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How the SBA's Affiliation Rules May Affect Your Loan Eligibility for COVID-19 Economic Relief

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UPDATE: On April 15, 2020, the SBA released [additional guidance on frequently asked questions](#) (FAQs) related to the new Paycheck Protection Program (PPP) Loans provided for in the CARES Act. As it relates to the affiliation rules under 13 C.F.R. 121.301(f) discussed below, the FAQs clarify application of the affiliation rules to franchises and businesses assigned a North American Industry Classification System (NAICS) code beginning with 72, which involve accommodation and food services.

Specifically, the SBA explained that if a franchise brand that is listed on the SBA Franchise Directory, each of its franchisees that meets the applicable size standard can apply for a PPP loan. Importantly, the franchisee is to be the applicant – the franchisor does not apply on behalf of its franchisees.) Further, the \$10 million cap on PPP loans is a limit per franchisee entity (who will not be deemed affiliated with other franchisees or the franchisor), and each franchisee is limited to one PPP loan.

With respect to business having an NAICS code beginning with 72, the SBA provided several examples showing application of the affiliation rules to these businesses. As noted below, under the CARES Act, any single business entity that is assigned a NAICS code beginning with 72 (including hotels and restaurants) and that employs not more than 500 employees per physical location is eligible to receive a PPP loan, and the SBA's affiliation rules do not apply. The SBA explained that if each hotel or restaurant location owned by a parent business is a separate legal business entity, each hotel or restaurant location that employs not more than 500 employees is permitted to apply for a separate PPP loan provided it uses its unique EIN. Further, the \$10 million maximum loan amount limitation applies to each eligible business entity. The following examples are instructive:

- *Company X directly owns multiple restaurants and has no affiliates.*
 - Company X may apply for a PPP loan if it employs 500 or fewer employees per location (including at its headquarters), even if the total number of employees employed across all locations is over 500.
- *Company X wholly owns Company Y and Company Z (as a result, Companies X, Y, and Z are all affiliates of one another). Company Y and Company Z each own a single restaurant with 500 or fewer employees .*
 - Company Y and Company Z can each apply for a separate PPP loan, because each has 500 or fewer employees. The affiliation rules do not apply, because Company Y and Company Z each has 500 or fewer employees and is in the food services business (with a NAICS code beginning with 72).
- *Company X wholly owns Company Y and Company Z (as a result, Companies X, Y, and Z are all affiliates of one another). Company Y owns a restaurant with 400 employees. Company Z is a construction company with 400 employees.*

- Company Y is eligible for a PPP loan because it has 500 or fewer employees. The affiliation rules do not apply to Company Y, because it has 500 or fewer employees and is in the food services business (with a NAICS code beginning with 72).
- Conversely, the waiver of the affiliation rules *does not* apply to Company Z, because Company Z is in the construction industry. Under SBA's affiliation rules, 13 CFR 121.301(f)(1) and (3), Company Y and Company Z are affiliates of one another because they are under the common control of Company X, which wholly owns both companies. This means that the size of Company Z is determined by adding its employees to those of Companies X and Y. Therefore, Company Z is deemed to have more than 500 employees, together with its affiliates. However, Company Z may be eligible to receive a PPP loan as a small business concern if it, together with Companies X and Y, meets SBA's other "applicable size standards."

If you have any questions or want to discuss these matters further, please don't hesitate to contact the Gould & Ratner attorney with whom you work regularly, or any of the lawyers in our [Coronavirus/COVID19 Resources Team](#).

UPDATE: On April 7, 2020, the SBA released [guidance on frequently asked questions](#) (FAQs) related to the new Paycheck Protection Program (PPP) Loans provided for in the CARES Act. As it relates to the affiliation rules under 13 C.F.R. 121.301(f) discussed below, the FAQs clarify that it is the responsibility of the borrower to determine which entities (if any) are its affiliates and to determine the employee headcount of the borrower and its affiliates. Borrowers must apply the affiliation rules set forth in 13 C.F.R. 121.301(f) and as set forth in the SBA's Interim Final Rule on Affiliation, and must certify that they are eligible to receive a PPP loan. Lenders are permitted to rely on borrowers' certifications.

Additionally, the FAQs make clear that if a minority shareholder in a business irrevocably waives or relinquishes its rights to prevent a quorum or otherwise block action by the board of directors or shareholders of a business concern, the minority shareholder would no longer be an affiliate of the business (assuming no other relationship exists that triggers the affiliation rules).

