The federal government’s small business regime is integral to federal government contracting. Thus, understanding that regime and its intricacies allows both small and large contractors to advance their business goals of attracting and securing federal projects. As such, it is paramount for both small and large contractors to have a working knowledge of the Small Business Administration (SBA)’s affiliation rules.

The affiliation concept is important to government contractors because it can have a significant impact on whether a business is deemed large or small. Small businesses are eligible to participate in numerous beneficial government programs. The SBA determines the size of a business by examining a company’s average annual revenue or number of employees. When two companies are affiliated, the SBA combines the revenue or number of employees of both companies. Thus, each company is less likely to fall below the SBA’s applicable limit and is less likely to be eligible for preferred contracting status.

This article seeks to clear up some of the most common errors made by government contractors related to affiliation. It focuses on three areas that contractors often misunderstand. Each section will attempt to dispel a common myth or misconception about affiliation:

- Myth 1: Affiliation is solely based on 51 percent or more ownership of a business.
- Myth 2: The SBA’s affiliation rules, especially the exceptions, can be read in isolation.
- Myth 3: A contractor can create a small-business start-up company and funnel subcontracts to it or use it to pursue prime contracts set aside for small businesses with impunity.

Background

In 1958, Congress enacted the Small Business Act, which mandated that a fair proportion of the federal government’s total purchases and contracts or subcontracts for property and services be issued to small business enterprises. Since 1958, an elaborate scheme of regulations and additional legislation have emerged giving small businesses favored status in competing for federal procurement dollars. Small businesses are eligible for contract awards with limited competition—and sometimes no competition. In addition, federal government agencies must establish goals for contracting directly with small businesses. Furthermore—and perhaps what is most important for large businesses—the Small Business Act Amendment of 1978 established mandatory subcontracting requirements for most prime contractors doing business with the federal government. In fact, for many contracts, a contractor’s small business subcontracting plan is an important evaluation factor in its proposal.

Affiliation Generally

As briefly discussed above, when companies are affiliated, they have a more difficult time qualifying as small businesses. This is because the SBA reviews the revenue or employees of all the affiliated entities together to determine whether the businesses are large or small. Thus, it is significantly more difficult for each company to stay within the applicable North American Industry Classification System (NAICS) code limit that applies to the bidder’s industry. This is especially true if one of the affiliated businesses is already large. When facts arise that lead a small business to become affiliated with a large business, the small business will almost invariably lose its small business status immediately. Thus, for a company that would otherwise qualify for federal procurement preferences, a finding of affiliation can be extremely detrimental to its business interests.

The SBA generally finds two companies to be affiliated when one has the ability to control the other. The SBA’s regulations identify a number of different bases for finding affiliation. However, the idea of control runs through them all. Even if a company can negatively control—by blocking or preventing action, for example—or indirectly control a second company, the two will likely be affiliated.
evaluating whether companies can control each other, the SBA also considers factors such as the company’s ownership, management, previous relationships, ties to another company, and contractual relationships. Finally, the SBA also reviews the totality of the circumstances when making its determination as to whether or not two companies are affiliated.

**Myth 1: Affiliation is Solely Based on 51 Percent Ownership of a Company**

Many people mistakenly believe that the only way the SBA can find that two companies are affiliated is on the basis of stock ownership. Therefore, they incorrectly focus on this rule to the exclusion of the others. Government contractors, both small and large, frequently say that they do not understand how their company could be affiliated with another firm when they don’t have a majority ownership interest in that company. The appropriate response is that 51 percent ownership of one company by another is not the only way the SBA can find that two companies are affiliated. Stock ownership may be the most obvious way for the SBA to find affiliation, but there are many other ways for the SBA to reach the same result.

Within the context of the stock ownership basis for determining affiliation, there are a few explicit limitations on the 51 percent ownership rule. First, the rule is not 51 percent or more ownership; it is 50 percent or more. If a person or entity owns even a small decimal point percentage over 49.999 percent of a company, the SBA will say the owner controls that entity. Although this may be a subtle difference, it can be an important detail.

