

To Our Clients and Friends

Memorandum

April 4, 2020

Update on CARES Act Small Business Loans and Analysis of the Affiliation Rules as Applied to PE Portfolio Companies

The federal [Coronavirus Aid, Relief and Economic Security \(“CARES”\) Act](#), which was signed into law on March 27, 2020, provides \$349 billion for Small Business Administration (SBA) “Paycheck Protection Program” (PPP) loans. [Interim Final Regulations](#) were issued on April 2, 2020; and additional [Interim Final Regulations](#), which relate to the SBA’s “affiliation rules,” were issued on April 3, 2020. Under the Regulations, most portfolio companies controlled (by majority control or negative control) by private equity sponsors would *not* be eligible for loans under the PPP program unless they are in specific industries (as discussed below).

Eligibility for a loan.

Generally, the loans are available to any business concern (including sole proprietors, independent contractors, and eligible self-employed individuals and non-profits) that was in operation on February 15, 2020 and has no more than 500 employees whose principal place of residence is in the U.S.¹ Each employee (whether employed full-time, part-time, or on an “other basis” (including temporary employees acquired through a placement agency—but not including independent contractors or volunteers) is counted when determining if the business has 500 employees.² Employees of the company’s “affiliates” are also counted³ (see “Affiliation rules” below). There is no requirement that the company first has to seek to obtain loan funds from other sources (*i.e.*, the SBA’s usual “Credit Elsewhere” requirement is being waived.) A company is entitled to apply for only one loan under this program. Eligibility will be determined by the local approved lender who receives the application and will administer the loan if granted (see below—“Procedure for applying for a loan”).

¹ Businesses in certain industries can have more than 500 employees if they meet applicable SBA employee-based size standards for those industries—click [here](#) for additional detail.

² When determining if a business has 500 or fewer employees, the SBA considers the average number of employees for each pay period for the preceding 12 months.

³ If an affiliate was added within the 12-month period, its employee numbers count for the entire 12-month measurement period (not just after the affiliation arose). A former affiliate’s employees would not count if the affiliate relationship ceased before the date the application is accepted for processing (or, possibly the date that the loan is received--there is conflicting guidance on this).

Use of the loan proceeds.

The proceeds can be used only to cover “payroll costs” (see below—“Payroll costs”); interest on mortgage obligations; rent; utility costs; and/or interest payments on any other debt incurred before February 15, 2020. Under the Regulations, at least 75% of the proceeds must be used for payroll costs.⁴

“Payroll costs.”

“Payroll costs” include: (i) salary, wages, commissions, or tips (capped at \$100,000 on an annualized basis for each employee); (ii) employee benefits including costs for vacation, parental, family, medical, or sick leave; allowance for separation or dismissal; payments required for the provision of group health care benefits including insurance premiums; and payment of any retirement benefit; (iii) state and local taxes assessed on compensation; and (iv) in the case of a sole proprietor or independent contractor, wages, commissions, income, or net earnings from self-employment (capped at \$100,000 on an annualized basis for each employee).⁵

Forgiveness of the loan.

The loan and accrued interest will be forgiven in an amount equal to the company’s payments during the 8-week period following the loan origination (the “covered period”) for: “payroll costs” (described above); interest on mortgage obligations that were incurred before February 15, 2020; rent under leases in force before February 15, 2020; utilities if service began before February 15, 2020; and additional wages to tipped employees. However, the amount of forgiveness will be reduced by (i) the percentage of the average number of full-time equivalent employees employed by the company during the covered period as compared to the period between February 15 and June 30, 2019 (or, at the company’s election, the period between January 1 and February 29, 2020) (with special rules for “seasonal employers”) and (ii) the amounts by which, during the covered period, for any employee who in 2019 earned less than \$100,000 on an annualized basis, the company reduced the employee’s total salary or wages by more than 25% of the employee’s total salary or wages during the most recent full quarter during which the employee was employed.⁶ If the company made any reductions in employee headcount or decreases in salaries and wages between February 15 and April 26, 2020, to the extent the company reverses them by June 30, 2020, there will not be a reduction on this basis in the forgiveness amount. Only 25% of the forgiven amount can be attributable to permitted purposes other than payroll costs. The request for

⁴ The government’s guidance issued with the Interim Regulations states that if PPP proceeds are used for unauthorized purposes, SBA will direct the borrower to repay those amounts. If the funds are “knowingly used for unauthorized purposes,” then: “[The borrower] will be subject to additional liability such as charges for fraud. If one of [the borrower’s] shareholders, members or partners uses PPP funds for unauthorized purposes, SBA will have recourse against [such person].”

