

CROKE FAIRCHILD MORGAN & BERES

Updates on the Paycheck Protection Program Under the CARES Act

April 6, 2020

On March 27, 2020, the Coronavirus Aid, Relief and Economic Security (CARES) Act was signed into law. The legislation includes a new loan program – the Paycheck Protection Program (PPP) administered through the Small Business Administration (SBA) – that provides up to \$349 billion in loans to eligible entities, with such loans being subject to forgiveness under certain circumstances. The loans are 100% federally guaranteed and available under a new subsection 36 of Section 7(a) of the Small Business Act.

The CARES Act provides for small business concerns (qualified under the Small Business Act) and other businesses with less than 500 employees (as described below) to be eligible for PPP loans.

SBA 7(a) lenders have begun accepting applications for PPP loans. Applications must be submitted by June 30, 2020. Eligible applicants are encouraged to apply early as there are limited funds for the PPP.

The SBA has issued additional regulatory guidance for the PPP loans in the last few days. This alert discusses the recent updates that small businesses should know.

A. What Businesses Are Eligible for PPP Loans?

1. Small businesses that meet certain SBA or CARES Act size standards.

All entities that qualify as a “small business concern” under the Small Business Act are eligible for loans under the PPP.¹

In addition to “small business concerns” meeting the requirements of the Small Business Act, the CARES Act specifically states that the following will also be eligible for PPP loans: any business concern, nonprofit organization, veterans organization, or Tribal business concern so long as it employs not more than the greater of:

(a) 500 employees; or

¹ The Interim Final Rule issued by the SBA, as discussed below, seems to indicate that a small business concern also has to have 500 employees (or the size standard in number of employees established by the SBA for the industry in which the business concern operates) to qualify. This seems contrary to the express language in the CARES Act, and we await further guidance on this.

- (b) if applicable, the size standard in number of employees established by the SBA for the industry in which the business concern, nonprofit organization, veterans organization, or Tribal business concern operates.

The CARES Act also details some specifics for determining the number of employees for businesses in the accommodation and food services industry (NAICS 72) with multiple locations or that are independently owned franchises.

a. Businesses that are a “small business concern” based on NAICS code.

A business may qualify as a “small business concern” under the SBA rules if it meets certain size standards. These size standards are determined based on the SBA’s Table of Small Business Size Standards, which are matched to the business’ North American Industry Classification System (NAICS) code. These size standards are expressed in either millions of dollars or number of employees. A size standard is the largest that a business concern can be and still qualify as a small business for Federal Government programs.

The SBA determines whether an entity qualifies as a small business concern by counting its receipts, employees, or other measures, including those of all its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit.² The SBA’s rules on affiliation are found at 13 C.F.R. §121.103 and 13 C.F.R §121.301(f). Please see more information below about the affiliation rules.

b. Businesses that meet the alternative size standards.

§3(a)(5)(B) of the Small Business Act also provides that business concerns that meet the alternative size standard qualify for loan programs under 7(a) of the Small Business Act (which would include the PPP loans). These alternative size standards are:

- (1) The maximum tangible net worth of the business concern must not be more than \$15,000,000; and
- (2) The average net income after Federal income taxes (excluding any carry-over losses) of the business concern for the two full fiscal years before the date of application is not more than \$5,000,000.

These alternative size standards are often overlooked when businesses are determining if they qualify as a “small business concern”.

2. Other Qualified Contractors and Sole Proprietors.

As described in our alert issued on March 29, 2020, the eligible borrowers for the PPP loans include independent contractors, sole proprietorships, and self-employed individuals.

² 13 C.F.R. § 121.103(a)(6).

All of the above must have been in operation on February 15, 2020, and either had employees for whom they paid salaries and payroll taxes or paid independent contractors (as reported on Form 1099-MISC).

B. What Are the Affiliation Rules and How Are They Applied?

Under the Small Business Act, affiliation exists when one business controls or has the power to control another, or when a third party (or parties) controls or has the power to control both businesses. Control may arise through ownership, management, or other relationships or interactions between the parties. Control may be affirmative or negative.

