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ALERTS

Let's (Not) Get Together: Business Affiliation Issues Under The Paycheck Protection Loan Program

April 22, 2020

NOTE: As of April 22, 2020, the SBA is unable to accept new applications for the Paycheck Protection Program (PPP) based on available appropriations funding. Congress is negotiating legislation to appropriate additional funding for the PPP.

Small businesses nationwide were given access to a financial lifeline under the CARES Act when it was passed on March 27. Less than a week later, the U.S. Department of the Treasury released guidelines for the Paycheck Protection Program (PPP), which allocated $349 billion in the form of loans guaranteed by the Small Business Administration (SBA) to small businesses and other businesses and nonprofits with fewer than 500 employees.

In addition to small businesses that are traditionally eligible for SBA loans, the CARES Act expanded the business eligible to receive PPP loan funds to include businesses, 501(c)(3) nonprofit organizations, veterans organizations, or Tribal business concerns with 500 or fewer employees (including full-time and part-time employees). That number may be increased for certain industries that are subject to higher employee thresholds, as set forth in the SBA's size standard tool or for certain businesses in the hospitality and food service industries.

However, the situation grows murkier for businesses that are deemed to have affiliates due to certain control or management considerations.

Affiliation Rules

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Particularly in the private equity space, the SBA's standard rules on affiliation prohibit many businesses from applying for covered loans under the PPP. If two or more businesses are considered "affiliates" under the SBA's affiliation rules, the number of employees of each company (both domestic and foreign) will be aggregated to count toward the 500-employee limit. Businesses and entities are affiliates of each other when one controls or has the power to control the other, or if a third party controls or has the power to control both entities. Moreover, it does not matter whether control is actually exercised, so long as the power to control exists.

The definition of control by the SBA for affiliation purposes is very broad and can be based on a number of methods. Some methods are unrebuttable, such as owning or having the power to control more than 50 percent of the applicant's voting equity. Control is also found for significant minority ownership vis-à-vis other minority owners; certain contractual or voting veto, approval or similar rights; or managerial control.

The SBA will consider the totality of the circumstances and may find affiliation even though no single factor is sufficient to constitute affiliation.

Types of Control Factors

Ownership: Any individual, concern or entity that owns or has the power to control more than 50 percent of the applicant's total voting equity will be deemed to be an affiliate. Pursuant to Title 13 Section 121.301(f)(2), all stock options, convertible securities and agreements to merge are deemed exercised, so the voting equity in a structure where there are large numbers of warrants and options outstanding may be different from one that only has common and preferred stock issued and outstanding.

Management: If no individual, concern or entity is found to have control of the applicant, then the SBA will deem that control lies with the board of directors, chief executive officer, or managing members or partners who control the management of the applicant. A single individual, concern or entity that controls the board of directors or management of the applicant, and also controls the board or management of one or more entities, will cause both entities to be deemed affiliates. Control will also be found when an individual or entity controls the management of the applicant through a management agreement.

Control Rights: Guidance issued by the SBA and the SBA's Office of Hearings and Appeals has long held that control can be found if a minority investor has certain blocking rights or negative veto rights (bad veto rights) over the day-to-day business operations. Bad veto rights include blocking or approving payment of dividends or distributions; preventing a quorum of shareholders to take actions necessary to run the business; determining employee compensation; establishing or amending an incentive or employee stock ownership plan; broad powers to block changes in the company's strategic direction; or incurring debts or obligations.

When analyzing the bad veto rights held by minority investors, businesses must analyze each minority owner separately. If a minority shareholder can block an action by itself, without being a member of a certain group or class of shareholders, then the minority owner has control over the

action. However, control is not found where a minority owner has control over an action merely because the minority owner is a member of a class or series of shareholders. Further, some control rights held by minority investors are there to give a minority owner an "opportunity to block certain extraordinary actions to protect his investment as a minority shareholder in the concern," as noted in the SBA's decision in *Size Appeal of Southern Contracting Solutions III, LLC.*

What Can Business Owners Do?

Where bad veto rights have created an affiliate relationship, businesses and owners may want to consider amending corporate governance documents to irrevocably waive or relinquish any existing rights that create problems under the affiliation rules.

If a minority shareholder (or group of minority shareholders) have veto or blocking rights that would render the applicant an affiliate and push them out of eligibility for a PPP loan, the company and shareholders can work together to amend the organizational documents or contractual agreements that give rise to the bad veto rights and work to waive them completely.

The FAQs issued by the Department of the Treasury on April 8, specifically state that if a minority shareholder irrevocably waives or relinquishes rights to prevent a quorum or otherwise block action by the board of directors or shareholders, the minority owner will no longer be considered an affiliate of the applicant and those employees will not be counted toward the eligibility threshold.

Any amendments must be narrowly tailored to the specific rights at question. A broad, omnibus resolution waiving all "applicable rights" will be viewed unfavorably by the SBA.

Businesses should consider waiving rights that create problems under the affiliation rules. Such entities should also consider identifying the specific investor rights that need to be addressed and draft a narrowly tailored amendments to be filed with the Secretary of State or with the company's organizational documents.

Perhaps the best approach is to consider having the investor irrevocably waive all rights that might trigger affiliation under current SBA guidance. A conditioned waiver of certain rights only for the duration of the term of the PPP loan may be defensible under limited circumstances, but it does have a heightened risk that the SBA could later challenge effectiveness of the conditioned waiver.

To obtain more information, please contact the Barnes & Thornburg attorney with whom you work, or Jenni Tauzel at 214-258-4145 or jenni.tauzel@btlaw.com, or Jeremy Reidy at 260-425-4662 or Jeremy.reidy@btlaw.com, or Ryan Barncastle at 310-284-3822 or ryan.barncastle@btlaw.com.

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