In addition, the rule is not limited to stock ownership. It extends to the power to control stock, which gives the SBA significant leeway in determining affiliation. Thus, the stock ownership rule likely covers situations in which a company has a shareholder voting agreement, according to which, in reality, one person controls another’s stock. It also likely covers situations where, as discussed below, holders of minority interests can affirmatively or negatively control a company.

The SBA also has a number of affiliation rules covering minority owners. First, if a shareholder has a large block of voting stock compared to other outstanding blocks, he or she can be said to control a company. Second, if two or more people have less than 50 percent of the voting stock of a company, but their holdings are relatively the same size and are large compared to others’ holdings, the SBA presumes those shareholders can control the company. The rationale behind these rules is that a large minority shareholder or shareholders can exercise a significant amount of power compared to that of the smaller minority shareholders. Thus, the large minority shareholders likely can control the entity. As a result, the SBA will closely examine the stock ownership of individuals to determine whether they can actually control an entity, and the SBA can find affiliation even if no single person owns more than 49 percent of a company.

Moreover, if a company’s stock is so widely held that no single block is large compared to others, the company’s board of directors and chief executive officer or president will control the company. This finding can be rebutted by evidence to the contrary. However, in many cases, a company with widely held shares will be affiliated with any other company that its board or chief officers otherwise control.

Finally, the affiliation rules also deal with unexercised stock options, convertible securities, mergers, and agreements to terminate interests. The SBA views options and convertible securities as having a present effect, meaning that the SBA treats the owner as if he or she had already exercised the options or converted the securities. This is so unless the securities are subject to conditions that are highly unlikely to be fulfilled. On the other hand, the SBA does not view agreements to terminate equity rights as exercised until these agreements are actually executed. Thus, neither people nor entities can effectively terminate control of a company in this manner. Furthermore, the SBA will not find two companies negotiating a merger to be affiliated until the companies have reached an agreement. This means the SBA will not treat the companies as if they have merged until they have moved past the negotiating stage; and a nonbinding letter of intent will not cause two companies to be affiliated.

**Myth 2: The SBA’s Affiliation Rules Can Be Read in Isolation**

Many contractors will locate an exception to affiliation and either apply it too broadly or fail to read it in the context of the entire legislative scheme. The complex affiliation rules and numerous exceptions require close attention and reference to the decisions made by the SBA’s Office of Hearing and Appeals that interpret statutes and regulations. Because affiliation is so broadly defined, none of its rules can be read in isolation.

For example, companies that lease employees from certain leasing companies or enter into a co-employment arrangement with a professional employer organization are at least partially exempt from the affiliation rule. However, without a careful reading of the provision, one could miss the second half of the subsection, which states that the exception applies solely to the leasing agreement. If the leasing company or professional employer organization can otherwise control the small business concern or vice versa, the two companies will be affiliated.

Imagine a situation in which a prime contractor learns of a struggling firm owned by a veteran or a woman for example. That firm needs additional workers and the prime contractor needs additional dollars from subcontractors with veteran-owned or woman-owned firms to help meet its small business subcontracting goals. The prime contractor decides to set up a new employee leasing company, which will be primarily engaged in the employee leasing market and will lease its employees to the small business. The prime contractor then leases its workforce to the subcontractor and also awards subcontracts to the same subcontractor. Even though this plan solves both companies’ problems, it seems to be a precarious strategy. If the prime contractor can control the subcontractor in any way, the two firms will likely be affiliated and the
subcontractor will no longer be small. Thus, this is a good example to show that the exceptions to the affiliation rule are limited in scope.

Similarly, many contractors rely too heavily on the mentor-protégé exception to the affiliation rules. This exception states that a mentor firm will not be affiliated with its protégé based on the assistance the mentor provides the protégé under the mentor-protégé arrangement. However, the rule states that mentors and protégés remain subject to the affiliation rules and that affiliation may be found for other reasons. Thus, generally, only acts of the mentor that constitute assistance to the protégé will not trigger the rule.

