

Client Alert: SBA Updates to the Paycheck Protection Program

On April 2 and April 3, the Small Business Administration (SBA) issued rules and guidance regarding the new Paycheck Protection Program Loans (PPP Loans) created by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, which was signed into law in response to the COVID-19 pandemic.

On April 2, 2020, SBA adopted an Interim Final Rule (the “**April 2 Rule**”) that addresses the SBA’s implementation of the PPP Loans. The full text of the April 2 Rule can be found [here](#).

On April 3, 2020, SBA issued a second Interim Final Rule (the “**April 3 Rule**”) addressing the affiliation rules used to determine the eligibility of borrowers to receive PPP Loans and issued additional guidance (the “Affiliation Guidance”) regarding those affiliation rules. The full text of the April 3 Rule can be found [here](#) and the Affiliation Guidance can be found [here](#).

Clarification and Modification of the PPP Loan Program

The April 2 Rule clarifies or modifies several aspects of the PPP Loan program, including the following:

- **Interest Rate Increased** - The interest rate on PPP Loans has been raised from 0.5% to 1.0%. All loan payments (principal, interest and fees) are deferred for six months; however, interest will accrue during this six-month deferral period.
- **Accrued Interest Included in Maximum Forgivable Amount** - The amount of loan forgiveness can be up to the full principal amount of the loan and any accrued interest. The CARES Act provides that the amount of loan forgiveness may not exceed the principal amount of the PPP Loan, and does not address accrued interest. Accordingly, accrued interest was not thought to be included in the maximum loan forgiveness amount.
- **One Loan Per Borrower** - Borrowers may not receive more than one PPP Loan.
- **First-come, first-served** - PPP Loans are offered on a “first-come, first-served” basis. As such, the April 2 Interim Final Rule encourages borrowers to apply early and to consider applying for the maximum eligible amount.
- **25% Cap on Non-Payroll Uses** - No more than 25% of the loan forgiveness amount of a PPP Loan may be attributable to non-payroll costs. SBA has determined that the non-payroll uses of a forgivable loan should be limited to effectuate the core purpose of the CARES Act and to ensure that the program’s finite resources are devoted primarily to payroll. Borrowers will have to document the proceeds used for payroll costs in order to determine the amount of forgiveness.
- **Independent Contractors** - For purposes of calculating the maximum eligible loan size and the forgivable amount of a PPP Loan, borrowers may not treat independent contractors as employees. Accordingly, payments made to independent contractors may not be taken into account when determining a borrower’s maximum eligible loan amount or the amount of a PPP Loan that will be forgiven. Independent Contractors are eligible to receive PPP Loans directly under the program.
- **Non-U.S. Employees** - Employees whose principal place of residence is outside the United States are not included in determining whether a borrower has 500 or fewer employees. The CARES Act provided that compensation paid to such employees was not included in the definition of “payroll costs,” but did not address whether such employees would be counted for purposes of determining an applicant’s eligibility.
- **Additional Ineligible Borrower Categories** - An applicant will be ineligible for a PPP Loan if (1) the applicant is engaged in any activity that is illegal under federal, state, or local law; (2) the applicant is a household employer; (3) an owner of 20% or more of the equity of the applicant is incarcerated, on probation, or on parole, is presently subject to an indictment, criminal information, arraignment, or other means by which formal criminal charges are brought in any jurisdiction, or has been convicted of a felony within the last five years; or (4) the borrower, or any business owned or controlled by the borrower or any of its owners, has ever obtained a direct or guaranteed loan from SBA or any other Federal agency that is currently delinquent or has defaulted within the last seven years and caused a loss to the government.
- **Consequences for Misuse of Loan Proceeds** - Misuse of loan funds will result in SBA directing the borrower to repay the misused funds. Knowing misuse of PPP Loan funds will subject a borrower to additional liability (such as fraud charges). In addition, if a shareholder, member or partner of a borrower uses PPP Loan funds for an unauthorized purpose, SBA will have recourse against that shareholder, member or partner for the unauthorized use.

- **Additional Guidance to Come** - SBA will issue additional guidance on loan forgiveness.

Application of Affiliation Rules

The April 3 Rule clarifies that, except as expressly provided in the CARES Act and for certain faith-based organizations described below, borrowers will be considered with their affiliates for purposes of determining eligibility for PPP Loans. To determine the number of employees an applicant has, SBA aggregates the applicant's employees together with those of its affiliates. The April 3 Rule also notes that, pursuant to 13 C.F.R. section 121.301(f), which applies to other SBA loan programs, entities may be considered affiliates based on factors including stock ownership, overlapping management and identity of interest.

