



A Robinson+Cole Legal Update

Coronavirus (COVID-19)

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U.S. Small Business Administration Affiliation Rules and Their Application to the Payroll Protection Program

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Robinson+Cole has been tracking government relief programs being offered to help alleviate the economic impact of COVID-19 on businesses in the United States. On April 2, 2020, the U.S. Small Business Administration (SBA) published an interim final rule, Business Loan Program Temporary Changes; Paycheck Protection Program (the Initial Rule), providing guidance and clarification on the implementation of the “Paycheck Protection Program” (PPP) created by the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). On April 3, 2020, the SBA published an interim final rule, Business Loan Program Temporary Changes; Paycheck Protection Program (the SBA Rule), to supplement the Initial Rule with additional guidance regarding the application of certain affiliate rules applicable to the PPP. On April 4, 2020, the SBA’s Office of General Counsel issued a formal memo titled “Size Eligibility and Affiliation Under the CARES Act” in response to questions the SBA has received regarding the affiliation rules applicable to the CARES Act, with a focus on the PPP. The information below provides an overview of the affiliation rules applicable to the SBA’s PPP. Robinson+Cole will continue to monitor SBA regulations and guidance on this topic as both become available.

Overview

The CARES Act, enacted on March 27, 2020, offers businesses access to liquidity through a new SBA loan program, the PPP. The PPP provisions of the CARES Act appropriate \$349 billion for SBA-approved lenders to offer loans through the existing Section 7(a) Loan structure, and implements procedures to extend loan eligibility to an expanded group of businesses. For more information on the PPP, see our [Primer](#) and [FAQ on the Paycheck Protection Program](#).

The PPP provisions of the CARES Act provide that, in addition to Small Business Concerns (Small Business Concerns) [1], any Business Concern (Business Concern), nonprofit organization, veterans organization, or Native American Tribal Organization will be eligible for a PPP loan if the subject Business Concern has 500 or fewer employees whose principal place of residence is in the United States or is a business that operates in a certain industry and meets applicable SBA employee-based [size standards](#) for that industry.

Affiliation Rules Generally [2]

When calculating the total number of employees of an applicant Business Concern for purposes of the PPP provisions of the CARES Act, an applicant Business Concern must include the number of employees of each of its affiliates unless (i) the applicant Business Concern employs not more than 500 employees and has an NAICS code beginning with 72 (Accommodation and Food Services), (ii) the Business Concern is a franchise that has been assigned a franchise identifier code by the SBA, or (iii) the Business Concern receives financial assistance from a company licensed under the terms of the Small Business Investment Act of 1958. [3]

Because the CARES Act provides only limited exemptions from the SBA's affiliation rules, a Business Concern which seeks a loan under the provisions of the PPP must determine if and how the SBA's existing affiliation rules apply to it in order to determine its eligibility for such a loan. This determination of how the SBA's existing affiliation rules apply is of significant importance to private equity and venture capital funds in which seemingly unrelated portfolio companies could potentially be classified as "affiliates" and result in an aggregation of the number of employees across businesses in the venture capital or private equity portfolio.

What Constitutes an Affiliate?

The SBA considers an entity to be an affiliate of a Business Concern when one controls or has the power to control the other, or a third party controls or has the power to control both. It does not matter whether control is actually exercised; the mere existence of control is sufficient to create an affiliate relationship under the SBA affiliate rules.

What Constitutes Control?

Control, for purposes of determining affiliation under SBA regulations, may be affirmative or negative. Affirmative control is generally found in situations in which a Business Concern is owned or managed by another person or entity. Negative control may be found in situations in which, for example, a minority shareholder has the right, either under a Business Concern's organizational documents or other contract, to prevent a quorum or otherwise block action by the Business Concern's board of directors or management.

Affiliation Based on Ownership

Ownership of, or the power to control or direct, more than fifty percent (50%) of a Business Concern's voting equity constitutes control for purposes of applying the SBA's affiliation rules, and such an owner will be considered an affiliate of the Business Concern. Affiliation, for purposes of counting the employees of a Business Concern, would then extend to any other business concern under common ownership with the subject Business Concern. If no single individual or entity owns or has the power to control more than fifty percent (50%) of a Business Concern's voting equity, the SBA will deem its board of directors, President or Chief Executive Officer or other officers, managing members, or partners who direct and manage the Business Concern, to control the Business Concern.

Where a private equity or venture capital fund owns less than a majority of the voting equity of a Business Concern, particular attention must be paid to the affirmative and negative control rights in any organizational and equity ownership documents (such as shareholders agreements) of the portfolio company to determine whether the minority position constitutes control and, consequently, creates further affiliation among other portfolio companies.

