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Guidance on Potential Eligibility of "Friendly Professional Corporations" for SBA Loans Under the CARES Act

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On Friday, March 27, 2020, President Trump signed the “Coronavirus Aid, Relief, and Economic Security Act” or “CARES Act” (H.R. 748), which will make available to small businesses $349 billion in “paycheck protection loans” and $10 billion in “economic injury disaster loans” through the U.S. Small Business Administration (SBA).

Under the CARES Act, a business must meet certain existing SBA requirements to qualify as a “small business concern” and be eligible for loans under the Small Business Act. The SBA size regulations are generally based on the number of employees or annual receipts of the applicant and all of its affiliates. The CARES Act increased the limit on the number of employees to 500 but, importantly, other than three new exemptions not generally applicable to healthcare businesses, the SBA’s existing affiliation rules continue to apply. Affiliation is determined based on various control criteria established by the SBA. For example, affiliation may be established based on ownership of a controlling interest in an entity, common management, identity of interest, and economic dependence, among other factors. These criteria are likely to prevent a number of businesses that might otherwise be considered “small” from being eligible for the SBA programs authorized by the CARES Act due to being combined with affiliated businesses under the SBA’s size regulations.

For many professional corporations (PCs) affiliated with private-equity backed management service organizations (MSOs) and PCs that receive management services from health systems or other large healthcare providers, eligibility for SBA loans under the CARES Act will turn on whether the MSO or other management services provider is considered an affiliate of the PC. The PC will be required to aggregate with its own employees all employees of any affiliated MSO and any party that controls an affiliated MSO, such as a private equity sponsor (together with all of its controlled portfolio companies). There appears to be very little published guidance from the SBA with respect to affiliation in this particular context, although the general affiliation principles promulgated by the SBA include that control of an enterprise (and, thus, affiliation) can be established by certain management services arrangements. There is also one published decision of the SBA’s Office of Hearings and Appeals (OHA) which directly addresses the “friendly PC” structure commonly used to address corporate practice of medicine concerns and found the arrangement in that case not to result in affiliation (*In re B&L, LLC d/b/a Orange Grove Medical Specialties, P.A.,* SBA Office of Hearing and Appeals 1997).

The PC in *B&L* applied for a loan from the SBA and its application was initially denied because the SBA District Office determined that the PC was an affiliate of a hospital that provided management services to the PC and, when the affiliated entities were combined, they were too large to meet the applicable size requirements. The OHA reversed this determination, holding that the management arrangements in the *B&L* case did not create an affiliation.

The management services agreement (MSA) at issue in *B&L* provided that the hospital acting as an MSO would manage all non-clinical aspects of the practice in exchange for 40% of the PC’s gross revenue. The MSA further provided:

- The PC maintained hiring/firing authority over physicians
- The PC had a right to jointly prepare the budget with the MSO
- The PC had sole authority to set medical fees and order pharmaceuticals and also had a right to approve advertising and publicity
- The MSO's right to withdraw funds from the practice was limited such that it could not leave the practice unable to pay its payables and other obligations
- The contract term was one-year, with three one-year options, such that the PC could renew or cancel in its discretion
- The MSO had a right of first refusal on a transfer of equity of the practice, but not an option or other right to purchase the equity or require its transfer

Based on its review of the MSA, the OHA held that the PC had not "relinquished control of the core of its business, its ultimate product, and its primary task" because the practice maintained control of the practice of medicine, and the hospital was merely a "vendor of office management services" whose activities were "incidental to the practice of medicine." Further, the hospital did not have "total financial control" of the business because of the PC's right to participate in setting the budget for the practice; furthermore, the hospital was prohibited from withdrawing funds from the PC's account if it would leave the practice unable to meet its obligations.

The OHA also distinguished the right of first refusal (ROFR) on a transfer of equity of the PC from an option to purchase since the ROFR would only be triggered if the shareholders of the PC first decided to sell the business.

While the 1997 *B&L* decision provides some clarity regarding the SBA's view of affiliation in the context of friendly PC structures, it should be noted that the relationship between the PC and the hospital in that case differs in a number of respects from the manner in which relationships are often structured between PCs and MSOs. For example, the shareholders of a PC that is a party to an MSA often are required to agree to transfer their shares on the occurrence of certain events or at the option of the MSO, often for nominal consideration. In addition, many MSAs have terms that are significantly longer than the MSA in the *B&L* case. Moreover, those features are typically insisted upon by any lender to the MSO and most of these businesses are leveraged to some degree. It is also often important that the operations of the MSO and the PC be consolidated for financial reporting purposes under generally accepted accounting principles (including for purposes of reporting to lenders) which requires a certain degree of control.

It is not clear that the differences present in these common friendly PC arrangements necessarily result in control by the MSO and, therefore, affiliation as defined by the SBA. A number of arguments can be made that there is not sufficient control to establish affiliation. It may also be possible to modify existing arrangements to make them more consistent with the SBA's guidelines in connection with the application by a PC for a loan under the CARES Act.

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