



Insights: Alerts

CARES Act | SBA Loan Programs Augmented - Who is "Small" and What Does "Affiliation" Mean?

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Written by **Gunjan R. Talati, G. William Joyner III, David A. Stockton,**

Please note: The below information may require updating, including additional clarification, as the COVID-19 pandemic continues to develop. Please monitor our main [COVID-19 Task Force page](#) and/or your email for updates.

The COVID-19 novel coronavirus pandemic ("COVID-19") threatens to devastate businesses worldwide, and U.S. small businesses are no stranger to this threat. The CARES Act—a \$2 trillion stimulus package—may provide some relief to struggling small businesses but applicants for Small Business Administration loans need to understand "affiliation" and whether they are truly "small" for these purposes. This alert addresses what "affiliation" means for businesses in evaluating whether they are "small" and qualify for any of the financial relief afforded under SBA programs affected by the CARES Act.

In an earlier alert (available [here](#)) we told you about the types of loan program available for small business and how the CARES Act expands the existing SBA 7(a) loan program—which provides SBA-backed/guaranteed loans—by appropriating \$349 billion under the new Paycheck Protection Program (PPP). The CARES Act also modifies other loan programs administered by the U.S. Small Business Administration (SBA), including the Economic Injury Disaster Loans (EIDLs) program.

As with other SBA programs, a company's eligibility depends on its size. Size, in turn, is determined based upon the company's number of employees or annual receipts, depending upon that company's industry and the SBA program involved. Generally speaking, a business concern must factor the average number of employees or average annual receipts over the past three years to determine size. In doing so, companies must consider and add the numbers from their "affiliates." Determining whether companies are affiliated can be highly technical and complex and impact whether businesses are "small" and, in turn, eligible for these programs.

How SBA Determines Eligibility Based on Size

To be eligible for the PPP loans and EIDL program a company must meet the SBA's existing "small business concern" standards, as temporarily modified by the CARES Act for these loan-related programs.

To qualify as a "small business concern" under the SBA rules, a company must not exceed the applicable North American Industry Classification System (NAICS) [code size standard](#), which expresses size standards either in the maximum number of employees (including all full-time, part-time, and other employees) or the maximum average annual receipts in millions of dollars and averaged over the past three years, unless otherwise

specified. The number of employees or annual receipts indicates the maximum allowed for a concern and its affiliates to be considered small.

As an example, a company seeking qualification as “small” under any of the NAICS Codes for Subsector 236-Construction of Buildings, must not exceed \$39.5 million in average annual receipts. By contrast, an insurance carrier seeking to qualify under NAICS Code 524126 for Subsector 321-Insurance Carriers and Related Activities limits the business concern to no more than 1,500 employees in order to be “small”.

How the SBA Calculates the Number of Employees

The SBA calculates the average number of employees (full-time, part-time, temporary, leased, and affiliated employees) per pay period for the 12 months preceding the business's size determination. As an example, SBA would look at pay periods from January 1, 2019 to December 31, 2019 in considering the business concern's size on January 1, 2020. Where a concern has operated for less than 12 months, the SBA would look at the average number of employees for each of the pay periods of operation.

How the SBA Calculates Annual Receipts

Receipts include “all revenue in whatever form received or accrued from whatever source.” [13 CFR § 121.104](#). Receipts includes revenue from the sales of products or services, interest, dividends, rents, royalties, fees, or commissions, reduced by returns or allowances. In general, receipts are “total” or “gross” income plus the cost of goods sold. *Id.* In determining total receipts, for purposes of the CARES Act programs, the SBA looks at the average annual receipts over the past three years.¹

How the CARES Act Impacts SBA's Affiliation Rules for Determining Size

The CARES Act modifies the maximum number of employees threshold by providing that the borrower (together with its affiliates, as determined under the SBA rules) must have no more than the greater of:

- 500 employees;
- the number of employees set by the applicable NAICS code; or
- for businesses with more than one physical location and an assigned NAICS code beginning with “72”—which applies to accommodation and food service industries—500 employees at each physical location of the business.

With few exceptions,² the SBA looks to the number of employees of the company and the employees of all of its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit (or the aggregate receipts or other criteria, if applicable, depending on the applicant's NAICS category).

Generally, SBA deems entities to be affiliated with each other when one controls or has the power to control the other, or when a third party controls or has the power to control both; or where there is common ownership. It does not matter whether control is actually exercised, so long as the power to control exists. [13 C.F.R. § 121.103](#). SBA looks at the “totality of the circumstances,” and may find affiliation even though no single factor is sufficient to constitute affiliation. *Id.* In regards to its financial assistance programs, including its 7(a) lending program, SBA will not overturn an affiliation determination made by an SBA lender, so long as that determination was reasonable when made given the information available. 13 C.F.R. § 121.301.

In basic terms, the affiliation rules were established to make sure that a business is legitimately “small” and not a strawman for a large business or a person who is not properly economically or socially disadvantaged. One can imagine a situation where an individual claims to be small but owns a multitude of small businesses, which are each small but when looked at in the aggregate have many millions of dollars in receipts. Another example is where a large business has a small subsidiary. SBA developed its affiliation rules to preclude improper parties from claiming small business status.

