# REFLECTIONS ON DAY 1 OF THE PAYCHECK PROTECTION LOAN PROGRAM AND THE FINAL AFFILIATION RULES

On April 3, 2020, the United States Small Business Administration ("SBA") by way of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") began accepting loan applications for its expanded SBA 7(a) loan program to offer payroll protection loans.

The program was off to a bit of a rocky start, as many banks and lenders did not receive the final guidelines (attached here) ("Final Rules") until late in the evening on April 2, 2020. Additionally, the final form application provided by the SBA (found here) ("Application") was materially different from the sample form provided by the United States Department of Treasury on Wednesday, April 1, including relaxing signature standards by no longer requiring both owners and authorized representatives to sign; and editing the application question related to "affiliates" as defined by the Code of Federal Regulations. The Final Rules also made significant changes to the bill, including requiring 75% of the loan amounts to be used on payroll to qualify for forgiveness, effectively reducing the amount that can be used on rent, mortgage interest, and utilities to 25% of the proposed forgiven amount. Additionally, the Final Rules changed the interest rate to 1% (initially, it was 0.5% but changed before applications were accepted after community banks threatened to pull of the program), and the maturity date was set at two (2) years.

Many banks around the country scrambled to try to allow their borrowers to apply immediately, and many borrowers were very concerned about availability because of the demand and the fact that the program is being implemented on a first come first serve basis. Many of the country's largest lenders were not prepared to accept applications on Friday. JP Morgan Chase sent its customers an alert late Thursday evening that the application system would not be ready, and then sent an alert around noon on Friday that it has started accepting applications. US Bank is rolling out its system gradually, and currently is only accepting applications for single-owner businesses. Several other banks needed to call a timeout late Friday after their systems were overloaded with applications and site visits, causing technical difficulties.

Additionally, small businesses all over the country were preparing applications without knowing how the SBA "affiliation" rules would apply to these loans because the Final Rules provided that entities qualifying as a "small business" concern" would qualify. Many attorneys, lenders, and borrowers were under the mistaken impression that only businesses under 500 employees would qualify, but that was not necessarily the case as a "small business concern" also allows for revenue or employee qualifications different than the 500 employee threshold based on NAICS codes in the SBA Size Standards as posted on the http://www.sba.gov website. Additionally, venture capital and private equity companies with majority stakes in small businesses were confused about whether they qualify based on affiliation rules, and the Final Rules did not provide sufficient insight by stating "SBA intends to promptly issue additional guidance with regard to the applicability of affiliation rules at 13 CFR §§ 121.103 and 121.301 to PPP loans."

Over the weekend, the SBA posted the final affiliation rules, which will be further discussed below. Additionally, Senator Marco Rubio, one of the principal authors of the bill, addressed a number of concerns via press release.

## Senator Rubio's Comments

Over the weekend, Senator Rubio issued a press release to address a number of issues that happened on the first day. The full release can be found here.

Some of his comments are summarized here:

- Concerns were raised that large banks were declining applications unless the business was an existing customer with an outstanding loan or credit card. Rubio said that banks had already started changing the policy, and that certain FinTech and online lenders such as Paypal will be up and running soon.
- Banks raised concerns regarding the interim rule that provides a lender must hold a loan for seven (7) weeks or more before being eligible for a government forgiveness repurchase. Rubio said that the government understands the liquidity concern, and the Federal Reserve should address this with lending facilities to community banks shortly.
- Many raised issues that the final rules and the CARES Act contradict one another with respect to inclusion of 1099 contractors in the payroll cost calculation. He said this should be resolved soon.
- Rubio also stated that the government is addressing technology issues with the E-Tran system by contracting Amazon to assist, and requested patience given the loan application processing.
- Finally, Rubio said it is clear that not enough money is appropriated, that money will likely run out in May, and he has committed to providing additional funding under the program.

## Final Affiliation Rules

The final SBA rules on affiliation were posted over the weekend and can be found in their entirety here. The United States Department of Treasury has also provided guidance for the public here.

