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APPLICATION OF AFFILIATION RULES TO PRIVATE EQUITY FUNDS AND PORTFOLIO COMPANIES UNDER THE PAYCHECK PROTECTION PROGRAM

by Nancy Bostic, Wes Dorman and Chad Kell

May 14, 2020

Companies with private equity fund investors have experienced challenges in determining whether they qualify as a borrower that is eligible to participate in the Paycheck Protection Program (PPP) created by the Coronavirus Aid, Relief and Economic Securities (CARES) Act. This is due in large part to the provisions of the CARES Act which provide that, in addition to small business concerns, any business concern, certain nonprofit organizations, veterans organizations and tribal business concerns are eligible for a PPP loan if the business concern has 500 or fewer employees or, if applicable, the larger employee size standard established by the Small Business Administration (SBA) for that industry. To determine the number of employees of the applicant for purposes of the PPP, the applicant needs to comply with the affiliation rules of the SBA. Except for certain businesses described below, these rules require that the applicant include the employees of its domestic and foreign affiliates for purposes of determining whether the aggregate number of employees causes the potential borrower to exceed the size requirement to qualify as an eligible borrower under the PPP.

The CARES Act waives the affiliation rules from February 15, 2020 to June 30, 2020 for any business concern that (a) has an NAICS code beginning with 72 (Accommodation and Food Services), (b) is operating as a franchise that is assigned a franchise identifier code by the SBA or (c) receives financial assistance from a company licensed under Section 301 of the Small Business Investment Act.

The SBA stated in interim final rules published after the adoption of the CARES Act that its affiliation rules apply to private-equity backed PPP loan applicants, so before applying for a PPP loan, such applicant should carefully evaluate whether it may be considered affiliated with its private equity fund investors and, if so, if the applicant is thereby affiliated with some or all of the private equity fund's other portfolio companies and other potential affiliates.

The PPP is a key provision of the CARES Act through which the SBA provides potentially forgivable loans to small businesses and certain other organizations. A broad overview of the PPP's eligibility requirements and limitations may be found in Gray Reed's prior client alerts on the subject, linked here and here. Below is an overview of certain SBA affiliation rules which may disqualify a private-equity backed company from PPP loan eligibility.

OVERVIEW

The SBA's affiliation rules for "Business Loans" such as PPP loans are found in 13 CFR 121.301, which outlines in clause (f) six bases for a finding of affiliation. In general, 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. It does not matter whether control is exercised, so long as the power to control exists. Affiliation under any of the circumstances described below is sufficient to establish affiliation for applicants for purposes of the PPP. Notably, on April 3, 2020, the SBA released guidance titled "Affiliation Rules Applicable to U.S. Small Business Administration Paycheck Protection Program" (Guidance) which states that the first four of the bases for affiliation under 13 CFR 121.301(f) will apply with respect to PPP applicants. The Guidance is silent on why the other bases for affiliation under 13 CFR 121.301(f) are not included. The CARES Act, as implemented by the Code of Federal Regulations, is contrary to the Guidance in that it states that the SBA's existing affiliation rules under 13 CFR 131.301(f) apply to PPP applicants outside of a few limited exceptions. For this reason, all of the bases for affiliation are discussed below (other than with respect to franchises, as the CARES Act exception for franchises is discussed above).

1. *Ownership*
   a. *Greater Than 50 Percent Percent Ownership.* An entity is considered affiliated with an individual, concern or entity that owns or has the power to control more than 50 percent of the business's voting equity. If no such controlling person or entity is evident based on ownership of voting equity alone, the SBA will deem the board of directors, president or chief executive officer (or other officers, managers, managing members or partners who control management of the concern) to be in control of the concern.

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b. *Negative Control.* A minority shareholder will be deemed to control a concern if that minority shareholder has the ability to prevent a quorum or block certain actions by the board of directors or shareholders. Although 13 CFR 121.301(f) does not refer to members and partners, it is likely that the same concept would apply to minority equity owners of limited liability companies and partnerships that have the ability to prevent quorum or block action by the governing authorities of those entities. The nature and extent of the negative control determines whether it constitutes affiliation on its own basis alone. Control and thus affiliation is a fact dependent analysis but is likely to be found where a minority owner can block "ordinary" actions essential to running the company. In contrast, where a minority owner is only able to block "extraordinary" actions designed to protect the minority owner's investment, this has been found by the SBA to not constitute affiliation through negative control.

