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Congress of the United States

U.S. House of Representatives

Committee on Small Business

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To: Members, Committee on Small Business
From: Committee Staff
Date: February 27, 2013
Re: What is a Small Business for Purpose of Federal Contracting?

This is one in a series of memorandum prepared by the staff of the Committee on Small Business to explain the key concepts and programs integral to government contracting for small businesses. As such, it is not tied to one particular hearing, but serves as a basis for hearing memoranda related to government contracting.

While each of the small business contracting programs has its own specific requirements, each requires that the program participant be small.[1] However, determining whether a firm is indeed a small business is not always simple. Doing so first requires ascertaining who may decide whether a firm is small. Next, it requires that the arbiters of size ascertain whether the firm meets the relevant size standard, whether the firm is independently owned and controlled, and whether any special exceptions apply. The following guide attempts to explain the rules that govern these determinations, and then explain how the Small Business Administration (SBA) applies these rules.

I. Who Decides Whether a Company is a Small Business?

Most of the 360,000 small businesses seeking contracts from the federal government self-certify as small.[2] If a firm is simply certifying as a small business, it certifies its size at the time of

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[1] While this memorandum attempts to provide an overview of size standards and size determinations, it is by no means comprehensive and should be relied upon primarily for federal contracting programs. Many statutes provide alternate definitions of small – for example, Section 1421 of the Patient Protection and Affordable Care Act defines a small business as one with fewer than 25 full-time equivalent employees and average wages below $50,000. Pub. Law No. 111–148 (2010). There is variation even within SBA, as the Office of Advocacy uses a 500 employee size standard, *see* http://www.sba.gov/sites/default/files/FAQ_Sept_2012.pdf, and the Small Business Investment Company program has an alternate size standard based on a net worth of $18 million and average net income of $6 million. 13 C.F.R. § 121.301. Therefore, the Committee recommends that if a reader requires a specific size standard for a specific program, additional research should be conducted. *See also* Committee on Small Business, "Small Business Act Programs for Small Federal Contractors" (2013) available at http://smallbusiness.house.gov/uploadedfiles/small_business_act_programs_for_small_federal_contractors.pdf (hereinafter Small Business Act Programs) for information on the other federal contracting programs.

[2] There are approximately 360,000 small businesses registered to participate in federal contracting through SBA's Dynamic Small Business Search tool, www.dsbs.sba.gov. Of these, 8,269 are certified as 8(a) Business Development (8(a) BD) program participants; 32,911 as Small Disadvantaged Businesses (SDBs), (cont'd)

offer[3] through the System for Award Management (SAM).[4] If another offeror or the contracting officer (KO) believes that the successful bidder is not actually a small business, SBA's size specialists and Office of Hearings and Appeals (OHA) will adjudicate the firm's size.[5] Initial appeals on size are addressed to the appropriate size specialist, with appeals from those decisions heard by OHA.[6]

This process is more complex for SBA's other federal contracting programs. Each program has its own rules for determining whether a firm is small and meets the additional requirements of each specific program. The certification and appeal process will be briefly discussed here, but for a more comprehensive discussion and explanation of the various small business contracting programs, please see the Committee memorandum, "Small Business Act Programs for Small Federal Contractors."

SBA's Service-Disabled Veteran-Owned Small Business (SDVOSB) program also uses a self-certification process similar to that of small business certification. For purposes of contracting with any agency other than the Department of Veterans Affairs (VA), a SDVOSB concern must certify its status in SAM, and is subject to protest by other interested parties, the KO, or the SBA.[7] In contrast, pursuant to the Historically Underutilized Business Zone (HUBZone)[8] program, a small business must apply on the SBA website, recertify every three years, certify through SAM, and qualify as a HUBZone small business concern at the time of offer and the time of award.[9] SBA has the authority to conduct program examinations of firms to verify their continued eligibility[10] or to hear appeals from contracting officers or other offerors at the program office level and at OHA regarding a firm's size[11] or eligibility for the program.[12]

The 8(a) Business Development (8(a)) program requires certification by SBA, with annual reviews throughout the nine years of program participation to ensure a firm's continued eligibility.[13] Once SBA has admitted a firm to the 8(a) program, its eligibility for the program can only be challenged by SBA.[14] However, whether or not the 8(a) firm is eligible for a particular contract based on the the size of the firm may be challenged to OHA by the SBA, KO

5,646 as Historically Underutilized Business Zone (HUBZone) program participants; 12,779 as Service Disabled Veteran Owned Small Businesses (SDVOSB); and 25,901 a Women-Owned Small Business (WOSB) program participants. *Id.* This does not account for the fact that there is significant overlap between the programs; for example, there are 2,520 HUBZone program participants who are also SDB or 8(a) BD companies.

[3] 13 C.F.R. § 121.404.

[4] *Available at* www.sam.gov.

[5] 13 C.F.R. § 121.1001.

[6] *Id.*

[7] *Id.* at § 125.25. VA has its own separate certification program for SDVOSBs seeking contracts with VA.

[8] HUBZone are defined as any area located in a qualified census tract, qualified nonmetropolitan county, within the external boundaries of an Indian reservation or an area subject to the Base Realignment and Closure Act (BRAC). 15 U.S.C. § 632(p).