The SBA has provided that a business qualifies as a small business in two ways: (i) it has less than 500 employees; or (ii) is otherwise defined as a "small business concern" either by employees or revenue, as provided in the Small Business Size Standards. In considering whether a business meets that threshold, it takes into account affiliates. Given the amount of questions about the affiliate rules, the SBA has posted Affiliation Rules.

The SBA has provided that an affiliation will exist when "concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists."

The SBA has outlined four (4) specific situations when control will be found to exist:

1. Ownership. Affiliation can be found based on equity ownership. If an individual, concern, or entity that owns or has the power to control more than 50% of the voting equity of both the borrower and another business. If no individual, concern, or entity has more than 50%, the SBA would "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." A minority shareholder can be found to be in control if under the charter, bylaws, operating agreement, etc. it would be able to prevent a quorum or block an action by the board or shareholders.

2. Stock Options, Convertible Securities, and Merger Agreements. The SBA considers stock options, convertible securities, and agreements to merge as a power to control, and the SBA treats each as if the rights granted have been fully exercised. It is important to note that agreements to open or continue negotiations towards a merger are not given present effect. Additionally, the SBA will not permit an individual, concern, or other entity to terminate such contracts in order to divest ownership to avoid a finding of affiliation.

3. Management. SBA affiliation rules will examine common management when determining affiliation. Specifically, affiliation will occur when a CEO or President of the applicant (or other officers, managing members, or partners who control the management of the concern) also control the management of one or more other entities. Affiliation can also arise through a management agreement, or if an individual or entity controls the board of directors of multiple entities.

4. Identity of Interest. An affiliation also can arise if close relatives operate substantially identical entities, or have substantially identical economic interests. "Close relatives" is defined as a spouse, parent, child, or sibling. This presumption can be rebutted with evidence that the interests are in fact separate.

There are a number of exceptions to the affiliation rules. Specifically, the following are exempted: "(1) any business concern with not more than 500 employees that, as of the date on which the loan is disbursed, is assigned a NAICS code beginning with 72; (2) any business concern operating as a franchise that is assigned a franchise identifier code by the Administration; and (3) 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). Finally, there are exemptions for religious organizations.

- NAICS Code 72 relates to the Accommodation and Food Services industries, including hotels, caterers, restaurants, and food service contractors.

- Franchises are exempted as well under the CARES Act. Qualifying franchises are listed on the SBA Franchise Directory, and they have been already reviewed by the SBA and are eligible for SBA financial assistance. The directory will only include business models that the SBA determines are eligible under the SBA's affiliation rules and other eligibility criteria. If not listed, the franchise will have to apply to have the franchise listed as a qualifying franchise.

- Section 301 of the Small Business Investment Act provides funding for small business investment companies, which are privately operated and use their own funds and SBA funds to supply equity, capital, long-term loans, and assistance to qualifying small businesses.

- The SBA has provided the following guidance as to religious organizations: "[t]he relationship of a faith-based organization 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."

**SBA Addresses Frequently Asked Question Regarding Lender Responsibility for Borrower Calculations**

The final update provided over the weekend was that the SBA posted an answer to the following frequently asked question here:

*Paragraph 3.b.iii of the PPP Interim Final Rule states that lenders must "[c]onfirm the dollar amount of average monthly payroll costs for the preceding calendar year by reviewing the payroll documentation submitted with the borrower's application." Does that require the lender to replicate every borrower's calculations?*

The SBA has definitively answered no, a lender is not required to replicate the borrower's calculations. Specifically, the SBA has advised that the lender is required to obtain the borrower's attestation as to the accuracy of the calculations, which is contained in the application form. That being said, the SBA still expects lenders to conduct a good-faith review of the calculations and supporting documents required, such as minimal review of calculations done by a third-party payroll processor. Lenders may specifically rely on borrower representations, but are expected to raise errors that the Lender identifies in the supporting documents to the borrower, and to reasonably work with the borrower to rectify the issue.

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https://www.grsm.com/publications/2020/day-1-of-the-paycheck-protection-loan-program-and-the-final-affiliation-rules