Examples of "extraordinary action" which the SBA has found not to constitute affiliation through negative control include:

i. amending an entity's governing documents;
ii. admitting new members;
iii. issuing new stock;
iv. entering a new, unrelated business;
v. filing for bankruptcy;
vi. engaging in a fundamental transaction; and,
vii. terminating or winding up the business.

Conversely, the SBA has articulated a number of "ordinary" actions which, if the minority shareholder has the right to control (e.g., through an approval or veto right), would likely constitute an affiliation finding, including:

i. control over an organization's budget;
ii. the power to hire and fire officers;
iii. declaring dividends or distributions;
iv. incurring or guaranteeing debt;
v. purchasing equipment;
vi. entering into contracts;
vii. choosing independent auditors;
viii. entering, amending or terminating lease agreements;
ix. initiating lawsuits (presumably other than lawsuits arising out of the shareholder's equity interest); and
x. the ability to set employee compensation.

As a result, private equity investors that have an active role in managing certain ordinary day-to-day affairs of a portfolio company are likely to be found to be affiliated with these companies.

However, in the SBA's Frequently Asked Questions (FAQ) document for the PPP, Question 6 states that if a minority owner irrevocably waives or relinquishes existing rights in a loan applicant, then it will not be considered an affiliate of the applicant. While minority owners will likely not want to relinquish these rights, they may consider doing so if the loan applicant's business outlook becomes dire enough.

2. *Potential Control*

(a) *Triggers.* The SBA considers the mere right to control a loan applicant as a criterion for affiliation purposes, whether or not this control is actually exercised. This also true for instruments that if triggered would cause a change of control of the applicant, such as stock options, convertible securities and agreements to merge (including "agreements in principle"). The SBA treats these instruments as though the rights granted have been exercised or consummated.

(b) *Exceptions.* Agreements to commence or continue negotiations toward a possible merger or sale of stock are not considered agreements in principle by the SBA and are thus not given present effect. Options, convertible securities and agreements subject to conditions precedent which are incapable of fulfillment, speculative or unenforceable due to being in violation of applicable law are also not given consideration for control purposes.

(c) *Divestiture.* Finally, a person or entity that controls a concern cannot use options, convertible securities or agreements to appear to terminate such control before actually doing so in order to avoid an affiliation determination by the SBA.

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3. *Management*. The SBA considers affiliation to be present where the chief executive officer or president of the applicant (or other officers, managing members or partners who control the concern) also controls the management of one or more other concerns. Affiliation through common management may also be found where a single individual, concern or entity that controls the board of directors or management of one concern also controls the board of managers or management of one or more other concerns. This type of affiliation may also occur where a single individual, concern or entity controls the management of the applicant through a management agreement. This is particularly relevant for private equity firms that use a recurring group of officers, managers or directors to govern the affairs of multiple portfolio companies that are otherwise unrelated by equity ownership. Setting aside concerns arising from common equity ownership, potential loan applicants with private equity investors should compare their officer, manager and board slates to the slates of their investors' other portfolio companies.

4. *Identity of Interest.* A rebuttable presumption of affiliation arises when there is an identity of interest between persons or businesses with identical or substantially identical business or economic interests. Examples of this type of affiliation include where: (i) close relatives (as defined in 13 CFR 120.10) operate concerns in the same or similar industry in the same geographic area, (ii) a group of common persons or entities own a substantial portion of multiple businesses in related industries, and these businesses transact or share resources with one another or (iii) a business derives greater than 85 percent of its revenue with another single business, unless the business is earned through non-exclusive contracts, and the SBA agrees that the contracts do not permit one party to the contract to effectively control the other. If any of these relationships are deemed to exist, an applicant may rebut the presumption of affiliation with evidence showing that the interests deemed to be one are in fact separate.

5. *Successor Affiliation*. The SBA may find also find affiliation between two businesses where: (i) the officers, directors, managers, managing members or owners of greater than 20 percent of a given business organize a new business in the same or a related industry, (ii) these persons serve in the same capacity of the "new" business and (iii) "direct monetary benefits" flow from the new business to the original business. The SBA considers a business to be "new" for purposes of this affiliation criterion if it has been "actively operating" for two or fewer years.

6. *Totality of the Circumstances*. The SBA is granted the latitude to consider all connections between two persons or entities when making an affiliation of determination, which shall be made on a "case-by-case basis where there is clear and convincing evidence based on the totality of the circumstances." However, once a determination of no affiliation is made, the SBA will not overturn this determination "as long as it was reasonable when made given the information available to the SBA Lender at the time."