[9] 13 C.F.R. § 126.300.

[10] *Id.* at § 126.401.

[11] *Id.* at § 121.1001.

[12] SBA, the KO, or any other interested party may protest the apparent successful offeror's qualified HUBZone SBC status. *Id.* at § 126.801.

[13] *Id.* at § 124.201, 124.601.

[14] 13 C.F.R. § 124.517.

or an interested party if the contract is competitively awarded.[15] The Small Disadvantaged Business (SDB) program allows firms to self-certify to either the procuring agency or to a third-party certifier, although all 8(a) firms are automatically considered SDBs.[16]

An amalgam of the other certification programs, the Women-Owned Small Business (WOSB) and Economically Disadvantaged Women-Owned Small Business (EDWOSB) programs require that firms must register and self-certify as such in SAM, and then provide the KO with supporting documents.[17] Additionally, the firm must either be certified by an SBA-approved third party certifier or provide supporting documentation to the Program Repository.[18] While the KO is charged with reviewing the initial file, the KO or another offeror may challenge the firm's status to SBA's size specialists with appeals heard by OHA.[19]

II. SBA's Size Standards

Having ascertained which parties must make the determination as to whether a firm is small, the memorandum now turns to the question of size standards. Section 3(a)(1) of the Small Business Act ("The Act"), 15 U.S.C. § 632(a)(1), provides, in pertinent part:

> [a] small business concern ... shall be deemed to be one that is independently owned and operated and which is not dominant in its field of operation.

The Act does not define the terms "independently owned and operated" or "dominant in its field of operation." Instead, the Administrator is authorized to:

> specify detailed definitions or standards by which a business concern may be determined to be small for purposes of this Act or *any other Act*.

15 U.S.C. § 632(a)(2)(A) (emphasis added). The Administrator is authorized to consider number of employees, dollar volume of business,[20] net worth,[21] net income, other factors, or any combination of those factors. In short, Congress has granted the Administrator substantial discretion in the factors that will be utilized in calculating the size of a small business. The SBA's discretion is tempered by the fact that any size standard determined by the factors set forth in § 3(a)(2) of the Small Business Act must meet one overarching principle – the business must be independently owned and operated and not dominant in its field.

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[15] *Id.*
[16] *Id.* at § 124.1003.
[17] *Id.* at § 127.300.
[18] *Id.* at § 127.600.
[19] *Id.*
[20] Current SBA size standards use gross revenue as a measure of dollar volume. Nothing in the Act requires reliance on dollar volume and other measures could be used.
[21] The net worth standard is used, for among other purposes, to determine eligibility for investments made by small business investment companies, loans made pursuant to Title V of the Small Business Investment Act of 1958, and for participation in the program established by § 8(a) of the Small Business Act.

The SBA took the authority granted by Congress and developed size standards for individual categories of small businesses. Originally, the size standards were developed based on four-digit classifications of each type of business using Standard Industrial Classifications or SIC codes. When the federal government moved to the more exact North American Industrial Classification System or NAICS for data collection, the SBA modified its size standards to fit the new NAICS codes.

Historically, the SBA utilized two distinct standards for determining whether a business was not dominant in its field. Manufacturers, distributors, and certain utilities were measured by the number of employees. All other businesses, both services and retail establishments, are calculated by the gross revenue of the firm. The two standards never overlapped. If the SBA determined that a particular industry was measured by gross revenue, the SBA also did not impose an employee threshold. Thus, the SBA created a bright line standard in which a business either was required to enumerate employees or tabulate gross revenue.[22]

SBA formalized its process for establishing size standards when it published a white paper entitled "Size Standards Methodology" detailing the five primary industry factors considered when establishing size standards.[23] An in-depth explanation of the current process would be quite lengthy, so this memorandum attempts to summarize the process. However, the full methodology is available at www.sba.gov/size.

The five factor analysis begins by examining four economic characteristics of the industry: average firm size, startup costs and entry barriers, industry competition, and distribution of firms by size.[24] Additionally, and perhaps most relevant here, SBA's fifth factor examines the impact of an existing size standard as well as the potential impact of a size standard revision on SBA's federal contract assistance to small businesses. After considering the primary evaluation factors, SBA will then assess any industry specific factors, such as technological changes and industry growth trends. This methodology supports the Committee's longstanding view of how size-standards should be developed: granular analysis of specific industry characteristics. After the analysis is complete, SBA then proposes what it believes to be the correct size standard. Final size standards are selected after input from the public through notice and comment rulemaking.

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[22] Revenue-based size standards are based on actual receipts, meaning total or gross income plus cost of goods sold as defined by the Internal Revenue Service tax return forms, and does not include net capital gains or losses; taxes collected for and remitted to a taxing authority if included in gross or total income, such as sales or other taxes collected from customers and excluding taxes levied on the concern or its employees; proceeds from transactions between a concern and its domestic or foreign affiliates; and amounts collected for another by a travel agent, real estate agent, advertising agent, conference management service provider, freight forwarder or customs broker. 13 C.F.R. § 121.104. Employee-based size standards are based on the total number of employees per pay period over the course of a year, divided by the number of pay periods, regardless of whether the employees are full-time, part-time, or employed on any other basis, such as a temporary employee agency, professional employee organization or leasing concern. 13 C.F.R. § 121.106.

