Small Business Administration (S.B.A.)
Office of Hearings and Appeals

[Size Appeal]

CYTEL SOFTWARE, INC., APPELLANT
SIZ-2006-10-12-60
Solicitation No. 1R43RR23228-01
National Institutes of Health
Office of Grants Management
Bethesda, Maryland
November 20, 2006

Appearances

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For Appellant

DIGEST

A large concern which holds a 44.07% block of stock in a challenged concern, which is large as compared to the next closest block of 24.75%, will be found to have the power to control the challenged concern, making the challenged concern ineligible for an SBIR award.

A large concern which has the power to deadlock the challenged firm's Board of Directors through their power to appoint or approve four of the seven members of the Board, has the power to exert negative control over the challenged firm, and the firms are affiliated because of that control, making the challenged concern ineligible for an SBIR award.

DECISION

HOLLEMAN, Administrative Judge:

Jurisdiction

This appeal is decided under the Small Business Act of 1958, 15 U.S.C. ß 631 et seq., and 13 C.F.R. Parts 121 and 134.

Issues

Whether a large concern which holds a 44.07% block of stock in a challenged concern, which is large as compared to the next closest block of 24.75%, will be found to have the power to control the challenged concern, making the challenged concern ineligible for an SBIR award.

Whether a large concern which has the power to deadlock the challenged firm's Board of Directors through their power to appoint or approve four of the seven members of the Board, has the power to exert negative control over the challenged firm, and the firms are affiliated because of that control, making the challenged concern ineligible for an SBIR award.

I. BACKGROUND

A. The Size Determination

On September 13, 2006, the National Center for Research Resources at the National Institute of Health, Department of Health and Human Services (NIH) requested that the Small Business Administration (SBA) Office of Government Contracting - Area I (Area Office) perform a size determination on Cytel Software, Inc. (Appellant). Appellant had a pending grant application with NIH under the Small Business Innovation Research (SBIR) program.

On September 15, 2006, the Area Office informed Appellant of the protest and requested Appellant submit a completed SBA Form 355 and certain other information. On September 18, 2006, the Area Office via e-mail requested information relating to the stock ownership of the firm and the citizenship status of the common stockholders of the firm. Appellant responded to the Area Office's e-mail request on September 20, 2006, and provided their SBA Form 355 and other corporate information on September 22nd and 25th, 2006.

On September 25, 2006, the Area Office issued a size determination finding Appellant other than small. Size Determination No. 01-SD-2006-58. The Area Office found that Appellant is controlled by and affiliated with Merck Capital Ventures, L.L.C. (Merck), a large business. The Area Office found that Merck had the power to deadlock Appellant's Board of Directors, and thereby assert negative control over Appellant, because Merck has the power of designation or approval of designation of four of seven members of Appellant's Board of Directors. In addition, the Area Office found that Appellant is affiliated with Merck through stock ownership because Merck owns 35.06% of the entire firm and 44.07% of Appellant's voting shares, which is large as compared with other holdings (Mr. Cyrus Mehta and Mr. Nitin Patel each own 24.75%). See 13 C.F.R. ß 121.103(c)(1). The Area Office also found there was no economic identity of interest between Mr. Mehta and Mr. Patel that indicated they would vote as a single block.

B. The Appeal

Appellant received the size determination on September 28, 2006. On October 13, 2006, Appellant filed the instant appeal. Appellant asserts that Merck does not control Appellant on the basis of stock ownership. Appellant asserts that the Area Office made a clear error of law in relying on Intercontinental Manufacturing for the proposition that a minority shareholder that owns a block of voting stock that is large as compared to other outstanding blocks of voting stock may be deemed to control or have the power to control that concern. See Size Appeal of Intercontinental Manufacturing Co., SBA No. SIZ-3879 (1994). Specifically, Appellant asserts that Intercontinental Manufacturing makes no attempt to articulate a legal standard for what interests might be "large compared to other outstanding blocks" and does not even identify the second largest block of shares. Appellant argues that the Area Office ignored the key issue of the "relative difference in size among the largest minority blocks of shares." Appeal Petition, at 3. Appellant urges that the proper legal standard is that a minority shareholder's block is considered large compared to others when it is at least twice as large as the next closest block, and Merck does not

