

Interim Final Rule Guidance from the SBA on Section 7(a) Paycheck Protection Program Loans

The attorneys at Bodman PLC summarized the SBA's latest guidance on SBA 7(a) (Paycheck Protection Program or "PPP") affiliation rules, which was released late on Friday, April 3, 2020. This guidance impacts loan eligibility for small business concerns that may have related third parties, including parent companies, subsidiary companies, or related entities under common control.

The full SBA guidance in the Interim Final Rule published on Thursday, April 2nd can be found [here](#).

See also the SBA's PPP Loan Information website for updates and further guidance on related matters. It can be found [here](#).

1. General Q&A

- a. Why is this being released?
 - i. The interim final rule supplements the Initial Rule with additional guidance regarding the application of certain affiliate rules applicable to SBA PPP loan applications.
- b. What are the general principles of Affiliation?
 - i. Generally, 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. SBA's regulations on affiliation are contained in 13 C.F.R. § 121.103 (available at www.sba.gov/size).
- c. What are the general guidelines to remember when looking for affiliation?
 - i. Four tests for affiliation based on control apply to participants in the Paycheck Protection Program. Following is a summary of the applicable affiliation tests. Please review the latter portion of this Client Alert for examples directly from the SBA.

- 1. Test #1: 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, 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. 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.
- 2. Test #2: Affiliation arising under stock options, convertible securities, and agreements to merge.**
 - a. In determining size, 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. SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.
 - b. 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.
 - c. 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.
 - d. 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. 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.
- 3. Test #3: Affiliation based on management.**
 - a. 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.

4. Test #4: Affiliation based on identity of interest.

- a. Affiliation arises when there is an identity of interest between close relatives, as defined in 13 CFR 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 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.

d. Are there exemptions?

i. Yes. There are waivers for:

1. Faith-based organizations. A faith-based organization's relationship to another organization is not considered an affiliation with the other organization if the relationship is based on a religious teaching or belief or otherwise constitutes a part of the exercise of religion. 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 under this provision, and SBA will not assess, and will not require participating lenders to assess, the reasonableness of the faith-based organization's determination
2. any business concern with not more than 500 employees that, as of the date on which the loan is disbursed, is assigned a North American Industry Classification System code beginning with 72 (Accommodation and Food Services, e.g., hotels, motels, RV parks, restaurants and bars)(see: <https://www.naics.com/six-digit-naics/?code=72>)
3. any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and
4. 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).

2. Q&A on why Affiliation Rules are important

a. *Are affiliates considered together for purposes of determining eligibility?*

- i. In most cases, a borrower applying for a PPP loan will be considered together with its affiliates for purposes of determining eligibility for the PPP. Under SBA rules, entities may be considered affiliates based on multiple factors including stock ownership, overlapping or common management, and identity of interest. 13 CFR § 121.301.

b. *How do SBA's affiliation rules affect my eligibility and apply to me under the PPP?*

- i. An entity borrower generally is eligible for the PPP if it, combined with its affiliates, is a "small business concern" (as defined in section 3 of the Small Business Act (15 U.S.C. 632).) Generally, that means it is an entity organized for profit that:
 1. has 500 or fewer employees whose principal place of residence is in the United States; or
 2. it is a business that operates in a certain industry and meets applicable SBA employee-based size standards for that industry; or
 3. it 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.
 - a. **NOTE:** Other than with respect to the qualified faith-based organization exemption discussed above, nonprofits are subject to affiliation rules just like for profits businesses.

3. *SBA Affiliation Examples*

- a. Examples of the application of the SBA's affiliation rules to borrowers are provided below. Note that the affiliate analysis is intensely fact dependent and each borrower should consult their attorney or a professional service provider with expertise in SBA PPP loans before submitting an application. The borrower must also review all applicable regulations carefully before certifying a business's size status to an SBA lender.
- b. The following are some of the affiliation rules that may apply to a business concern. When the term "person" is used, it means an individual, entity, or business concern. Where the example or guidance notes that a presumption is "rebuttable," a borrower may be able to provide additional facts or context that would change the conclusion of the example.

