What Counts Towards 500? Employee Calculation and Affiliation Rules Under SBA Regulations

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THREE KEY TAKEAWAYS:

1. When determining if a business has fewer than 500 employees, the SBA considers the average number of employees for each pay period for the preceding 12 months. Part-time and temporary employees are counted the same as full-time employees.

2. Under SBA regulations, certain businesses may be required to include in the total number of employees the employees of each business for which affiliation exists. Affiliation rules are waived for businesses with a NAICS code beginning with 72 (Accommodation and Food Services), franchises with an SBA franchise identifier code, and businesses receiving assistance from an SBIC. The SBA has also created a religious exemption to the affiliation rules for certain faith-based organizations.

3. Affiliation exists when one business controls or has power to control the other, or a third party controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists.

The Small Business Administration (“SBA”) loan programs have become a household name over the last few weeks following the passage of two key pieces of COVID-19 Response legislation: the Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020; and the Coronavirus
Aid, Relief, and Economic Security Act ("CARES Act"). As a result of the worldwide pandemic caused by COVID-19, these Acts have greatly expanded access to two important disaster relief programs to be administered under the SBA, the Economic Injury Disaster Loan ("EIDL") and the newly created Paycheck Protection Program Loan ("PPP Loan"). One key eligibility requirement for these loans is that the business employ no more than 500 employees, or, if applicable, the size standard in number of employees established by SBA for the industry in which the business operates. On April 2, 2020, the SBA published the Interim Final Rule regarding the PPP Loan program detailing the general requirements and on April 3, 2020 published a second Interim Final Rule regarding the affiliation rules under the PPP Loan program. The SBA’s affiliation rules may require a business to count employees of an affiliate business towards the employee cap for SBA loans.

**How does SBA calculate the number of employees?**

In determining a business’ number of employees, SBA counts all individuals employed on a full-time, part-time, or other basis. This includes employees obtained from a temporary employee agency, professional employer organization, or leasing business. The method used by the SBA for determining a business' size based on number of employees includes the following principles:

- The average number of employees of the business is used based upon numbers of employees for each of the pay periods for the preceding completed 12 calendar months.
- Part-time and temporary employees are counted the same as full-time employees.
- If a business has not been in business for 12 months, the average number of employees is used for each of the pay periods during which it has been in business.
- The average number of employees of a business with affiliates is calculated by adding the average number of employees of the business with the average number of employees of each affiliate.
- The employees of a former affiliate are not counted if affiliation ceased before the date used for determining size.

**What are SBA size standards and how are they applicable to SBA loan programs?**
SBA’s size standards govern whether a business is eligible for loans administered by the SBA, such as the EIDL, PPP Loan, and other Business Loan programs under 7(a), 7(m), and 504 (“other Business Loan programs”). Size standards have been established for types of economic activity, or industry, generally under the North American Industry Classification System (NAICS). The NAICS code online search tool is available at: https://www.naics.com/search/.

A business applying for an EIDL, PPP Loan, and/or other Business Loan programs must satisfy two criteria, unless the affiliation rules are not applicable:

• The size of the business alone must not exceed the size standard designated for the industry in which the applicant is primarily engaged; and
• The size of the applicant combined with its affiliates must not exceed the size standard designated for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher. These size standards are set forth in 13 CFR 121.201.

What is the Affiliation Rule and how does it affect Size Standards?

Under SBA regulations, certain affiliation rules are considered when calculating the number of employees of a business to determine whether it meets the SBA size standards for a small business. This is important in determine whether a business is “small” (i.e., less than 500 employees) which is required to be eligible for certain loan programs (such as the EIDL, PPP Loan, and other Business Loan programs). The CARES Act waives affiliation rules for businesses applying for a PPP Loan as it applies to the following businesses:

• All businesses with fewer than 500 employees which are assigned a NAICS code beginning with 72 (Accommodation and Food Services) as of the date the PPP Loan is disbursed;
• Any business operating as a franchise that is assigned a franchise identifier code by SBA; and
• Any business that receives financial assistance from small business investment companies (SBICs).

The SBA, through the second Interim Final Rule published on April 3, 2020, has also created a religious exemption in which the relationship of a faith-
based organization to another organization is not considered to be in affiliation with the other organization if the relationship is based on a religious teaching or belief or otherwise constitutes a part of the exercise of religion.

For other businesses, and for all other SBA loan options besides the PPP Loan, the affiliation rules still apply and an applicant must meet the size standards in order to be eligible.

How does SBA determine Affiliation?

Under the SBA regulations, affiliation exists when one business controls or has power to control the other, or a third party controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists. Control may arise through ownership, management, previous relationships with or ties to another business, and contractual relationships. Control may be affirmative or negative. Affiliation between businesses may be found where an individual, concern, or entity exercises control indirectly through a third party.

In determining whether affiliation exists, SBA will consider the totality of the circumstances, and may find affiliation even though no single factor is sufficient to constitute affiliation. If SBA determines that affiliation exists, then SBA will count the number of employees for the business whose size is at issue combined with the number of employees for all of its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit. The rules and regulations surrounding affiliations, therefore, become a key factor in determining the employee size for businesses seeking assistance from an SBA loan program, including EIDL, PPP, and other Business Loan programs. For applicants in SBA's Business Loan, Disaster Loan, and Surety Bond Guarantee Programs, the size standards and bases for affiliation are set forth in 13 CFR 121.301.