⁵ Expressly excluded from “payroll costs” are (i) compensation of an employee whose principal place of residence is outside the U.S.; (ii) compensation of an individual employee in excess of \$100,000 (prorated if necessary); (iii) federal employment taxes imposed or withheld between February 15, 2020 and June 30, 2020 (including the employee’s and employer’s share of social security taxes) and income taxes required to be withheld; and (iv) qualified sick and family leave for which a credit is allowed under the CARES Act. Compensation paid to independent contractors is not included in payroll costs (with the stated rationale that independent contractors are themselves eligible to apply for PPP loans).

⁶ It is not clear whether the reduction in forgiveness would be the full percentage by which the salary and wages were reduced, or only the percentage of the reduction that is in excess of 25%.

forgiveness of the loan will be made to the lender and will require (i) supporting documents verifying the number of full-time equivalent employees and pay rates, as well as the payments on eligible mortgage, lease and utility obligations and (ii) certification that the requirements for forgiveness were met. The lender must make a decision on the forgiveness within 60 days of the request.⁷

Size of the loan.

A loan can be for an amount up to two months of the company's average monthly payroll costs from the last year, plus an additional 25% of that amount—but not more than \$10 million.⁸ (Seasonal or new businesses will use different applicable time periods for the calculation. Payroll costs will be capped at \$100,000 annualized for each employee.)⁹

Timing for applying for a loan.

Small businesses and sole proprietorships have been applying since April 3, 2020. Independent contractors and self-employed individuals can apply starting April 10, 2020. Applications can be submitted through June 30, 2020 and will be provided on a first come, first served basis. In light of the funding cap and expected high number of applications, applications should be submitted as soon as practicable.

Procedure for applying for a loan.

Applications (together with the required supporting payroll documentation) can be made to any existing SBA lender¹⁰ or any federally insured depository institution or federally insured credit union.¹¹ Click [here](#) for a list of the existing SBA lenders. Click [here](#) for the application form. E-signatures and e-consents will be accepted (including if a borrower has multiple owners). Fees payable by borrowers are waived.¹²

⁷ The SBA has stated that it will be issuing additional guidance relating to forgiveness of the loans.

⁸ The calculation is made as follows: (i) aggregate payroll costs from the last 12 months (for employees whose principal place of residence is the U.S.), (ii) subtract any compensation paid to an employee in excess of an annual salary of \$100,000, (iii) calculate average monthly payroll costs (*i.e.*, divide the amount from step (ii) by 12), and (iv) multiply the average monthly payroll costs (from step iii) by 2.5.

⁹ A borrower also can apply for an additional amount to refinance an EIDL loan if it has one (see below--“EIDL loans”).

¹⁰ The following are among the most active existing SBA lenders (by number of applications and total loan amounts): Wells Fargo Bank, N.A.; JP Morgan Chase Bank, N.A.; The Huntington National Bank; U.S. Bank, N.A.; Key Bank, N.A.; and TD Bank, N.A. Click [here](#) for a list of the 100 most active existing SBA lenders.

¹¹ These institutions will not be eligible to provide PPP loans if they are currently are designated in “Troubled Condition” by, or are subject to a formal enforcement action with, their primary federal regulator. Applications also can be made to certain Farm Credit System institutions and the SBA will be considering enrolment by other depository or non-depository financing providers that provide, maintain and service business loans or other commercial financial receivables and participation interests, subject to certain criteria.

