

Treasury and SBA Issue Updates on the Affiliation Rules Applicable to the Paycheck Protection Program

Client Alert

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In the wake of the COVID-19 pandemic, the U.S. Department of the Treasury (Treasury) and the U.S. Small Business Administration (SBA) have released further guidance on the affiliation rules applicable to the Paycheck Protection Program (PPP) enacted under the Coronavirus Aid, Relief, and Economic Security Act.

This guidance, which supplements the SBA's Interim Final Rules, will be of particular interest to private equity firms and venture capital funds and their relationships with their portfolio companies and investments.

Drilling down further, the relationship between healthcare management service organizations and the entities that they manage will need to be looked at given the affiliation guidance, however the applicability of the affiliation rules and guidance is not limited to the healthcare industry.

Four tests for affiliation based on control will apply to participants in the PPP. For purposes of determining the number of employees of an applicant to the PPP, the applicant is considered together with its "affiliates."

Entities are affiliates of each other when one controls or has the power to control the other, or when a third party or parties control or have the power to control both. It does not matter whether control is exercised, as long as the power to control exists.

Healthcare stakeholders considering the applicability of this guidance should keep in mind the applicability of the corporate practice of medicine doctrine and its similar brethren when deciding whether or not "the power to control exists." Terms used in the Treasury and SBA guidance do not necessarily have the same meaning as those terms in other laws, particularly state law.

Affiliation under any of the four circumstances described below is sufficient to establish affiliation for applicants for the PPP:

1. Affiliation based on ownership. For determining affiliation based on equity ownership, a concern is an affiliate of an individual, concern, or entity that owns or has the power to control more than 50 percent of the concern's voting equity. If no individual, concern, or entity is found to control, the SBA will deem the Board of Directors

(Managers) 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 (member) to be in control if that individual or entity has the ability, under the concern's charter, by-laws, shareholder's agreement, limited liability company operating agreement or similar governing document, to prevent a quorum or otherwise block action by the Board of Directors (Managers) or shareholders (members).

2. Affiliation arising under stock options, convertible securities, and agreements to merge. 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. The SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised. Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date are not considered "agreements in principle" and are thus not given present effect. Options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under state or federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote, are not given present effect. 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 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.

3. Affiliation based on management. Affiliation arises where the President or CEO 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. Affiliation also arises where a single individual, concern, or entity that controls the Board of Directors (Managers) or management of one concern also controls the Board of Directors (Managers) or management of one or more other concerns. Affiliation also arises where a single individual, concern or entity controls the management of the applicant concern through a management agreement.

4. Affiliation based on identity of interest. Affiliation arises when there is an identity of interest between close relatives, as defined in 13 CFR 120.10, with identical or substantially identical business or economic interests (such as where close relatives operate concerns in the same or similar industry in the same geographic area). Where the SBA determines that 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.

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 affiliation rules are waived for any business concern with not more than 500 employees that, as of the date on which the loan is disbursed, is (1) assigned a North American Industry Classification System code beginning with 72 (hospitality and food service industries); (2) any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and (3) any business concern that receives financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958.