The Rules of Affiliation – an Overview

By James E. Krause, Attorney
Federal Contract Law – Jacksonville, FL
January 2016

The SBA provides significant Federal Contract advantages to certain small businesses pursuant to the regulations and laws of Federal procurement law under the Small Business Act. However, these advantages were created for small businesses only. Over the years large businesses have attempted to gain access to these opportunities by owning, teaming or joint venturing with small businesses, both innocently and willfully. Congress, to identify when a small business and a large business have improperly joined, has created the rules of affiliation. They are located at 13 CFR 121.103. A violation of these rules can result in a determination of Federal Fraud, both civilly and criminally.

This means that Federal Regulations dictate the amount of ownership, control and management a large business may have over a small business. The SBA uses the rules of affiliation to determine such issues as Identity of Interests, inter affiliate transactions, common ownership and control, Common Management, Newly Organized Concern Rule, and Successor in Interest, among other potential rules. In addition, the Totality of Circumstances, and Economic Dependence tests will apply.

Where 51% ownership, and 100% Control and Management MUST be by a specific small business category, such as Service Disabled Veterans or Women owned small businesses, no negative controls may exist as deceitful impediments to either the overall control, or the day to day operations of the small business. Examples include hiring and firing, purchase of all material, supplies and equipment, accounting for Federal standards (including payroll and single control for writing checks). This is not an exhaustive list, but a sample of some of the more common areas that arise in investigations.

The SBA has become quite sophisticated at analysis of company structures for this purpose, and regularly look into the affiliation issues of a company. Companies may be visited by the SBA's Inspector General without any warning to determine if Federal fraud has occurred. These investigations may be raised by anyone, and are commonly raised by competitors as well as the SBA.

> Affiliation is best defined by Case law:
>
> "Firms are affiliated when one firm controls or has the power to control the other, or a third party controls or has the power to control both. 13 C.F.R. § 121.103(a)(1). Further, affiliation arises where one or more officers, directors, managing members, or partners who control the board of directors and/or management of one concern also control the board of directors or management of one or more other concerns. 13 C.F.R. § 121.103(e). In order to find that firms are affiliated due to common management, both concerns must be controlled by the same person or persons." *Size Appeal of US Builders Group*, SBA No. SIZ-5519 (2013)

The SBA does not typically monitor small businesses for size. Most challenges to size come from competitors though the vehicle of a Protest, irrespective of the authority the Government Contracting Officer can individually exercise to raise a challenge. The SBA's Area Directors are the initial decision

JAMES E. KRAUSE, ATTORNEY
9700 Philips Highway, Suite 107, Jacksonville, FL 32256
904.353.5533 jimkrause@krauselaw.net www.krauselaw.net
FEDERAL & PUBLIC CONTRACT LAW - CONSTRUCTION - LITIGATION

makers, with a possibility of appeal only to the SBA's Office of Hearings and Appeals (OHA). These challenges are frequent.

Per 13 CFR §121.105(a)(1), the SBA defines "business concern or concern" as a business concern eligible for assistance from SBA. It must be a small business entity 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. 13 CFR §121.105(b) Also states a business concern may be in the legal form of an individual proprietorship, partnership, limited liability company, corporation, joint venture, association, trust or cooperative, except 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.

Affiliation arises under several specific areas, of which the most important include Common Ownership, Stock Options, Common Management, Identity of Interest, the Newly Organized Concern Rule, Joint Ventures, whether intentional or created under the Ostensible Subcontractor Rule, Franchise and Licensing Agreements. Finally, the Successor in Interest and Economic Dependence Rules create additional hurdles that could affiliate both companies.

13 CFR § 121.103

(a) *General Principles of Affiliation.*

*(1) 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. It does not matter whether control is exercised, so long as the power to control exists.

(2) SBA considers factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.

(3) Control may be affirmative or negative. Negative 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 any action by the board of directors or shareholders.

(4) Affiliation may be found where an individual, concern, or entity exercises control indirectly through a third party.

*(5) 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.

(6) In determining the 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.

