NOW + NEXT

CORONAVIRUS STIMULUS AND RELIEF ALERT | NIXON PEABODY LLP

APRIL 6, 2020

NP

Review of the SBA's interim final rule implementing the Paycheck Protection Program

By Caitlin Duncan, Dustin Hawks, Christopher Keefe, William Kelly, and Anita Pelletier

In previous thought pieces, we have discussed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) (Stimulus provides relief for businesses during coronavirus crisis) and the Paycheck Protection Program (PPP) loan program authorized under section 1102 of the CARES Act (SBA issues interim final rule clarifying changes to PPP loans for eligible businesses).

On Thursday, April 2, 2020, the SBA posted an Interim Final Rule implementing the PPP and on Friday, April 3, 2020 posted another Interim Final Rule providing guidance on calculating the number of a borrower's employees for purposes of determining whether the borrower is eligible for a loan under the PPP.[1]

To qualify for a PPP loan, a business must have been in operation on February 15, 2020, and fit within one of the following categories:

- Companies with 500 or fewer employees
- Companies that otherwise meet certain industry employee-based size standards
- Tax-exempt nonprofit organizations described in section 501(c)(3) of the Internal Revenue Code
- Sole proprietorships, independent contractors, or eligible self-employed individuals

An individual who employs only household workers (such as housekeepers and nannies) is not eligible for a PPP loan because the employment of household workers is a personal rather than a business expense.

Finally, a business is not eligible for a PPP loan if it falls into one of the following "bad actor" categories:

- A business engaged in any activity that is illegal under federal, state, or local law (which, among

[1] The Interim Final Rules cover applications submitted under the PPP through June 30, 2020, or until funds made available for the program are exhausted.

other things, excludes businesses in the cannabis industry which may be legal under state and local law but not under federal law)

- A business, or any of its owners, that is currently delinquent on any direct or guaranteed loan from the SBA or any federal government agency or that defaulted on any such loan within the last seven years resulting in a loss to the government
- A business that is owned 20% or more by a person who is incarcerated or on probation or parole, who is currently subject to an indictment, arraignment, or other means by which criminal charges are brought or who has been convicted of a felony within the last five years

In determining the number of employees, the SBA includes not only a company's direct employees, but also employees of affiliates. The CARES Act provides three exceptions to the SBA's affiliation rules, which are noted below. Recently, the SBA issued further guidelines and its Final Interim Rule which clarify that a company is not required to include in its head count employees whose principal place of residence is outside of the U.S.

Both full and part-time employees are counted in determining the number of a business's employees, but independent contractors who receive 1099 compensation are not counted.[2]

Affiliation rules

In determining a borrower's eligibility for a PPP loan, the SBA will apply the guidelines set forth in Section 121.301 of the SBA's regulations (subject to certain statutory and regulatory modifications). Generally, in determining PPP eligibility, a borrower will be considered together with its affiliates. Companies are deemed to be affiliates when one entity controls or has the power to control the other entity or when both entities are subject to the control of a third entity. It is important to note that *whether control is exercised or not is immaterial*—if the right to control exists, affiliation will be deemed to exist. Among other consequences of the SBA's deeming a borrower to include its affiliates is that a borrower must include not only its own employees but also the employees of all of its affiliates in determining whether it has 500 or fewer employees.

Section 121.301 provides the following tests for determining affiliation:

Affiliation based on ownership

A concern is an affiliate of a borrower if the concern owns or has the power to control more than 50% of the borrower's voting equity. If no equity holder is found to control, the SBA will deem a company's board of directors, president, chief executive officer, or managing members or general partners to be in control of the borrower. *Importantly, the SBA will also determine that a minority shareholder has control if that shareholder has blocking rights, including the ability to prevent a quorum or the right to block actions approved by the borrower's board of directors*.

For this reason, it is important that companies (as well the holders of blocking rights) review their governing documents (such as charters and by-laws) and shareholder agreements and consider the impact of those rights in the context of affiliation.

Affiliation arising under agreements to merge and stock options or convertible securities

2 This thought piece has been revised to correct a misstatement in an earlier version. Compensation paid to independent contractors will ***not*** be included in payroll costs in determining the loan amount available to a borrower.

Agreements to merge or sell and options and similar instruments are considered to have a present effect on the power to control a borrower as if the rights under those instruments had already been granted. Agreements to continue negotiations to merge or sell stock (as well as agreements that are subject to condition precedents that are incapable of fulfillment, speculative, conjectural, or unenforceable under state or federal law, or where the probability of the transaction or exercise of rights is extremely remote) are not given present effect and do not constitute the basis for control. Importantly, a person or entity deemed to have control cannot use options, convertible securities, or agreements to terminate such control before actually exercising such options or consummating the transactions contemplated by such agreements. And the SBA will not give present effect to the ability to divest ownership in order to avoid finding affiliation.

Affiliation based on management

Affiliation will also be found where the chief executive officer, president, or other officers, managing members, or general partners who control the borrower also control the management of one or more other businesses. Affiliation can also be found where a *single* individual, concern, or entity that controls the board or management of the borrower also controls the board or management of another concern. Similarly, management agreements will create affiliation.

