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SUBJECT: Size Eligibility and Affiliation Under the CARES Act

This is in response to questions we have received regarding the affiliation rules applicable to the Coronavirus Aid, Relief, and Economic Security (CARES) Act, Pub. L. 116-136. Section 1102(a)(1) of the CARES Act includes legislative exceptions to the affiliation rules that the Small Business Administration (SBA) ordinarily applies to determine an applicant's eligibility for small business programs. However, the waiver set forth in the statutory language refers explicitly to the general affiliation provisions contained in 13 CFR § 121.103, and not to the loan specific affiliation provisions contained in 13 CFR § 121.301(f). We have been asked to provide guidance as to how the CARES Act's exceptions to affiliation affect a business's eligibility for the Paycheck Protection Program, the principal small business program in the CARES Act. In addition, we have been asked for guidance regarding the implementation of the CARES Act as follows: Can the alternative size standard be relied on for eligibility for the Paycheck Protection Program?; At what point in time or over what period of time will SBA examine a concern's number of employees to determine whether it qualifies as small for purposes of Paycheck Protection Program eligibility?; Do the exceptions to affiliation contained in § 121.103 for entity-owned small business concerns apply to firms seeking assistance through the Paycheck Protection Program?; How will the affiliation rules pertaining to small business concerns owned in part by investment firms or groups of individuals be applied; and, Does an investment of any amount by a Small Business Investment Company (SBIC) in a small business concern causes all affiliation to be waived for the small business?

We will address each of these questions separately.

Affiliation Exceptions for Business Concerns

Generally, an applicant must qualify as a small business concern under part 121 of SBA's regulations in order to be eligible as a small business for any SBA assistance, including SBA financial assistance. SBA defines a "business concern" (or "concern") as an agricultural cooperative or for-profit business entity 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.

SBA typically determines whether a business concern is small by comparing the size of the business—as measured by revenues or by number of employees—against an industry-specific size standard.¹ In determining a concern’s size, SBA also adds the employees and revenues of each of the business concern’s affiliates. SBA defines the terms affiliation and affiliates in 13 CFR 121.103, which has general coverage and references to other SBA affiliation rules. The specific affiliation rule for SBA’s financial assistance programs is set forth in 13 CFR § 121.301. *See* 13 CFR § 121.103(a)(8). The rule provides that concerns and entities are affiliates 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. 13 CFR § 121.301(f). In the SBA loan programs, SBA can find affiliation for a business concern for the five distinct reasons² listed as “bases for affiliation.” SBA also applies nine affiliation exceptions.³

The CARES Act changes how SBA applies the affiliation rules for the Paycheck Protection Program. Generally, the Paycheck Protection Program offers small business loans of up to \$10 million to cover the recipient’s payroll and other specified costs during the loan period.⁴ The program expands eligibility for the loans to certain categories of food-service businesses, hotel and lodging establishments, franchisees, and portfolio companies of SBICs. Some firms in those industries might otherwise fail to qualify because of affiliation rules that SBA typically applies in its loan programs. To accomplish the expanded eligibility, the CARES Act states the following:

During the covered period, the provisions applicable to affiliations under section 121.103 of title 13, Code of Federal Regulations, or any successor regulation, are waived with respect to eligibility for a covered loan for—

- I. any business concern with not more than 500 employees that, as of the date on which the covered loan is disbursed, is assigned a North American Industry Classification System code beginning with 72;

¹ In limited cases, SBA specifies a size standard on a basis other than receipts or employees (e.g., megawatt hours).

² The five bases for affiliation are (1) ownership; (2) stock options, convertible securities, and agreements to merge; (3) common management; (4) identity of interest through close relatives, and (5) franchise and license agreements. 13 CFR § 121.301(f)(1)-(5) (2019). As discussed below, the CARES Act rescinds the changes that SBA made to § 121.301(f) through an interim final rule published on Feb. 10, 2020. *See* Pub. L. 116-136, § 1102(e). Thus, references are to the pre-2020 version of the regulation.

³ *See* 13 CFR 121.103(b) (applied to the loan programs through 13 CFR § 121.301(f)(7) (2019)).

