

# Treasury Department Finally Issues Affiliation Guidance for Paycheck Protection Program

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Late on April 3, 2020, the Treasury Department issued the much awaited affiliation rules that govern whether business concerns are eligible to borrow as “small businesses” under the U.S. Small Business Administration’s (“SBA”) Paycheck Protection Program (“PPP”).<sup>1</sup> The bottom line: the guidance offers no new relief to for-profit businesses and reaffirms the SBA’s existing rules regarding affiliation (13 CFR §121.301(f)).

## Affiliation Generally

Under the SBA’s existing rules for business loans, including PPP loans, prospective borrowers are aggregated with their “affiliates” for purposes of determining their size as a criterion for loan eligibility. Entities are “affiliates” when one entity controls or has the power to control the other, or a third party or parties controls or has the power to control both. It does not matter if control is actually exercised. The affiliation rules are particularly troublesome for private equity or venture capital backed businesses, as in many cases the rules deem the businesses affiliated not only with their investors, but also with those investors’ other portfolio companies.

## Did the Rules Change Affiliation Based on Majority Ownership?

No. Any individual or entity that owns or has the power to control more than 50% of the voting equity securities of a prospective borrower is deemed to control, and be an affiliate of, the prospective borrower. The SBA generally treats options, warrants and convertible securities as fully converted when calculating ownership of voting equity. The effect of the rules is that a portfolio company that is majority owned by a private equity fund will generally be aggregated together with the fund and its other controlled portfolio companies for purposes of the SBA’s size determination, unless the portfolio company qualifies for one of the waivers discussed below.

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<sup>1</sup> Generally, small businesses are those with 500 or fewer employees, but size determinations are complex and fact-specific. See Choate’s alert [“COVID-19 Stimulus Loans: Are PE and VC Portfolio Companies Eligible?”](#) for further discussion of business size and eligibility for the PPP.

## Did the Rules Change Affiliation for Certain Minority Owners?

No. A minority shareholder that has the ability, under the borrower's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors (or shareholders of the borrower) is still deemed to control and be an affiliate of the borrower, unless the shareholder's rights relate to certain "extraordinary" situations as discussed below. SBA administrative decisions make it clear that certain minority shareholder rights may also constitute control if a minority shareholder has approval rights over, or the power to block, an important aspect of a business.<sup>2</sup> However, approval rights over certain "extraordinary" decisions, such as a sale of the company or mergers, issuing new equity, amending a company's organizational documents, or entering liquidation or bankruptcy, are not deemed to result in control of a business because they do not allow the minority shareholder to influence ordinary day-to-day business operations of the company.<sup>3</sup>

To be clear, minority investor rights that influence day-to-day business operations of the company do not create control if the rights cannot be unilaterally exercised by a single investor but rather require at least two or more unaffiliated investors to exercise them. Minority investors with only shared power to exercise their rights would not be affiliates of the company. An example of such a shared power arrangement would be a provision to the effect that the approval of two of three investors is required before the company may take specified actions.

The control analysis for minority shareholders is fact-intensive and often involves judgment calls regarding specific investor rights. Choate is actively working with clients to analyze portfolio company and investment documents and consider relinquishing applicable shareholder rights in order to allow portfolio companies to access financing through the PPP.

## Reminder of Waivers of Affiliation Rules

Some portfolio companies controlled by private equity funds may still escape the net of the affiliation rules. Under the PPP, the affiliation rules discussed above are waived for (1) any business concern with 500 or fewer employees that, as of the date on which a PPP loan is disbursed, is in the hospitality and food service business<sup>4</sup>; (2) franchises; and (3) recipients of financial assistance from a small business investment company licensed by the SBA.

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<sup>2</sup>The following is a non-exhaustive list of such approval rights: (1) payment of dividends or making of distributions, (2) hiring and firing executives, (3) determining executive or employee compensation, (4) establishing/amending incentive equity plans, (5) budgeting and expenditure decisions, (6) borrowing or issuing guarantees, (7) changing the strategic direction of the business, (8) entering into or amending contracts or joint ventures, (9) amending or terminating leases, and (10) bringing or defending lawsuits.

<sup>3</sup>The following is a non-exhaustive list of other "extraordinary" approval rights: (1) changing the nature or amount of capital contributions to a company, (2) changing a company's line of business (as opposed to only changing business strategy), (3) changing the amount or classification of a company's authorized capital, (4) changing the number of directors, (5) encumbering substantially all of a company's assets, (6) disposing of a company's good will, or (6) entering into a confession of judgment.

<sup>4</sup>This waiver applies to any business assigned a North American Industry Classification System, or "NAICS", code beginning with 72.

If you have questions regarding these developments, please contact a member of our Private Equity team.

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