendment added an aggregate stock ownership requirement *without* removing the requirement of ownership for each class of voting stock:

> In the case of an applicant concern which is a corporation, 51 percent of each class of voting stock and 51 percent of the aggregate of all outstanding shares of stock must be unconditionally owned by an individual(s) determined by SBA to be socially and economically disadvantaged.[41]

In the *Federal Register* notice announcing the final rule, the SBA noted that some commenters had objected to the aggregate requirement, but stated that "[t]he proposed requirement resulted from a General Counsel's opinion which found that such ownership was necessary to meet the 51 percent ownership requirement of section 8(a) of the Small Business Act[.]"[42] Tellingly, the SBA acknowledged that the 51 percent ownership requirement for each class of voting stock went to control, not ownership:

> While disadvantaged ownership of 51 percent of the voting stock would satisfy the control requirement, it would not satisfy the separate requirement of 51 percent disadvantaged ownership. Therefore, the requirement of 51 percent ownership of the aggregate of all classes of stock remains unchanged in this final rule.[43]

Thus, the SBA plainly recognized that the requirement to own 51 percent of each class of voting stock related only to control, not ownership. Despite that recognition, the SBA did not remove that provision in favor of the 51 percent aggregate ownership provision. In the *Federal Register* notice announcing the proposed rule for the 1989 amendment, the SBA stated that the voting stock ownership requirement was retained only "to reflect existing program procedures[.]"[44] By contrast, the SBA proposed to add the aggregate ownership requirement "to ensure that the statutorily required ownership interests are not diluted by issuances of other classes of stock."[45] Given the SBA's acknowledgement that the voting stock requirement related only to control—an aspect covered by a separate section of the 8(a) regulations—and the SBA's stated desire simply "to reflect existing program procedures," this retention can only be understood as driven by a goal of continuity, perhaps without full consideration of the implications.[46]

Accordingly, when the SBA promulgated the current version of the SDVO small business regulations, it relied upon 8(a) regulations that contained a superfluous requirement retained from a regulatory structure that the SBA had long abandoned. As *Precise* demonstrates, this regulatory accretion is not without consequences. Moreover, given that similar language also appears in the SBA's regulations regarding women-owned and economically-disadvantaged women-owned small businesses,[47] these consequences have the potential to extend further. The SBA should consider amending the ownership requirements for these programs to avoid circumstances like that in *Precise*, where a "hardline approach" to interpreting the regulations deprived the intended beneficiary of a socioeconomic program of the benefits of small business ownership. PL

Endnotes

1. ___ Fed. Cl. ___, No. 14-1174C (July 28, 2015) ("*Precise IV*").
2. Matter of Precise Sys., Inc., SBA No. VET-243 (Nov. 6, 2014) ("*Precise I*").
3. Precise Sys., Inc. v. United States, 120 Fed. Cl. 586 (2015) ("*Precise II*").
4. Matter of Precise Sys., Inc., SBA No. VET-246 (Apr. 30, 2015) ("*Precise III*").
5. *Precise III*, SBA No. VET-246 at *10.
6. *Id.*
7. *Id.*
8. *Id.*
9. *Id.* at *11.
10. *Id.* at *11.
11. *Id.*
12. *Id.*
13. *Id.*
14. *Id.* at *12.
15. *Id.* (citations omitted).
16. *Id.*
17. *Id.* at *13 (citing 13 C.F.R. § 125.9(d)).
18. *Precise IV*, No. 14-1174C at 14-17.
19. *Id.* at 16.
20. *Id.*
21. *Id.* at 17.
22. *Id.* at 18.
23. *Id.* at 17.
24. *See Precise III* at *11 ("Even if OHA were to assume, based on the definitions of 'common stock' and 'preferred stock,' that not every difference between groups of shares is pertinent in deciding whether or not there are separate classes of stock, it is nevertheless still apparent that Appellant in this case would have two separate classes of stock.").
25. *Precise IV* at 17.
26. *Id.* at 14.
27. SBA No. 384 (Nov. 4, 1991).
28. *Precise III* at *14.
29. *Id.*
30. *Precision Analytical*, SBA No. 384 at *6.
31. *Precise IV* at 17.
32. *Id.* at 12.
33. *Id.* at 13.
34. *Id.* (quoting *Precise III* at *12).

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35. 69 Fed. Reg. 25,262, 25,263 (May 5, 2004) ("SBA has also set forth guidance on the ownership criteria of a service-disabled veteran-owned SBC. . . . This is consistent with SBA's other programs, including the 8(a) Business Development Program."); *id.* ("In § 125.10, the SBA sets forth the criteria for determining who controls a service-disabled veteran-owned SBC. . . . SBA utilizes the same criteria for its 8(a) BD Program and SBA believes that this definition has worked well in determining who controls a business concern for purposes of eligibility into the 8(a) BD Program.").

36. 13 C.F.R. § 124.1-1(c)(2)(i)(A) (1985).

37. *See* 51 Fed. Reg. 36,132 (Oct. 8, 1986).

38. 13 C.F.R. § 124.103(b) (1987).

39. 13 C.F.R. § 124.104 (1987).

40. *See* 54 Fed. Reg. 34,692 (Aug. 21, 1989).

41. 13 C.F.R. § 124.103(b) (1990).

42. 54 Fed. Reg. 34,692, 34,694.

43. *Id.*

44. 54 Fed. Reg. 12,054, 12,056 (Mar. 23, 1989).

45. *Id.* OHA noted this latter comment, but misattributed it to the voting stock ownership requirement. *See Precise III* at *13 n.5. If the only ownership requirement is ownership of 51% of each class of voting stock, then a company could issue 51% of voting stock to the 8(a) disadvantaged individual and issue non-voting stock to non-disadvantaged individuals such that the disadvantaged individual's overall ownership is substantially less than 51%. Thus, the aggregate ownership requirement is necessitated precisely because issuances of non-voting stock would circumvent the aim of the voting stock ownership requirement, which was ownership of the corporation by a disadvantaged individual. The SBA recognized as much in its comments on the final rule when noting that the aggregate ownership provision was needed to ensure compliance with the ownership requirement. *See* 54 Fed. Reg. 34,692, 34,694. Accordingly, when the SBA noted that the regulatory amendment was needed "to ensure that the statutorily required ownership interests are not diluted by issuances of other classes of stock[,]" it was referring to the aggregate ownership requirement, not the requirement to own each class of voting stock. There is no small amount of irony in this. The regulatory change was necessitated because under the prior rules, a company could comply with the letter of the regulation, i.e., 51 percent ownership of each class of voting stock, while evading its spirit, i.e., ownership of the corporation by an 8(a) disadvantaged individual. Now, however, OHA has found that Precise was not eligible for SDVO status because it did not comply with the letter of the regulation, even though its ownership structure satisfied its spirit.

46. The SBA amended the 8(a) ownership and control regulations and moved them to their current locations in a 1998 final rule. *See* 63 Fed. Reg. 35,726 (June 30, 1998).

47. *See* 13 C.F.R. § 127.201(f).

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