[23] 74 Fed. Reg. 53940 (October 21, 2009).

[24] 13 C.F.R § 121.102(a). Data for this analysis is drawn from the Economic Census, and County Business Patterns, each published by the U.S. Census Bureau, as well as the U.S. Bureau of Labor Statistics' Quarterly Census of Employment and Wages and Business Employment Dynamics, the Risk Management Association's Annual Statement Studies, the Federal Procurement Data System, and SBA's own lending data.

Currently, there are roughly 1100 industrial classifications for which the SBA has implemented 38 size separate size standards. These standards are based on either the number of employees, gross revenue, or other factors[25] that the SBA believes reflect the correct size of the business. However, to simplify the size standards, SBA has proposed selecting future size standards from a limited number of fixed size standards. The eight revenue based standards will be $5.0 million, $7.0 million, $10.0 million, $14.0 million, $19.0 million, $25.5 million, $30.0 million, and $35.5 million, and the eight employee based standards will be 50 employees, 100 employees, 150 employees, 200 employees, 250 employees, 500 employees, 750 employees, and 1,000 employees. The SBA will transition to these size standards over the course of five years, as it conducts a systematic review of all its size standards, and the current proposed rule is an important first step in this transition.[26]

Thus, for a firm to be considered a small business, it must first demonstrate that it is at or below the relevant size standard established by SBA. While each of the 1100 plus industries have their own size standards, enumerated in SBA's regulations, a few general rules apply:[27]

- Manufacturing and mining industries will have a size standard of 500 employees, while other industries will have a size standard of $7 million in average annual receipts;[28]
- Construction tends to have size standard of $33.5 million for general contractors, $14 million for specialty contractors, $7 million for land subdivision, and $20 million for dredging;[29]
- Professional service size standards tend to be higher than other services contracts, with most computer programming, data processing and system design having a $25.5 million standard, some information technology (IT) services standards veer as high as $35.5 million, and IT value added resellers have a size standard of 150 employees.[30] However, architectural and engineering services tend to have lower size standards of $7 million and $14 million, respectively.[31]

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[25] For example, asset size is used to determine whether a bank is small.

[26] Pursuant to the Small Business Jobs Act of 2010, P.L. 111–240 (Sept. 27, 2010), SBA must conduct a detailed review of all size standards and to make appropriate adjustments to reflect market conditions, and at least one-third of all size standards must be reviewed every 18-months.

[27] 13 C.F.R. § 121.201 provides the definitive list of size standards.

[28] *Id.*

[29] *Id.*

[30] *Id.* at footnote 18 states that, "An Information Technology Value Added Reseller provides a total solution to information technology acquisitions by providing multi-vendor hardware and software along with significant services. Significant value added services consist of, but are not limited to, configuration consulting and design, systems integration, installation of multi-vendor computer equipment, customization of hardware or software, training, product technical support, maintenance, and end user support. For purposes of Government procurement, an information technology procurement classified under this industry category must consist of at least 15% and not more than 50% of value added services as measured by the total price less the cost of information technology hardware, computer software, and profit. If the contract consists of less than 15% of value added services, then it must be classified under an NAICS manufacturing industry. If the contract consists of more than 50% of value added services, then it must be classified under the NAICS industry that best describes the predominate service of the procurement. To qualify as an Information Technology Value Added Reseller for purposes of SBA assistance, other than for government procurement, a concern must be primarily engaged in providing information technology equipment and computer software and provide value added services which account for at least 15% of its receipts but not more than 50% of its receipts."

[31] 13 C.F.R. § 121.201.

- Wholesale companies have 100 person size standard, except for certain federal contracts for nonmanufacturers where the size standard is 500 employees.[32]

While knowing the relevant size standard is the first step to understanding whether a firm is small, it is by no means definitive. Therefore, this memorandum now turns to the other key factors in determining a firm's size.

III. Ownership and Control

Once the appropriate size standard is determined, the question becomes one of defining the entity to which the size standard will apply. While this may seem a straightforward inquiry, it is actually the area that provides the greatest pitfalls when determining the size of a business. SBA's defines a "business concern or concern" as one that is "organized for profit, with a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor."[33] SBA does not dictate the corporate form of a concern, except to say that "where the form is a joint venture there can be no more than 49 percent participation by foreign business entities in the joint venture."[34] However, SBA will consider what otherwise appears to be separate concerns to be one entity for the purpose of assessing the concern's size if SBA finds the concerns to be affiliated.

Affiliation is SBA's way of adhering to the statutory principle that a small business must be "independently owned and operated."[35] Otherwise, large corporations could simply create subsidiaries that meet the size standards previously discussed. Therefore, SBA finds that "concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both."[36] To better understand the concept of affiliation, this memorandum first enumerates the general principles governing affiliation and then addresses the general exceptions to affiliation. Finally, it will discuss the seven most common reasons for a finding of affiliation.

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[32] 13 C.F.R. § 406(b) states that, "(1) A firm may qualify as a small business concern for a requirement to provide manufactured products or other supply items as a nonmanufacturer if it: (i) Does not exceed 500 employees; (ii) Is primarily engaged in the retail or wholesale trade and normally sells the type of item being supplied; (iii) Takes ownership or possession of the item(s) with its personnel, equipment or facilities in a manner consistent with industry practice; and (iv) Will supply the end item of a small business manufacturer, processor or producer made in the United States, or obtains a waiver of such requirement pursuant to paragraph (b)(5) of this section."

