

## AFFILIATION

### **Why is Affiliation an Important Issue?**

SBA determines whether an entity qualifies as a small business concern by counting its receipts, employees, or other measure including those of all its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit. 13 C.F.R. § 121.103(a)(6).

### **What are the General Principles of Affiliation?**

Generally, affiliation exists when one business controls or has the power to control another or when a third party (or parties) controls or has the power to control both businesses. Control may arise through ownership, management, or other relationships or interactions between the parties. SBA's regulations on affiliation are contained in 13 C.F.R. § 121.103 (available at [www.sba.gov/size](http://www.sba.gov/size)).

The following are some of the affiliation rules that may apply when a business concern receives equity investment from one or more venture capital companies:

#### **1. Stock ownership (13 C.F.R. § 121.103(c))**

- Control of 50% or more of voting stock. A person<sup>1</sup> is an affiliate of a concern if the person owns or controls, or has the power to control, 50% or more of the concern's voting stock.

*Example 1:* Company A is the majority owner of Companies B, C and D (54.5%, 81%, and 60% respectively). Company A has the power to control Companies B, C and D. The companies are all affiliated. The receipts and/or number of employees of all four companies will be aggregated in determining the size of any one of them.

- Control of less than 50% voting stock, but large compared to others. Affiliation may also occur when a person owns and controls, or has the power to control, a block of voting stock that is large compared to all other outstanding blocks of stock.

*Example 1:* Company A owns 40 percent of the voting stock of Company B and the next largest share is 2 percent. Company A controls Company B due to the fact it owns the largest block of voting stock compared to all other outstanding blocks of voting stock. Company A and Company B are affiliates. In addition, all other companies controlled by Company A will be considered affiliates of Company B.

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<sup>1</sup> The term "person" used throughout this document and the regulations includes an individual, entity, or business concern. § 121.103(c)(1).

Example 2: Two individuals each own blocks of shares of Company A. One individual owns 46.67% of the business and the other owns 33.333%. The individual that owns 46.67% of the stock owns the largest single block, which is large compared to any other block, and therefore probably has the power to control the concern. This individual also controls Company B. There is affiliation between Company A and Company, but it is rebuttable .

- Control of less than 50% voting stock by multiple minority owners. In addition, if two or more persons each owns or controls (or has the power to control) less than 50% of a concern's voting stock and (i) the minority holdings are all approximately equal in size and (ii) all of the minority holdings taken together are large compared to any other stock holdings, affiliation is presumed to exist with each of those persons. It is important to note that this is a rebuttable presumption .

Example: Investor X, Investor Y, and Company A each own 23% of Company B. No other stockholder owns more than 5% of Company B. All three persons will be presumed to control Company B, unless they successfully rebut this presumption. If the presumption is not overcome, then Company A and Investors X and Y will all be considered affiliates of Company B. In addition, all companies controlled by Company A and Investors X and Y are affiliates of Company B.

- Voting stock is widely held. When a concern's voting stock is widely held and no single block of stock is large as compared with all other stock holdings, the business concern's Board of Directors and Chief Executive Officer (CEO) or President are deemed to have the power to control the concern unless evidence is provided to show otherwise.

Example: In a corporation where no one stockholder has a block of voting stock sufficient to give it control or the power to control the concern, control instead rests in each member of the Board of Directors and the CEO or President. This means that any business controlled by a member of the Board and by the CEO or President is an affiliate of the business concern in question, unless the individual Board members and CEO or President can rebut this presumption.

## **2. Stock options, convertible securities, and agreements to merge** **(13 C.F.R. § 121.103(d))**

SBA treats each of these cases as though the rights granted have been actually exercised. Regulations give present effect to an agreement to merge (including an agreement in principle) or to sell stock. If these rights have been granted and they confer the power to control, affiliation exists.

*Example 1:* If Company A holds an option to purchase a controlling interest in Company B, the situation is treated as though Company A had exercised its rights and had become owner of the controlling interests in Company B. Company A and B are affiliates. In addition, all companies controlled by Company A will be considered affiliates of Company B.

*Example 2:* Company A and Company B are in discussion about a merger between the two of them. Both companies' representatives have met several times over the past two months. There is neither a formal nor informal agreement to merge, although merging -the two companies is their stated objective. Unless the two companies have an agreement to merge, SBA will not find affiliation between the two companies based on these open and continuing discussions of merger alone.

**3. Common management (13 C.F.R. § 121.103(e)).**

If one or more officers, directors, managing members, or general partners of a business controls the Board of Directors and/or the management of another business the businesses are affiliates. SBA usually finds affiliation in these examples:

*Example 1:* Members of Company A's Board of Directors occupy three out of five positions in Company B's Board of Directors. Company A has control of Company B and the two concerns are affiliated. In addition, all companies controlled by Company A will be considered affiliates of Company B.

*Example 2:* A member of Company A's Board of Directors has veto rights over the majority decisions of Company B's Board of Directors. By possessing such negative control, Company A has control of the Board of Directors of Company B and the two concerns are affiliated. In addition, all companies controlled by Company A will be considered affiliates of Company B.

