

# Who's Counting? A Closer Look at SBA Affiliation Rules and Size Standards Under the CARES Act

April 10, 2020

---

The CARES Act limits eligibility for Paycheck Protection Program (PPP) and Economic Injury Disaster Loans (EIDL) to borrowers with 500 or fewer employees or those who would otherwise qualify under the existing definition of a "small business concern" under Small Business Administration (SBA) rules. Though this headcount rule seems simple, in practice it requires a complex analysis of rules and exceptions regarding whether borrowers must consider in their headcount employees of all affiliates.

If a borrower has more than 500 employees, as an alternative, it may look to existing SBA employee-based or revenue-based size standards corresponding to an applicant's primary industry to see if it qualifies. Additionally, as clarified by the Treasury Department's PPP Loans FAQ issued on April 6, borrowers may also qualify under the SBA's "alternative size test" originally promulgated in 2010.[1] This advisory describes the affiliation rules and non-headcount alternatives at play in determining PPP and EIDL eligibility.

## **Counting All Employees**

As a first principle, in determining the number of a borrower's employees, the SBA counts all individuals employed by the borrower on a full-time, part-time, temporary or other basis (and volunteers are excluded).[2] Additional guidance regarding counting employees for these purposes is included in our separate client advisory regarding the Paycheck Protection Program which can be found [here](#).

## **Affiliation Rules**

For SBA loan eligibility purposes, unless the borrower falls under an exception, it must include in its employee headcount all of its affiliates' employees. The CARES Act waives the affiliation rules for borrowers: (i) assigned NAICS code 72 (accommodation and food services), (ii) that are franchises listed in the [SBA franchise directory](#) or (iii) receiving financial assistance from an SBIC licensed entity. There are also certain existing exceptions to SBA affiliation rules which apply to the PPP program included in [13 CFR 121.103\(b\)](#), for example, businesses owned and controlled by Indian tribes. In addition, the SBA's Interim Final Rule of April 3, 2020, provides that faith-based organizations are also exempt from the affiliation rules.

Importantly, each borrower is responsible for determining if any entities are its affiliates and determining the employee headcount of the borrower and its affiliates. Under the CARES Act, lenders are permitted to rely on borrowers' certification in their loan applications.[3]

The affiliation rules are set forth in the SBA’s existing regulations rather than in the CARES Act itself. See 13 CFR § 121.301(f). In general, affiliation is broadly defined, and there are several specific categories of affiliation -- but the overarching principle behind each test is whether there is common control among parties. If affiliation is found, a borrower’s aggregate headcount across all affiliates may render them ineligible for a PPP or EIDL loan even if the individual borrower itself has less than 500 employees. The various scenarios where affiliation may be found under the affiliation rules are discussed below.

**Categories of Affiliation**

1. **Affiliation based on ownership.** For determining affiliation based on equity ownership, a borrower is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50 percent of the borrower’s voting equity. If no individual, concern, or entity is found to control, SBA will deem the board of directors or 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 borrower. The 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 to otherwise block action by the board of directors or shareholders. Such minority consent or veto rights are differentiated in OHA case law between those giving the shareholder control over day-to-day operations of the applicant (e.g., payment of dividends or distributions, incurrence of debt, hiring and firing executives, etc.) versus rights over extraordinary corporate actions (e.g., sale of the company or substantially all of its assets, amendment of governing documents, increasing or decreasing the size of the board, etc.). Those consent rights over day-to-day operations lend themselves to a finding of affiliation whereas those over extraordinary corporate actions do not. A detailed analysis of any and all such consent rights is required to determine if affiliation exists, particularly for borrowers with private equity or venture capital investors who frequently hold such rights. The table below, while not exhaustive, sets forth examples of the types of actions that have been found to be indicative of a finding of control.

If a minority shareholder irrevocably waives or relinquishes such control rights, it will no longer be an affiliate of the business (assuming no other relationship that triggers the affiliation rules).<sup>[4]</sup>

<b>Day-to-day operations control rights (lead to affiliation finding)</b>	<b>Extraordinary control rights (do not lead to affiliation finding)</b>
<ul style="list-style-type: none"> <li>• Payment of dividends or distributions</li> <li>• Incurrence of debt</li> <li>• Hiring and firing officers and executives</li> <li>• Entering into contracts</li> </ul>	<ul style="list-style-type: none"> <li>• Sale of all or substantially all assets or a merger transaction</li> <li>• Mortgage or encumber all or substantially all assets</li> <li>• Entry into a substantially</li> </ul>

