

# CARES Act: SBA Paycheck Protection Program Loans - Affiliation Considerations

April 7, 2020

Venture Capital and Emerging Companies

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Ninety-five percent of employing businesses in the United States are small businesses. As we discussed in detail [here](#), the CARES Act seeks to support small businesses through the [Paycheck Protection Program](#) (PPP) and the [Economic Injury Disaster Loan](#) (EIDL), in addition to other Small Business Administration (SBA) efforts involving the Emergency Advance: [SBA Express Bridge Loans](#) and [SBA Debt Relief](#).

On April 2, the SBA released the [interim final rule](#) for the Paycheck Protection Program and, a day later, the [application for the PPP](#) and a separate [rule on affiliation](#). The rule and application create some flexibility to determine that entities that own up to 49 percent of an applicant are not affiliated for Paycheck Protection Program purposes. Determining affiliation in those situations becomes a facts-and-circumstances assessment, depending on board control, common management, and certain shareholder veto rights. The SBA, in consultation with the Department of Treasury, is maintaining a [list of frequently asked questions](#), most recently updated as of April 6.

Generally, in order to be eligible for the Paycheck Protection Program, companies must have fewer than 500 U.S.-based employees unless they fall within one of a few industry exceptions. Importantly, outside of the hospitality and food services industries and for certain franchisees and businesses receiving other small business assistance, the number of employees includes the employees of any “affiliates” of the company, and the determination of affiliation is based on SBA rules. Such rules capture not only the typical affiliates – those people or entities holding more than 50% of the company’s stock or otherwise controlling the board – but also minority investors with negative or positive control rights that amount to control over day-to-day operational decisions of the company. In other words, the very types of rights that VCs will typically hold.

A bipartisan group of 55 Members of the House of Representatives [sent a letter](#) to the Treasury Department on April 2 urging “the SBA to issue the necessary waiver to the affiliation rule, that is needed to protect thousands of startups across the nation and the employees who depend on their survival.” However, no such waiver has been granted and for now the affiliation rules continue to apply to companies seeking a Paycheck Protection Program Loan.

Companies will need to identify certain affiliates in their loan application and make eligibility certifications related thereto. Banks will also likely perform some level of diligence on these matters. Any false statements can have civil and/or criminal consequences and thus such

determinations should be made carefully and thoughtfully, with the assistance of counsel where necessary.

In order to assist with thinking about these matters, we have prepared the below tables, which list various types of approval rights typically granted to investors, or to their representatives on the Board, and organizes them into categories based on whether:

- the SBA has found them acceptable (or we believe the SBA would find them acceptable);
- we believe they are potentially problematic; or
- the SBA has found them to be problematic.

It is also important to note that there is no definitive guidance on many of these items. The regulations do not state what specific rights would create control and thus the below chart is based upon administrative case law decided in highly fact-specific circumstances.

#### Acceptable Rights

- Liquidation or deemed liquidation event (acquisition, dissolution, etc.)
- Amendment of the Certificate of Incorporation, Bylaws, or Operating Agreement
- Authorization of a new series or class of stock or an increase to an existing series or class or adding new members
- Redemption of outstanding stock
- Changing the principal business of the company
- Changing the size of the Board
- Filing for bankruptcy
- Disposing or encumbering all or substantially all assets or goodwill

### Potentially Problematic Rights

- Approving dividends and other distributions (previously described as problematic by SBA when combined with other factors)
- Approving the annual budget (previously described as problematic by SBA when combined with other factors)
- Loans to/from any employee or director
- Interested party transactions
- Making investments outside the scope of a Board approved investment policy
- Obligation to obtain/maintain D&O policy
- Deviation from a standard vesting schedule for employee option/equity grants
- Approval of the company's confidentiality and invention assignment agreement
- Amendment to or change in existing stock option agreements with a non-executive employee (previously described as problematic by SBA when combined with other factors)
- Establishing or amending an incentive or employee stock ownership plan (previously described as problematic by SBA when combined with other factors)
- Changing accounting methods or selecting accountants
- Submission of a claim to arbitration
- Restrictions on competition

### Problematic Rights

- The ability to block a quorum of shareholders or the Board
- Creation of a debt security, incurrence of debt or granting a guarantee or security interest (unless encumbering all or substantially all assets)
- Matters relating to officer and executive compensation, hiring and termination
- Entering into a new line of business (as opposed to substantial deviations from an existing line of business)
- Selling or licensing IP or assets or other strategic actions (potentially excluding disposal of key company technologies)
- Amending or terminating lease agreements
- Bringing or defending a lawsuit
- Submitting proposals or entering into contracts (other than contracts that would be covered by an Acceptable Right)
- Purchasing or selling ordinary assets
- Procedures for maintaining records

In addition to the above, it is also possible that affiliation between two or more entities will be found based on overlapping directors or management. If this might be the case for your company, we are happy to discuss the nuances with you.

In the event the foregoing analysis reveals that a company has one or more affiliates that would cause the company to no longer meet the eligibility requirements, it may be possible to amend the applicable agreements or governing documents, or secure an irrevocable waiver from the investors holding the problematic rights, such that the affiliation concern disappears.

We recommend that any venture capital backed company seeking a Paycheck Protection Program loan speak with one of Covington's lawyers who are experienced in these matters. The affiliation analysis is complex and highly fact specific and requires familiarity with past SBA administrative case law. A member of our Covid-19 task force experienced in emerging company and venture capital matters can efficiently review and discuss your company's governing documents and determine whether action should be taken prior to applying for the loan.

If you have any questions concerning the material discussed in this client alert, please contact the following members of our Venture Capital and Emerging Companies practice:

<b><u>Scott Anthony</u></b>	+1 650 632 4703	<a href="mailto:scanthony@cov.com">scanthony@cov.com</a>
<b><u>Bradley Chernin</u></b>	+1 415 591 7041	<a href="mailto:bchernin@cov.com">bchernin@cov.com</a>
<b><u>Ellen Corenswet</u></b>	+1 212 841 1256	<a href="mailto:ecorenswet@cov.com">ecorenswet@cov.com</a>
<b><u>Tom DeFilipps</u></b>	+1 650 632 4713	<a href="mailto:tdefilipps@cov.com">tdefilipps@cov.com</a>
<b><u>Tyler Evans</u></b>	+1 202 662 5836	<a href="mailto:tevans@cov.com">tevans@cov.com</a>
<b><u>Joseph Gangitano</u></b>	+1 212 841 1015	<a href="mailto:jgangitano@cov.com">jgangitano@cov.com</a>
<b><u>Catharina Min</u></b>	+1 650 632 4730	<a href="mailto:cmin@cov.com">cmin@cov.com</a>
<b><u>Ingrid Rechten</u></b>	+1 415 591 7080	<a href="mailto:irechten@cov.com">irechten@cov.com</a>

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