Private equity funds that are affiliated with a company in which they invest will need to conduct the above analysis for their other affiliates, both upper tier equity owners in the private equity funds and their respective portfolio companies in order to determine which entities would be aggregated with a borrower for purposes of determining if the SBA's employee size standard is exceeded and the applicant is therefore ineligible to apply for a PPP loan.

CERTIFICATION REQUIREMENTS

On April 24, 2020, the SBA released a new interim final rule (IFR) containing additional guidance for PPP applicants. The IFR states that "Hedge funds and private equity firms are primarily engaged in investment or speculation, and such businesses are therefore ineligible to receive a PPP loan. The Administrator, in consultation with the Secretary, does not believe that Congress intended for these types of businesses, which are generally ineligible for section 7(a) loans under existing SBA regulations, to obtain PPP financing."

The IFR states that "The affiliation rules apply to private equity-owned businesses in the same manner as any other business subject to outside ownership or control. However, in addition to applying any applicable affiliation rules, all borrowers should carefully review the required certification on the Paycheck Protection Program Borrower Application Form (SBA Form 2483) stating that '[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant' (referred to herein as the Need Certification)."

Recent additions to the SBA's FAQ document have added color to the PPP certifications in SBA Form 2483. Question 31 of the FAQ, added April 23, 2020, states that borrowers must take into account their ability to *access other sources of liquidity sufficient to support then ongoing operations in a manner that is not "significantly detrimental" to the business* when applying for a PPP loan. Question 31 also states that "For example, it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith…." FAQ Question 37, added April 28, 2020, clarifies that the liquidity considerations discussed by Question 31 are also applicable to private companies.

On April 12, 2020, the SBA added Question 46 to the FAQ, which provides that the SBA has determined that any borrower that, *together with its affiliates*, received PPP loans with an original principal amount of less than $2 million will be deemed to have made the

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Need Certification in good faith. The SBA states in Question 46 that this safe harbor is appropriate ". . . because borrowers with loans below this threshold are generally less likely to have had access to adequate sources of liquidity in the current economic environment than borrowers that obtained larger loans. This safe harbor will also promote economic certainty as PPP borrowers with more limited resources endeavor to retain and rehire employees."

The SBA notes in Question 46 that borrowers with loans greater than $2 million may still have an adequate basis for making the Need Certification based on their individual circumstances in light of the language of the certification and SBA guidance. All PPP loans in excess of $2 million, and other PPP loans as appropriate, will be subject to review by the SBA for compliance with program requirements. Of note, the SBA states in Question 46 that "If SBA determines during the course of its review that a borrower lacked an adequate basis for the required certification concerning the necessity of the loan request, SBA will seek repayment of the outstanding PPP loan balance and will inform the lender that the borrower is not eligible for loan forgiveness. If the borrower repays the loan after receiving notification from SBA, SBA will not pursue administrative enforcement or referrals to other agencies based on its determination with respect to the certification concerning necessity of the loan request."

In addition, FAQ Questions 31, 42 and 47 provide that any borrower that applied for a PPP loan prior to the issuance of the FAQ that repays the loan in full by May 18, 2020 will be deemed by the SBA to have made the Need Certification in good faith.

CONCLUSION

Portfolio companies of private equity or venture capital funds should consider the affirmative and negative controls granted to private equity and venture capital funds in their governing documents to determine the likelihood of the SBA finding that the fund is an affiliate of the portfolio company, thereby mandating an aggregation of the employees of all portfolio companies that are also deemed to be affiliates of the private equity or venture capital fund. If the affiliate relationships are due to minority ownership controls causing the applicant to exceed the permitted size, then it may be that the private equity or venture capital fund would be willing, under the circumstances, to amend the governing documents of the portfolio company to eliminate the provisions causing the affiliate relationship.

In addition to the affiliation concerns, the above demonstrates that while the CARES Act suspends for purposes of the PPP the SBA's otherwise applicable requirement that borrowers be unable to obtain credit elsewhere, the IFR and FAQ Questions 31 and 37 state that borrowers need to take *other sources of liquidity* into consideration, and FAQ Question 46 then provides that if any borrower, *together with its affiliates*, received PPP loans with an original principal amount of less than $2 million will be deemed to have made the Need Certification in good faith. Since the FAQ states that it does not carry the force and effect of law independent of the statute and regulations on which it is based, borrowers would be well served by proceeding with caution in determining eligibility for a PPP loan as well as providing the Need Certification.

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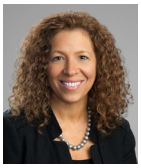

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