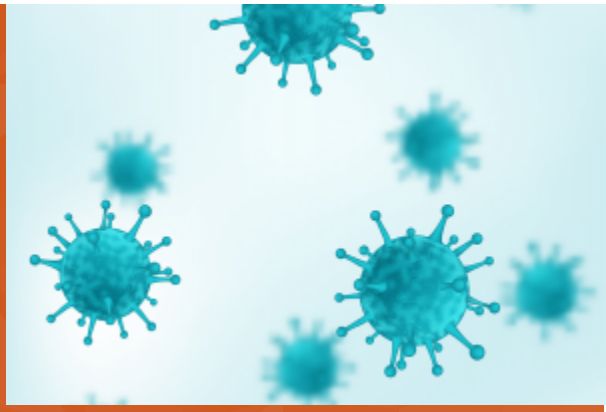
COVID-19 Alert: Interim Final Rule on Affiliation

PPP Loan Program: Analysis of Treasury Interim Final Rule on Affiliation; Impact on Portfolio Companies

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On April 3, 2020, the United States Treasury Department issued "Interim Final Rules" and a related guideline concerning the Paycheck Protection Program's "Affiliation Rule." The Interim Final Rule and guideline may be found here:

- Interim Final Rule on Affiliation (the "Interim Rule")
- Applicable Affiliation Rule Guideline (the "Guideline")

The instructions included in the Interim Rule and Guideline *significantly limit*, by application of the Affiliation Rule, the types of businesses that are eligible to apply for loans under the Paycheck Protection Program. ***Of particular note:*** The Interim Rule and Guideline apply the restrictions of the Affiliation Rule to start-up and emerging businesses, likely *precluding* many such companies from access to PPP loans funds.

Below is a summary of the basic concepts:

RELEVANT BACKGROUND

Among the terms contained in the CARES Act are provisions authorizing the Small Business Administration (the "SBA") to temporarily guarantee loans under the Paycheck Protection Program (the "PPP"). Loans under the PPP are 100% guaranteed by the SBA, are available to "small businesses," and the full principal amount of the loans may qualify for loan forgiveness.

In general, a business entity is eligible for a PPP loan if it employs 500 or fewer employees whose principal place of residence is in the United States (the "Employee Threshold").

In counting employees, for purposes of determining the Employee Threshold, the PPP adopts the so-called "**Affiliation Rule**" – a complex rule imbedded in the Small Business Act.

The Affiliation Rule instructs, in basic form, that a borrower must be considered together with its "Affiliates" for purposes of determining loan eligibility, including for purposes of calculating the Employee Threshold. In other words, under the Affiliation Rule, Affiliated companies are considered a single entity for purposes of loan eligibility determination. This concept has several implications for the PPP:

- In counting employees for purposes of the Employee Threshold, the Affiliation Rule requires the borrower to aggregate and count together its direct employees, *and* the employees of any

Affiliated entity.

- Because the PPP limits eligible borrowers to a single PPP loan, the Affiliation rule appears to instruct that once a business applies for a PPP loan, any Affiliates of that business are precluded from separately applying for another PPP loan.

In determining whether business entities are "Affiliated," the Affiliation Rule requires a multi-factored evaluation that includes, but is not limited to, an evaluation of stock ownership, overlapping management, and co-identity of family interests (*discussed in further detail below*).

As has been widely reported, since the passage of the CARES Act, concerns about the application of the Affiliation Rule have been raised by the start-up and emerging company communities. Specifically, a concern has been raised that the Affiliation Rule may operate to deem portfolio companies of a common venture or private equity fund as Affiliates, resulting in the following outcomes:

- ***For purposes of calculating the Employee Threshold:*** There is a concern that the Affiliation Rule operates to require a single portfolio company to include employee headcounts from other portfolio companies of common venture or private equity funds – *effectively precluding businesses sponsored by large, multi-portfolio funds from PPP loans.*

- ***For purposes of determining general eligibility for PPP loans:*** Because Affiliates are considered a single entity, there is a concern that separate PPP loan applications from multiple portfolio companies of the same venture or private equity fund would be precluded. *(Although, perhaps, the rule would permit a group of common portfolio companies to apply for a PPP loan as a single "Affiliated unit," if the total employee headcount for all of the portfolio companies was under 500 employees.)*

In the past week, the application of the Affiliation Rule has been the subject of heavy lobbying efforts by the venture and private equity business communities. As a result of those efforts, some commentators predicted that the Treasury Department would act, through implementing regulations, to relax the Affiliation Rules to ensure PPP eligibility for venture and private equity backed start-ups and emerging businesses. ***That does not appear to be the case.***

On April 3, 2020, the Treasury Department issued the Interim Rule and Guideline concerning the Affiliation Rule. Although the Interim Rule does limit the application of the Affiliation Rule for certain non-profits and "faith-based" groups, the Interim Rule ***leaves the Affiliation Rule intact for venture and private equity backed businesses, likely precluding many such companies that have taken capital under standard terms and conditions from access to PPP loans.***

That said, there are elements of the Interim Rule and Guideline that may open eligibility to a greater scope of venture and private equity backed companies than originally anticipated. (In addition, it is conceivable that the Interim Rule is subject to future change. However, future substantive modifications to the Interim Rule are not anticipated.)

A summary of the Affiliation Rule, as instructed in the Interim Rule and Guideline, and a description of provisions that apply specifically to portfolio companies, follows.

THE AFFILIATION RULE, AND THE SCOPE OF ITS APPLICATION

The Guideline offers a plain language explanation of the Affiliation Rule, and adopts a four-part test for determining Affiliation.

