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The Paycheck Protection Program: Determining Affiliation

Section 1102 of the [Coronavirus Aid, Relief, and Economic Security Act](#) (PDF) (the “CARES Act”) established the [Paycheck Protection Program](#) (“PPP”), which is intended to provide some much-needed financial assistance to “small businesses.” The U.S. Small Business Administration (the “SBA”) has established rules to determine which businesses qualify as small, of which some determinations are based on the size of the business as measured in terms of the number of employees or amount of revenues generated by such business. For example, the CARES Act provides a 500-employee cap for all applicants for the PPP, but the SBA has established a higher cap for certain industries. While such measures may seem straightforward enough to readily evaluate for an independent company, the issue becomes murky if it’s necessary to account for the SBA’s affiliation rules for an entity with subsidiaries or other related entities or businesses. In such a case, the rules provide for a business to aggregate its employees and revenues with those other entities that the SBA considers to be the business’ affiliates in order to determine its eligibility to participate in the PPP. In this alert we will provide a general overview of the SBA’s affiliation determination rules in the hope of affording a little more clarity about how to apply them.

Principles to Determine Affiliation

The SBA’s general principles of affiliation are set forth in [13 C.F.R. §121.103](#) (“Section 103”) and they focus primarily on matters of control. Generally speaking, entities are affiliates of each other when one controls or has the power to control the other, or a third party (or parties) controls or has the power to control both. Control can be evidenced by ownership, management, prior relationships, or contractual arrangements, and control could be affirmative or negative. Ultimately, it does not matter whether control is actually exercised; it just matters that the power to control exists.

The SBA’s primary affiliation rule applicable to its loan programs, such as the PPP, can be found at [13 C.F.R. §121.301](#) (“Section 301”). Section 301(f) provides the main principles upon which to determine whether or not entities are affiliated, any one of which would be sufficient to establish affiliation.

They are as follows:

- **Affiliation based on ownership.** In the case of equity ownership, an entity would be an affiliate of another entity that owns or has the power to control more than 50% of the first entity’s voting equity. If no individual or entity is determined to control, then the SBA will deem the Board or the President/CEO (or other officers, managers, or partners who control the management) to be in control of the entity. A minority shareholder will be deemed to be in control if that shareholder has the ability, under a business’ governing documents or a shareholder’s agreement, to prevent a quorum or otherwise block action by the Board or the shareholders (although certain minority rights could be acceptable, such as the power to veto unusual or extraordinary actions that are designed to protect a minority holder’s interest (such as a sale of all of a company’s assets). Note that a minority holder could irrevocably waive any rights that might cause an affiliate determination.

- **Affiliation arising under stock options, convertible securities, and agreements to merge.** 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 an entity. The SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.

However, options, convertible securities, and agreements that are subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable under 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, and neither are agreements to open or continue negotiations toward the possibility of a merger or a sale of stock at some later date.

- **Affiliation based on management.** Affiliation arises where the CEO or President of an entity (or other officers, managing members, or partners who control the management of the entity) also controls the management of one or more other entities. Affiliation also arises where a single entity that controls the Board or management of one entity also controls the Board or management of one or more other entities. Additionally, affiliation can be found where an entity controls the management of another entity through a management agreement.
- **Affiliation based on identity of interest.** Affiliation arises when there is an identity of interest between close relatives 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). However, a determination of affiliation under this principle may be rebutted with evidence showing that the interests deemed to be one are, in fact, separate.
- **Affiliation based on franchise and license agreements.** The restraints imposed on a franchisee or licensee by its franchise or license agreement (such as restrictions on advertising or accounting) generally will not be considered in determining whether the franchisor or licensor is affiliated with the franchisee or licensee, unless the franchisee or licensee has no right to profit from its efforts and does not bear the risk of loss commensurate with ownership. For this analysis, the SBA will only consider the franchise or license agreement of the entity applying for the PPP.

Notably, several recently enacted additional principles of affiliation relating to common-investment affiliation and economic-dependence affiliation were permanently rescinded in the CARES Act, so the bases upon which to find affiliation have been winnowed down. Nevertheless, in determining whether affiliation exists, the SBA could consider the totality of the circumstances and may find affiliation even though no single factor alone is sufficient to constitute affiliation.

