Guidance Issued On Paycheck Protection Program "Affiliation" Rules

Description

The SBA has recently issued guidance (the "Guidance") attempting to clarify the affiliation rules related to the "Paycheck Protection Program" loan ("PPP Loan") under the CARES Act. Businesses can generally apply for a PPP Loan so long as such applicant, combined with its affiliates, has 500 or fewer employees or qualifies under another SBA size standard.

Understanding the concept of affiliation is critical in determining whether an applicant meets the 500-employee threshold or other applicable size standard. 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. If an applicant is affiliated with another person, entity or group of entities, such applicant will have its employees counted along with those employees of its affiliates to determine compliance with the threshold.

Because of the way many equity investment-backed companies are typically structured (i.e., board representation, negative controls (sometimes referred to as protective provisions), etc.), the 'control' requirements described above often trigger an affiliation, which is likely to increase the chance of PPP Loan ineligibility. This has caused concern and consternation among the venture capital, private equity, and investment communities. The SBA has attempted to respond to these concerns by releasing the Guidance to provide additional clarity for PPP Loan applicants to determine whether an affiliation arises based on (1) ownership, (2) stock options, convertible securities, and agreements to merge, (3) management, or (4) identity of interest. The guidelines are summarized as follows:

- **1. Ownership.** Affiliation will be found if an entity or individual owns or has power to control a majority of the voting rights of another entity or individual. Even if a shareholder or member has a minority interest, however, the "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."
- 2. Stock Options, Convertible Securities, and Agreements to Merge. These agreements are considered to have a present effect on the power to control an entity, and will be deemed to have been exercised, in determining whether an affiliation will arise. However, the rules include carve-outs providing that present effect is not given (and therefore not considered) to agreements that are speculative, conjectural, or include conditions precedent that cannot be fulfilled or are unenforceable.
- **3. Management.** If the CEO or President (or other officers, partners, or managing members with control), of an applicant controls the management of one or more other entities, then such common management is considered an affiliation. Affiliation is also found where an individual controls the Board of Directors or management of a particular entity and controls the Board of Directors or management agreements also trigger affiliations.
- **4. Identity of Interest.** An identity of interest between close relatives (defined as spouse, parent, child, sibling, or the spouse of any such person) with identical or substantially identical business or economic interests (such as a close relative operating a similar business in the same geographic area) creates an affiliation between the entities and/or entities.

The Guidance also details an exemption to the affiliation rules for faith-based organizations. Generally, if the relationship of a faith-based organization to another organization is based on a religious teaching or belief, or

otherwise constitutes a part of the exercise of the religion, then the relationship is not considered an affiliation.

The Guidance concludes with a list of businesses which the affiliation rules do not apply. The affiliation rules are waived for (1) any business concern with not more than 500 employees that is assigned a North American Industry Classification System code beginning with 72 (accommodations and food service); (2) any business that is assigned a franchise identifier code by the SBA; and (3) any business that receives financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958 (15 U.S.C. 681).

For most applicants that have received equity investment, the 'ownership' analysis is likely to be problematic, especially if the equity investors have board representation and/or enjoy negative controls, both of which are common. As such, this category of applicant should pay special attention to its governance structure. In some situations, there may be simple amendments that can be made to 'cure' an applicant's apparent ineligibility. In other situations, the legal costs/process might be too much of a hurdle, forcing applicants to walk away.

Rumors continue to circulate that the government may make another attempt at fixing the affiliation rules because of the seemingly unintended consequences described above. In order for the PPP Loan program to live up to its purpose, many believe that such a fix is necessary.

The Business Law Group at Partridge Snow & Hahn is ready to answer questions regarding the PPP Loan.

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