

SUMMARY OF KEY POINTS FROM SBA'S APRIL 3 ADDITIONAL GUIDANCE FOR AFFILIATION RULES UNDER THE PAYCHECK PROTECTION PROGRAM

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On Friday, March 27, 2020, President Donald J. Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act), which among other COVID-19 relief items, provides \$349 billion in Paycheck Protection Program (PPP) loans for small businesses as well as other businesses and non-profit organizations that meet certain criteria. On March 30, 2020 Baker Donelson issued an alert describing the SBA's loan eligibility requirements, including affiliation rules and how those rules could impact eligibility for PPP loans. On April 2, 2020, the SBA issued an Interim Final Rule addressing further eligibility items, along with a draft application which we summarized in an alert. Late on April 3, 2020 the SBA issued further PPP Affiliation Guidance that supplements the April 2 Interim Final Rule and a summary addressing Affiliation Rules Applicable to SBA Paycheck Protection Program (PPP Loan Affiliation Rules).

Summary of Key Points From April 3 Affiliation Guidance: Some Relief Is Given Under the Identity of Interest Test for PPP Loans

SBA's guidance related to PPP Loan Affiliation Rules has confirmed that only four affiliation tests will be considered for PPP loans:

- Affiliation based on ownership;
- Affiliation arising under stock options, convertible securities, and agreements to merge;
- Affiliation based on management; and
- Affiliation based on identity of interest.

Each of these tests are taken from the prior version of 13 C.F.R. § 121.301(f), which existed before March 11, 2020. On February 11, 2020, the SBA issued an interim final rule changing the affiliation standards for SBA loans, which took effect on March 11, 2020. The CARES Act permanently rescinded that rule, but it was unclear what would be put in its place. SBA's issuance of the PPP Loan Affiliation Rules confirm that SBA is reverting to the old version of 13 C.F.R. § 121.301(f).

The reversion to the pre-March 11, 2020 form of the affiliation rules has little impact on the major tests for affiliation based on ownership; affiliation arising under stock options, convertible securities, and agreements to merge; and affiliation based on management. However, the PPP Loan Affiliation Rules greatly narrow the identity of interest affiliation test.

Identity of Interest Test Now Limited to Close Relatives

The affiliation rules that went into effect on March 11, 2020, which no longer apply to the PPP loans, expanded the "identity of interest" affiliation analysis to include affiliation between individuals or firms

that have identical or substantially identical economic interests (individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships). However, the recently issued PPP Loan Affiliation Rules confirm that SBA has eliminated both the *common investments* and *economic dependence* tests related to identity of interest affiliation, which will provide relief to several entities that would have otherwise been affiliated when applying for PPP loans.

Specifically, under the *common investments test*, it stated that affiliation arose where the same individuals or firms together owned a substantial portion of multiple concerns in the same or related industry, and such concerns conducted business with each other or shared resources, equipment, locations, or employees with one another, or provided loan guaranties or financial or managerial support to each other. This affiliation test now does not apply to the PPP loans.

Under the *economic dependence* test that also has been eliminated in relation to PPP loans, businesses no longer have to be concerned about affiliation if the concern derived 85 percent or more of its receipts over the previous three fiscal years from another concern. This affiliation test also will not apply to PPP loans.

Therefore, the only remaining identity of interest affiliation test relates to business relationships between close relatives, defined as a spouse; a parent; a child or sibling; or the spouse of any such person. Affiliation will be found among close relatives with identical or substantially identical business or economic interests (such as where close relatives operate concerns in the same or similar industry in the same geographic area). However, when a presumption of identity of interest affiliation exists, applicants may rebut that presumption with evidence showing that the interests deemed to be one are in fact separate. In SBA contract cases that have regulations similar to the loan program, this is proven by showing a "clear line of fracture" between the concerns. [*Size Appeal of: Alleo Corp., SIZ-5405 \(Sept. 26, 2012\)*](#).

