Comments of Engine Advocacy to the Small Business Administration regarding the Business Loan Program Temporary Changes; Paycheck Protection Program Final Rule

Docket Number: SBA-2020-0015

Engine is a non-profit technology policy, research, and advocacy organization that bridges the gap between policymakers and startups. Engine works with government and a community of thousands of high-technology, growth-oriented startups across the nation to support the development of technology entrepreneurship. To that end, we welcome the opportunity to comment on the Small Business Administration's (SBA) final rule on the implementation of sections 1102 and 1106 of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act).

Startups are major drivers of economic growth, innovation, and competitiveness. As new and young firms make outsized contributions to net job creation,[1] it is important that startups are supported now so that they can survive the pandemic and are well-positioned to expand and hire rapidly after it ends. Congress passed the CARES Act in part to provide immediate relief to small businesses adversely impacted by the COVID-19 crisis. The temporary 7(a) loan program known as the Paycheck Protection Program (PPP) is an important tool for startups to weather the crisis. However, for many startups, loan funds from the PPP are inaccessible or accessible only in a limited fashion due to the contours of the SBA's interim final rule. Without access to these funds, many startups will have to lay off workers and may have to shutter their businesses entirely. Accordingly, these comments suggest changes to the SBA's final rule to expand its utility to the startups that are so vital to our economy.

1. **<u>Application of SBA's affiliation rule to venture capital-backed startups</u>**

The interim rule, at part III(2)(A)(i)(A), dictates that the SBA's affiliation rule, 13 C.F.R. § 121.301(f), applies to PPP loans. Because direct application of this rule may render many startups ineligible for PPP funds, the SBA should waive or modify the affiliation rule for purposes of the PPP program. Indeed, there have been broad calls from Congress and interested third parties for the SBA to waive or modify this rule so that venture capital (VC)-backed startups are able to apply for loans.[2] To date, the SBA and Treasury Department have attempted to clarify the affiliation rule.[3] But many startups have been unable to apply for loans, and

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[1] Arnobio Morelix, *The Impact of COVID-19 on the Global Startup Ecosystem*, Startup Genome (April 1, 2020), https://startupgenome.com/blog/impact-of-covid19-on-global-startup-ecosystems.

[2] Letter to Secretary Steven Mnuchin & Administrator Jovita Carranza (March 27, 2020), https://eshoo.house.gov/sites/eshoo.house.gov/files/Letter%20to%20SBA%20re%20affiliate%20rule%20-%203.27.20.pdf; Letter to Secretary Steven Mnuchin & Administrator Jovita Carranza (March 29, 2020), https://www.engine.is/s/32920-Final-Coalition-Letter-SBA-Affiliation-Rule-Startups.pdf; Letter to Secretary Steven Mnuchin & Administrator Jovita Carranza (April 2, 2020), https://phillips.house.gov/sites/phillips.house.gov/files/wysiwyg_uploaded/04-02-20%20Phillips%20House%20Letter%20-%20SBA%20Affiliation%20Rule%20Waiver%20FINAL.pdf;
To amend the Small Business Act to include certain small business concerns in the paycheck protection program, and for other purposes, H.R.6751, 116th Congress, 2nd Session, 2020.

[3] *See, e.g.*, Business Loan Program Temporary Changes; Paycheck Protection Program, 85 Fed. Reg. 20,817 (Apr. 15, 2020); Paycheck Protection Program Loans Frequently Asked Questions (May 13, 2020), https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf.

sufficient confusion remains about how and when the rule applies. Startups have limited manpower and may have many investors, such that parsing the affiliation rule to determine eligibility is sufficiently difficult, leading some startups to forego applying to the PPP.[4] To fix the problem, Engine encourages the SBA to waive the affiliation rule for the purposes of the PPP or otherwise craft a tailored solution that allows VC-backed startups to be eligible for PPP. For example, the SBA could amend and simplify the affiliation rule by narrowing the definition of affiliates to entities that own more than 50% of a company at present (i.e., look only at whether a startup is currently controlled by a single outside shareholder). Such a solution will ensure that the startups and small businesses Congress intended to receive PPP loan funds are eligible to do so.