The case law reinforces and, I think, simplifies the general definition of affiliation:

> "Firms are affiliated when one firm controls or has the power to control the other, or a third party controls or has the power to control both. 13 C.F.R. § 121.103(a)(1). Further, affiliation arises where one or more officers, directors, managing members, or partners who control the board of directors and/or management of one concern also control the board of directors or management of one or more other concerns. 13 C.F.R. § 121.103(e). In order to find that firms are affiliated due to common management, both concerns must be controlled by the same person or persons. See Size Appeal of Bob Jones Realty Co., SBA No. SIZ-4059, at 5 (1995)." *Size Appeal of US Builders Group*, SBA No. SIZ-5519 (2013)

However, there are other specific affiliations are listed in 13 CFR 121.103:

(c) *Affiliation based on stock ownership.*
(d) *Affiliation arising under stock options, convertible securities, and agreements to merge.*
(e) *Affiliation based on common management.*
(f) *Affiliation based on identity of interest.*
(g) *Affiliation based on the newly organized concern rule.*
(h) *Affiliation based on joint ventures.*
(i) *Affiliation based on franchise and license agreements.*

The case law is very specific, and does not necessarily simplify a study of affiliation.

For Example, regardless of each individual issue addressed in an affiliation analysis, the "totality of the circumstances" statement in 13 CFR § 121.103 (5) is a nonspecific test that has been applied by the SBA to determine a business is not small despite another significant rule violation. This catch-all statement means that the SBA can, and will, review all factors, however small or seemingly insignificant, and may find affiliation by combining all smaller and nondeterminative issues into a significant decision.

Where two companies may have accidentally become affiliated over the years, they can proactively separate the companies. A recent decision at OHA identified the period of separation as a method of substantiating the break between the individuals and the companies for affiliation purposes, saying:

> "Pursuant to SBA regulations, a concern's former affiliates are excluded from the size determination "if affiliation ceased before the date used for determining size." See 13 C.F.R. §§ 121.104(d)(4) and 121.106(b)(4)(ii). Similarly, OHA has repeatedly held that historic ties between a challenged firm and an alleged affiliate do not establish current affiliation when the historic ties no longer exist as of the date to determine size. Size Appeal of OBXtek, Inc., SBA No. SIZ-5451, at 12 (2013) ("So long as affiliation ceases before the date for determining size, the firms are former affiliates and their receipts will not be aggregated."); see also Size Appeal of Washington Patriot Construction, LLC, SBA No. SIZ-5491 (2013); Size Appeal of A & H Contractors, Inc., SBA No. SIZ-5459

(2013); Size Appeal of Chu & Gassman, Inc., SBA No. SIZ-5291 (2011)." *Size Appeals of Real Estate Resource Services, Inc. and OneSource REO, LLC*, SBA No. SIZ-5522 (2013)

After the definition of affiliation, the SBA immediately provides exceptions. There are numerous exceptions to affiliation rules identified in §121.103(b).

(b) ***Exceptions to affiliation coverage.***

(4) 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.

(5) 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.

(i) Venture capital operating companies, as defined in the U.S. Department of Labor regulations found at 29 CFR 2510.3-101(d);

(ii) 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;

(iii) 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*.);

(iv) 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));

(v) Investment companies registered under the Investment Company Act of 1940, as amended (1940 Act) (15 U.S.C. 80a-1, *et seq*.); and

(vi) 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.

(6) An 8(a) BD Participant that has an SBA-approved mentor/protégé agreement is not affiliated with a 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 § 121.903. Affiliation may be found in either case for other reasons.

The rules of affiliation specifically do not allow negative as well as positive control. While this is spelled out in 13 CFR 121.103, it is commonly misunderstood by Contractors not familiar with Federal small business regulations. The CFR states that "Negative 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 any action by the board of directors or shareholders." Other examples of negative control could include private future agreements or purchase requirements from the large business or allow others to block the small business from taking an affirmative action. In one case, OHA found that

> Further, under Michigan law, a majority of a corporation's shareholders may remove one or more directors without cause unless the Bylaws provide otherwise. MCL § 450.1511.
>
> OHA has held that where a majority shareholder has the power to call a shareholders meeting and, at that meeting, to remove any and all directors with or without cause; it is the majority shareholder, not the directors, who controls the firm, and any control by the directors is illusory. Size Appeal of Environmental Quality Management, Inc., SBA No. SIZ-5429, at 6 (2012); Size Appeal of The Clement Group, LLC, SBA No. SIZ-5146, at 6 (2010). Mr. Pomante, as DCCI's 75% shareholder, has the ability to call a shareholders meeting and remove any and all the directors. Mr. Pomante thus has control of DCCI."
>
> *Size Appeal of US Builders Group*, SBA No. SIZ-5519 (2013)

In analyzing questions of affiliation, the ultimate question is always whether one concern can control the other. "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. It does not matter whether control is exercised, so long as the power to control exists." *Size Appeal of US Builders Group*, SBA No. SIZ-5519 (2013).

As is obvious, the rules of affiliation are quite specialized and complex, and this overview merely touches the surface of the topic. If you have any questions, please contact James Krause at (904) 353-5533 or jimkrause@krauselaw.net.