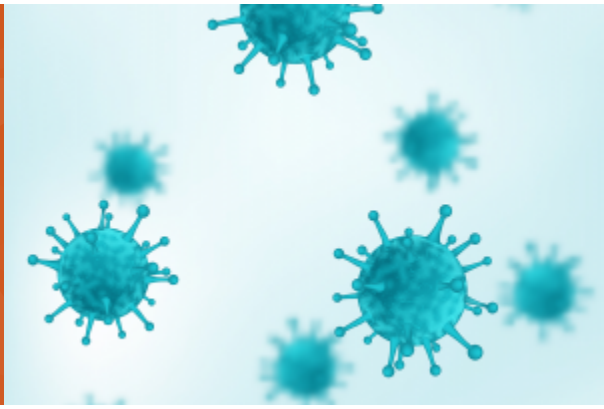
COVID-19 Alert: The Affiliation Rules

Practical Strategies for Venture and Private Equity Backed Businesses Considering PPP Loans

By:Matthew L. Mitchell and Jonathan D. Gworek
April 10, 2020



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As previously discussed, on April 3, 2020, the United States Treasury Department issued "Interim Final Rules" and a related guideline concerning the Paycheck Protection Program's ("PPE") "Affiliation Rules." As has been widely reported, since the passage of the CARES Act, concerns about the application of these Affiliation Rules have been raised by the venture capital and private equity communities. Specifically, the Affiliation Rules may operate to deem portfolio companies of a common venture capital or private equity fund as affiliates of the fund and of each other. As a result of this affiliate status, applicants would need to include employee headcounts from other portfolio companies of common venture or private equity funds. This would *preclude many venture capital or private equity-backed businesses from receiving PPP loans.* That said, strategies are emerging that venture capital and private equity backed companies may use to navigate the Affiliation Rules and meet eligibility requirements for the PPP Loans. Those strategies are discussed below.

NAVIGATING AFFILIATION RULE RESTRICTIONS

The Affiliation Rules state that the "SBA will deem a minority shareholder to be in control, if that individual or entity has the ability, under the concern's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders." Most venture and private equity investors do maintain "negative controls" or "blocking rights" in their portfolio businesses that allow investors to block actions of the board of directors and/or the shareholders. When these rights run to a single investor, whether explicitly or by virtue of that investor's controlling ownership position within the preferred stockholder class, the company may be affiliated with such investor. Fortunately, and as discussed further below, SBA guidance has also made it clear that companies and investors may agree to remove the provisions in the financing documents that extend such rights to investors prior to applying for a PPP loan.

What is "Control?"

The question that remains is to what extent these rights must be eliminated in order to allow a company to avoid affiliation with its private equity or venture capital investors.

Based on a plain English reading, this part of the Affiliation Rules would require *any and all* such blocking rights to be removed in order for the company to qualify for a loan under the PPP. This would include standard blocking rights that are found in the company's charter over fundamental transactions, such as a sale of the company or a subsequent round of financing, as well as blocking rights more typically found in the investor rights agreement pertaining to decisions that are generally more operational in nature. The SBA's Office of Hearings and Appeals ("OHA") case law has interpreted control more narrowly in the context of similar, pre-existing affiliation rules. While there is some overlap with the fundamental transactions that are

frequently the subject of stockholder veto rights in the charter, most of the indicia of control cited by the SBA are more operational in nature and, somewhat surprisingly, the cases have not found that a veto over a sale of the company or subsequent financing round constitutes control under the affiliation rules. Examples of operational protective provisions that could trigger affiliation include paying dividends, approving or changing the company's budget or approving expenditures outside of the budget, determining employee compensation, hiring and firing executive officers, blocking changes in the company's strategic direction, establishing or changing an equity incentive plan, incurring or guaranteeing debt, initiating or defending a lawsuit, and entering into or amending material contracts. Other standard protective provisions that have not historically been viewed as creating affiliation include effecting a merger or selling all or substantially all of its assets, dissolving the company, issuing additional equity, amending the company's governing documents, filing for bankruptcy, dissolving the company, and changing the size of the board of directors.

In light of this backdrop, companies and investors are left with two choices. First, they can take the safe and conservative approach and strip out all negative controls in the financing documents that might otherwise result in a determination of affiliation. This should satisfy the Affiliation Rules without question and allow the company and its directors to submit the application with a high degree of confidence. However, if the investor is uncomfortable with a wholesale removal of these previously negotiated rights, a more surgical approach may be taken in which the parties agree to strip out only those negative controls that get to the items above as determined under existing OHA case law.