¹² A PPP loan may be sold on the secondary market after it is fully disbursed. The sale may be at a premium or a discount to par value. SBA will be issuing guidance regarding any advance purchase for loans sold in the secondary market. A lender may request that the SBA purchase the expected forgiveness amount of a PPP loan or pool of PPP loans at the end of the seventh week of the covered period.

Certification to be provided with the application.

The company¹³ must certify in good faith that (i) current economic uncertainty makes the loan necessary to support ongoing operations; (ii) the funds will be used to retain workers and maintain payroll or to make mortgage, lease, and utility payments; (iii) another loan has not been (and will not be) received under this program; (iv) the documentation provided with the application verifies the number of full-time equivalent employees on the payroll and the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight weeks following receipt of the loan; (v) loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities—but not more than 25% of the forgiven amount may be for non-payroll costs; and (vi) all of the information provided in the application and all supporting documents and forms is true and accurate and the applicant is aware that knowingly making a false statement to obtain the loan is punishable under the law (including criminal laws). In addition, the company must (i) acknowledge that the lender will calculate the eligible loan amount using the tax documents submitted; (ii) affirm that the tax documents submitted are identical to those that were submitted to the IRS; and (iii) state that the company understands, acknowledges and agrees that the lender can share the tax information with the SBA's authorized representatives, including authorized representatives of the SBA Office of Inspector General, for the purpose of compliance with SBA Loan Program Requirements and all SBA reviews.

Interest rate; repayment; no guarantees.

Interest is a fixed rate of 1.0%. All payments are deferred for 6 months, but interest continues to accrue over this period. The loan is due (to the extent not forgiven) in two years. There are no penalties or fees for prepayment. No personal guarantees or collateral are required.

Affiliation rules—and application to private equity-sponsored portfolio companies.

As noted above (see "Eligibility for a loan"), in determining whether a company meets the 500-employees size test, the SBA aggregates the company *and* its "affiliates." The Interim Regulations issued April 3, 2020 provide that the affiliation rules applicable to the PPP loans will be the same as those that have applied to other "Business Loans" under the SBA's Section 7(a) program. Affiliation is defined broadly and is based on control or the power to control (whether affirmative or negative control) and includes companies under common control.

In most cases, portfolio companies of private equity firms would not be eligible for PPP loans due to the affiliation rules, because typically a private equity firm, even if a minority shareholder, controls the company.¹⁴ A sponsor could be deemed to have control of a company based on: (i) ownership of a majority of the voting stock; (ii) ownership of a minority of the voting stock if it has consent rights over any ordinary business decisions¹⁵; (iii) overlapping boards or management among portfolio companies; (iv) an

¹³ A "representative" of the applicant can certify for the business as a whole if the representative is legally authorized to do so.

¹⁴ We note that venture capital-backed companies may be eligible for PPP loans in many cases because their investments often do not include control over the company.

¹⁵ The following consent rights have been present in cases in which the OHS deemed there to be control: Forming a quorum of shareholders; payment of dividends or distributions; determining employee compensation; ability to

“identity of interest” based on “substantially identical” business or economic interests (such as common investments or “economic dependence” through contractual or other relationships).

- **Exclusion from the affiliation rules.** Under the CARES Act,¹⁶ the aggregation with affiliates requirement is waived for a business that (i) does not employ more than 500 employees per physical location and is in the hotel or food services industries (*i.e.*, those businesses with NAICS code 72—click [here](#) to confirm), (ii) is a franchise listed in the SBA’s Franchise Directory (click [here](#) to confirm); or (iii) receives financial assistance from small business investment companies (SBICs) licensed by the SBA.¹⁷
- **More than one entity controls.** Note that, based on the SBA Hearings Office (OHS) decisions, more than one person or entity may be deemed to be in control of a company under the affiliation rules. Thus, for example, if a company has three equal minority shareholders, and unanimous consent of the three is required for all decisions, the three shareholders and the company (and all other companies controlled by any of the three shareholders or the company) would be affiliates—even though none of the three shareholders has the ability to direct what the company does.