Exceptions to Affiliation

Although any one of the bases above may otherwise result in a finding of affiliation, certain exceptions to affiliation apply to prevent the aggregation of such entities as affiliates. The CARES Act itself provides exemption provisions tailored to certain industries that were heavily impacted by the COVID-19 pandemic. In particular, the CARES Act and its rules provide that the affiliation provisions shall not apply to the following:

- **Accommodation and Food Service Businesses.** Any business concern with not more than 500 employees at a single location that is assigned a North American Industry Classification System code beginning with 72, which generally covers a wide range of restaurants and other food services and hotels and other lodging.

- **Certain Franchises.** Any business operating as a franchise that is assigned a franchise identifier code by the SBA.
- **SBIC Companies.** Any business that receives financial assistance from a Small Business Investment Company (basically SBIC portfolio companies).
- **Religious Organizations.** 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.

In addition to the above, Section 301 specifically provides that the exceptions to affiliation listed in Section 103 also apply to the PPP. They are somewhat more specific and limited, and are generally as follows:

- **Investment Companies.** A business that is wholly or substantially owned by investment companies or development companies that are licensed or qualified under the Small Business Investment Act of 1958 are not considered affiliates of those investment companies or development companies.
- **Indian Tribes, etc.** A business that is owned and controlled by Indian Tribes, Alaska Native Corporations (ANCs), Native Hawaiian Organizations (NHOs), and Community Development Corporations (CDCs), or which is owned and controlled by an entity that is wholly owned by an Indian Tribe, ANC, NHO or CDC, are not considered affiliates of such business concerns or entities.
- **R&D Joint Programs, etc.** A business that is part of an SBA-approved pool of concerns for a joint program of research and development, or for defense production as authorized by the Small Business Act, are not affiliates of one another because of the pool.
- **Leased Employees and PEOs.** A business that leases employees from a business primarily engaged in leasing employees to other businesses or which enters into a co-employer arrangement with a Professional Employer Organization (PEO) is not affiliated with the leasing company or PEO solely because it leases or co-employs employees.
- **Certain Assistance Programs.** An applicant for financial, management, or technical assistance in the Small Business Investment Company Program, the 504 Loan Program, or the Surety Bond Program (none of which include the PPP) is not affiliated with certain enumerated investors, including venture capital operating companies, employee benefit plans, and others.
- **Mentor-Protégé Agreement.** A business that has an SBA-approved mentor-protégé agreement under the 8(a) Mentor-Protégé Program or the All-Small Mentor-Protégé Program is not affiliated with a mentor firm solely because the protégé firm receives assistance from the mentor under the agreement.
- **Agricultural Cooperative Members.** The member shareholders of a small agricultural cooperative, as defined in the Agricultural Marketing Act, are not considered affiliated with the cooperative by virtue of their membership in the cooperative.
- **Small Business Teaming Arrangement.** For a bundled contract with a small business reserve, a prime and its subcontractors that form a Small Business Teaming Arrangement are not considered affiliated if each team member is small under the size standard assigned to the contract and if there is a written and signed agreement amongst all the small businesses.

At the End of the Day

The CARES Act provides a 500-employee cap for all applicants for the PPP (unless the SBA has established a higher cap for the applicant's industry). The concept of affiliation can be tricky for PPP applicants and could cause the applicable employee limit to be inadvertently triggered. The above is just a brief summary of the complex affiliation principles, but it should provide the basis to determine whether or not a deeper dive is needed to assess a PPP applicant's affiliation status.

If affiliation is potentially involved, the applicable relationships should be carefully examined before moving forward. It is worth noting that each applicant for PPP funds must make several attestations in its application, including some that will depend heavily on an affiliation determination, and an incorrect attestation could lead to unexpected liability and potentially severe consequences.

If you have additional questions about force majeure provisions or notices, please contact your Kutak Rock attorney, or any of the attorneys in the [Business, Corporate and Securities Group](#).

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