Affiliation based on equity ownership (13 C.F.R. § 121.103(c))

a. Control of 50% or more of voting stock.

- i. A person is an affiliate of a concern if the person owns or controls, or has the power to control, 50% or more of the concern's voting stock.
 1. Example 1: Company A is the majority owner of Companies B, C and D (54.5%, 81%, and 60% respectively). Company A has the power to control Companies B, C and D. The companies are all affiliated. The receipts and/or number of employees of all four companies will be aggregated in determining the size of any one of them.

b. Control of less than 50% voting stock, but large compared to others.

- i. Affiliation may also occur when a person owns and controls, or has the power to control, a block of voting stock that is large compared to all other outstanding blocks of stock.
 - 1. Example 1: Company A owns 40 percent of the voting stock of Company B and the next largest share is 2 percent. Company A controls Company B due to the fact it owns the largest block of voting stock compared to all other outstanding blocks of voting stock. Company A and Company B are affiliates. In addition, all other companies controlled by Company A will be considered affiliates of Company B.
 - 2. Example 2: Two individuals each own blocks of shares of Company A. One individual owns 46.67% of the business and the other owns 33.333%. The individual that owns 46.67% of the stock owns the largest single block, which is large compared to any other block, and therefore probably has the power to control the concern. This individual also controls Company B. There is affiliation between Company A and Company, but it is rebuttable.

c. Control of less than 50% voting stock by multiple minority owners.

- i. In addition, if two or more persons each owns or controls (or has the power to control) less than 50% of a concern's voting stock and (i) the minority holdings are all approximately equal in size and (ii) all of the minority holdings taken together are large compared to any other stock holdings, affiliation is presumed to exist with each of those persons. It is important to note that this is a rebuttable presumption.
 - 1. Example: Investor X, Investor Y, and Company A each own 23% of Company B. No other stockholder owns more than 5% of Company B. All three persons will be presumed to control Company B, unless they successfully rebut this presumption. If the presumption is not overcome, then Company A and Investors X and Y will all be considered affiliates of Company B. In addition, all companies controlled by Company A and Investors X and Y are affiliates of Company B.

d. Voting stock is widely held.

- i. When a concern's voting stock is widely held and no single block of stock is large as compared with all other stock holdings, the business concern's Board of Directors and Chief Executive Officer (CEO) or President are deemed to have the power to control the concern unless evidence is provided to show otherwise.
 - 1. Example: In a corporation where no one stockholder has a block of voting stock sufficient to give it control or the power to control the concern, control instead rests in each member of the Board of Directors and the CEO or President. This means that any business controlled by a member of the Board and by the CEO or President is an affiliate of the business concern in

question, unless the individual Board members and CEO or President can rebut this presumption.

e. Stock options, convertible securities, and agreements to merge (13 C.F.R. § 121.103(d))

- i. SBA treats each of these cases as though the rights granted have been actually exercised. Regulations give present effect to an agreement to merge (including an agreement in principle) or to sell stock. If these rights have been granted and they confer the power to control, affiliation exists.
 1. Example 1: If Company A holds an option to purchase a controlling interest in Company B, the situation is treated as though Company A had exercised its rights and had become owner of the controlling interests in Company B. Company A and B are affiliates. In addition, all companies controlled by Company A will be considered affiliates of Company B.
 2. Example 2: Company A and Company B are in discussion about a merger between the two of them. Both companies' representatives have met several times over the past two months. There is neither a formal nor informal agreement to merge, although merging -the two companies is their stated objective. Unless the two companies have an agreement to merge, SBA will not find affiliation between the two companies based on these open and continuing discussions of merger alone.

Affiliation based on common management (13 C.F.R. § 121.103(e)).