2. **Limiting non-payroll costs to 25 percent of the loan forgiveness amount**

The interim rule, at parts III(2)(O) and III(2)(T)(v), requires applicants to spend 75 percent of any loan proceeds on payroll costs to qualify for forgiveness. This restrictive threshold does not reflect the emergency funding needs of many startups and small businesses. Indeed, consistent with a finding of the SBA's Inspector General, this threshold is not a statutory requirement of the CARES Act.[5]

For many startups and small businesses, payroll represents a comparatively small portion of total operating expenses. Even if a startup were able to cover payroll costs with a loan, if it cannot cover other basic operating expenses such as rent and utilities, the entire business and its employees will still be at risk. Thus, this requirement is particularly onerous for the enterprises the PPP is intended to help, and may prevent them from making full use of the program as intended by Congress.[6] As such, Engine asks that SBA remove this requirement, and instead impose no percent-threshold for payroll expenses in determining forgivability. Alternatively, we encourage the SBA to at least significantly reduce the current 75% threshold.

3. **Treatment of independent contractors**

Per part III(2)(H) of this rule, payments to independent contractors cannot be considered in the calculation of a business' PPP loan amount. Thus, startups and small businesses are unable to acquire funds through the PPP to pay 1099-independent contractors as payroll expenses, which severely limits the effectiveness of the PPP.

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[4] *SBA's Affiliation Rules Still Unclear for VC-Backed Startups*, Engine Advocacy (April 7, 2020), https://www.engine.is/news/sbas-affiliation-rules-still-unclear-for-vc-backed-startups

[5] *Flash Report Small Business Administration's Implementation of Paycheck Protection Program Requirements*, U.S. Small Business Administration Office of Inspector General (May 8, 2020), https://www.sba.gov/sites/default/files/2020-05/SBA_OIG_Report_20-14_508.pdf.

[6] *See, e.g.*, Letter to Secretary Steven Mnuchin & Administrator Jovita Carranza (May 5, 2020), https://www.lankford.senate.gov/imo/media/doc/PPP%20forgiveness%20letter.pdf.

Many startups, especially very early-stage firms, are not yet able to hire permanent staff and instead build and rely on teams of independent contractors. Startups frequently employ software developers, engineers, and project managers as independent contractors, at least initially. This interim rule prevents companies from obtaining SBA loans to continue to pay their 1099 contractors. The SBA can be more nimble in this rulemaking to better achieve Congress's goals for the PPP—to allow startups to keep paying their teams—and to accommodate the realities of the startup ecosystem. Indeed, the statutory definition of "payroll costs" expressly includes "the sum of payments of any compensation to . . . [an] independent contractor."[7] Part III(2)(H) of the interim rule effectively reads-out this portion of the "payroll costs" definition.

The SBA should create a rule that allows startups to count their payments to independent contractors when determining how much they may borrow. To the extent it is a concern, the SBA could prevent "double-dipping" by asking the applicant company and its contractor to certify that the contractor will not apply for a separate PPP loan, or alternatively deduct what the contractor receives from the company from any independent PPP application made by the contractor. To this end, the SBA should strike or amend part III(2)(H) of this rule to reflect this eligibility, and add a certification requirement in part III(2)(T) to the extent there is a need to prevent one individual from receiving double funds from the PPP. Such a rule would better suit the needs of many early stage companies that are not yet able to hire employees, and instead employ their teams through the 1099 independent contractor mechanism.

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Engine appreciates the opportunity to provide these comments on the Small Business Administration's final rule governing the implementation of the Paycheck Protection Program. As in all policy areas, Engine strives to seek solutions and work with policymakers to promote innovation, entrepreneurship, and healthy startup ecosystems across the country. We appreciate the urgency with which the SBA acted in issuing the interim rule to quickly relay funds to ailing businesses, and hope the final rule reflects the experiences of startups that have attempted to make use of the Program as relayed in these comments.

Respectfully Submitted,

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[7] 15 U.S.C. § 636(a)(36)(A)(viii)(I)(bb).