[33] 13 C.F.R. § 121.102. However, an agricultural cooperative may qualify as a small business if it is an "association (corporate or otherwise) acting pursuant to the provisions of the Agricultural Marketing Act (12 U.S.C.A. 1141j) whose size does not exceed the size standard established by SBA for other similar agricultural small business concerns. A small agricultural cooperative's member shareholders are not considered to be affiliates of the cooperative by virtue of their membership in the cooperative. However, a business concern or cooperative that does not qualify as small under this part may not be a member of a small agricultural cooperative." *Id.*

[34] *Id.*

[35] 15 U.S.C. § 632(a)(1).

[36] 13 C.F.R. § 121.103(a).

a. General Principles of Affiliation

There are six general principles of affiliation, each of which will now be addressed. The first principle, as previously discussed, states that firms are affiliated if either has the power to control the other, or if a third party has the ability to control them both.[37] Importantly, the control does not need to be exercised, if the power to exercise control exists.[38]

To determine whether the ability to control exists, the second principle of affiliation states that SBA will examine "factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships."[39] While ownership has its roots in statute, management, previous relationships and contracts are used to assess whether the firm is independently operated. For example, a firm will not be treated as a separate business concern if a substantial portion of its assets are the same as those of a predecessor entity, or if the firm shares liabilities with a predecessor entity.[40] Thus, a firm cannot simply reform itself and restart the clock for purposes of calculating receipts or employees.

The third principle of affiliation is that control may be affirmative or negative.[41] This harkens back to the first principle that states that control need not be exercised to exist.[42] SBA expands on its prior statement by explaining that, "[n]egative control includes, but is not limited to, instances 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."[43] Thus, this principle attempts to prevent scenarios where ownership itself may make a firm appear independent, but operating agreements or other entanglements prevent the firm from acting contrary to the interests of a minority owner. The fact that a minority owner exists does not necessarily mean the firm is other-than-small, simply that companies controlled by the minority owner must be added to the size of the company in question before the final size is determined.

Fourth, "[a]ffiliation may be found where an individual, concern, or entity exercises control indirectly through a third party."[44] With this principle, SBA asserts that it will look at ownership and control of any party that itself is affiliated with the entity in question. Take for example, the scenario outlined for the third principle – a minority shareholder has the ability to block the actions of the principal owner. Under the fourth principle, SBA will look not only at the minority shareholder to determine size, but SBA will also look at any entity that controls or is affiliated with the minority shareholder.

Fifth, and perhaps most important to a firm trying to determine its size, when assessing affiliation SBA will "consider the totality of the circumstances, and may find affiliation even

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[37] *Id.* at § 121.103(a)(1).
[38] *Id.*
[39] *Id.* at § 121.103(a)(2).
[40] *Id.* at § 121.102(c).
[41] *Id.* at § 121.103(a)(3).
[42] *Id.* at § 121.103(a)(1).
[43] *Id.* at § 121.103(a)(3).
[44] *Id.* at 121.103(a)(4).

though no single factor is sufficient to constitute affiliation."[45] OHA has stated that the totality of the circumstance may be the basis for a finding of affiliation when, "affiliation cannot be established under any of the specific affiliation rules, yet the relationship between the parties taken as a whole is indicative of affiliation."[46] Businesses find this principle particularly frustrating, as its application means that the firm adhered to the letter of SBA's rules, but SBA still finds that the firm abrogated the spirit of the regulations.

The sixth and final general principle states that when determining a "concern's size, SBA counts the receipts, employees, or other measure of size of the concern whose size is at issue and all of its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit."[47] Therefore, all affiliates are amalgamated into one combined entity for the purpose of size, even if some of the affiliates would not be affiliated with each other. The nexus to the business with its size at issue is sufficient for this principle to apply.

b. General Exceptions to the Principles of Affiliation

In contrast to the expansive six principles governing affiliation, SBA has also enumerated eight circumstances where affiliation will not apply. These exceptions generally have their basis in statute, but for purposes of this memorandum only the relevant regulations will be discussed.

The first exception occurs if a concern is owned "in whole or substantial part" by "investment companies licensed, or development companies qualifying, under the Small Business Investment Act of 1958."[48] For practical purposes, this exempts companies owned in part by a Small Business Investment Company (SBIC) or Section 504 Certified Development Company (504 Company) from being found affiliated with either the SBIC or 504 or other companies owned in part by the SBIC or 504 Company.