What are the Grounds that the SBA considers for Affiliation under the PPP Loan program?

- **Stock Ownership**
  - For determining affiliation based on equity ownership, a concern is 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 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 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.
• **Stock options, convertible securities and agreements to merge**
  • In determining size, SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern.
  • SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.
  • However, SBA will not give present effect to:
    • agreements that are open or merely continue negotiations about a possible merger;
    • options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under state or Federal law, or where the probability of the transaction occurring is how to be extremely remote; or
    • individuals’, concerns’, or other entities’ ability to divest all or part of their ownership in order to avoid a finding of affiliation.
• **Common Management**
  • Affiliation arises where the CEO or President of the applicant concern (or other officers, managing members, or partners who control the management of the concern) also controls the management of one or more other concerns.
  • Affiliation also arises where a single individual, concern, or entity that controls the Board of Directors or management of one concern also controls the Board of Directors or management of one of more other concerns.
  • Affiliation also arises where a single individual, concern or entity controls the management of the applicant concern through a management agreement.
• **Identity of interest between individuals or businesses, including family members**
• Affiliation arises when there is an identity of interest between close relatives with identical or substantially identical business or economic interests (such as where the close relatives operate concerns in the same or similar industry in the same geographic area).
• Where SBA determines that interests should be aggregated, an individual or firm may rebut that determination with evidence showing that the interests deemed to be one are in fact separate.
• “Close relatives” is defined as a spouse, parent, child, sibling or spouse of any such person.

What are the Exceptions to Affiliation Rules (13 CFR 121.103(b))?

• Business concerns owned in whole or substantial part by investment companies licensed, or development companies qualifying, under the Small Business Investment Act of 1958, as amended, are not considered affiliates of such investment companies or development companies.
• Business concerns owned and controlled by Indian Tribes, Alaska Native Corporations (ANCs) organized pursuant to the Alaska Native Claims Settlement Act, Native Hawaiian Organizations (NHOs), Community Development Corporations (CDCs) or wholly-owned entities of Indian Tribes, ANCs, NHOs, or CDCs are not considered affiliates of such entities. Business concerns owned and controlled by Indian Tribes, ANCs, NHOs, CDCs, or wholly-owned entities of Indian Tribes, ANCs, NHOs, or CDCs, are not considered to be affiliated with other concerns owned by these entities because of their common ownership or common management. In addition, affiliation will not be found based upon the performance of common administrative services so long as adequate payment is provided for those services. Affiliation may be found for other reasons.
• Business concerns which are part of an SBA-approved pool of concerns for a joint program of research and development or for defense production as authorized by the Small Business Act are not affiliates of one another because of the pool.
• Business concerns which lease employees from concerns primarily engaged in leasing employees to other businesses or which enter into a co-employer arrangement with a Professional Employer Organization (PEO) are not affiliated with the leasing company or PEO solely on the basis of a leasing agreement.
For financial, management or technical assistance under the Small Business Investment Act of 1958, as amended, an applicant is not affiliated with the investors listed in paragraphs (b)(5)(i) through (vi) of this section.

- Venture capital operating companies, as defined in the U.S. Department of Labor regulations found at 29 CFR 2510.3–101(d);
- Employee benefit or pension plans established and maintained by the Federal government or any state, or their political subdivisions, or any agency or instrumentality thereof, for the benefit of employees;
- Employee benefit or pension plans within the meaning of the Employee Retirement Income Security Act of 1974, as amended (29 U.S.C. 1001, et seq.);
- Charitable trusts, foundations, endowments, or similar organizations exempt from Federal income taxation under section 501(c) of the Internal Revenue Code of 1986, as amended (26 U.S.C. 501(c));
- Investment companies registered under the Investment Company Act of 1940, as amended (1940 Act) (15 U.S.C. 80a–1, et seq.); and
- Investment companies, as defined under the 1940 Act, which are not registered under the 1940 Act because they are beneficially owned by less than 100 persons, if the company’s sales literature or organizational documents indicate that its principal purpose is investment in securities rather than the operation of commercial enterprises.

A firm that has an SBA–approved mentor-protégé agreement authorized under 13 CFR 124.520 or 13 CFR 125.9 of this chapter is not affiliated with its mentor firm solely because the protégé firm receives assistance from the mentor under the agreement. Similarly, a protégé firm is not affiliated with its mentor solely because the protégé firm receives assistance from the mentor under a federal mentor-protégé program where an exception to affiliation is specifically authorized by statute or by SBA under the procedures set forth in 13 CFR 121.903. Affiliation may be found in either case for other reasons as set forth in this section.

The member shareholders of a small agricultural cooperative, as defined in the Agricultural Marketing Act (12 U.S.C. 1141j), are not considered affiliated with the cooperative by virtue of their membership in the cooperative.
• These exceptions to affiliation and any others set forth in 13 CFR 121.702 apply for purposes of SBA's SBIR and STTR programs.
• In the case of a solicitation for a bundled contract, a small business contractor may enter into a Small Business Teaming Arrangement with one or more small business subcontractors and submit an offer as a small business without regard to affiliation, so long as each team member is small for the size standard assigned to the contract or subcontract. The agency shall evaluate the offer in the same manner as other offers with due consideration of the capabilities of the subcontractors.