Bases for affiliation.

- **Ownership.**¹⁸ If an entity¹⁹ owns, or has the power to control more than 50% of a company’s voting stock (or membership interests), the entity and the company are affiliates. If there is no such more-than-50% owner, then the board of directors or the CEO (or other officers, managing members, or partners who control the management of the company) are deemed to control the company.

Importantly, a minority shareholder will be deemed to control the company if it has the ability (under the company’s charter, bylaws or a shareholders agreement) “to prevent a quorum or otherwise block

hire and fire executives; establishing or amending an incentive or employee stock ownership plan; broad power to block any changes in the company’s strategic direction; committing any act that would alienate or encumber assets; amending or terminating lease agreements; purchasing equipment; incurring debts or obligations; adopting a budget or making changes to it; instituting or defending legal actions. The following consent rights have been deemed by OHS not to constitute control: rights designed only to protect the shareholder’s minority interest; mergers or sale of all or substantially all of the assets; mortgaging or encumbering all or substantially all of the assets; changing the amount or character of contributions to capital; issuing additional equity; increasing or decreasing the amount, or reclassifying, the authorized stock or interests; adding new members; changing the character of the business; entering into substantially different business lines; dissolving the company; filing for bankruptcy; amending the charter, bylaws, operating agreement of similar governing documents; disposing of the good will; submitting a claim to arbitration; entering into a confession of judgment; or acts required for the company to carry on its ordinary course of business.

¹⁶ Under the Regulations issued April 3, 2020, “faith-based” organizations also were exempted from the affiliation rules with respect to affiliations based on religious belief or practice.

¹⁷ Note that a private equity-sponsored portfolio company that is not otherwise eligible for a PPP loan due to the affiliation rules may qualify for and obtain a loan under the SBA’s SBIC program and thus become eligible for a PPP loan through this exemption from the affiliation rules. However, SBIC loans are restricted to very small companies (based on assets and revenues) and the application process is time-consuming.

¹⁸ Stock options and convertible securities are treated as if already exercised and a pending merger agreement (including an “agreement in principle”) is treated as already having been effected--unless the likelihood of exercise of the rights or consummation of the transaction is shown to be “extremely remote.”

¹⁹ Throughout the Regulations, an “entity” includes also any individual person.

action by the board of directors or shareholders.” The Regulations do not indicate whether a right to block *any* action, or only a right to block certain kinds of actions, would be sufficient for a finding of control. However, decisions issued by the SBA Hearings Office (which hears appeals of the SBA’s size test determinations) indicate that minority holder consent rights that can block “ordinary business decisions” or “ordinary actions essential to operating the company”²⁰ are sufficient to indicate affiliation; while consent rights that are designed only to protect the minority holder’s interest, or that can block only “extraordinary actions,” are not sufficient to indicate affiliation.

- **Management.** If the CEO (or other officers, managing members, or partners who control management of the company) also controls management of another company, the companies are affiliates. Also, if a single entity that controls the board or management of a company also controls the board or management of another company, the companies are affiliates. Also, an entity that controls the management of a company through a management agreement is an affiliate.
- **Identity of interest.** (i) *General.* Entities may be affiliated if they have an “identity of interest”—meaning “identical or substantially identical business or economic interests” (“such as close relatives, individuals or firms with common investments, or firms that are economically dependent through contractual or other relationships”). The determination on this basis can be rebutted by “evidence showing that the interests deemed to be one are in fact separate.” (ii) *Close relatives.* Affiliation arises when there is an identity of interest between close relatives (specifically, a spouse, parent, child or sibling, or the spouse of any such person) with identical or substantially identical business or economic interests (such as where they operate concerns in the same or similar industry in the same geographic area). (iii) *Common investments.* Affiliation arises through 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, equipment, locations, or employees with one another, or provide loan guaranties or other financial or managerial support to each other. However, where an SBA Lender has made a determination of no affiliation under this ground, SBA will not overturn that determination as long as it was reasonable when made given the information available to the SBA Lender at the time. (iv) *Economic dependence.* Affiliation based on economic dependence may arise when a company derived more than 85% of its receipts over the previous three fiscal years from a contractual relationship with another entity (unless the contracts do not restrict the company from selling the same type of products or services to another purchaser or the SBA agrees that the contracts do not provide the purchase with control or the power to control the seller).
- **Newly organized concern** (*i.e.*, actively operating for two years or less). Affiliation may arise where current or former officers, directors, owners of a 20% or more interest, managing members, or persons hired to manage day-to-day operations of one company organize a new company in the same or related industry or field of operation, and serve in those capacities at the new company, and there are “direct monetary benefits flowing from” the new company to the original company. A