Second, business concerns "owned and controlled by Indian Tribes, Alaska Native Corporations (ANCs), Native Hawaiian Organizations (NHOs), Community Development Corporations (CDCs)," or wholly owned entities of ANCs, NHOs, or CDCs are not considered affiliates of such entities.[49] Indeed, SBA expressly states that neither ownership, common management, or shared administrative services shall be the basis for finding affiliation between these types of business concerns, although affiliation may be found for other reasons.[50]

Third, concerns that "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."[51] However, this does not mean that the employees leased from the leasing company or PEO can be excluded from the employee count if the firm operates under and

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[45] *Id.* at § 121.103(a)(5).
[46] *Size Appeal of CJW Construction, Inc.*, SBA No. SIZ-5254, at 8 (2011), *citing Size Appeal of LOGMET, LLC*, SBA No. SIZ-5155, at 10 (2010).
[47] 13 C.F.R. § 121.103(a)(6).
[48] *Id.* at § 121.103(b)(1).
[49] *Id.* at § 121.103(b)(2)(i).
[50] *Id.* at § 121.103(b)(2)(ii).
[51] *Id.* at § 121.103(b)(4).

employee-based size standard.[52]

The fourth category of exceptions exists to ensure that firms receiving financial, management or technical assistance not be penalized for that assistance, if it is provided by an enumerated list of exempted providers.[53] These include SBICs, 504 Companies, venture capital operating companies, as defined in the U.S. Department of Labor regulations found at 29 CFR 2510.3-101(d); government established and maintained employee benefit or pension plans or benefit and pension plans as defined by the Employee Retirement Income Security Act of 1974;[54] charitable trusts, foundations, endowments, or similar organizations exempt from Federal income taxation under section 501(c) of the Internal Revenue Code of 1986;[55] and investment companies registered under the Investment Company Act of 1940, (1940 Act) or as defined by the 1940 Act but with too few employees to require registration.[56]

The fifth exemption exists for participants in an SBA mentor-protégé program or a mentor protégé program that provides a statutory exemption from affiliation.[57] In these circumstances, a firm will not be found to be affiliated with its mentor if the assistance being provided is itself contemplated by an approved mentor-protégé agreement. At this time, only the SBA and the Department of Defense have qualifying mentor-protégé programs.

The sixth exemption addresses agricultural endeavors. Specifically, it allows that "member shareholders of a small agricultural cooperative, as defined in the Agricultural Marketing Act[58] are not considered affiliated with the cooperative by virtue of their membership in the cooperative."[59]

The seventh and eighth exceptions address research and development. The seventh states that "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."[60] This exception applies primarily to companies participating in the Small Business Innovation Research (SBIR) or Small Business Technology Transfer (STTR) programs, which have a size standard of 500 employees.[61] Likewise, the eighth and final exception applies specifically to SBIR/STTR firms.[62] The SBIR/STTR programs have special size standards and rules regarding affiliation, ownership and control.[63]

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[52] *Supra*, note 3.
[53] 13 C.F.R. § 121.103(b)(5).
[54] 29 U.S.C. § 1001, et seq.
[55] 26 U.S.C. § 501(c).
[56] 15 U.S.C. § 80a-1, et seq.
[57] 13 C.F.R. § 121.103(b)(6).
[58] 12 U.S.C. § 1141j.
[59] 13 C.F.R. § 121.103(b)(7).
[60] *Id.* at § 121.103(b)(3).
[61] *Id.* at § 121.701.
[62] *Id.* at § 121.103(b)(8).
[63] *Id.* at § 121.702.

Rather than address these here, they will be discussed later in the context of the seven primary reasons SBA finds affiliation.[64]

c. Primary Reasons SBA Finds Affiliation

Based on the six general principles of affiliation, and accounting for the eight general exceptions from affiliation, SBA has arrived at seven primary reasons for finding affiliation. These will now be discussed.

1. Stock Ownership

The first common reason to find affiliation is based on stock ownership. When an entity issues voting stock, SBA has stated that the individual, concern or other entity that owns or has the power to control 50 percent of that stock will be considered to have the power to control the concern in question.[65] Thus any other concern controlled by the owner of the 50 percent of the stock, or that controls the owner of the 50 percent of the stock, will be considered affiliated. However, the calculus becomes more complicated if no one entity owns 50 percent of the stock. In such a case, SBA states that the owner of "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 and is the nexus for affiliation. [66]

Furthermore, in cases where there is no single largest shareholder, if "two or more [entities] each owns, controls, or has the power to control less than 50 percent of a concern's voting stock, and such minority holdings are equal or approximately equal in size, and the aggregate of these minority holdings is large as compared with any other stock holding, SBA presumes that each such person controls or has the power to control the concern whose size is at issue."[67] Thus, a company equally owned by three individuals each owning one third of the voting shares would be considered controlled by all three of the individuals, and affiliation would attach through each of them. In circumstances such as these, SBA will allow a company to rebut the presumption of affiliation by "showing that such control or power to control does not in fact exist."[68] If such a showing is made, or if the voting stock is widely held so that no single block is considered to control, "the concern's Board of Directors and CEO or President will be deemed to have the power to control the concern in the absence of evidence to the contrary."[69]

Affiliation based on stock ownership is somewhat different for SBIR/STTR firms.[70] In such cases, SBA will find affiliation with entity that controls more than 50 percent of the voting stock, but that percentage may be reduced to 40 percent based on the totality of the circumstances. If no shareholder is found to control, the Board of Directors, CEO or President will be found to control. The difference is magnified if the entity owning the shares is a venture capital operating

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[64] Anyone seeking to work with these programs is advised to read all of the associated rules, found in 13 C.F.R. § 121.700 et seq.
[65] 13 C.F.R. § 121.103(c)(1).
[66] *Id.* at § 121.103(c)(1).
[67] *Id.* at § 121.103(c)(2).
[68] *Id.* at § 121.103(c)(2).
[69] *Id.* at § 121.103(c)(3).
[70] *Id.* at § 121.702(c)(1).