The Affiliation Guidance states that four tests for affiliation based on control apply to participants in the PPP. Businesses are affiliates of each other when one controls or has the power to control the other, or a third party has the power to control both. It does not matter whether control is exercised, so long as the power to control exists. Affiliation may be established using any of the following tests:

- **Affiliation Based on Ownership** - A business is an affiliate of any individual, concern or entity that owns or has the power to control more than 50% of its voting equity. If no individual or entity is found to control, SBA will deem the Board of Directors or President or CEO (or other officers, managing members, or partners who control the management of the business) to be in control of the business.

In addition, a minority shareholder can be deemed to control a company if that individual or entity has the ability, under the company's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders. In interpreting similar language in 13 C.F.R. section 121.103(a)(3), SBA has generally determined that a minority owner has control over a company if the minority owner can block ordinary actions essential to operating the company. We believe that SBA is likely to apply a similar interpretation with respect to PPP Loans, although it may take some time for that to be clarified. Examples of essential actions include approving budgets, hiring and firing officers, setting employee compensation, borrowing money, paying dividends, purchasing equipment, incurring expenses over a specified dollar amount, selling or encumbering assets and amending or terminating leases.

On the other hand, these interpretations provide that a minority owner's right to approve extraordinary actions outside the ordinary course of business that are intended to protect the value of the owner's investment may not result in the minority owner having control. Such extraordinary actions include the issuance of additional capital stock, the sale of all of the company's assets, amendments of the bylaws, operating agreement or charter documents, changes to the nature of the company's business, dissolution of the company and filing for bankruptcy.

- **Affiliation arising under stock options, convertible securities, and agreements to merge.** - In determining a business's size, SBA deems stock options, convertible securities, and merger agreements to have a present effect on the power to control the business, and SBA treats them as though the rights granted by them have been exercised. However, agreements to open or continue negotiations are not given present effect. Similarly, options, convertible securities, and other contingent equity rights agreements that are incapable of fulfillment, speculative, conjectural, or unenforceable are not given present effect. SBA will not give present effect to individuals' or other entities' ability to divest their ownership interest in order to avoid a finding of affiliation.
- **Affiliation based on management** - Affiliation will arise where (1) the applicant's CEO or president (or other officers, managing members, or partners who control the management of the applicant) also controls the management of one or more other businesses, (2) a single individual or entity that controls the Board of Directors or management of the applicant also controls the Board of Directors or management of one or more other businesses, and (3) a single individual or entity controls the management of the applicant through a management agreement.
- **Affiliation based on identity of interest** - Affiliation arises when there is an identity of interest between close relatives (*i.e.*, a spouse; a parent; or a child or sibling, or the spouse of any such person) with identical or substantially identical business or economic interests (such as where the close relatives operate businesses in the same or similar industry in the same geographic area). Such SBA determinations are rebuttable.

Exceptions to Affiliation Rules

The April 3 Rule amends SBA rule 103 to provide that the 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.

The April 3 Rule and the Affiliation Guidance also confirm that, as set forth in the text of the CARES Act, the affiliation rules described above do not apply to (1) any business with 500 or fewer employees that is in the accommodation and food services sector; (2) any business operating as a franchise that is assigned a franchise identifier code by the SBA; and (3) any business that receives financial assistance from a small business investment company, as set forth in section 301 of the Small Business Investment Act of 1958 (15 U.S.C. 681).

Other Considerations

While lenders were expected to begin processing applications for PPP Loans on April 3, 2020, several lenders have delayed accepting applications. If you want to apply for a PPP Loan, you should reach out to your bank to determine the status of their application program.

Applicants for a PPP Loan should be aware that information about approved PPP Loans will be released by the SBA in response to FOIA requests. Such information includes the name of the borrower (and its officers, directors, stockholders or partners), the amount of the loan, its purpose in general terms and the maturity date. As part of an application for a PPP Loan, the applicant must certify that, where feasible, it will purchase only American-made equipment and products.

For additional background on small business loans available under the CARES Act, including PPP Loans, please see our Client Alert on Small Business Loans under the CARES Act, available [here](#). Due to the recent adoption of the CARES Act, interpretation of some of its provisions is uncertain, and it is subject to additional clarification and interpretation by Treasury, IRS, SBA and other federal regulatory agencies.