

# Applying SBA's Affiliation Rules and Guidance to Private Equity and Venture Capital Portfolio Companies Seeking PPP Loans

Alert

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By now, businesses are deep into consideration of whether they should seek a loan under the [Paycheck Protection Program \(PPP\)](#), being administered by the [Small Business Administration \(SBA\)](#) under the [Coronavirus Aid, Relief, and Economic Security Act \(CARES\)](#). For private equity and venture capital portfolio companies, PPP participation is laden with a perplexing complication as a result of SBA affiliation rules.

Since PPP eligibility is based on qualification as a small business concern under applicable SBA rules, which related companies (both domestic and foreign) need to be counted to determine the size of a loan applicant for PPP purposes? Some guidance has been forthcoming from the SBA, but questions remain. Of particular concern are the SBA rules [13 CFR §121.103(a)(3) and 13 CFR §121.301(f)(1)] focused on whether a related concern that does not own more than 50% equity still exercises "control" by virtue of negative covenants that can block company actions, thereby constituting an "affiliate" that must be included in the size calculation. This alert seeks to synthesize various authorities and simplify the analysis process for PE and VC firms.

## BACKGROUND

The guaranteed, forgivable PPP loans are meant to provide payroll and certain other operating expense relief to small businesses meaning, with respect to for-profits, those that already qualify as "small business concerns" under SBA programs, those with 500 or fewer employees whose principal place of residence is in the U.S., or those that meet the SBA's employee-based size standards for their industry. It is widely

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acknowledged that there will be more demand for PPP loans than there will be money to distribute under the program, notwithstanding that the overall allocation for the program, as it stands today, is \$349 billion and that there is talk in Washington, DC that the amount of the program could potentially increase under future legislation.

With June 30, 2020, the last day to apply for and receive loans, approaching quickly and with current daily applications already outpacing the SBA's normal annual loan processing volume, the agency has implemented expedited rulemaking around PPP, which means that interpretation and application of the legislation is happening real time in a rather piecemeal fashion. Thus far, the SBA has published an [Interim Final Rule](#) and a [Supplementary Interim Final Rule](#), both followed by [guidance materials](#). Eligibility for the loan application, including affiliation, is determined based on the SBA rules and guidance in effect at the time of the loan application. This means that applicants need to track the rules and guidance in effect at the time that they apply.

## APPLICATION OF CONTROL RULES:

- As an initial matter, note that the SBA affiliation rules are waived relative to PPP for accommodation and food service companies (NAICS code 72) and certain franchisees and affiliates of companies licensed as SBICs.
- Unless one of those exceptions applies, however, a body of guidelines surrounding the control issue that has developed over time for SBA programs and application of its affiliation regulations must be taken into account. Generally speaking, if an equity holder's veto rights create control (whether dormant or exercised) over what is considered day-to-day business operations, affiliation will exist for purposes of SBA loan qualification. If a veto or consent right affects the following categories of corporate decisions, it likely will trigger affiliation (although this list is not necessarily exhaustive):
  - Dividends and distributions
  - Executive or other employee hiring, firing, compensation, incentives and benefits
  - Budgets and strategic direction
  - Indebtedness, leasing and purchasing
  - Lawsuits

However, that leaves a variety of veto rights that are common in PE and VC ownership that will not necessarily constitute the kind of control that will establish affiliation. Careful analysis of each unique minority protection that exists in either a company's governing documents such as the articles of incorporation, bylaws, stockholders agreement, investor rights agreement, LLC operating agreement or its other investment-related contracts must be undertaken to best determine how it will be interpreted for SBA purposes.

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- If it is likely that a minority control would trigger affiliation and therefore cause an issue with qualifying for PPP, there are several options to consider. First, is the problematic control right a right that the investor might waive in light of the compelling need for economic support under PPP? In recently published FAQs, the SBA indicated that if a minority owner that is an affiliate by reason of veto rights "irrevocably waives or relinquishes" the disqualifying veto right, then the minority owner would no longer be an affiliate. Interested parties continue to press the SBA for more guidance on this possibility. For instance, if waiver of a veto right is irreversible for the duration of the PPP loan, but thereafter springs back into existence, can it still be considered "irrevocable"? In other contexts, the SBA has applied a "present-effect" principle that may have application here and cause the future resurrection of a veto right to trigger a finding of control in a present analysis of affiliation.

Second, an investor might consider whether there is a suitable substitute protection that is not a veto right but otherwise accomplishes the same general goal without triggering affiliation for SBA purposes. For instance, might there be outright limitations on certain matters agreed to in the governing documents that could establish acceptable threshold protections without leaving the ultimate decision to the discretion of a minority owner to block an action? Any such substitute obviously will require sensitivity to SBA guidelines, creativity and precision drafting.

- While focus may be on the control issue discussed above, any analysis of affiliation for purposes of PPP must continue to take into account all other components of the SBA's rules. To summarize those very briefly, affiliation may be driven due to:
  - Stock options, convertible securities and agreements to merge or sell stock
  - Common management
  - Identity of interest (such as substantially identical business interests, close relatives, common investments, shared resources, or economic dependence through contractual and other relationships)
  - Newly organized concern (former stakeholders form a new company and there is no clear line of fracture such that there is deemed to be an ongoing connection between the former and the new concerns)
  - Joint ventures
  - Franchise and license agreements
- Given the complexity of the situation and the potential for existing SBA rules to exclude from PPP coverage a significant number of small to medium sized employers, there is [political pressure building for relief](#). We will continue to follow closely developments in this regard.

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Please contact us if we can assist in your analysis of options related to PPP. The firm's Coronavirus Task Force is monitoring and prepared to quickly and efficiently respond to questions and ongoing legal issues unique to the coronavirus situation including, but not limited to, employment and labor matters, contract enforcement and force majeure issues, and insurance coverages.

For more information on the SBA's new rules, please contact [Tessa Trelz](#), [David Jennings](#), [David J. Kim](#), [Susan Warshaw Ebner](#), [David Jenson](#), [Gerald Weidner](#) or the Stinson LLP contact with whom you regularly work.

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