**4. Identity of interest between individuals or businesses , including family members (13 C.F.R. § 121.103(f))**

Individuals or firms that have identical (or substantially identical) business or economic interests may be treated as though they are affiliated unless they can demonstrate otherwise. Family members, persons with common investments, or firms that are economically dependent through contractual (or other) relationships, are among those treated this way. However, individuals or firms may seek to demonstrate that no affiliation exists by providing convincing proof that apparently identical interests are, in fact, separate. Patterns of subcontracting, commingling of staff and/or facilities, and other veiled attempts to disguise the true nature of the relationship may evidence an identity of interest.

Example 1: Several officers of Company A are also officers of Company B. The two companies are in the same line of work and extensively subcontract with each other. The interrelationship between the two companies results in them acting as one, and therefore, the two are considered affiliates.

Example 2: Company A and B share office space and equipment in the same location and also share key employees. In addition, Company A has sent a substantial amount of business to Company B for each of the last three years. All this, taken together, is an indication that the two companies have combined their resources to each other's benefit, and therefore, are likely to be affiliated

Example 3: When three of four members of a concern's Board of Directors have investments in common with each other outside the concern and have also provided the concern with substantial financial assistance, they may be viewed as sharing an identity of interest. The three directors would be deemed to control the Board and to therefore also control the business. Each outside business that these three directors control would be an affiliate of the business concern in question.

Example 4: A husband and wife founded an accounting firm in 1974. Their daughter was a division head for two years in 2005-2007. In 2008, the daughter opened an office supply store using her own funds and a bank loan. Her parents purchase supplies from the daughter's store, and sales to her parents represent 10% of the daughter's revenues. Although the parents and daughter have business dealings, they are minimal in nature. There are no other business interactions between the daughter and her parents. If there are no other indicia of affiliation, SBA would find that affiliation due to family relationships is rebuttable.

**5. *Contractual relationships or economic dependency (13 C.F.R § 121.103(a),(f) and (g))***

A concern that is unlikely to be able to survive on its own or is economically dependent upon another person will probably be found to be affiliated with the concern(s) on which it is dependent.

Example 1: Company A performs subcontracts for Company B, and Company B accounts for 90% of Company A's revenues. Company A's existence depends on work from Company B and the two are deemed affiliates.

Example 2: Company A provides significant loans to Company B and guarantees other loans to Company B. Company B's over reliance of dependence on Company A's financial support (both direct and indirect) results in their affiliation.

*Example 3:* A loan between two businesses is not an arm's-length transaction and the terms and conditions of the loan demonstrate financial dependence by one business on the other. The two are deemed affiliates.

*Example 4:* Company A obtained a patent for a product it developed. It licenses the use of the product to Company B, and makes it available for other companies to obtain a license. No affiliation exists between Company A and Company B based solely on the licensing agreement.

### **CONCLUSION**

The above is an overview of some basic principles of affiliation as set forth in SBA's regulations and the Office of Hearings and Appeals rulings (see [http://www.sba.gov/aboutsba/sbaprograms/oha/OHADecisions/OHA\\_DECISIONS.html](http://www.sba.gov/aboutsba/sbaprograms/oha/OHADecisions/OHA_DECISIONS.html)) The reader must review all applicable regulations carefully before certifying a business's size status. For further information or questions, please contact the SBA Size Specialist who is responsible for the area in which the company is located. Below is a listing of Size Specialists and the geographical areas they serve.

WHOM TO CONTACT FOR SIZE DETERMINATION INFORMATION?
<p><b>Government Contracting Area Office I, Boston, MA</b> Janette Fasano, Director, (617) 565-5622</p> <p>Contact: Paul Taravella, (631) 454-0759 ext. 224 Sandy Liu, (631) 454-0750 Malinda Chen, (631) 454-0750</p> <p><b><u>AREA I</u></b> = CT. MA. ME. NH. NJ. NY. RI. VT. &amp; Puerto Rico &amp; the Virgin Islands</p>
<p><b>Government Contracting Area Office II, Philadelphia, PA</b> David Loines, Director, (202) 205-7311 -----</p> <p>Contact: Vince Mazzotta, (215) 580-2809 Carol Decker, (717)-605-7525</p> <p><b><u>AREA II</u></b> = DC. DE. MD. PA. VA. WV.</p>

**Government Contracting Area Office III, Atlanta, GA**

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**AREA III = AL. FL. GA. KY. MS. NC. SC. TN.**

**Government Contracting Area Office IV, Chicago, IL**

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**AREA IV = IN. IA. IL. KS. MI. MN. MO. ND. NE. OH. SD. WI.**

**Government Contracting Area Office V, Dallas/Fort Worth, TX**

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**AREA V = AR. CO. LA. NM. OK. TX.**

**Office of Government Contracting VI, San Francisco, CA**  
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**Area VI = AK, AZ, CA, HI, ID, MT, NV, OR, UT, WA, WY, GU**