

# WILLIAMS MULLEN

## Small Business Administration's Affiliation Rules and Related Illustrations

| Name of Rule             | Rule   | Example   |
|--------------------------|--|---|
| <b>Common Ownership</b>  | Two or more companies are affiliated if the same person owns 50% or more of each company. If no person owns 50% or more of the voting equity of a concern, then the SBA will deem the Board of Directors or president to be in control of the concern. | VC owns 51% of each of XCorp and YCorp. Because of VC's majority ownership in each of these concerns, XCorp, YCorp, and VC are affiliated. Because XCorp and YCorp are affiliated due to their common ownership, the average employee or annual receipt counts of XCorp, YCorp, and VC will be aggregated.  |
| <b>Present Effect</b>    | Stock options, convertible securities (e.g., convertible notes), purchase agreements, and even letters of intent are given "present effect" and treated as though they have been exercised/consummated.  | VC has acquired convertible preferred shares of XCorp that, if converted to common stock, would equal 51% of the voting rights in XCorp. VC's convertible shares will be given present effect as if converted to common stock; and, thus, VC will be deemed to control XCorp.   |
| <b>Common Management</b> | Two or more companies may be affiliated when one or more officers, managers, or directors holds a controlling position in two or more companies.   | <p>Although VC only owns a 33% interest in each of XCorp and YCorp, VC is entitled to 1 of 3 board seats on the Board of Directors of each of XCorp and YCorp. The Bylaws for both XCorp and YCorp require a representative of VC to be present in order to constitute a quorum. Because VC can prevent a quorum, it will be deemed to control both XCorp and YCorp, which results in XCorp, YCorp, and VC being deemed affiliated.</p> <p>Same facts as above except that, instead of the Bylaws quorum provision, the Investors' Rights Agreements for each XCorp and YCorp provide that the Board may not approve the company's operating budget or amend its stock incentive plan without the approval of the director designated by VC. Due to these veto rights, XCorp, YCorp, and VC likely will be deemed affiliated.</p> |

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| Name of Rule   | Rule  | Example  |
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| <b>Identity of Interest – Close Family Relationships</b> | Two companies that are owned or controlled by close family members (e.g., husband and wife) are presumed to be affiliated.  | XCorp is owned and controlled by Sarah. YCorp is owned and controlled by Mark. If Mark and Sarah are husband and wife, then XCorp and YCorp are presumed to be affiliated.   |
| <b>Identity of Interest - Economic Dependence</b>        | If a concern derived 85% or more of its receipts from another company over the previous 3 fiscal years, then those companies will be presumed to be affiliated.   | VC owns a minority interest in each of XCorp and YCorp. VC introduced XCorp and YCorp to collaborate on projects, which has resulted in XCorp accounting for 85% of YCorp’s revenue, on average, over the last 3 years. Because YCorp derives 85% of its revenue, on average, over the last 3 years from XCorp, those entities may be deemed affiliated.   |
| <b>Identity of Interest – Common Investments</b>         | The SBA may find two or more companies to be affiliated if the individuals who own or control the businesses have common economic interests, including common and substantial investments in multiple concerns in related industries, and where such concerns conduct business with each other and also share resources, equipment, employees, or office space. | Entrepreneur 1 and Entrepreneur 2 have founded companies together in the past and act as seed investors in startups in a local private incubator. Entrepreneur 1 and Entrepreneur 2 only invest in startups in the mobile application development industry so that they can lease space in a building that they own to the companies in which they invest. The Entrepreneurs also supply the companies with access to equipment and certain administrative resources. The SBA may deem the Entrepreneurs (and each of their respective ventures) to be affiliated. |
| <b>Newly Organized Concern</b>                           | Two or more companies may be affiliated when a key employee or owner of one company creates or joins a new company in a similar line of work and continues to receive material from the prior company (e.g., bonding).  | Founder 1 grew XCorp to be a large business before eventually selling to a strategic acquirer. Founder 1 creates YCorp, which is in a small niche of the same industry as XCorp and receives substantial support from XCorp and its parent company. YCorp may be deemed to be affiliated with XCorp under the newly organized concern rule.  |

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| Name of Rule                     | Rule   | Example  |
|----------------------------------|--|--|
| <b>Successor-in-Interest</b>     | Two or more companies may be affiliated if a substantial portion of the assets and/or liabilities of a company are the same as those of a predecessor company. | XCorp grew to become a large technology company and spun off its IT services branch into a separate entity called YCorp. Because YCorp succeeded to substantially all of the assets of XCorp, they may be affiliated.  |
| <b>Totality of Circumstances</b> | When the facts and circumstances suggest that two companies are very closely intertwined, they may be deemed affiliated.                                       | Same facts as “Identity of Interest – Common Investment” but also consider that the portfolio startup in the incubator holds the other startup out to the public (e.g., on website and marketing material) as a “partner.” The SBA may look at the totality of these circumstances and find the startups affiliated. |