

April 4, 2020

SMALL BUSINESS ADMINISTRATION ISSUES INTERIM FINAL RULE ON AFFILIATION, SUMMARY OF AFFILIATION TESTS, LENDER APPLICATION FORM AND AGREEMENT, AND FAQs FOR PAYCHECK PROTECTION PROGRAM

To Our Clients and Friends:

Yesterday, the U.S. Small Business Administration (“SBA”) published an interim final rule on affiliation (the “Affiliation IFR”) (available [here](#)), a summary of affiliation tests (available [here](#)) (the “Summary”), a lender application form and agreement (available [here](#) and [here](#), respectively), and FAQs (available [here](#)), with respect to, the Paycheck Protection Program (the “Program” or “PPP” and such rule, the “Rule”). As described in greater detail in our previous client alerts, *SBA “Paycheck Protection” Loan Program Under the CARES Act, Small Business Administration and Department of Treasury Publish Paycheck Protection Program Loan Application Form and Instructions to Help Businesses Keep Workforce Employed, and Small Business Administration Issues Interim Final Rule and Final Application Form for Paycheck Protection Program*, the Program provides \$349 billion to help small businesses impacted by COVID-19 keep their employees on the payroll and their businesses solvent.

The Affiliation IFR is effective immediately and confirms the general principle that a borrower will be considered together with its affiliates for purposes of determining eligibility for the PPP. The only waivers to this general rule for purposes of the Program are a new exemption for faith-based organizations established by the Affiliation IFR and the three affiliation rule waivers established by the *CARES Act* for any business concern: (1) with not more than 500 employees and that is assigned a North American Industry Classification System code beginning with 72; (2) operating as a franchise that is assigned a franchise identifier code by the SBA; and (3) that receive financial assistance from a small business investment company (i.e., a company licensed under section 301 of the *Small Business Investment Act of 1958*). The *CARES Act* also makes eligible a business concern that “employs not more than 500 employees per physical location of the business concern and that is assigned a North American Industry Classification System code beginning with 72 at the time of disbursement.”

The Affiliation IFR also clarifies that the 500 employee eligibility standard applies to only “employees whose principal place of residence is in the United States.” The *CARES Act* itself does not state a clear rule as to the locus of employees for purposes of determining whether a business concern meets the eligibility standard; it simply sets the eligibility standard at “500 employees.” The SBA size standards regulations at 13 CFR 121.106 clearly state that the employee eligibility calculation includes domestic and foreign employees. The Affiliation IFR, on the other hand, states the different standard noted above. Our view is that clients should know what the Affiliation IFR states and that this interpretation

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is neither compelled by nor inconsistent with the *CARES Act*. If a business concern chooses to apply for a PPP loan, we recommend that it state clearly in an addendum to the application form how it is interpreting the employee eligibility requirements and note its foreign employees. We recommend further that the applicant state in an addendum that it would use the portion of the funds allocated to payroll costs exclusively to benefit its employees in the U.S., and not its non-U.S. employees.

The Summary is almost identical to the language of the first four bases for affiliation described in the existing SBA affiliation rules.^[1] The Summary provides that affiliation under four different circumstances is sufficient to establish affiliation under the Program:

1. *Ownership*. Affiliation exists as a result of ownership or the power to control more than 50% of voting equity.
 - If no individual, concern, or entity owns or controls more than 50% of a concern's voting equity, the Board of Directors or President or CEO (or other officers, managing members, or partners who control the concern's management) are deemed to control the concern.
 - A minority shareholder is deemed to control the concern if the shareholder has the right under the concern's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board or shareholders.
2. *Stock options, convertible securities, and merger agreements*. The rights granted under stock options, convertible securities, and agreements to merge (including agreements in principle, but not agreements to negotiate) are deemed to have been exercised. For example, if a 20% stockholder has an option to acquire another 30% of the concern's voting stock, that stockholder is deemed an affiliate of the concern.
 - SBA will not deem exercise of the following to have occurred: options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable, or where the probability of the transaction (or exercise of the rights) occurring is extremely remote.
 - A shareholder that agrees to divest its ownership interest in a concern is still deemed to own such interest.
3. *Management*. If the CEO, President, other officers, managing members, or partners who control the management of a concern also control the management of another concern, the concerns are affiliates. If a single individual, concern, or entity that controls the Board of Directors or management of a concern also control the Board of Directors or management of another concern, the concerns are affiliates.
 - Affiliation also arises where a single individual, concern or entity controls the management of a concern through a management agreement.

4. *Identity of interest.* If an individual and his or her spouse, parent, child, sibling or spouse of such any such person have identical or substantially identical business or economic interests (such as where they operate concerns in the same or similar industry in the same geographic area), they are affiliates.
 - Affiliation based on identity of interest may be rebutted with evidence showing that the interests deemed to be one are in fact separate.

Unlike the SBA’s existing rules (available [here](#)), the Summary does not provide that affiliation may arise between individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships). Also unlike the existing SBA rules, the Summary does not establish affiliation based on: the “newly organized concern rule” applicable to concerns actively operating for two years or less; the totality of the circumstances; or franchise agreements.

While the Affiliation Rule is effective immediately, the SBA will solicit public comments and consider the need to make revisions in light of such comments.

The FAQ states that the SBA, in consultation with the Department of Treasury, intends to provide timely additional guidance to address borrower and lender questions concerning the Program. Such guidance may be relied upon as the SBA’s interpretation of the *CARES Act* and the Paycheck Protection Program Interim Final Rule. The FAQ states it will be updated on a regular basis. The initial FAQ provided clarifies that Program lenders are not required to replicate every borrower calculation. Instead, “lenders are expected to perform a good faith review, in a reasonable time, of the borrower’s calculations and supporting documents concerning average monthly payroll cost.” The SBA also issued a separate set of FAQs for faith-based organizations.

[1] The Affiliation Rule states that the detailed affiliation standards contained in 13 CFR 121.103 do not apply to PPP borrowers. This is consistent with SBA regulations in effect prior to the enactment of the *CARES Act*. Applicants for Section 7(a) loans, including PPP loans, are subject to the affiliation rule contained in 13 CFR 121.301 pursuant to 13 CFR 103(a)(8) and 13 CFR 301(f).



Gibson Dunn’s lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, or the following authors:

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