When small businesses determine their eligibility for the PPP loan, they must include in their employee count (and receipts total) the employees (and receipts) of their affiliates. Many questions have been raised as to how the affiliation rules apply to small businesses that are backed by venture capital companies or wholly-owned by a private equity firm.

1. Four tests for affiliation.

On April 3, 2020, the SBA issued guidance on the affiliation rules applicable to participants in the PPP. Under that guidance, four tests apply to determine affiliation based on control apply to eligible PPP businesses.

- (a) **Affiliation based on ownership.** For determining affiliation based on equity ownership, a concern is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50 percent of the concern's voting equity. If no individual, concern, or entity is found to control, the SBA will deem the Board of Directors or President or Chief Executive Officer (CEO) (or other officers, managing members, or partners who control the management of the concern) to be in control of the concern. The 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.
- (b) **Affiliation arising under stock options, convertible securities, and agreements to merge.** In determining size, the SBA considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. The SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised. Further:
 - (i) agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered "agreements in principle" and are thus not given present effect.
 - (ii) Options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative,

conjectural, or unenforceable under state or Federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote, are not given present effect.

- (iii) An individual, concern, or other entity that controls one or more other concerns cannot use options, convertible securities, or agreements to appear to terminate such control before actually doing so. The SBA will not give present effect to individuals', concerns', or other entities' ability to divest all or part of their ownership interest in order to avoid a finding of affiliation.

(c) **Affiliation based on management.** 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. 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.

(d) **Affiliation based on identity of interest.** Affiliation arises when there is an identity of interest between close relatives, as defined in 13 C.F.R 120.10, with identical or substantially identical business or economic interests (such as where the close relatives operate concerns in the same or similar industry in the same geographic area). Where the SBA determines that interests should be aggregated, an individual or firm may rebut that determination with evidence showing that the interests deemed to be one are in fact separate.

Based on the four tests above, if a venture capital firm does not control (by equity ownership, negative covenants, or common management control) a business concern, the business concern applying for the PPP will not have to count the employees of the venture capital firm (or its other affiliates) towards its own employee count. On April 2, 2020, members of both major political parties asked the US Treasury Secretary to take action with respect to the SBA's affiliation rules to make it easier for certain "venture-backed" small businesses to qualify for a PPP loan.

2. Waivers of affiliation rules.

The affiliation rules described above are waived for:

- (a) any business concern with not more than 500 employees that, as of the date on which the loan is disbursed, is assigned an NAICS code beginning with 72;

- (b) any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and
- (c) 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).

C. SBA Interim Final Rule for the PPP (IFR) – Key Takeaways

On April 2, 2020, the SBA issued an Interim Final Rule for purposes of its implementation of the PPP. There are a number of notable items in the IFR:

- (a) Business concerns should not use payments to independent contractors when calculating their borrowing amount under the PPP loans.
- (b) Household employers (individuals who employ household employees such as nannies or housekeepers) are not eligible for PPP loans.
- (c) While the CARES Act does not include federal payroll and unemployment taxes in the description of payroll costs (but does include state and local taxes assessed on employee compensation), the IFR provides that federal employment taxes imposed or withheld between February 15, 2020 and June 30, 2020, are not included in payroll costs. This makes it unclear if federal payroll employment taxes paid prior to February 15, 2020, may be included in payroll costs. We await further guidance on this. Currently, we are advising our clients to exclude federal unemployment taxes from their payroll costs calculation pending additional guidance.
- (d) 75% of the PPP loan proceeds must be used for payroll costs. No more than 25% of the loan forgiveness amount may be attributable to non-payroll costs.
- (e) At the time of forgiveness of PPP loans, lenders will be able to rely on the borrower's submission of documentation supporting its request for loan forgiveness, without further verification.
- (f) The interest rate on the PPP loans is 1.0%.
- (g) The PPP loans are first-come, first-served. Only one PPP loan is available per taxpayer ID number. Eligible participants should apply early.

Please contact us if you have any questions about the CARES Act or the PPP loan application process. Businesses are encouraged to reach out to their banks to determine whether such banks are SBA-approved lenders. Croke Fairchild can help with finding an SBA-approved bank partner. We look forward to your questions and calls.



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