⁴ The CARES Act defines “covered period” as February 15, 2020 through June 30, 2020.

- II. any business concern operating as a franchise that is assigned a franchise identifier code by the Administration; and
- III. any business concern that receives financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958 (15 U.S.C. 681).

15 USC § 636(a)(36)(D)(iv), as added by Pub. L. 116-136, § 1102(a).⁵

In our view, this language clearly waives affiliation for businesses in the three named categories, including applicants in North American Industry Classification System (NAICS) Sector 72, which covers lodging, accommodations, and food service. Some have noted that the language refers specifically to 13 CFR § 121.103 but not to the regulation at § 121.301(f), which governs affiliation in SBA's loan programs. This does not mean, however, that § 121.301(f) should apply as presently written, for several reasons.

First, unless SBA were to waive § 121.301, the specified categories of businesses still would be subject to SBA's affiliation rules. That would be contrary to Congressional intent. A statute must be read as a whole, and each phrase must have meaning. *Block v. Community Nutrition Inst.*, 467 U.S. 340, 349 (1984); *U.S. v. Menasche*, 348 U.S. 528, 538-39 (1955). Continuing to apply § 121.301 would render the CARES Act's affiliation waiver meaningless. Additionally, the CARES Act elsewhere provides that a sector 72 business with multiple locations is eligible for the Paycheck Protection Program if each physical location has fewer than 500 employees. 15 U.S.C. § 636(a)(36)(D)(iii). That provision evinces an intent to expand eligibility for sector 72 firms. Failing to waive the financial assistance rule would thwart that intent. Thus, consistent with Congressional intent, it is our view that SBA should read the affiliation waiver language to waive affiliation under both affiliation rules, § 121.103 and § 121.301.

Second, the CARES Act waives affiliation under § 121.301(f) through the statute's general reference to SBA's affiliation rules. The CARES Act text waives affiliation "under section 121.103 of title 13, Code of Federal Regulations, or any successor regulation." The financial assistance rule at 13 CFR § 121.301(f) is a successor regulation to the affiliation rule at § 121.103, for the purposes of applicants to SBA's loan programs. SBA promulgated the rule at § 121.301(f) in 2016, more than 20 years after SBA issued § 121.103. *See* 81 FR 41423 (Jan. 27, 2016); 61 FR 3286 (Jan. 31, 1996). In finalizing the financial assistance rule, SBA stated that the former principles of affiliation in § 121.103(a)(8) "will be moved to a new § 121.301(f)." Thus, § 121.301(f) directly succeeds § 121.103 for SBA loan program affiliation, and, for sector 72 firms and the other specified categories, the CARES Act text expressly waives affiliation under the financial assistance affiliation rule at § 121.103(f).

⁵ Subsequent citations to 15 USC § 636(a)(36) are to the additions made by § 1102(a) of the CARES Act, Pub. L. 116-136.

Size Standards

In determining the size of loan applicants, SBA typically uses two sets of size standards. The first is the industry-specific list of size standards at 13 CFR § 121.201. The second is the alternative size standard in section 3(a)(5) of the Small Business Act, 15 USC § 632(a)(5). Under the alternative size standard, a business is eligible for an SBA loan if the maximum tangible net worth of the business is not more than \$15 million; and the average net income after Federal income taxes (excluding any carry-over losses) of the business for the 2 full fiscal years before the date of the application is not more than \$5 million. The CARES Act supplements these two sets of size standards with a 500-employee size standard that applies to all applicants. *See* Pub. L. 116-136, § 1101 (incorporating the Small Business Act definition of “small business concern”); 15 USC § 636(a)(36)(D) (providing for increased eligibility for certain small businesses and organizations).

Because the CARES Act supplements SBA’s size standards, lenders still may determine the size of a business using the SBA’s industry-specific size standards or the alternative size standard expressed in tangible net worth and average net income. In particular, small businesses in industries with size standards that exceed 500 employees may use the higher SBA size standards. 15 USC § 636(a)(36)(D)(i)(II). This includes firms in several manufacturing industries. 13 CFR § 121.201.