Control can be either affirmative or negative, as discussed in more detail below.

Affirmative Control

Under SBA's general affiliation rules, examples of affirmative control include a person (including any individual, concern, or other entity such as the aforementioned large business) that owns, or has the power to control, 50 percent or more of a concern's voting stock, or a block of voting stock which is large compared to other outstanding blocks of voting stock, controls or has the power to control the concern. 13 C.F.R. § 121.103(c)(1). Affiliation also arises where one or more officers, directors, managing members, or partners control the board of directors and/or management of one concern also control the board of directors or management of one or more other concerns. 13 C.F.R. § 121.103(d).

Under SBA's specific lending programs, examples of affiliation through affirmative control can be based on equity ownership. SBA considers a concern to be an affiliate of an individual, concern, or entity that owns or has the power to control more than 50 percent of the concern's voting equity. If no individual, concern, or entity is found to control, SBA will deem the Board of Directors, President or Chief Executive Officer (CEO) (or other officers, managing members, or partners who control the management of the concern) to be in control of the concern. SBA will deem a minority shareholder to be in control, if that individual or entity has the ability, under the concern's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders. 13 C.F.R. § 121.301 (f)(1).

Negative Control

Negative control may occur where a minority shareholder “has the ability, under the concern's charter, by-laws, or shareholder's agreement, to prevent a *quorum* or otherwise block action by the board of directors or shareholders.” For example, a company that is 49% owned by a venture capital or equity fund can be deemed to be an affiliate of the fund, if the fund can block certain actions by the company's board.

The SBA's Office of Hearing Appeals (OHA) has interpreted this rule to mean that negative control arises from a minority shareholder's power to block ordinary actions essential to operating the company. *See Size Appeal of: Southern Contracting Solutions, LLC*, SBA No. SIZ-5956, 2018 (SBA), 2018 WL 4492382. There, OHA found that an affiliation existed as a result of a minority shareholder's ability to block ordinary corporate actions, including:

- Taking on new debt
- Issuing dividends
- Setting officers' compensation
- Purchasing equipment
- Making changes to a budget

- Incurring expenses over \$5,000
- Amending or terminating leases

OHA did recognize, however, that negative control does not exist for purposes of finding affiliation if supermajority provisions are to protect the investment of the minority owners, and not to impede the majority's ability to control the company's operations or to conduct the company's business, including:

- Adding new members
- Dissolving the company
- Filing for bankruptcy
- Amending the bylaws
- Issuing additional capital stock
- Entering into a substantially new business
- Selling all or substantially all the company's assets
- Mortgaging or encumbering all or substantially all of the company's assets
- Committing any act that could result in a change in the amount or character of the company's contribution to capital

Not surprisingly, these considerations can be problematic for companies that have taken venture capital or private equity investment because often times those operational agreements contain many of these covenants. If SBA considers one of these investors an affiliate of the PPP borrower, and the same investor also “controls” other entities (e.g., portfolio companies), those relationships could result in aggregating all employees across all entities, and cause the PPP borrower to exceed the size limitation threshold.

Takeaways: Affiliation May Affect Whether a Business Concern is Eligible for CARES Act Funding

- With few exceptions, there is no explicit waiver of affiliation under the CARES Act. Consequently, business concerns who have accepted venture capital, private equity or other types of investments may not be qualified to apply to, and receive funds from, the PPP and other SBA loan program relief. This is a fact intensive, party-specific analysis that is not a “one size fits all”.
- Business concerns will need to assess whether there is affiliation before applying for such loans as submitting an incorrect or fraudulent application can subject an applicant to a number of enforcement exposures ranging from administrative items such as suspension or debarment from federal programs and contracts to civil liability under the False Claims Act to criminal liability for false statements.
- In evaluating eligibility, companies should review their shareholder and operating agreements, and other corporate documents to whether provisions within those documents give rise to affiliation through either affirmative or negative control.
- Whether negative control can lead to a finding of affiliation depends on the specific facts of the individual company.

How Kilpatrick Townsend Can Help

Kilpatrick Townsend has a multi-disciplinary SBA Loan Program Team that can assist your organization in navigating affiliation and other eligibility issues. For assistance, please reach out to your usual Kilpatrick contact or the COVID-19 Task Force at #COVID-19KTSTaskForce@kilpatricktownsend.com.

Footnotes

¹ SBA's Business Loan and Disaster Loan Programs are excepted from the newly enacted five-year annual receipt calculation provided for in the Small Business Runway Extension Act. See SBA's recent [final rule](#) modifying its method for calculating average annual receipts used to determine size standards for small businesses.

² Exceptions to affiliation under the CARES Act include: a) businesses with 500 or fewer employees and that are assigned a North American Industry Classification (NAICS) code starting with 72; b) franchises; and c) businesses that receive financial assistance from a small business investment company licensed under section 301 of the Small Business Investment Act of 1958.

Related People



Gunjan R. Talati

t 404.815.6503
gtalati@ktslaw.com



G. William Joyner III

t 336.607.7342
wijoyner@ktslaw.com



David A. Stockton

t 404.815.6444
dstockton@ktslaw.com