Outside of the Identity of Interest Change, the Affiliation Guidance Does Not Provide Any New Exceptions for Business

As more fully discussed in our [prior alert](#) on this topic, the affiliation rules impact eligibility for several start-up, early-stage, and other businesses that have outside investors. Investor term sheets typically include certain negative control provisions to protect the investment, which can create an affiliation issue in the SBA small business context.

SBA's size decisions related to government contracts, which are based on similar SBA size standards, hold that supermajority provisions blocking extraordinary actions do not give rise to affiliation while those blocking ordinary actions like establishing a quorum, entering into contracts or leases, approving or making changes to the company's budget, initiating or defending lawsuits, or determining employee compensation (among several others) will create affiliation.

Several venture capital and investor trade groups were hoping that SBA would create additional exceptions for some of these negative control provisions to avoid affiliation. The PPP Affiliation Guidance does not create any new exceptions for these provisions. Instead, it just confirms the affiliation exceptions for (1) Businesses in the accommodation and food services industries (NAICS Code starting with "72") with not more than 500 employees as of the date on which the loan is disbursed; (2) Any business concern operating as a franchise that is assigned a franchise identifier code by the SBA ([SBA Franchise Directory](#)); and (3) Any business that receives financial assistance from a Small Business Investment Corporation ([SBIC](#)).

Any additional affiliation relief under the PPP will need to result from legislation passed by Congress and signed by the President.

PPP Affiliation Guidance Creates a New Affiliation Exception for Faith-Based Organizations

The PPP Affiliation Guidance creates a new exception to the affiliation rules related to faith-based entities. It confirms that the SBA's affiliation rules do not apply to the relationship of any church,

convention, or association of churches, or other faith-based organization or entity to any other person, group, organization, or entity that is based on a sincere religious teaching or belief or otherwise constitutes a part of the exercise of religion.

The guidance further confirms that "[a] faith-based organization seeking loans under this program may rely on a reasonable, good faith interpretation in determining whether its relationship to any other person, group, organization, or entity is exempt from the affiliation rules" The PPP Affiliation Guidance also confirms that the SBA will not assess and will not require lenders to assess the reasonableness of a faith-based organization's determination. Notably, this affiliation exception does not appear to be limited to SBA loans, but will instead apply to all SBA programs, including government contracts.

The SBA also issued additional information about this exception in the form of [Frequently Asked Questions](#). Faith-based organizations interested in the PPP should closely review these materials to determine eligibility.

Do the SBA Loan Affiliation Rules Apply to Non-Profit Entities?

The CARES Act made 501(c)(3) non-profit organizations eligible to get PPP loans. The Act also states "[t]he provisions applicable to affiliations under **section 121.103 of title 13, Code of Federal Regulations**, or any successor thereto, shall apply with respect to a nonprofit organization . . . in the same manner as with respect to a small business concern." However, the PPP Affiliation Guidance confirms that **"the detailed affiliation standards contained in section 121.103 currently do not apply to PPP borrowers, because section 121.103(a)(8) provides that applicants in SBA's Business Loan Programs (which include the PPP) are subject to the affiliation rule contained in 13 CFR 121.301."**

This regulatory distinction is significant. While it appears that Congress may have intended to make 501(c)(3) non-profit entities subject to affiliation rules related to SBA loans, they actually made non-profit entities subject to affiliation rules related to SBA's government contract programs. The affiliation rules in [13 C.F.R. § 121.103](#) relate to SBA's government contract programs, not to SBA loans. As discussed in our prior alert, the SBA's affiliation rules related to SBA loans are found at 13 C.F.R. § 121.301(f), not in 13 C.F.R. § 121.103. Therefore, the express terms of the CARES Act make non-profit entities subject to the SBA government contract affiliation rules, but do not make them subject to SBA's affiliation rules related to SBA loans.