The CARES Act adds a 500-employee size standard for the Paycheck Protection Program. An applicant may use the 500-employee size standard regardless of whether the applicant qualifies as a small business under SBA’s two existing size standards. *See* 15 USC § 636(a)(36)(D)(i) (providing for eligibility “in addition to small business concerns” to “any business concern” that meets the 500-employee size standard). Additionally, a business in NAICS sector 72 qualifies for the program if it employs 500 employees or less per physical location. *See* 15 USC § 636(a)(36)(D)(iii).

SBA ordinarily applies size standards only to for-profit businesses. *See* 13 CFR § 121.105. The CARES Act, however, provides that the Paycheck Protection Program also is open to a nonprofit organizations and veterans organizations. 15 USC § 636(a)(36)(A)(vii), (ix). For those applicants, SBA might not have established size standards for their industries. Thus, the CARES Act directs that applicants are eligible for the Paycheck Protection Program if they employ not more than the greater of 500 employees or, if applicable, the SBA employee-based size standard for the industry in which the organization or business operates.

Time of Size for Determining Number of Employees

Pursuant to 13 CFR § 121.302(a), the size status of an applicant for SBA financial assistance is determined as of the date the application for financial assistance is accepted for processing by SBA. SBA generally measures employees by calculating the average number of all individuals employed on a full-time, part-time, or other basis for each pay period in the preceding completed 12 calendar months. 13 CFR § 121.106(a), (b)(1).

Although nothing in the CARES Act specifically addresses the time at which size should be determined for purposes of Paycheck Protection Program eligibility, Section 1102(a)(1) of the CARES Act does provide that affiliation will be waived for “any business concern with not more than 500 employees, . . . as of the date on which the covered loan is disbursed, [that] is assigned a North American Industrial Classification System code beginning with 72.” However, we do not believe that it would make sense to determine size eligibility as of the date of disbursement. Disbursement of a Paycheck Protection Program loan occurs only after an affirmative finding that a loan applicant is eligible for the loan has been made. SBA does not allow, and cannot allow, a lender to disburse loan funds to business concerns that have not demonstrated their eligibility prior to disbursement as part of the normal application processing. To provide that a lender should process a loan up until the point of disbursement and then determine whether a business concern qualifies as small makes no sense and would needlessly tie up valuable processing time that could otherwise be used to process additional loans for eligible applicants in this time of crisis.

As such, we conclude that the general rules that average the number of individuals employed in the preceding completed 12 calendar months as of the date of application apply for Paycheck Protection Program eligibility.

Application of Entity-Owned Affiliation Exception

The CARES Act is not the only source of affiliation exceptions. SBA’s ordinary affiliation exceptions still apply. *See* 13 CFR § 121.103(b). These include an exception for 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), and wholly-owned entities of Indian Tribes, ANCs, NHOs, or CDCs. These concerns are not considered affiliates of the entities, nor are they considered to be affiliated with other concerns owned by the entities because of their common ownership, common management or common administrative services. 13 CFR § 121.103(b). Although the CARES Act specifically identifies Tribal business concerns employing less than 500 employees as being eligible for the Paycheck Protection Program, 15 USC § 636(a)(36)(D)(i), we believe such specific identification is superfluous and that tribal business concerns would be eligible as “small business concerns” generally if they employ less than 500 individuals. We believe the same is true for business concerns owned by ANCs, NHOs and CDCs. As long as such business concerns employ less than 500 individuals, while applying the pre-existing SBA affiliation exceptions in § 121.103(b), they are eligible for the Paycheck Protection Program.

Investment Firms

Unless they are listed in § 121.103(b) or in the CARES Act waiver, other applicants are subject to SBA’s existing affiliation rule for financial assistance. This includes business concerns owned or controlled by investment firms, including, but not limited to, venture capital operating companies, private equity companies, investment companies and others.⁶ Though

⁶ Nonprofit organizations and veterans organizations also are subject to the same affiliation rules as small business concerns. *See* 15 USC § 636(a)(36)(D)(vi).

certain investment firms and financial investors, including, but not limited to, venture capital operating companies and certain types of investment companies, are listed in § 121.103(b)(5), the exclusion they receive is limited to assistance under the SBIC program and other programs in the Small Business Investment Act of 1958. 15 USC § 662(5)(A). The most relevant affiliation rules for such firms are discussed below.