qualify as controlling under this standard. Appeal Petition, at 3 (citing Size Appeal of Engineering Documentation Systems, Inc., SBA No. 4058 (1995) (finding control where a 47% block of voting stock is more than twice as large as the next closest block of 21%); Size Appeal of Procedyne Corp., SBA No. 4354 (1999) (finding control where a 42.1% block is more than twice as large as the next closest block of 18.9%)).

Appellant further asserts that Mr. Mehta and Mr. Patel's interests should be considered in the aggregate because of an economic identity of interest "vis-à-vis Merck's outstanding Series A preferred stock." Appeal Petition, at 4. Merck is Appellant's only preferred stockholder, while Mr. Mehta and Mr. Patel hold common stock. Merck will receive a liquidation preference prior to the payout of any proceeds to common stockholders, including Mr. Mehta and Mr. Patel. Therefore, Appellant asserts that Mr. Mehta and Mr. Patel's interests should be aggregated because they share an economic interest due to their "closely aligned interests in the future." Id. Once aggregated, Appellant argues Merck's block of Appellant's stock is actually smaller than the aggregated holdings of Mr. Mehta and Mr. Patel.

Appellant further asserts that the Area Office erred in concluding that Merck controls four of the seven directors and can thereby deadlock Appellant's Board of Directors. Appellant asserts that the Area Office offers no rationale for concluding that Merck controls any Appellant-appointed director that Merck merely approves. Following the Area Office's reasoning that a business can control any director that it designates or approves, Appellant asserts that it would effectively control six of the seven directors with Merck controlling four directors, "even though there can be no more than seven members of the Board." Appeal Petition, at 5 (emphasis in original). Appellant asserts that "logic requires that a distinction be made between unilateral appointments to the Board--of which Merck has only one--and joint selection of mutually acceptable directors, who are not under any shareholder's control." Id. Applying this reasoning, Appellant argues Merck only controls one director that it has the power to unilaterally appoint. Moreover, Appellant contends that the Area Office failed to address the removal provisions of Appellant's Shareholder Voting Agreement (SVA), in which Merck has the power to remove without cause only one director while the other six directors' removal without cause requires Appellant's approval.

Appellant further challenges the Area Office's reliance on National Welders. See Size Appeal of National Welders Supply Co., Inc., SBA No. SIZ-4315 (1998). Appellant argues that National Welders is distinguishable because that case involved three directors that were unilaterally appointed by the large business with no provisions in their SVA regarding the joint selection of directors. Appellant asserts that "no amount of fuzzy math can equate the Cytel [Appellant] Board to the board in National Welders ...." Appeal Petition, at 6.

Appellant also asserts that Merck lacks the power to block action by Appellant's Board of directors through quorum or voting requirements. See 13 C.F.R. ß 121.103(a)(3). Appellant contends that the absence of Merck's one Board member will not prevent a quorum nor can the vote of Merck's one Board member single-handedly prevent Board action. Therefore, Appellant asserts that Merck is not affiliated with Appellant because Merck does not have the power to deadlock Appellant's Board of Directors and does not have the power to exert negative

control over Appellant.

II. DISCUSSION

Appellant filed the instant appeal within 30 days of receiving the size determination, and thus the appeal is timely. 13 C.F.R. ß 134.304(a)(2).

Appellant has the burden of proving, by a preponderance of the evidence, all elements of its appeal. Specifically, it must prove the Area Office size determination is based on a clear error of fact or law. 13 C.F.R. ß 134.314; Size Appeal of Procedyne Corp., SBA No. SIZ-4354, at 4-5 (1999). This Office will disturb the Area Office's size determination only if the Administrative Judge, after reviewing the record and pleadings, has a definite and firm conviction the Area Office erred in key findings of law or fact. Size Appeal of Taylor Consultants, Inc., SBA No. SIZ-4775, at 11 (2006).