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UPDATE: On April 3, 2020, the Small Business Association (SBA) issued additional guidance regarding application of the affiliation rules to applicants for the Paycheck Protection Program (PPP). According to the SBA guidance, only the following tests will be used in determining whether an applicant for a PPP loan has affiliates:

- **Affiliation based on ownership:** This test is the same as the ownership test discussed below. Namely, a concern is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50% 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.
- **Affiliation arising under stock options, convertible securities and agreements to merge:** Again, this test remains the same as that discussed below. 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. Further, the SBA treats such options, convertible securities and agreements as though the rights granted have been exercised. As before, agreements to open or continue negotiations toward the possibility of a merger are not agreements in principle.

Importantly, the recently issued guidance closes a loophole to prevent concerns from divesting interests to make the applicant eligible for a PPP loan: "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 goes on to state that it "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."

- **Affiliation based on management:** This test also remained unchanged in the latest guidance. Affiliation arises in three scenarios of common 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 (*as shown below*).
 - 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 or more other concerns (*as shown below*).
 - Affiliation also arises where a single individual, concern or entity controls the management of the applicant concern through a management agreement (*as shown below*).
- **Affiliation based on identity of interest:** The identity of interest test was narrowed by the SBA for applicants seeking loans under the PPP. For purposes of determining eligibility for a PPP loan, affiliation arises when there is an identity of interest between close relatives (spouse, 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 concerns in the same or similar industry in the same geographic area). This, however, remains a rebuttable presumption, and the applicant may submit evidence showing that the interests deemed to be one are in fact separate (*as shown below*).

The SBA also added a religious exemption for the affiliation based on identity of interest: “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.”

Finally, as noted in the original post, the SBA reiterated that these affiliation rules are waived as to:

- All businesses with fewer than 500 employees that are assigned a NAICS code beginning with 72 (such as restaurants and hotels) as of the date the PPP Loan is disbursed;
- Any business operating as a franchise that is assigned a franchise identifier code by the SBA; and
- Any business that receives financial assistance from small business investment companies (SBICs).

Note that the remainder of the affiliation rules (discussed below) still apply to applicants who are pursuing an Economic Injury Disaster Loan (EIDL).

If you have any questions or want to discuss these matters further, please don't hesitate to contact the Gould & Ratner attorney with whom you work regularly, or any of the lawyers in our [Coronavirus/COVID19 Resources Team](#).

(Originally Posted April 3, 2020)

In the week since Congress passed a \$2 trillion stimulus bill to provide economic relief from the impact of the coronavirus (COVID-19) pandemic, many businesses with affiliate status or affiliate relationships have been trying to determine their eligibility for loans administered by the Small Business Administration (SBA). The following analysis gives an overview of how affiliates may take advantage of the SBA's existing Economic Injury Disaster Loan (EIDL) program or its new Paycheck Protection Program Loan (PPP Loan).

One key provision for these loans – expanded or created by the Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020 and the Coronavirus Aid, Relief, and Economic Security (CARES) Act – is that businesses employ no more than 500 employees, or, if applicable, the size standard in number of employees established by the SBA for the industry in which the business operates.

Additionally, under SBA regulations, certain “affiliation” rules may require you to include the number of employees or annual receipts of another business when determining your eligibility. If you're a business with fewer than 500 employees, how do you determine

whether you are “affiliated” with another business?

First, in understanding the SBA affiliation rules discussed below, it is important to understand the term “business concern” or “concern.” The SBA defines a business concern broadly, providing that “except for small agricultural cooperatives, a business concern eligible for assistance from SBA as a small business is a business entity organized for profit, with a place of business located in the United States, and which operates primarily within the United States or which makes a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor.”¹³ C.F.R. § 121.105(a)(1).

Outside of the exceptions listed in the CARES Act, affiliation must be considered when evaluating eligibility for SBA loans. Therefore, unless an exception applies, a business determining its size must identify and include the annual receipts or number of employees of its affiliates when determining whether it meets the applicable size standard.

All About Control

Under SBA regulations, affiliation is generally determined by a determination of “control”: it exists when one entity controls the other, 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 the control is actually exercised, just that the power to control exists. Affiliation may also be found where control is exercised indirectly through a third party. The SBA will consider factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships, in determining whether affiliation exists.

Control may be affirmative or negative. Negative control, as seen below, includes instances where a minority shareholder has the ability, under the business’s charter, by-laws, or shareholder’s agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.

When determining whether affiliation exists, the SBA will consider the totality of the circumstances, and may find affiliation even though no single factor is sufficient to constitute affiliation. If the SBA determines that affiliation exists, the SBA will count the receipts, employees or other measure of size, as well as all of its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit.

The employees of a former affiliate are not counted if affiliation ceased before the date used for determining size.