company, hedge fund, or private equity firm.[71] While the business at issue may be found affiliated with the venture capital operating company, hedge fund, or private equity firm, it will not normally be found to be affiliated with other companies owned by the venture capital operating company, hedge fund, or private equity firm, hereinafter referred to as portfolio companies.[72] However, affiliation with these portfolio companies will exist if the venture capital operating company, hedge fund, or private equity firm owns a majority of the portfolio company or holds a majority of the seats of the board of directors of the portfolio company.[73]

2. The Present Effects Test

The second common reason for a finding of affiliation arises due to stock options, convertible securities, or agreements to merge. This is often referred to as the "present effects" test. In such cases, SBA looks at stock options, convertible securities, and agreements to merge, "including agreements in principle" and acts as if they have been exercised, thus treating them as being presently in effect.[74] In such a circumstance, affiliation could attach based on the arrangement being afforded present effect; thus, if there is an agreement to sell a certain number of shares to one party that would then give the party control based on stock ownership, SBA will find that party to already have control. However, "[a]greements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered 'agreements in principle' and are thus not given present effect."[75] Likewise, if the option, convertible security, or agreement is "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 (or exercise of the rights) occurring is shown to be extremely remote," SBA will not give the agreement present effect.[76]

Importantly, while the present effects test can be used to find prospective control, it cannot be used to disclaim current control. Specifically, SBA states that an "individual, concern or other entity that controls one or more other concerns cannot use options, convertible securities, or agreements to appear to terminate such control before actually doing so. SBA will not give present effect to the individuals', concerns' or other entities' ability to divest all or part of their ownership interest in order to avoid a finding of affiliation."[77] Thus, if affiliation would be found due to stock ownership, the finding of affiliation will remain even if the owner of the stock enters into an agreement to sell the shares at a future date. In such case, both the current and future owners could be found affiliated.

3. Common Management

The third common reason for a finding of affiliation arises due to common management. Specifically, 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

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[71] *Id.* at § 121.702(c)(9).
[72] *Id.* at § 121.702(c)(9).
[73] *Id.* at § 121.702(c)(9).
[74] *Id.* at § 121.103(d)(1).
[75] *Id.* at § 121.103(d)(2).
[76] *Id.* at § 121.103(d)(3).
[77] *Id.* at § 121.103(d)(4).

management of one or more other concerns."[78] Thus, if an individual is the president of two companies, and there is no other party determined to control either company, the two companies will be considered affiliated even if they are engaged in entirely separate lines of business.

4. Identity of Interest

Less obvious, the fourth common reason for a finding of affiliation is an identity of interests. Thus, two or more persons or firms with "identical or substantially identical business or economic interests . . . may be treated as one party with such interests aggregated."[79] Identity of interests covers a broad spectrum, encompassing everything from family members to individuals or firms with "common investments, or firms that are economically dependent through contractual or other relationships."[80] While it is easier to understand the presumption that siblings, spouses, or parents and children may share common interests, the rest of the scope is more difficult to apply. These cases tend to be fact specific, with the SBA having held that "[a]n identity of interest is found where common interests establish 'a relationship that bespeaks a concert of purpose and effort' and 'cause the parties to act in union for their common benefit.'"[81] Thus, the fact that two entities share common investments in unrelated third party companies could mean that the two entities are predisposed to have the entity in question act in concert. However, the Committee is unaware of any cases where affiliation has been found based on two companies being resellers of the same products of the same manufacturer, even though the channel management agreements might force the parties to act in concert. However, under the identity of interest principle, the concerns in question always have the ability to rebut any presumed affiliation by demonstrating that the "interests deemed to be one are in fact separate."[82] Firms have therefore been able to successfully assert that even companies controlled by spouses need not be affiliated if the "the husband and wife are not closely involved with each other's business transactions."[83] Identity of interest presents one of the areas where the SBIR/STTR programs have clearer rules than the other contracting programs. For purposes of the SBIR/STTR program, SBA will find affiliation if an SBIR/STTR awardee relies upon another concern or entity for 70% or more of its receipts, but an SBIR or STTR awardee is not affiliated with a portfolio company of a venture capital operating company, hedge fund, or private equity firm, solely on the basis of one or more shared investors.[84]

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[78] *Id.* at § 121.103(e).
[79] *Id.* at § 121.103(f).
[80] *Id.* at § 121.103(f).
[81] *Size Appeal of SolarCity Corporation*, SBA No. SIZ-5257, at 6 (2011) *quoting Size Appeal of The H.L. Turner Group., Inc.*, SBA No. SIZ-4896, at 6 (2008). *See also Size Appeal of Bend Research, Inc.*, SBA No. SIZ-4369, at 7 (1999)); *Size Appeal of Cytel Software, Inc.*, SBA No. SIZ-4822, at 5 (2006), *Size Appeal of Ridge Instrument Co., Inc.*, SBA No. SIZ-4207 (1996)).
[82] 13 C.F.R. § 121.103(f).
[83] *Size Appeal of Appeal of Trailboss Enterprises, Inc.*, SBA No. SIZ-5442, at 3 (2013) *citing Size Appeal of Golden Bear Arborists, Inc.*, SBA No. SIZ-1899, at 7 (1984) ("the presumption may be rebutted upon the proof of certain factors, such as remoteness of the family tie, estrangement, or lack of close involvement is business matters.")
[84] 13 C.F.R. § 121.702(c)(4).