<ul style="list-style-type: none"> <li>• Determining employee compensation</li> <li>• Establishing or amending employee equity incentive plan</li> <li>• Changing the company's budget</li> <li>• Amending or terminating leases</li> <li>• Encumbering assets</li> <li>• Bringing or defending lawsuits</li> <li>• Maintaining company records</li> </ul>	<p>different business</p> <ul style="list-style-type: none"> <li>• Increasing, decreasing, or reclassifying authorized capital</li> <li>• Changing the amount or character of capital contributions</li> <li>• Issuing additional capital stock or equity</li> <li>• Amending governing documents</li> <li>• Addition or withdrawal of a member or shareholder</li> <li>• Increase or decrease size of board</li> <li>• Dissolution</li> <li>• Filing for bankruptcy</li> </ul>
--	---

1. **Affiliation arising under stock options, convertible securities, and agreements to merge.** Affiliation can also arise from circumstances that have a "present effect on the power to control a concern." The SBA treats all such items as though the rights have already been exercised unless such rights are subject to conditions precedent that are incapable of being fulfilled (or where the probability of exercise of such rights is extremely remote). For example, if an entity held a freely exercisable option that would permit it to gain control of the borrower upon exercise of the option, the option holder would be treated as the borrower's affiliate under the SBA affiliation rules.
1. **Affiliation based on management.** Affiliation among business concerns arises where the CEO/President/other officers or management of the borrower also controls the management of one or more other business concerns. Affiliation also arises where a single individual, concern, or entity that controls the board of directors or management body of the borrower also controls the board of another business. Finally, affiliation may also arise through management agreements with a common manager.
1. **Affiliation based on identity of interest.** Affiliation may arise among two or more individuals or firms with an identity of interest. Individuals or firms that have identical or substantially identical business or economic interests (such as close relatives, 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, though such a finding is rebuttable. This factor is an important consideration for families with multiple businesses.

1. **Affiliation based on the newly organized concern rule.** Affiliation may arise where current or former officers, directors, owners of a 20 percent interest or greater, managing members, or persons hired to manage day-to-day operations of one concern organize a new concern in the same or related industry or field of operation, and serve in similar control positions, and there are direct monetary benefits flowing from the new concern to the original concern.
1. **Affiliation based on totality of the circumstances.** SBA may consider all connections between the borrower and a possible affiliate even if no single factor is sufficient to constitute affiliation. SBA may find affiliation on a case-by-case basis where there is clear and convincing evidence based on the totality of the circumstances.
1. **Affiliation based on franchise agreements.** The restraints imposed on a franchisee by its franchise agreement generally will not be considered in determining whether the franchisor is affiliated with an applicant franchisee provided that the applicant franchisee has the right to profit from its efforts and bears the risk of loss commensurate with ownership.

### **SBA's employee and revenue-based industry standards**

A borrower who does not qualify for SBA loans because it (with any affiliates) has more than 500 employees may still qualify if it meets the SBA employee-based or revenue-based size standards corresponding to its primary industry, which can be found [here](#).

Notably, certain manufacturing and heavy industry categories have higher headcounts thresholds (e.g., 1,000 or 1,500) – though a borrower falling into these categories must still include any employees of its affiliates.

### **Alternative Size Standard**

The “alternative size standard” originally promulgated in 2010 pursuant to the Small Business Jobs Act may also be used to determine if a borrower can qualify for SBA loans.

Under the “alternative size standard”, if a business can show that its (i) maximum tangible net worth is not more than \$15 million and (ii) average net income after Federal income taxes (excluding any carry-over losses) for the two full fiscal years before the date of the application is

not more than \$5 million, then it may qualify as a small business concern eligible to receive loans under the PPP and EIDL irrespective of its number of employees.

Note, however, that the SBA rules regarding affiliation would still apply to a business that qualifies under the alternative size standard. This means that businesses need to take into account the finances (rather than number of employees) of any of its affiliates when calculating whether it qualifies under the alternative size standard unless there is an exception or exclusion to such affiliation rules (as described above).

Originally meant as a temporary size standard until the SBA promulgated a permanent size standard (which has not occurred), the alternative size standard may provide a path to becoming eligible for a PPP loan to businesses with over 500 employees with significant indebtedness and measured net income, who might otherwise not otherwise qualify.

## **Help Counting**

Given the complexities described above and valuable relief available to borrowers who successfully navigate these issues, businesses should consider obtaining professional assistance in analyzing the complex web of existing affiliation rules and employee head-count alternatives, as well as newly-crafted CARES Act provisions, which are all at play in connection with SBA loan eligibility. Some borrowers who may appear to be ineligible based on news headlines and surface-level coverage of the CARES Act may still find pathways to eligibility through a deeper analysis of SBA rules as they pertain to a particular business's facts and circumstances.

[1] FAQ Question 2.

[2] 13 CFR § 121.106(a).

[3] FAQ Question 4.

[4] FAQ Question 6.