In a separate regulation, the SBA describes the typical assistance a mentor can give its protégé, including the following:

- technical and/or management assistance;
- financial assistance in the form of equity investments and/or loans;
- subcontracts; and/or
- assistance in performing prime contracts with the federal government in the form of joint ventures.

Thus, it can be argued that the affiliation exception is limited to these types of assistance generally.

One specific type of assistance a mentor may give to a protégé—namely, equity investments—deserves further discussion. A mentor may own an equity interest of up to 40 percent in the protégé’s firm as a way to help it raise capital. This provision, together with the affiliation exception, allows a mentor to own some of the protégé’s firm without worrying about triggering the stock ownership rules discussed earlier. However, a contractor entering into such an arrangement should be aware of any other “bad affiliation facts” that are present or may arise in the mentor’s relationship with the protégé. Even though the 40 percent equity interest itself, or in combination with other permitted assistance, should not cause affiliation, if the mentor performs a few acts that tend to show it can control the protégé, the 40 percent ownership interest may be a factor in the SBA’s analysis of the totality of the circumstances of the relationship between the two firms. As such, the 40 percent equity rule is yet another area in which the SBA’s affiliation rules should not be read in isolation.

It should be noted that there are cases dealing with the identity of interest rule, a concept discussed further below, that puts some limits on which transactions the SBA’s Office of Hearing and Appeals may analyze when determining whether affiliation between a mentor and a protégé exists. These cases show that the Office of Hearing and Appeals may not examine a mentor and protégé’s business transactions after the SBA has approved a mentor-protégé agreement between them unless the transactions are clearly not at arms’ length. These cases may provide mentors and protégés with an additional layer of comfort regarding their arrangement. However, the SBA has a number of other ways by which it can find a mentor and protégé to be affiliated other than the identity of interest rule. As such, it would behoove both parties to exercise caution regarding their mentor-protégé relationship.

Myth 3: A Large Business Can Create a Small-Business Start-Up Company to Pursue Prime Contracts or Federal Subcontracts and Face No Affiliation Risk

Another potential trap for a large government contractor is the idea that it can spin off a small business and take advantage of federal procurement preferences with impunity. The idea can be especially tempting when a contractor learns that one of its employees is a veteran, is economically or socially disadvantaged, or otherwise has a “special status.” Through such a plan, a large business could more easily meet its small-business subcontracting goals and award subcontracts to a company it trusts. Moreover, the new company may be able to compete for prime contracts for which its competitors are only other small businesses. However, for a number of reasons, creating a new entity based on these premises may not be a prudent idea.

If a contractor wants to take advantage of the benefits of the small-business regime, the company needs to essentially show a clear line of separation between itself and the new business. Doing so enables the contractor to effectuate its intent to create an independent business. However, the contractor must exercise a high degree of caution in carrying out its goal and take several rules into account. The first rule—and probably the largest obstacle—to this plan is the rule related to newly organized business concerns. In addition, the identity of interest and the common management rules may also place limits on such a contractor’s plan.

The rule governing newly organized concerns is triggered when former officers, directors, principal stockholders, managing members, or key employees of one company establish a new company in the same industry or in a related one and serve as principals for the new company. The two companies will be affiliated if the former company gives the new company certain types of assistance, including contracts, financial or technical assistance, indemnification on bid or performance bonds, and/or other facilities. The fact that the new company pays the old company for that assistance is irrelevant in determining affiliation.