Determining Whether a Minority Investor has Control

To determine whether a minority investor has a level of "control" such that the company is affiliated with its minority investors for these purposes, a company should look at its governing documents, including its certificate of incorporation, the financing documents governing a private equity or venture capital investor's investment, and any other agreements between the company and a minority owner. A company should look for actions that require stockholder approval. In addition, if an investor has the right to appoint a director to the company's board of directors, the company should look for actions that require approval of that director. Governing documents based on the National Venture Capital Association forms, for example, often have "protective provisions" in the certificate of incorporation, and a list of matters requiring investor director approval in the Investors' Rights Agreement; a side letter with an investor may also give an investor a specific blocking right.

Blocking Action by the Stockholders

If one lead investor has a veto right, it is likely that the portfolio company will be deemed affiliated with the investor for these purposes. For example, if one investor holds 55% of a company's preferred stock, and the company's charter provides that holders of a majority of the preferred stock are required to approve incurrence of debt, that lead investor will have a block, and the company may be deemed an affiliate of that investor. If, however, the company has investment from a syndicate of investors, and no one investor individually has a veto right, there may be less of an affiliation concern. For example, if a company's charter provides that the company needs approval from holders of a majority of its preferred stock in order to declare a dividend, and the company has three holders of preferred stock who each hold one-third of the preferred stock, no one investor has a block, and therefore, the company will not likely be deemed an affiliate of any of those investors by virtue of this protective provision. This can also cut the other way. If the company's charter provides that the company needs the approval of seventy-five percent of the preferred stock in order to declare a dividend, then all three of the investors in the syndicate would have a block and potentially be deemed affiliates.

Blocking Action by the Board

Similarly, if an investor has the right to designate a member of a company's board of directors, and approval of that director is required to take certain actions, the company may be deemed an affiliate of the investor. For example, an investor rights agreement may require approval of an

investor-appointed director to sell intellectual property. If, however, there are two investor-appointed directors and a company's documents provide that approval from at least one of them is required, neither of them will have a block, and the affiliation concern will be lessened.

Blocking Quorum

If reaching a quorum of the board requires a director designated by a minority shareholder, then that minority shareholder will be deemed an affiliate. This is less common in NVCA-style governing documents.

Waiving or Relinquishing Rights

The "Frequently Asked Questions" document with respect to the PPP loans, as last updated on April 8, 2020, indicates that if a minority shareholder irrevocably waives or relinquishes its existing control rights, the minority shareholder would no longer be an affiliate of the business. Therefore, one strategy to remove any affiliation that would cause the company to exceed the Employee Threshold is to modify governing documents to remove such problematic control rights.

Amending Corporate Documents

If one investor or investor-appointed director acting alone has a veto right, companies may wish to consider amending their governing documents to remove this veto right. This necessarily involves a conversation with the lead investor, who likely negotiated strongly for this right, to determine whether the lead investor, and any other stockholders whose consent would be required, would be comfortable with a different governance threshold that would not result in a finding of affiliation.

For example, a company with multiple investors does not have an investor who is able to block an action of stockholders, but its investor rights agreement provides that the company cannot hire or fire executive officers without the consent of a director appointed by one investor. The company may discuss with this investor, and other investors, the possibility of amending the investor rights agreement to instead provide that taking such actions requires simple majority of the board. If the investors are not comfortable with that from a corporate governance perspective (if, for example, the other directors are all executive officers), the agreement could provide that taking such actions requires either approval of the investor-appointed director, or approval of holders of a majority of the preferred stock. In this way, the investor-appointed director does not have a veto right over such actions, nor does any particular stockholder. This may result in the company not being deemed an affiliate of any one stockholder.

Any such amendment should be effective from at least immediately before the company applies for the PPP loan, so the company can accurately certify that it meets the Employee Threshold.

Waivers of Corporate Documents

If one investor has a right to block certain transactions, in lieu of amending the company's governing documents to remove such a right, the investor could instead agree with the company to waive their blocking right. In order to be applicable for a PPP loan, this waiver must be effective from at least immediately before the company applies for the PPP loan. A company should review its agreements carefully to determine whether the investor can unilaterally waive a right it holds, or whether a waiver under the applicable corporate document requires approval from other stockholders as well.

Advice for These Strategies

An amendment or waiver designed to eliminate control rights of an investor to ensure that the investor would not be deemed an affiliate of the company should be:

- enforceable and lawful;

- not revocable by the investor — in other words, the agreement or amendment would need to specify that it could only be revoked or amended by consent of the investor (and, if applicable, other investors) and the company;
- in writing;
- effective from at least immediately before the startup makes the certification and applies for the PPP loan until at least as long as the loan is outstanding (maybe longer, but that's a debate we can have later), and
- in good faith, and therefore actually fully respected by the parties.

Morse is following this topic closely. Please feel free to reach out to your Morse contact, or to speak with Jon Gworek or Matt Mitchell directly, should you have any questions as to whether your company may be affiliated with one or more of your minority investors, or whether an amendment or waiver of your corporate documents may be helpful.

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