While the SBA has announced that it intends to issue guidance on how the affiliation rules will be applied to these loan programs, it has not done so yet. Instead, it has advised that the affiliation rules set forth in 13 C.F.R. § 121.301 still apply. Thus, in determining control, affiliation under any of the circumstances described below may be sufficient to establish affiliation for applicants: [\[1\]](#)

- **Ownership:** A person (including an individual, concern or other entity) that owns or has the power to control more than 50% of the concern’s voting equity controls or has the power to control the concern is deemed an affiliate. If no individual, concern, or entity is found to control, the SBA will deem the board of directors, president, chief executive officer (CEO), or other officers, managing members or partners who control the management of the concern to be in control. Where a minority shareholder has the ability to prevent a quorum or otherwise block action by the board of directors or shareholders, pursuant to the concern’s charter, by-laws or shareholder’s agreement, the SBA will deem the minority shareholder to be in control, and therefore, an affiliate of the applicant.
- **Stock options, convertible securities and agreements to merge:** The SBA treats these rights as though they have actually been exercised. In determining size, the SBA gives present effect to stock options, convertible securities and agreements to merge (including agreements in principle). Agreements in principle do not include agreements that are open or merely continue negotiations towards the possibility of a merger and are thus not given present effect. Likewise, options, convertible securities and agreements are not given present effect when (i) they are subject to conditions precedent that are speculative or unenforceable under state or federal law or (ii) the probability of the transaction or exercise of rights is shown to be extremely remote.
- **Common Management:** Affiliation exists for the purposes of these loans under each of the following common management situations:

- where one or more of the officers, managing members or partners who control the management of one concern also control the management of one or more other concerns;
- 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 or more other concerns; or
- where a single individual, concern or entity controls the management of the applicant business through a management agreement.

- **Identity of interest between individuals or businesses, including family members:** Affiliation through identity of interest includes “close relatives” with identical or substantially identical businesses or economics interests (such as where the close relatives operate concerns in the same or similar industry in the same geographic area). Close relatives is defined as a spouse, parent, child, sibling or spouse of any such person.

Identity of interest also exists between common investments, where the same individuals or firms together own a substantial portion of multiple concerns in the same or related industry, and such concerns conduct business with each other or share resources.

Finally, identity of interest can exist among businesses that are economically dependent on each other. Thus, affiliation exists when a concern derived more than 85% of its receipts over the previous three fiscal years from a contractual relationship with another concern. There are exceptions to this rule, so if you have a similar contractual relationship, you should review the statute to see if an exception is applicable to your circumstance.

Note that affiliation through identity of interest can be rebutted by the applicant with “evidence showing that the interests deemed to be one are in fact separate.”

- **Newly organized concern:** A new concern that has been actively operating for two years or less may be deemed affiliated with another entity if the new concern is organized by the current or former officers, directors, owners of 20% interest or greater, or managers of the other entity, those individuals serve as the new concern’s officers, directors, managers or owners, and the new concern operates in the same field or a related industry or field, and monetary benefits flow back to the original entity. This can be rebutted by showing a clear line of fracture between the two businesses.
- **Franchise Agreements:** Generally, the restraints imposed on a franchisee by its franchise agreement will not be considered in determining whether the franchisor is affiliated with an applicant franchisee provided the applicant franchisee has the right to profit from its efforts and bears the risk of loss commensurate with ownership. However, the CARES Act has waived affiliation rules for businesses operating as franchises (as discussed below).
- **Totality of the Circumstances:** The SBA retains a catch-all affiliation basis in its regulations. Even though no single factor is sufficient to constitute affiliation, the SBA may find affiliation on a case-by-case basis where there is clear and convincing evidence based on the totality of the circumstances.

In addition, the SBA also recognizes many exceptions to the affiliation rules, set forth in 13 CFR § 121.103(b), in determining an applicant’s affiliates for these loan programs. If an affiliation rule appears to apply, you should review the exceptions before making a final determination.

Importantly, the CARES Act waives affiliation rules for businesses applying for a PPP Loan as it applies to the following businesses:

- All businesses with fewer than 500 employees which are assigned a NAICS code beginning with 72 (such as restaurants and hotels) as of the date the PPP Loan is disbursed;
- Any business operating as a franchise that is assigned a franchise identifier code by the SBA; and
- Any business that receives financial assistance from small business investment companies (SBICs).

For other business and for all loan options beyond the PPP Loan, the affiliation rules still apply, and applicants must meet the size standards to be eligible.

SBA guidance on application of the affiliation rules is expected soon; we will update this article as needed once such guidance is issued.

If you have any questions or want to discuss these matters further, please don't hesitate to contact the Gould & Ratner attorney with whom you work regularly, or any of the lawyers in our [Coronavirus/COVID19 Resources Team](#).

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[1] The affiliation rules applicable to the PPP and EDIL programs are set forth in 13 C.F.R. § 121.301.