The existing affiliation rule provides that SBA counts the employees of the applicant and all of the applicant's affiliates. 13 CFR § 121.301(f)(6) (2019). To determine an applicant's affiliates, applicants and lenders should refer to the pre-2020 version of the rule.⁷ Section 1102(e) of the CARES Act permanently rescinds an amendment that SBA issued in February. See 85 FR 7622 (Feb. 10, 2020). Thus, going forward, the common-investment affiliation rule and the economic-dependence affiliation rule do not apply to the Paycheck Protection Program or to other financial assistance programs. This means that SBA will not use common investments to affiliate multiple owners of an applicant. SBA also will not use the economic-dependence rule to affiliate an applicant with a firm from which it obtains 85 percent or more of its revenues.⁸

Most relevantly, the remaining affiliation rules include affiliation through ownership and affiliation through common management. In ownership affiliation, an applicant is affiliated with any owner that owns or has the power to control more than 50 percent of the concern's voting equity. 13 CFR § 121.301(f)(1) (2019). 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. *Id.* SBA often refers to this latter concept as "negative control," and the caselaw of the SBA Office of Hearings and Appeals (OHA) includes several cases interpreting the rule.⁹ OHA has ruled that "the power to veto unusual or 'extraordinary' actions may be designed to protect the interests of the minority investor and therefore do not pose issues of negative control." *Size Appeal of Carntribe-Clement 8AJV # 1, LLC*, SBA No. SIZ-5357 (2012).

In management affiliation, 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. 13 CFR § 121.301(f)(3) (2019). 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. The common-management basis of affiliation also may be particularly relevant to nonprofit organizations that might apply for the Paycheck Protection Program.

⁷ The pre-2020 version is available at <https://www.govinfo.gov/content/pkg/CFR-2019-title13-vol1/pdf/CFR-2019-title13-vol1-sec121-301.pdf>.

⁸ Therefore, SBA will no longer review contracts under the economic-dependence review process that the February change added through an amendment to § 121.301(f)(4)(iv)(B).

⁹ The caselaw is available to search at <https://www.sba.gov/about-sba/oversight-advocacy/office-hearings-appeals/oha-decisions>.

Waiver of Affiliation for SBIC Investment

The affiliation rules at § 121.103 and § 121.301(f) are waived for entities that apply for a loan as part of the Paycheck Protection Program and which also receive financial assistance from an SBIC. Specifically, affiliation is waived for “any business concern that receives financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958 (15 U.S.C. 681).” The statutory text does not require any particular amount of financial assistance from an SBIC nor does it require that the loan applicant receive financial assistance exclusively from SBICs. *See* 15 USC § 636(a)(36)(D)(iv)(III), as added by Pub. L. 116-136, § 1102(a). The waiver to affiliation applies to such entities regardless of the amount of investment from an SBIC and regardless of whether there are also non-SBIC investors. Thus, despite the affiliation rules applying generally to business concerns owned in part by investment firms, as described above, if an SBIC has provided financial assistance to a business concern in any amount (including loans, debt with equity features, equity, guarantees, and/or securities purchased from an underwriter as set forth under § 107.825), and that business concern is owned or controlled by one or more investment firms, all affiliation rules are waived.

Conclusion

In sum, the CARES Act applies a 500-employee size standard to all applicants for the Paycheck Protection Program, unless SBA has established a higher employee-based size standard for the applicant’s industry or an applicant qualifies as a small business under the alternative size standard. The CARES Act also waives SBA’s affiliation rules—including the bases for affiliation found in the financial assistance rule at 13 CFR § 121.301(f)—for applicants in NAICS sector 72, which covers accommodations and food service. An applicant receives the same affiliation waiver if it operates as a franchise that is assigned an SBA franchise identifier; or if it receives financial assistance from an SBIC. SBA’s general affiliation rules and exceptions to affiliation apply to other small business concerns (e.g., for business concerns owned in part by investment firms, or business concerns owned and controlled by tribes, ANCs, NHOs and CDCs).