Affiliation based on identity of interest

Persons and entities that conduct identical or substantially identical businesses or that have identical or substantially identical economic interests (such as when close relatives both operate concerns in the same or similar industry in the same geographic area) will be considered affiliates. However, if the SBA determines such affiliation exists by reason of an identity of interest, a borrower may rebut such determination with evidence showing that the businesses are, in fact, separate.

Notably, in certain circumstances, the CARES Act waives the affiliation rules discussed above:

- 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 (NAICS) code beginning with 72 (the hotel and food service industry)
- Any business concern operating as a franchise that is assigned an NAICS franchise identifier code
- Any business concern that receives financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958 (an SBIC)

Counting only employees whose principal residence is in the United States

In determining whether a borrower has 500 or fewer employees, any employee whose principal residence is outside of the U.S. will not be counted. Unfortunately, neither the CARES Act, the SBA guidelines nor applicable federal income tax regulations provide a clear definition of the term "principal residence," especially as it relates to U.S. citizens or nationals assigned to work abroad either temporarily or on a long-term basis.

Because certain federal income tax benefits (such as the mortgage interest deduction and the exclusion of sales proceeds from taxable gains) are afforded to a taxpayer's "principal residence," the Internal Revenue Code and Treasury regulations provide significant guidance in determining whether the foreign-based employee of a borrower or its affiliate should be counted. For tax purposes, such a determination is to be based on a number of facts and circumstances, and, while not dispositive in the context of the PPP, such facts and circumstances may help determine whether a borrower's employees should be deemed to have a principal residence outside of the United States. These factors include (without limitation):

— The address on a person's driver's license and voter registration
— The address on a person's utility bills
— The address on a person's federal income tax return
— Whether a person has a present intention to resume full-time residence in the United States
— Whether the person maintains a residence in more than one jurisdiction

If a person maintains two or more residences, the IRS will usually assume that his or her "principal residence" for any particular year is the location in which he or she spends the most time during such year. Similarly, if a person is married and temporarily lives apart from his or her spouse and children, the marital home will usually be considered his or her "principal residence."

Waiver for faith-based organizations

The SBA affiliation rules will not apply to faith-based organizations in connection with PPP loans if the affiliation is "based on a sincere religious teaching or belief or otherwise constitutes a part of the exercise of religion." The exception is based on the SBA's interpretation of the Religious Freedom Restoration Act (RFRA) and applies to any organization associated with a church or convention or association of churches. Of note, this exception includes faith-based organizations that have a parent/subsidiary relationship (which is a common structure) because such structures are frequently based on religious requirements and not those typically understood in the civil context. Affiliations for administrative convenience are still subject to the SBA affiliation rules.

Determining maximum loan amount

The maximum amount a business may borrow under the PPP is the lesser of $10 million or an amount calculated under a payroll-based formula set forth in the CARES Act. To calculate the maximum loan amount using the payroll based formula, a borrower must (i) add (a) its average gross monthly wage payroll for the last twelve months prior to the date of its loan application or, at its election, for the 2019 calendar year, (b) additional *employer paid* contributions for state or local (but not federal) employer payroll tax obligations (e.g., unemployment taxes), and (c) employer-paid employee benefits not already included in the wage payroll (e.g., insurance, retirement, severance, leave benefits), then (ii) subtract (a) any compensation paid to employees whose principal residence is not in the United States and (b) the amount of compensation in excess of $100,000 paid to any individual employee whose annual compensation is in excess of $100,000[3], and (iii) multiply that amount by 2.5.

Borrower certifications

It is important that borrowers provide correct and complete information on their PPP loan applications. Each borrower is required to certify in good faith to its lenders that it meets all of the

[3] This thought piece has been revised to correct a misstatement in an earlier version. The first $100,000 (or less) of compensation paid to every employee should be included in the calculation and only the amount in excess of $100,000 should be excluded.

eligibility requirements for a PPP loan, and lenders are entitled to rely on borrowers' certifications of eligibility and will be "held harmless for borrowers' failure to comply with the program criteria." If a borrower (or the borrower's representative who makes the certification) knowingly makes a false statement on its application or any supporting documentation, including statements about affiliates, it is subject to punishment by imprisonment of up to five years and/or fines of up to $250,00, which amounts are increased, in the case of loans from federally insured institutions to imprisonment of up to thirty years and/or fines of up to $1,250,000.

When applying for a PPP loan, an organization that makes a good-faith determination that it qualifies for the affiliation exception should include the statement set forth as Addendum A to the Interim Final Rule. Consistent with the requirements of the RFRA, the SBA and lenders will not assess or question the reasonableness of a faith-based organization's good-faith determination that it qualifies for the exception.

For more information on the content of this alert, please contact our Coronavirus Response team, your Nixon Peabody attorney, or:

— Caitlin Duncan at **cduncan@nixonpeabody.com** or 617-345-6180
— Dustin Hawks at **dhawks@nixonpeabody.com** or 617-345-6125
— Christopher Keefe at **ckeefe@nixonpeabody.com** or 617-345-1350
— William Kelly at **wkelly@nixonpeabody.com** or 617-345-1195
— Anita Pelletier at **apelletier@nixonpeabody.com** or 585-263-1164

[1] The Interim Final Rule covers applications submitted under the PPP through June 30, 2020, or until funds made available for the program are exhausted.