Specifically, under the Guideline, associations between multiple entities under *any* of the

circumstances described below establishes Affiliation for borrower applicants to the PPP loan program:

TEST	ELEMENTS OF PROOF
1. Affiliation Based on Ownership	*Under the Affiliation Rule, business entities are Affiliated if they are controlled by the same individual or entity.* For purposes of this instruction: A PPP loan applicant is an Affiliate of any individual or entity that owns or has the power to control **more than 50 percent** of the applicant's voting equity. If no single individual or entity controls a majority equity position, the Affiliation Rule deems the Board of Directors or President or Chief Executive Officer (or other officers, managing members, or partners who control the management of the concern) to be in control of the applicant. A minority shareholder is deemed to be in control of an applicant, if that individual or entity has the ability, under the applicant's charter, by-laws, or shareholder's agreement, to **prevent a quorum or otherwise block action by the board of directors or shareholders.** For example, "negative control" rights to block any of the following corporate actions *might be deemed* to create Affiliation: • Making, declaring, or paying distributions or dividends other than tax distributions. • Establishing a quorum at a meeting of stockholders. • 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.
2. Affiliation Arising Under Stock Option, Convertible Securities, and Agreements to Merge	*For purposes of determining "common control" under Test 1, the Affiliation Rule considers stock options, convertible securities, and agreements to merge (including agreements in principle) to have a present effect. As such, the Affiliation Rule treats such options, convertible securities, and agreements as though the rights granted have been exercised.* For purposes of this instruction: Agreements to open or continue negotiations towards the possibility of a merger or a sale of stock at some later date **are not considered "agreements in principle" and are thus not given present effect.** Options, convertible securities, and agreements that are **subject to conditions precedent which are incapable of fulfillment, speculative, conjectural, or unenforceable** under state or Federal law, or where the probability of the transaction (or exercise of the rights) occurring is shown to be extremely remote, are not given present effect.
3. Affiliation Based on Management	*Under the Affiliation Rule, businesses entities are Affiliated if they share common management.* Affiliation arises where the CEO or President of the applicant business concern (or other officers, managing members, or partners who control the management of the concern) also controls the management of one or more other business concerns. Affiliation also arises where a single individual, business concern, or entity that controls the Board of Directors or management of one business concern also controls the Board of Directors or management of one of more other business concerns. Affiliation further arises where a single individual, business concern or entity controls the management of the applicant business through a management agreement.

4. Affiliation Based on Identity of Interest / Close Family Relationships	*Under the Affiliation Rule, businesses entities are Affiliated, with certain limitations, if they are owned or operated by common, close family members.* Affiliation arises when *close relatives* (spouse; a parent; or a child or sibling, or the spouse of any such person) own or operate identical or substantially, identical business or economic interests (such as where the close relatives operate concerns in the same or similar industry in the same geographic area). When there is a determination of "family interest" Affiliation, the loan applicant may rebut that determination with evidence that the businesses are in fact distinct.

In addition to the above, four-part test, the Guideline also instructs that certain "faith-based" organizations are exempt from the Affiliation Rule. The Affiliation Rule is also waived for: (i) any business in the accommodation (*i.e.*, hotel) and food industries; (ii) any business concern operating as a franchise; and (iii) any business that receives financial assistance from a Small Business Investment Company (an "SBIC").

As such, contrary to predictions by several commentators, the Treasury Department has declined to relax Affiliation Rules for venture and private equity backed portfolio companies – *likely precluding many start-up and emerging businesses from access to PPP loans funds.*

Although the Affiliation Rule remains applicable to venture and private equity backed businesses, there are some elements of the Interim Rule and Guideline that appear to limit the restrictions of the Affiliation Rule for certain portfolio companies:

- The Interim Rule and Guideline specifically exempt SBIC-backed businesses from the Affiliation Rule. ***As such, if a portfolio Company has also received any financial assistance from an SBIC, it appears that such portfolio company may apply for a PPP loan, without Affiliation Rule restriction.***
- Original concerns raised by the venture and private equity communities were based on an interpretation of pre-existing SBA Affiliation Rules set forth in **13 C.F.R. §121.103** (which includes very complex rules for determining Affiliation when institutional investors control minority positions in portfolio companies). The Interim Rule, however, makes clear that "*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.*" Unlike 13 C.F.R. §121.103, **13 C.F.R. §121.301** contains a simplified Affiliation Rule consistent with the above, four-part test. As described above, with respect to determining Affiliation based on equity ownership (Test 1), a loan applicant is an Affiliate of another individual or entity ***only if*** that other individual or entity owns or has the power to control more than 50 percent of the applicant's voting equity or retains the right to prevent a quorum or otherwise block action by the board of directors or shareholders. ***To the extent a venture or private equity fund holds less than 50% ownership (and does not hold significant negative control rights) in a portfolio company, that portfolio company may be unrestricted by the Affiliation Rule for purposes of PPP loan eligibility.***
- It may be possible to avoid the restrictions of the Affiliation Rule by amending governing documents to remove institutional investor control rights, prior to submitting a PPP loan application. In particular, based on prior SBA interpretations, the operational controls that investors frequently negotiate the rights to in investor rights or similar agreements may need to be removed along with certain other features.

As is evident from the above, the Affiliation Rule injects significant complexity into determinations of PPP loan eligibility – *which may result in loan processing delays.* As such, if there is any doubt regarding whether the Affiliation Rule applies, it remains prudent for companies to apply for the maximum authorized loan amounts (*with full and clear disclosure of ownership structures as required by the application form*), in order to reserve a position in the first-come-first-

served application process of the PPP.

Morse is following this topic closely. Please feel free to reach out to your Morse contact, or to speak with Matt Mitchell directly, should you have any questions.

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