In order to be eligible for an SBIR award, a business concern must have, together with its affiliates, no more than 500 employees. 13 C.F.R. ß 121.702(b). For size determination purposes, two businesses are affiliated, and their respective number of employees must be aggregated, when one business either controls or has the power to control the other business. 13 C.F.R. ß 121.103(a)(1).

A. Affiliation Based on Stock Ownership

SBA predicates its affiliation regulations upon the power of one concern to control another. 13 C.F.R. ß 121.103(a). Affiliation exists if one concern owns or controls, or has the power to control, 50% or more of another concern's voting stock, or a block of voting stock which is large compared to other outstanding blocks of voting stock. 13 C.F.R. ß 121.103(c)(1). Therefore, a shareholder with a minority interest may nonetheless have the power to control a concern through stock ownership if its block of voting stock is large compared to other outstanding blocks of stock.

In assessing the relative difference in size among minority blocks of shares, this Office has not articulated a fixed rule for how much larger a minority interest must be "compared to other outstanding blocks of voting stock" in order to be found to control or have the power to control the concern under 13 C.F.R. ß 121.103(c)(1). While OHA has repeatedly referenced an "at least twice as large" or "more than twice as large" as the next closest block of stock standard for evaluating whether minority interests have the power to control a concern (See, e.g., Size Appeal of Procedyne Corp., SBA No. SIZ-4354 (1999) (finding control where a 42.1% block of stock is "more than twice as large as the next closest block" of 18.9%)), we have not applied this rule mechanically.

We have found control where the alleged affiliate had 45% stock ownership, which was large as compared with the next largest block of 30%, a standard less than the "at least twice as large" standard espoused by Appellant. See Size Appeal of Asphalt Products Corp., SBA No. SIZ-2589 (1987); Size Appeal of Lebanon Foundry & Machine Company, SBA No. SIZ-2433 (1986). Under these precedents, Merck's holding here (44.07%) can certainly be said to be large compared to the next largest block of stock (24.75%), and thus Merck has the power to control

Appellant and the firms are affiliated.

Appellant's argument that Mr. Mehta and Patel's interests should be aggregated because of an economic identity of interest is without merit. The regulation governing economic identity of interest provides:

> Individuals or firms that have identical or substantially identical business or economic interests (such as family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships) may be treated as one party with such interests aggregated.

13 C.F.R. ß 121.103(f).

This Office has held that an identity of interest may be found among those who have common investments in more than one concern, whose common business interests cause the parties to act in union for their common benefit. Size Appeal of Ridge Instrument Co., Inc., SBA No. SIZ-4207 (1996) (citing Agrigold Juice Products, SBA No. SIZ-4136 (1996)). Appellant has not presented evidence that Mr. Patel and Mr. Mehta have common investments beyond their interests in Appellant that requires them to be treated as one party. Id.; See also Size Appeal of Cellegy Pharmaceuticals, Inc., SBA No. SIZ-4439, at 4 (2001).

Even if Appellant is hinging their identity of interest argument on the general principle of Mr. Mehta and Mr. Patel having substantially identical economic interests (rather than the illustrative common investment example provided in 13 C.F.R. ß 121.103(f)), Appellant nonetheless fails to establish they would act in unison. The fact that Mr. Mehta and Mr. Patel are both Appellant's common stockholders that share an interest in not diluting their common share ownership during a liquidation event and have "closely aligned interests in the future" does not establish that they will generally act in unison for their common benefit. This is distinguishable from Size Appeal of MPC Computers, LLC, SBA No. SIZ-4806 (2006), where management and employees were found to share an identity of interest (and thus their stock holdings were aggregated) after the protested firm's President submitted a declaration in which he explained how the directors, management, and employees united in an effort to continue operating the firm according to a common strategy after problems involving previous owners threatened the company. Appellant has not presented a similar document here, so the cases are not analogous and Appellant's reliance is misplaced. Accordingly, Appellant has not demonstrated an economic identity of interest between Mr. Patel and Mr. Mehta, which would require that their shares be aggregated, with the result that Merck's block of stock is smaller than their aggregated shares.