One particularly confusing part of the newly organized concern rule is the part dealing with key employees. It is likely that most contractors understand that it may not prudent to make the president of a large business the president of a new small business. However, the rules regarding key employees may be less obvious. A key employee—that is, someone who has a critical influence in or substantive control over the operations of a company—could be the director of operations, director of sales, or some sort of vice president. A helpful fact for contractors in the construction industry, for example, is that the SBA has held that a project manager was not a key employee. However, in general, contractors need to critically examine the decision to use former high-level employees as leaders in a new small business start-up if the new company will be involved in a related industry.
when companies or those running them have business or economic interests that are substantially identical to those of a small business. 59 The classic example is of businesses run by family members. 58 Family members desire to act in one another’s best interests and are likely to run their businesses accordingly. Moreover, owners of different businesses with common investments or those who are economically dependent on one another may have an identity of interest. 59 These individuals are likely to act in unison for one another’s common benefit; therefore, the SBA believes these types of businesses should be treated as one. 50 For example, the SBA may find identity of interest in a case in which a key employee plays a major role in a business concern’s growth and then shares ownership with that concern in companies he or she helped create. 51 The rule may also be triggered when two firms engage in long-term business ventures with each other, 52 because a long-term relationship can create a situation in which both firms’ business interests become aligned.

Finally, the common management rule also may apply in cases where a large business creates a new small business. If one or more officers, directors, managing members, or partners who 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, the firms will be affiliated. 63 This rule teaches us what the other rules have already stated: If a contractor establishes a new small business, it should not use the same principals for the venture.

Thus, it is easy to see how SBA’s three rules on this subject overlap. The basic message of these rules is that if a contractor starts a new business, the new business should be sufficiently separate from the old business in order to avoid affiliation.

Conclusion

The goal of this article was to be a primer on common misconceptions regarding affiliation and to help contracting attorneys avoid the more frequent affiliation errors. However, because of the numerous tools the Small Business Administration has to make a finding of affiliation, a contracting attorney should examine the entire regulatory scheme in this area carefully. TFL

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Endnotes

1 Most businesses must be “small” to qualify for a preferred contracting status. This is true even if the business is owned and controlled by a woman, a service-disabled veteran, is eligible to be a HUBZone concern, and so forth. See 13 C.F.R § 121.401. A different set of rules apply to corporations owned by Alaskan Natives. See, e.g., 13 C.F.R. § 124.109 (2009).

2 13 C.F.R. § 121.201 (2008); see 13 C.F.R. § 121.104 and § 121.106 for the rules on how average annual receipts and average number of employees are calculated by the government, respectively. Generally, annual receipts are calculated based on a three-year average, and the number of employees is calculated as a 12-month average.

3 13 C.F.R. § 121.103(a)(6) (2005); 13 C.F.R. § 121.104(d); 13 C.F.R. § 121.106(b)(4).

4 15 U.S.C. § 631 et seq.; 15 U.S.C.A. § 644(a) (stating that “[t]o effectuate the purposes of this chapter, small-business concerns shall receive any award or contract or any part thereof as to which it is determined by the Administration and the contracting procurement or disposal agency ... to be in the interest of assuring that a fair proportion of the total purchases and contracts for property and services for the Government in each industry category are placed with small-business concerns”).

5 As used herein, the term “small business” shall include 8(a) small-business concerns, small-businesses concerns owned by disadvantaged persons, HUBZone small-business concerns, and small-business concerns owned by women and veterans who are disabled as a result of military service.

6 15 U.S.C. § 644(a), (i); 48 C.F.R. 19.501 (containing rules related to the small-business set-aside program); 48 C.F.R. 19.800 (containing rules related to 8(a) sole-source contracts); see also 48 C.F.R. 219.800.


8 The Small Business Act Amendments of 1978, Pub. L. No. 95-507, 92 Stat 1757; 15 U.S.C. § 637(d); 13 C.F.R § 125.3 (2009); see 10 U.S.C. § 2323(h)(2) (requiring subcontracting plans that have been submitted to the Department of Defense in support of a sealed bid or a competitive proposal to be specifically considered a competitive evaluation factor in making award selections).