- a. If one or more officers, directors, managing members, or general partners of a business controls the Board of Directors and/or the management of another business the businesses are affiliates. SBA usually finds affiliation in these examples:
 - ii. Example 1: Members of Company A's Board of Directors occupy three out of five positions in Company B's Board of Directors. Company A has control of Company B and the two concerns are affiliated. In addition, all companies controlled by Company A will be considered affiliates of Company B.
 - iii. Example 2: A member of Company A's Board of Directors has veto rights over the majority decisions of Company B's Board of Directors. By possessing such negative control, Company A has control of the Board of Directors of Company B and the two concerns are affiliated. In addition, all companies controlled by Company A will be considered affiliates of Company B.

Affiliation based on identity of interest between individuals or businesses, including family members (13 C.F.R. § 121.103(f))

- a. Individuals or firms that have identical (or substantially identical) business or economic interests may be treated as though they are affiliated unless they can demonstrate otherwise. Family members, persons with common investments, or firms that are economically dependent through contractual (or other) relationships, are among those treated this way. However, individuals or firms may seek to demonstrate that no affiliation exists by providing convincing proof that apparently identical interests are, in fact, separate. Patterns of subcontracting, commingling of staff and/or facilities, and other veiled attempts to disguise the true nature of the relationship may evidence an identity of interest.
 - iv. Example 1: Several officers of Company A are also officers of Company B. The two companies are in the same line of work and extensively subcontract with each other. The interrelationship between the two companies results in them acting as one, and therefore, the two are considered affiliates.
 - v. Example 2: Company A and B share office space and equipment in the same location and also share key employees. In addition, Company A has sent a substantial amount of business to Company B for each of the last three years. All this, taken together, is an indication that the two companies have combined their resources to each other's benefit, and therefore, are likely to be affiliated.
 - vi. Example 3: When three of four members of a concern's Board of Directors have investments in common with each other outside the concern and have also provided the concern with substantial financial assistance, they may be viewed as sharing an identity of interest. The three directors would be deemed to control the Board and to therefore also control the business. Each outside business that these three directors control would be an affiliate of the business concern in question.
 - vii. Example 4: A husband and wife founded an accounting firm in 1974. Their daughter was a division head for two years in 2005-2007. In 2008, the daughter opened an office supply store using her own funds and a bank loan. Her parents purchase supplies from the daughter's store, and sales to her parents represent 10% of the daughter's revenues. Although the parents and daughter have business dealings, they are minimal in nature. There are no other business interactions between the daughter and her parents. If there are no other indicia of affiliation, SBA would find that affiliation due to family relationships is rebuttable.

Affiliation based on contractual relationships or economic dependency (13 C.F.R § 121.103(a),(f) and (g))

- a. A concern that is unlikely to be able to survive on its own or is economically dependent upon another person will probably be found to be affiliated with the concern(s) on which it is dependent.
 - i. Example 1: Company A performs subcontracts for Company B, and Company B accounts for 90% of Company A's revenues. Company A's existence depends on work from Company B and the two are deemed affiliates.
 - ii. Example 2: Company A provides significant loans to Company B and guarantees other loans to Company B. Company B's over reliance of dependence on Company A's financial support (both direct and indirect) results in their affiliation.
 - iii. Example 3: A loan between two businesses is not an arm's-length transaction and the terms and conditions of the loan demonstrate financial dependence by one business on the other. The two are deemed affiliates.
 - iv. Example 4: Company A obtained a patent for a product it developed. It licenses the use of the product to Company B, and makes it available for other companies to obtain a license. No affiliation exists between Company A and Company B based solely on the licensing agreement.

Please contact your Bodman attorney or Brian Kersey at 616-205-3129 or bkersey@bodmanlaw.com or Darren Burmania at 616-205-3313 or dburmania@bodmanlaw.com for more information. Bodman cannot respond to your questions or receive information from you without first clearing potential conflicts with other clients. Thank you for your patience and understanding.