B. Affiliation Based on Negative Control

A concern has negative control over another when, though lacking the affirmative ability to approve actions, it can block corporate action by the other concern. See Size Appeal of Regent Manufacturing, Inc., SBA No. SIZ-4533, at 6 (2003). A minority shareholder may exert negative control over a concern by blocking action by the Board of Directors, and thus be deemed an affiliate of the concern. 13 C.F.R. ß 121.103(a)(3); Size Appeal of National Welders Supply Co., Inc., SBA No. SIZ-4315 (1998).

Appellant's Shareholders' Voting Agreement fixes the number of directors on its Board at seven. The Board is to consist of: (1) the

CEO (Mr. Nayak); (2) Mr. Mehta, as long as he is employed; (3) Mr. Patel, as long as he is employed; (4) one person designated by Merck; (5) two persons designated by Appellant and approved by Merck; and (6) one person designated by Merck and approved by Appellant.

Our precedent holds that when a challenged firm's Board of Directors consists of an equal number of persons representing the challenged firm and the alleged large affiliate, the latter has the negative power to control the challenged firm since its Board members can block any action proposed by the other members. Size Appeal of National Welders Supply Co., Inc., SBA No. SIZ-4315 (1998); Size Appeal of First American Tax Valuation, Inc., SBA No. SIZ-4206 (1996).

The Area Office found that Merck has the power to deadlock Appellant's Board of Directors through its power of designation or approval of designation of four of the seven Board members. The Area Office concluded that Merck's power to exert negative control over Appellant's Board of Directors constituted affiliation.

Appellant contends that Merck only has the power to control directors that it unilaterally appoints, and not directors that Merck and Appellant mutually appoint. Appellant argues that to hold otherwise would mean that Appellant controls six of the seven directors with Merck controlling four directors, even though there can only be seven directors.

However, Appellant fails to appreciate that our precedent holds that the existence of veto power over an important aspect of a business constitutes negative control. Size Appeal of Kansas City LLC d/b/a Best Harvest Bakeries, SBA No. SIZ-4574, at 7 (2003). This ability to block important actions may be limited to certain important business transactions, or it can extend to the ability to block a quorum at Board of Director meetings. Size Appeal of Jensco Marine, Inc., SBA No. SIZ-4330, at 7 (1998). The existence of the veto means the challenged firm "is not entirely free to conduct its business as it chooses." Id. There are multiple examples of veto power establishing the negative power to control including a firm's ability to withhold its consent as co-indemnifier on performance bonds (Size Appeal of J.E. McAmis Industries, Inc., SBA No. SIZ-2352 (1986)), and an individual with veto power over how a firm votes its stock to elect directors (Size Appeal of Robert R. Anderson Co., SBA No. SIZ-2388 (1986)). Most relevant to the instant case, a firm having control of two of six directors, and veto power over two of the remaining six, constitutes negative control. Size Appeal of Gain Electronics Corporation, SBA No. SIZ-2779, at 7 (1987).

Here, while Merck only names one director itself, it has veto power over three, and thus negative control over the Board as a whole. This negative control means that Merck is affiliated with Appellant, and that Appellant is thus other than small.

Appellant has failed to meet the regulatory size requirements for eligibility as an SBIR concern. Appellant has thus failed to establish any error of law or fact in the size determination, and I must deny its appeal.

III. CONCLUSION

For the above reasons, I AFFIRM the Area Office's size determination and DENY the instant appeal.

This is the final decision of the Small Business Administration. See 13 C.F.R. ß 134.316(b).

Christopher Holleman

Administrative Judge

SBA No. SIZ-4822, 2006