9 See, e.g., 10 U.S.C. § 2323(h)(2).

10 Note that the calculations for the employee-based and revenue standard are fairly complex. See 13 C.F.R. § 121.104, 13 C.F.R. § 121.106. See also 13 C.F.R. § 121.105(c) (2005) (defining a small-business concern and stating that “a firm will not be treated as a separate business concern if a substantial portion of its assets and/or liabilities are the same as those of a predecessor entity. In such case, the annual receipts and employees of the predecessor will be taken into account in determining size.”).

As of 2010, the SIC codes can be found online at www.osha.gov/pls/imi/sicsreach.html, and the NAICS codes can be found at www.census.gov/eos/www/naics/. The NAICS codes can also be obtained by contacting the National Technical Information Service at 5285 Port Royal Rd., Springfield, VA 22161, or by calling (800) 553–6847 or (703) 605–6000. Each NAICS code corresponds to a different industry, and there are thousands of different NAICS codes representative of the different industries. A firm applying to the 8(a) Business Development Program or applying to be certified as a HUBZone entity must be small as to its primary industry. 13 C.F.R. § 121.404(b); 13 C.F.R. § 121.107. For small business subcontracting plan purposes, a firm must be small as to the NAICS code the prime contractor thinks best describes the goods or services to be provided by the subcontractor under the subcontract. 13 C.F.R. § 121.410.

The SBA uses a variety of factors to set its size standards. The size standards are based on the idea that, once a business reaches a certain size, it may become dominant in its field of operation. Thus, in determining appropriate size standards, the SBA evaluates factors relating to the industry at issue, such as “degree of competition, average firm size, start-up costs and entry barriers, and distribution of firms by size … technological changes, competition from other industries, growth trends, [and] historical activity.” 13 C.F.R. § 121.102 (2007).

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Office's determination that a mentor and protégé were affiliated under the identity of interest and totality of the circumstances rules in part because an area office cannot review evidence of business transactions occurring after the SBA approves the agreement between the mentor and the protégé to evince affiliation under the identity of interest rule, except when they are not arms' length transactions or are so extraordinary as to cause suspicion in a reasonable person, but also acknowledging that the SBA may find affiliation between a mentor and protégé for reasons other than the assistance the mentor gives the protégé; TKTM Corp., supra, note 38 (stating that 13 CFR 121.103(b)(6) is not a bar to a finding of affiliation between a mentor and protégé under the ostensible subcontractor rule in a case where the DOD's mentor-protégé program was at issue).

4See TKTM Corp., supra, note 38.

7Note that, although not discussed in detail here, this set of facts may also raise the ostensible subcontractor basis for affiliation. Under this rule, the SBA will find that a small-business prime contractor that is unduly reliant on a subcontractor, presumably its large-business predecessor, is affiliated with that subcontractor. 13 C.F.R. § 121.103(h)(4). Thus, the small business is often precluded from participating in small-business set-asides or sole source solicitations. The term of art is “clear line of franchise.” Id.

2013 C.F.R. § 121.103(g).

21Id.

2013 C.F.R. § 121.103(e), (f).

21Id.


5See, e.g., Size Appeal of Fiore Industries Inc., SBA SIZ-3401, SBA Office of Hearings and Appeals (Jan. 11, 1991), c.f. Size Appeal of: Blue Cord Construction Inc, SBA SIZ-5077, SBA Office of Hearings and Appeals (Oct. 7, 2009) (affirming the area office's size determination that a construction company was other than a small business under the newly organized concern rule in part because the vice president of construction of the old company was a “quintessential key employee”).

5313 C.F.R. § 121.103(f).

54For example, if a husband and wife both open small businesses, there is a good chance the two companies will be affiliated based on the identity of interest rule. 13 C.F.R. § 121.103(f). Each party is likely to act in the best interest of the other with respect to his or her own business.

5513 C.F.R. § 121.103(f) (stating that firms can be economically dependent on each other through “contractual relations,” which are likely to includes subcontracts).


58Id.

59Id.