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Editorial Office
230 Park Ave., 7th Floor, New York, NY 10169 (800) 543-6862
www.lexisnexis.com

MATTHEW BENDER

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The CARES Act: SBA Loan Eligibility and Process

By Tina D. Reynolds and Damien C. Specht*

In this article, the authors explain the essential elements of the payroll protection loan available under the CARES Act.

The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") allows certain eligible companies and individuals to obtain loans of up to $10 million or 2.5 times the average monthly payroll costs over the last year, whichever is less, from the Small Business Administration ("SBA"). The CARES Act further specifies the SBA regulations that will be used as a baseline to determine eligibility, although the CARES Act has, in some instances, expanded these eligibility standards.

WHO IS ELIGIBLE?

At the outset, to be eligible for a covered loan, a company must have been in operation on February 15, 2020 (the start date of the "covered period," which extends through June 30, 2020), and must have or have had employees for whom the company paid salaries and payroll taxes or independent contractors to which 1099s were issued.

The company must also be an eligible small business (including their affiliates). There are multiple paths to qualifying. Companies that currently qualify as small under the SBA regulations in 13 C.F.R. Part 121 are eligible based on their primary North American Industry Classification System ("NAICS") code.[1]

Some NAICS codes determine eligibility based on average revenue over the last three years while others use the average number of employees over the last calendar year. Under the CARES Act, eligibility has also been expanded to any company with no more than 500 employees that would not otherwise qualify under its primary NAICS. Finally, a higher threshold was put in place for restaurants and hotels (those companies under NAICS Code 72, Accommodation and Food Services). For those companies only, the relevant eligibility

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* Tina D. Reynolds, a partner in Morrison & Foerster's Government Contracts practice, may be contacted at treynolds@mofo.com. Damien C. Specht, a partner in the firm's Government Contracts & Public Procurement practice, may be contacted at dspecht@mofo.com. This article was current as of the time it was prepared.

[1] For NAICS codes and corresponding size standards, *see* https://www.sba.gov/document/support--table-size-standards.

standard is whether they have fewer than 500 employees per physical location, although corporate groups owned directly or indirectly by a single entity will be limited in the total amount they can borrow.

Under SBA regulations, the number of qualifying employees is calculated by taking an average of the number of employees (full or part time) for each of the pay periods over the preceding completed 12 calendar months and adding the average number of employees of any affiliates (more below on this) over the same period.

Note that the SBA has taken the position that a business in bankruptcy at the time it submits its application or at the time the loan is disbursed is not eligible for Paycheck Protection Program ("PPP") funds. If the applicant or the owner of the applicant becomes the debtor in a bankruptcy proceeding after submitting a PPP application but before the loan is disbursed, it is the applicant's obligation to notify the lender and request cancellation of the application. Failure by the applicant to do so could be regarded as a use of PPP funds for unauthorized purposes.

HOW DO AFFILIATION RULES COME INTO PLAY?

Except with respect to Accommodation and Food Services businesses and firms with Small Business Investment Company ("SBIC") investment, when calculating both average revenue and number of employees, a company must include the revenues and employees of any "affiliates." As defined under the SBA regulations, affiliates include companies under common ownership, companies owned and managed by investors, and the holdings of venture capital investors.

SBA guidance indicates that four tests for affiliation will apply to PPP loans under the CARES Act. Under those tests, companies are considered to be affiliates "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."[2] Control is considered to be present whether or not exercised, and may be affirmative or negative.[3]

The following circumstances create affiliation and the affiliates' revenues/employees must be included in the calculation of average revenues/number of employees for purposes of determining eligibility:

- Any person or entity owns or has the power to control more than 50

[2] 13 C.F.R. 121.1301(f).

[3] 13 C.F.R. 121.301(f), (f)(1).

percent of the concern's voting equity.

- If no individual, concern, or entity is found to control, SBA will deem the Board of Directors or President or Chief Executive Officer (or other officers, managing members, or partners who control the management of the concern) to be in control of the concern.
- 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. Although SBA has in the past, allowed some negative controls by a minority shareholder, these are limited and counsel should be consulted if negative controls (even those common to venture capital or private equity investment) are present.
- With some limited exceptions, 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. SBA treats such options, convertible securities, and agreements as though the rights granted have been exercised.
- Affiliation will also arise where concerns have common management or "identity of interests" such as where close relatives have significantly similar business interests.

The following sorts of companies are exceptions to these affiliation rules and are not to be considered to create affiliation under this specific program:

- Businesses that have investments from an SBIC.
- Businesses owned by Native American tribes or Alaska native or Hawaiian native corporations.
- Businesses that lease employees or use co-employer arrangements under a Professional Employer Organization ("PEO").
- For business concerns with investors that fit very specific defined criteria, including "venture capital operating companies," state or federal employee pensions or benefit plans, charitable trusts, or foundations, etc., the investors are not to be considered affiliates.
- Mentor-protégé arrangements under SBA regulations.

SBA provides additional guidance on affiliation considerations in a resource guide.[4]

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[4] https://www.sba.gov/sites/default/files/2018-09/2018-07-13%20AFFILIATION%20GUIDE_Updated%20%281%29.pdf.

HOW CAN THE MONEY BE USED AND WHAT ARE THE TERMS?

Loan funds can be used to pay payroll costs, mortgage loan interest for business property, interest on any other debt obligations that were incurred before the covered period, rent for business, utilities, and health benefits costs. To pursue forgiveness, borrowers must demonstrate that 75 percent of funds were used for payroll costs.

The loans are non-recourse, and no collateral or personal guarantee is required. However, applicants need to submit a certification attesting to their eligibility (including their size status), specifying that the loan is necessary to support ongoing obligations and asserting that the funds will be used for permitted purposes. Any requirement that the applicant not have access to credit elsewhere is waived during the covered period, but there may be a focus on liquidity when determining if, in fact, the loan was necessary for ongoing obligations.

The maximum interest rate that may be charged is one percent and, under the CARES ACT, the maximum maturity will be 10 years from the date on which borrower applies.

The CARES Act also contains a loan forgiveness program which allows a certain portion of the loans equal to payroll costs, rent, and mortgage payments to be forgiven.

WHAT IS THE PROCESS FOR APPLYING?

Applications are submitted through any existing SBA lender or through any federally insured depository institution, federally insured credit union, and Farm Credit System institution that is participating. In general, borrowers should start with institutions which they have a current borrowing relationship, which can expedite some of the paperwork required by individual lenders.

Borrowers are required to submit signed certifications with their application including that:

- Current economic uncertainty makes the loan necessary to support your ongoing operations.
- The funds will be used to retain workers and maintain payroll or to make mortgage, lease, and utility payments.
- They have not and will not receive another loan under this program.
- They will provide to the lender documentation that verifies the number of full-time equivalent employees on payroll and the dollar amounts of

payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight weeks after getting this loan.

- All the information provided in the application and in all supporting documents and forms is true and accurate.

Note that knowingly making a false statement to get a loan under this program is punishable by law.

Banks will then calculate the eligible loan amount using the tax documents submitted with the application. Again, the borrower must affirm that the tax documents are identical to those they submitted to the IRS and 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.

To that end, recipients of more than $2 million should expect an audit of their loan for compliance with these requirements.