5. The Newly Organized Concern Rule

The fifth common reason for a finding affiliation is the newly organized concern rule. This rule states that affiliation may occur if "former officers, directors, principal stockholders, managing members, or key employees" of one business start a new business in the "same or related industry or field of operation" while serving as "the new concern's officers, directors, principal stockholders, managing members, or key employees."[85] Key employees are those, who because of their "position in the concern, [have] a critical influence in or substantive control over the operations or management of the concern."[86] However, for affiliation to attach, the original concern must either furnish or intend to furnish the "new concern with contracts, financial or technical assistance, indemnification on bid or performance bonds, and/or other facilities, whether for a fee or otherwise."[87] Like the identity of interest test, this presumption of affiliation may be rebutted, in this case by demonstrating a "clear line of fracture between the two concerns."[88]

The purpose of the newly organized concern rule is "to prevent circumvention of the size standards by the creation of 'spin-off' firms that appear to be small, independent firms but are, in actuality, affiliates or extensions of large firms."[89] Often the most problematic element for enforcement the newly organized concern rule arises from problems defining "new." OHA has found that the "mere passage of time does not necessarily bar application of the 'newly organized concern' rule."[90] In some cases, firms incorporated six years prior to the challenge are considered newly organized if the firm had not been active throughout its existence.[91] However, OHA has also held that six years was "clearly not new" when the firm has been active.[92] Thus the calendar itself must be viewed in light of whether the "a firm has been an active concern for an extended period."[93] For the SBIR/STTR program, "new" is defined as one year.[94]

6. Affiliation Based on Joint Ventures and the Ostensible Subcontractor Rule

The sixth common reason for finding affiliation is based on joint ventures (JVs). While the term JV is often used to refer to a separate legal entity established as a shared endeavor between two or more parties, SBA uses the term more broadly. SBA states that a JV is "an association of individuals and/or concerns with interests in any degree or proportion consorting to engage in and carry out no more than three specific or limited-purpose business ventures for joint profit over a two year period, for which purpose they combine their efforts, property, money, skill, or

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[85] *Id.* at § 121.103(g).
[86] *Id.* at § 121.103(g).
[87] *Id.* at § 121.103(g).
[88] *Id.* at § 121.103(g).
[89] *Size Appeal of Coastal Management Solutions, Inc.*, SBA No. SIZ-5281, at 4 (2011) *citing Size Appeal of J.W. Mills Management, Inc.* SBA No. SIZ-4909, at 5 (2008).
[90] *Size Appeal of Coastal Management Solutions, Inc.*, SBA No. SIZ-5281, at 5 (2011).
[91] *Size Appeal of Taylor Consultants, Inc.*, SBA No. SIZ-4775, (2006).
[92] *Size Appeal of ACI Mechanical Corp., Inc.*, SBA No. SIZ-3030 (1988).
[93] *Size Appeal of Coastal Management Solutions, Inc.*, SBA No. SIZ-5281, at 5 (2011).
[94] 13 C.F.R. § 121.702(c)(5).

knowledge, but not on a continuing or permanent basis for conducting business generally."[95] In some cases, such a JV may be permissible without a finding of affiliation, but "a specific [JV] entity generally may not be awarded more than three contracts over a two year period, starting from the date of the award of the first contract, without the partners to the [JV] being deemed affiliated for all purposes."[96] Thus, SBA requires that the JV agreement be in writing and do business under its own name, but it need not be a separate legal entity as is traditionally understood.[97] Further, as will be discussed later, SBA reserves the right to find a JV even if the parties did not enter into a joint venture agreement.[98]

While the basis for finding affiliation when a separate legal entity is formed is obvious – the firms have voluntarily aligned themselves to work in concert pursuing and performing opportunities – the application is often complicated due to SBA's broader use of the term JV and application of the three contracts rule. Specifically, most businesses do not form JVs limited to three awards per two years. Further complicating the application of this rule is SBA's pronouncement that "[t]he same two (or more) entities may create additional [JVs], and each new [JV] entity may be awarded up to three contracts in accordance with this section" without a finding of affiliation, but "[a]t some point, however, such a longstanding inter-relationship or contractual dependence between the same [JV] partners will lead to a finding of general affiliation between and among them."[99]

To illustrate the complexities of the JV rule, SBA provides three examples. In the first, it assumes that a JV has already received two contracts and then submits three additional offers prior to receiving an additional award. In such a case, SBA states that "[e]ven though the award of the three contracts would give [the JV] a total of five contract awards, it could receive those awards without causing general affiliation between its joint venture partners because [the JV] had not yet received three contract awards as of the dates of the offers for each of three solicitations at issue."[100]