²⁰ These have included incurring indebtedness, alienating or encumbering assets, purchasing equipment, or increasing employee compensation.

company may rebut a determination of affiliation on the ground “by demonstrating a clear line of fracture between the two concerns.”²¹

- ***Totality of the circumstances.*** In determining whether affiliation exists, “all connections between the company and a possible affiliate can be considered.” Even though no single factor is sufficient to constitute affiliation, affiliation may be found “where there is clear and convincing evidence based on the totality of the circumstances.”

Uncertainty regarding application of the eligibility rules.

To the extent that there continues to be ambiguity in the rules or discretion is accorded to the SBA lender, it is unknown how the affiliation rules will be applied (particularly in the case of the affiliation rules, which are complicated and can require nuanced judgments). It is uncertain whether the lenders will be more liberal in finding eligibility (given their relative inexperience in making these determinations, as well as the intention that they ensure a rapid turnaround on making the loans available)—or whether they will be more conservative (and simply not want to entertain any applications that present complicated issues). It is also possible that the lenders will be inconsistent among one another and we understand that banks are initially focusing on applicants with whom they have a pre-established relationship.

EIDL loans.

A small business concern also continues to be eligible to apply for a loan under the SBA’s Economic Injury Disaster Loan (“EIDL”) program. The CARES Act expands eligibility for EIDLs to cover certain new categories of businesses and provides for forgiveness of the loans similar to that for loans under the PPP program (described above). An EIDL is limited to \$2 million in most cases. The applying business is subject to the same size and affiliation rules as are applicable to the SBA’s Section 7(a) loan programs generally and, in addition, must show it has suffered a substantial economic injury (meaning the business is unable to meet its obligations and to pay its ordinary and necessary operating expenses). If an EIDL loan was obtained between January 1, 2020 and April 30, 2020 and it was used for payroll costs, the PPP loan must be used to refinance the EIDL loan (and any advance up to \$10,000 on the EIDL loan will be deducted from the forgiveness amount of the PPP loan). If the EIDL loan was not used for payroll costs, eligibility for a PPP loan is not affected.²²

Tax Changes.

We note that several key tax changes included in the CARES Act are relevant to businesses that are or may become distressed as a result of the Coronavirus pandemic, including changes to net operating loss rules, limitations on business interest deductions, depreciation of qualified improvement property, corporate alternative minimum tax credit refunds, excess business loss deductions for individuals and new payroll tax credits. A number of these changes could have an effect on acquisition agreements,

²¹ However, where an SBA lender has made a determination of no affiliation under this ground, the SBA will not overturn that determination as long as it was reasonable when made given the information available to the SBA lender at the time.

²² Small businesses meeting the eligibility criteria for SBA’s Section 7(a) loans are also eligible to apply for the SBA’s Express Loan Program, which, as expanded under the CARES Act, provides loans up to \$1 million, with approval or denial of an application provided on an expedited basis.

including those that have previously been entered into. For example, transactions with pending purchase price adjustments could have changes to the amounts of working capital, transaction expenses, or indebtedness as a result of the payroll and income tax changes. Companies considering amending their tax returns to obtain tax refunds should consider whether the relevant purchase agreement permits such amendments and who (buyer or seller) would be entitled to the refunds.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its contents. If you have any questions about the contents of this memorandum, please call your regular Fried Frank contact or an attorney listed below:

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