SBA case law (as decided by the SBA Office of Hearings and Appeals (OHA)) has held that minority owners may have veto rights to protect their investment without creating affiliation as long as the veto rights do not create control over day-to-day business operations. SBA's OHA has previously issued guidance with examples of rights that create control over day-to-day business operations (and create affiliation relationships) and others that are only considered extraordinary (and which do not create affiliation relationships). The following non-exhaustive list contains examples of minority control which do and do not create affiliation relationships:

Control of Day-to-Day Business Operations (Affiliation):

- Making, declaring, or paying distributions or dividends other than tax distributions.
- Establishing a quorum at a meeting of stockholders (and likely, by extension, at a meeting of the board).
- Approving or making changes to the company's budget or approving capital expenditures outside the budget.
- Determining employee compensation.
- Hiring and firing officers and executives.
- Blocking changes in the company's strategic direction.
- Establishing or amending an incentive or employee stock ownership plan.
- Incurring or guaranteeing debts or obligations.

- Initiating or defending a lawsuit.
- Entering into contracts or joint ventures.
- Amending or terminating leases.

Extraordinary Minority Control Rights (No Affiliation):

- Selling all or substantially all of the company's assets.
- Placing an encumbrance on all or substantially all of the company's assets.
- Engaging in any action that could result in a change in the amount or character of a company's capital contributions.
- Changing the company's line of business.
- Engaging in a merger transaction.
- Issuing additional stock/equity.
- Amending the organizational documents of a company.
- Filing for bankruptcy.
- Amending the governing documents.
- Dissolving the company.
- Increasing, decreasing, or re-classifying the authorized capital of the company.
- Increasing or decreasing the size of the board.
- Entering into a confession of judgment.
- Disposing of the goodwill of the company.
- Committing to take any action that would make it impossible for the company to carry on its ordinary course of business.

Private equity and venture capital funds with minority investments in businesses that wish to apply for a PPP loan would need to review all relevant investment and governance documents relating to their investments in order to evaluate whether control rights vested in the private equity or venture capital fund will constitute control of the day-to-day operations of the subject business. If a minority owner has control over day-to-day business operations, the subject company and any minority owners may want to consider amending any documents or agreements which create such control, so that no single minority owner will be deemed to have a minority right constituting control over the subject company. It is important to note, however, that any modifications would need to be in effect at the time the subject company applies for a PPP loan and, in any event, will still need to pass muster under the totality of the circumstances.

Affiliation Arising Under Stock Options, Convertible Securities and Agreements to Merge

Stock options, convertible securities (including convertible promissory notes) and agreements to merge (including letters of intent) are generally included as "present interests" for purposes of determining stock ownership. This means that the SBA will deem interests that have not yet been exercised, or which have not vested pursuant to convertible securities, including warrants and options, to be fully vested as of the date that affiliation is being determined, and that the SBA will assess control based on stock ownership on an as-converted, as-diluted basis.

Affiliation Based on Management

Affiliation will be found where the CEO or President of an applicant Business Concern (or other officers, managing members, or partners who control the management of the concern) also control the board of directors or management of another concern. [4]

Affiliation Based on Identity of Interest

The SBA may deem a Business Concern and another entity or person to be affiliates in situations in which the two have substantially identical business or economic interests. Family members, persons or entities with common investments, and economically dependent entities may be considered affiliates under this concept. Where identical or substantially identical identities of interest exist, the SBA may aggregate the individual interests as one, absent evidence showing that the interests are in fact separate.

Conclusion

Any borrower seeking a PPP loan, including portfolio companies of private equity or venture capital funds, will need to review their investment and governance documents to ascertain whether the SBA might find an affiliate relationship and therefore require an aggregation of employees across all portfolio companies. If an affiliate relationship exists, there may be an opportunity to renegotiate investment and governance documents with a view toward eliminating the affiliate relationship. This should be done prior to submitting an application for the PPP.

ENDNOTES

[1] A “Business Concern” is a business entity organized for profit, with a place of business in the United States which operates primarily in the United States or which makes a significant contribution to the U.S. economy through payment of taxes or use of U.S. products, materials or labor. A “Small Business Concern” is a Business Concern that meets existing SBA size standards.

[2] The detailed affiliation standards contained in section 121.103 currently do not apply to PPP borrowers, because section 121.103(a)(8) provides that applicants in SBA’s Business Loan Programs (which include the PPP) are subject to the affiliation rule contained in 13 CFR 121.301.

[3] The SBA Rule rule exempts otherwise qualified faith-based organizations from the SBA’s affiliation rules, including those set forth in 13 CFR part 121.

[4] For purposes of determining affiliation based on management, affiliation may not be found where a single person serves on the board of directors of two distinct Business Concerns, but may be found where all of the directors of the board of directors of one entity also serve on the board of directors of another entity.

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