In contrast, if a JV "receives a contract on December 19, year 1" it may then "receive two additional contracts through December 19, year 3."[101] However, even if it only receives one additional contract during that period, it cannot submit any additional offers after December 19, year 3, without triggering a finding of affiliation because more than two years had passed. Instead, the parties need establish a new JV to seek additional contracts.[102] To further complicate this scenario, assume that the same JV received a contract on December 19, year 1, and submitted offers for two additional contracts before December 19, year 3. If the those two additional contracts were awarded after December 19, year 3, the JV would not be found affiliated because the offers were submitted before the end of the two year period.[103]

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[95] *Id.* at § 121.103(h).
[96] *Id.* at § 121.103(h).
[97] *Id.* at § 121.103(h).
[98] *Id.* at § 121.103(h)(4).
[99] *Id.* at § 121.103(h).
[100] *Id.*
[101] *Id.*
[102] *Id.*
[103] *Id.*

To further complicate matters, the three award rule does not itself ensure that JV parties will not be held affiliated. Rather, there are certain times when the JV will itself be reason for affiliation. Specifically, SBA has stated that JV parties are affiliated regardless of the three award rule if either party seeks SBA's financial assistance for use in connection with the JV.[104] Furthermore, while SBA may not find overall affiliation between JV parties following the three contract rule, "concerns submitting offers on a particular procurement or property sale as joint venturers are affiliated with each other with regard to the performance of that contract."[105] Thus, the JV may not cost a business its overall status as a small business, but it may mean that for a particular contract it is no longer small. Likewise, monies earned or individuals employed by the JV (must be included in a "proportionate share" for each of the parties for purposes of future size determinations and certifications.[106]

Yet even the pronouncement that the existence of a JV exempts the parties from general affiliation but not contract specific affiliation is not absolute. SBA further clarifies that otherwise acceptable JVs will not be the basis for affiliation even for a specific contract if the specific contract is: (1) a bundled contract; (2) a contract for more than half the receipt-based size standard for the NAICs code assigned to the contract; (3) a contract for more than $10 million if the NAICS code assigned to the contract has an employee-based size standard; or (4) a contract performed by a JV approved pursuant to SBA's 8(a) mentor-protégé program.[107] The rationale for these exceptions is that SBA will not apply affiliation in cases where the existence of the JV itself allows small businesses to remain competitive for contracts that would otherwise, due to their scope or size, be inaccessible to small businesses.

Finally, as previously mentioned, the lack of a written JV does not mean that SBA will not find that a JV exists. This is generally referred to as the ostensible subcontractor rule. An ostensible subcontractor "is a subcontractor that performs primary and vital requirements of a contract, or of an order under a multiple award schedule contract, or a subcontractor upon which the prime contractor is unusually reliant."[108] To determine whether undue reliance exists requires that SBA examine all aspects of the relationship between the prime and subcontractor, "including, but not limited to, the terms of the proposal (such as contract management, technical responsibilities, and the percentage of subcontracted work), agreements between the prime and subcontractor (such as bonding assistance or the teaming agreement), and whether the subcontractor is the incumbent contractor and is ineligible to submit a proposal because it exceeds the applicable size standard for that solicitation."[109] The purpose of the rule is to "prevent other than small firms from forming relationships with small firms to evade SBA's size requirements,"[110] and any decisions are "intensely fact-specific given that they are based upon the specific solicitation and specific proposal at issue."[111] If an ostensible subcontractor

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[104] *Id.* at § 121.103(h)(1).
[105] *Id.* at § 121.103(h)(2).
[106] *Id.* at § 121.103(h)(5).
[107] *Id.* at § 121.103(h)(2).
[108] *Id.* at § 121.103(h)(4).
[109] *Id.* at § 121.103(h)(4).
[110] *Size Appeal of Fischer Bus. Solutions, LLC*, SBA No. SIZ-5075, at 4 (2009).
[111] *Size Appeals of CWU, Inc., et al.*, SBA No. SIZ-5118, at 12 (2010).

relationship is found, the "contractor and its ostensible subcontractor are treated as joint venturers, and therefore affiliates, for size determination purposes."[112]

7. Franchise and License Agreements

The seventh and final common reason for findings of affiliation is the existence of a franchise or license agreement. This should not be read a prohibition on franchisees or licensees being considered small, since, "[t]he restraints imposed on a franchisee or licensee by its franchise or license agreement relating to standardized quality, advertising, accounting format and other similar provisions, generally will not be considered in determining whether the franchisor or licensor is affiliated with the franchisee or licensee provided the franchisee or licensee has the right to profit from its efforts and bears the risk of loss commensurate with ownership." [113] However, SBA may find affiliation between franchisors and franchisees, various franchisees, or licensor and licensee if these agreements themselves trigger "common ownership, common management or excessive restrictions upon the sale of the franchise interest."[114]

IV. Conclusion

Consistently applying SBA's rules and regulations regarding size standards is extremely complex, as the outcome of any inquiry relies on applying the correct size standards, program specific requirements, and affiliation rules. However, through the regulatory process and the case law developed by SBA over the last 55 years, SBA has made what remains a very fact specific process as transparent and predictable as possible. Any questions regarding the application of these standards may be addressed to Committee staff, the SBA, or the Small Business Development Centers and Procurement Technical Assistance Centers which have expertise in the area.

[112] 13 C.F.R. § 121.103(h)(4).
[113] 13 C.F.R. § 121.103(i).
[114] *Id.*