The SBA could have addressed this issue. For example, the CARES Act language granting the waiver of affiliation for NAICS 72 businesses with not more than 500 employees (discussed above) also references a waiver from the affiliation regulations at 13 C.F.R. § 121.103 (government contract rules); not 13 C.F.R. § 121.301 (SBA loan rules). To address this reference related to NAICS 72 businesses, the PPP Affiliation Guidance states in a footnote that "the affiliation rules contained in section 121.301 also do not apply to these types of entities." Instead of adding similar language addressing non-profits, the PPP Affiliation Guidance confirms that "the detailed affiliation standards contained in section 121.103 currently do not apply to PPP borrowers" Therefore, the PPP Affiliation Guidance does not include any language that would bring non-profits under the affiliation rules related to SBA loans.

Therefore, based on the language above, non-profit entities have good arguments that they can apply for loans without regard to affiliation rules related to SBA loans. However, when applying, it would be wise to confirm this position on the Addendum or in some form on the application. Because guidance and implementation are being implemented rapidly, documentation of these positions will avoid later issues with applications being deemed potential misrepresentations to the government, which can have significant consequences.

Do Small Businesses Under a Receipts-Based Size Standard Qualify for PPP?

The PPP statutory language in the CARES Act states that **"in addition to small business concerns,"** the PPP loans are available to any business concern, non-profit organization, veterans organization, or tribal business that employs not more than the greater of:

- 500 employees; or
- the number of employees allowed by the employee-based size standard applicable to that entity's business.

We noted in a [previous alert](#) that by a clear reading of the statute, the PPP program should be available to the entities that meet the above employee count criteria and to small businesses that qualify under SBA's other regulations (i.e., annual receipts), even though they may exceed 500 employees.

The SBA Guidance on this topic has not been clear. The Interim Final Rule issued on April 2 describes eligibility in a way inconsistent with the CARES Act. Specifically, that Interim Final Rule states that eligibility exists if (a) the business meets the above employee count criteria; **and** is a small business concern under SBA's statutes; a tax-exempt 501(c)(3) non-profit, a tax-exempt veterans organization under 501(c)(19), a tribal business under 31(b)(2)(C) of the Small Business Act, or any other business; **and** was in operation on February 15, 2020 and either had employees for whom they paid salaries and payroll taxes or paid independent contractors.

This eligibility description in the April 2 Interim Final Rule requires that even small businesses under a receipt-based size standard meet the employee-based size requirements, which appears inconsistent with the CARES Act and with the entire SBA small business program.

However, SBA's Affiliation Guidance issued late on April 3, 2020 states:

An entity generally is eligible for the PPP if it, **combined with its affiliates, is a small business as defined in section 3 of the Small Business Act (15 U.S.C. 632), or** (1) has 500 or fewer employees whose principal place of residence is in the United States or is a business that operates in a certain industry and meets applicable SBA employee-based size standards for that industry, and (2) is a tax-exempt nonprofit organization described in section 501(c)(3) of the Internal Revenue Code (IRC), a tax-exempt veterans organization described in section 501(c)(19) of the IRC, a Tribal business concern described in section 31(b)(2)(C) of the Small Business Act, or any other business concern.

The April 3 SBA's Affiliation Guidance appears inconsistent with the April 2 Interim Final Rule, but is consistent with the actual statutory language of the CARES Act and would open the PPP loans to small businesses that qualify under a receipts-based size standard, even if they exceed 500 employees.

However, and most importantly, the [PPP loan application](#) now requires business applicants to certify that it "employs no more than the greater of 500 or [sic] employees or, if applicable, the size standard in number of employees established by the SBA in 13 C.F.R. 121.201 for the Applicant's industry." Therefore, the application currently requires a certification about meeting the employee count criteria. If the PPP application continues to include that certification, businesses should not sign it if they do not meet the employee count requirements. This is particularly important when seeking government funds under a government program as a misrepresentation can lead to serious liability, including False Claims Act liability.

Baker Donelson is working hard to assist clients in these unprecedented times. Our team of professionals continue to monitor and advise on new issues as they develop. For specific guidance or more information on this alert, please contact [Jeff Wagner](#) or [Josh Mullen](#). For more information and general guidance on how to address legal issues related to COVID-19, please visit the [Coronavirus \(COVID-19\): What You Need to Know information page](#) on our website.