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COVID-19 CLIENT ALERT: AFFILIATION UPDATE TO PAYROLL PROTECTION PROGRAM

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UPDATE TO PAYROLL PROTECTION PROGRAM

This Article is an update to WLJ's [overview of the Payroll Protection Program](#) published on March 28th.

Since the date of the overview, the U.S. Treasury and Small Business Administration provided the following guidance with respect to the Payroll Protection Program (PPP):

- Applications may be submitted beginning on April 3, 2020
- All loan terms will be the same for everyone.
 - ◆ Interest Rate – 0.5%
 - ◆ Loan Term – 2 Years
 - ◆ Loan payments deferred for 6 months (interest will accrue)
 - ◆ Loan fees paid by SBA
- Submit the attached PPP Application Form to your SBA Lender: [SBA Application Form](#)
- PPP Information Sheet for Borrowers: [PPP Information Sheet for Borrowers](#).

Generally, PPP loans are available to small businesses and 501(c)(3) organizations with less than 500 employees. In this article, we discuss how this “500 employee” requirement is calculated under traditional SBA regulations and how this calculation is affected if businesses are deemed to be “affiliated” with another person or business entity.

AFFILIATION RULES & CALCULATION OF 500 EMPLOYEES

Under the CARES Act, the SBA is charged with administering PPP loans through its existing 7(a) loan program. Like other SBA loan programs, PPP eligibility is based on the size of the small-business applicant. Generally, PPP is available to any business with fewer than 500 employees and was operational before February 15, 2020. The 500-employee threshold includes full-time, part-time and other employees but does not include independent contractors.

Practice Note: The term “other employees” includes leased employees and temp employees but not volunteers. Other employees, such as those working under a Federal Work Study Program are determined on the totality of the circumstances. (13 CFR § 121.106)

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Businesses that don't qualify under the general standards referenced above may still be eligible for the Paycheck Protection Program if any of the following are true:

- Businesses with more than 500 employees may still be eligible if the business has less than the maximum number of employees specified in the current SBA size standards applicable to its specific industry (Information on SBA Size Standards can be found here: <https://www.sba.gov/document/support--table-size-standards>);
- Restaurant, Food Service and Hospitality businesses with more than one location are eligible as long as the business does not have more than 500 employees at any one location (these are businesses whose NAICS code starts with "72" at the time of the loan disbursement); or
- Certain franchises and recipients of Small Business Investment Company investment with more than 500 employees may be eligible as long as the business does not have more than 500 employees at any one location.

HOW DOES A BUSINESS CALCULATE NUMBER OF EMPLOYEES?

In order to determine eligibility for the PPP, lenders and borrowers must accurately calculate, and certify to SBA, the applicant's number of employees. Under the 7(a) loan program, employee size standards are calculated based on the applicant's average number of employees for each pay period during the 12-month period prior to the date of the loan application (if the applicant has not been in business for 12 months, the average number of employees is used for each of the pay periods during which it has been in business).

Most businesses have 24 (bi-monthly) or 26 (bi-weekly) pay periods. For example, an applicant using a bi-monthly pay period would calculate the number of employees paid during each of the 24 pay periods preceding the date of the loan. The applicant would add the total number of employees employed during all pay periods and then divide by the number of pay periods (e.g., 24) to determine the average number of employees.

Practice Note: The CARES Act simply states that a business must have "not more than 500 employees." The CARES Act does not specifically reference "average" employees, but this is the methodology used by the SBA for other loan programs.

AFFILIATION RULES

Under existing SBA regulations, when determining the size of a business concern, the business must also include the number of employees of each affiliate of the business concern. (13 CFR § 121.106 and 13 CFR § 121.301). Accordingly, when calculating its number of employees for the 500-employee requirement, an applicant must also determine the number of employees of all other businesses that are considered affiliates under the SBA regulations.

As a side note, the CARES Act references the affiliation rules in 13 CFR § 121.103 when discussing the exemptions for food and restaurant businesses; however, 13 CFR § 121.301

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typically governs affiliation within the SBA's 7(a) loan program. It's unclear which set of rules would take precedent given the ambiguity in the CARES Act. However, both sets of rules are substantially similar with respect to the determining factors of affiliation.

WHO IS AN AFFILIATE?

So how does SBA define affiliation? Very broadly. When considering whether businesses are considered to be affiliates of one another, SBA considers the following:

- **CONTROL** - Businesses 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.

Practice Note: Control can be exhibited through stock ownership, a common management structure or Board of Directors, or through contractual relationships.

- **NEGATIVE CONTROL** - Negative control includes, but is not limited to, instances where a minority shareholder 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.

Practice Note: Any applicant who has received private-equity investment should review its governing documents to determine if a minority investor exercises negative control. It is common for private-equity and other investors to receive preferential rights with respect to voting on certain "extraordinary matters" such as a decision to issue additional shares, remove directors or officers, or sell the business's assets.

- **TOTALITY OF CIRCUMSTANCES** - In determining whether affiliation exists, SBA will consider the totality of the circumstances, and may find affiliation even though no single factor is sufficient to constitute affiliation.

Practice Note: This allows the SBA and its enforcement division to consider affiliation on a case-by-case basis and essentially means that your lender or attorney can't give you a simple Yes/No answer.

(See 13 CFR § 121.103 & 13 CFR § 121.301)

SBA EXAMPLES OF AFFILIATION

Common Stock Ownership - A person or entity that owns, or has the power to control, fifty percent (50%) or more of a business's voting stock, or a block of voting stock which is large compared to other outstanding blocks of voting stock, controls or has the power to control the concern.

Common Management - Affiliation arises where one or more officers, directors, managing members, or partners who control the board of directors and/or management of one business also control the board of directors or management of one or more other businesses. Affiliation also

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arises where a single individual or entity controls the management of the applicant through a management agreement.

Economic Dependency or “Identity of Interest” - Individuals or businesses that have identical or substantially identical business or economic interests (such as family members, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships) may be treated as one party with such interests aggregated. Where SBA determines that such 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.

SBA may presume affiliation based upon economic dependence if the business in question derived eighty-five percent (85%) or more of its revenues from another business over the previous three fiscal years, unless the contract (or contracts) does not restrict the business from selling the same type of products or services to another customer or third party or the SBA otherwise agrees that the terms of the contract (or contracts) do not provide the purchaser with control or the power to control the seller.

Example: Business A has been in business for five years. It has 50 total contracts. Of that 50, 45 contracts are with Business B and the value of those contracts is greater than 85% of Business A’s revenue over the previous three years. In this case, SBA would most likely find the two firms affiliated unless Business A could provide some other compelling rebuttal to the very strong presumption that it should be considered affiliated with Business B.

WHAT DOES IT MEAN?

Any business looking to apply for the PPP must analyze whether it is affiliated with another person or business for the purposes of determining whether the applicant satisfies the 500-employee requirement of the PPP. If, under the rules and concepts discussed above, the applicant is affiliated with another business, the applicant must include each affiliate’s employees within its calculation of employee-size. If the applicant, when combined with all of its affiliates, has more than 500 full-time, part-time, or other employees under the “pay-period” test discussed above, the applicant may be ineligible for the PPP unless an exemption applies.

PPP Applicants must be especially diligent to avoid potential application of the False Claims Act (FCA), which penalizes false or fraudulent statements made to the government in connection with a request for payment. As a result, applicants should ensure that they meet the size requirements, including any aggregation with affiliated companies, before applying for a PPP loan.

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