Despite Contrary Reports, Many PE and VC-Backed Companies May Be Eligible for Forgivable PPP Loans During the COVID-19 Crisis

Tenley A. Carp and Joel N. Gossner

The private equity and venture capital communities have advocated forcefully that their portfolio companies should be able access loans available under the Paycheck Protection Program (the "PPP"), the $349 billion U.S. Small Business Administration ("SBA") loan program created by the Coronavirus, Aid, Relief, and Economic Security Act (the "CARES Act"). PPP loans are attractive because (among other reasons) portions of the loans are up to 100% forgivable, and they carry a 1% interest rate. Despite media reports to the contrary, numerous private equity and venture capital-backed companies should be eligible for PPP loans. We explain why below.

The CARES Act Significantly Changes or Waives Some SBA Affiliation Rules

Many portfolio companies and their investors believe portfolio companies are ineligible for PPP loans because of the SBA's affiliation rules. While those rules will preclude some portfolio companies from obtaining a PPP Loan, the CARES Act significantly changes or waives such rules in ways that benefit portfolio companies. To understand the effect of those changes and waivers, it is important to understand the PPP eligibility rules applicable to portfolio companies.

PPP Loans and Portfolio Company Eligibility

Subject to SBA's affiliation rules, a portfolio company is generally eligible for a PPP loan if it is one of the following:[1]

- A "small businesses concern" (as defined in SBA regulations and the Small Business Act);
- Any other business concern that employs not more than 500 employees;
- Any other business concern that employs not more than the number of employees set forth in the size standard established by SBA for the concern's industry; and
- A business concern whose headcount exceeds the limits described in the preceding two bullets if the business concern (a) has multiple physical locations, with no single location having more than 500 employees, and (b) has, likely as of the time it submits a PPP loan application, a North American Industry Classification System ("NAICS") code beginning with 72.

Affiliation Rules and Portfolio Companies

For purposes of determining eligibility under the standards described above, SBA's affiliation rules have historically required that the annual revenues over the most recent three years[2] or employees (as applicable) of the portfolio company's affiliates be aggregated with the portfolio company. And SBA has confirmed that its traditional affiliation rules still apply to applicants seeking PPP loans (subject to waivers described below). For example, because of those rules, one fund's portfolio company might be required to include employees of the fund's other portfolio companies to calculate if it meets one of the headcount-based eligibility criteria described above.

---

1 Portfolio companies must have been in operation as of February 15, 2020, and have had employees (or independent contractors) for whom they paid salaries and payroll taxes (or, for independent contractors, payments reported on a 1099-MISC).

2 This rule became effective on January 6, 2020, such that the annual revenues are now measured over the past five years, but companies have the choice as to whether to use a three-year average or a five-year average during a transitional period of time from January 6, 2020, through January 6, 2022.

Immediately prior to passage of the CARES Act, SBA's affiliation regulations identified seven primary bases (some of which had multiple sub-bases) for determining if one party was affiliated with another. [3] Judged under those rules, we believe many portfolio companies would have been ineligible for loans under the PPP.

However, the CARES Act rescinded some recently enacted affiliation rules and waived the application of some other affiliation rules to the PPP.

CARES ACT Affiliation Rule Rescissions and Portfolio Companies

The CARES Act rescinded SBA's February 10, 2020 revisions to its affiliation rules, a significant change we believe many in the private equity and venture capital communities have not recognized.[4] **This change should make more portfolio companies eligible for PPP Loans.**

We believe the February 10, 2020, revisions would have made it meaningfully more likely that the other companies in a fund's portfolio would be viewed as affiliates of the portfolio company seeking a PPP loan. For example, the February 10, 2020, revisions added the following (among other things) to the SBA's affiliation rules, additions which the CARES Act rescinded:

- A rule based on common investments by a person, under which parties in the same or similar industry could be deemed affiliates if they received investments (even non-controlling investments) from the same fund and engaged in some other activity described in the rule (e.g., sharing resources, providing managerial support or doing business together); and
- A rule that permitted SBA to determine parties were affiliated based on the "totality of the circumstances," even if no single affiliation rule was independently sufficient to deem them affiliated (though clear and convincing evidence was needed).

Even with the CARES Act's rollback of the February 10, 2020, revisions, determining if other companies in a fund's portfolio should be viewed as affiliates of the portfolio company seeking a PPP loan is fact dependent and complex. The principal affiliation rules now in effect base affiliation determinations on (at a very high level):

- ownership or control of 50% or more of a party's voting securities or a minority investor's so called "negative control" (generally where it may prevent a quorum or otherwise block certain actions by the party's shareholders or directors; **however**, under an SBA Office of General Counsel memorandum released on April 4, 2020, and SBA Office of Hearings and Appeal's case law, a minority investor's veto rights with respect to extraordinary or unusual actions may not give it negative control of the party);[5]
- stock options, convertible securities and merger agreements (all of which are treated as having been exercised or, in the case of merger agreements, performed);
- management (e.g., where one party's CEO also controls the management of another party or, particularly relevant for portfolio companies, where one party's board is controlled by the same party who controls the other party's board);
- relationships between close relatives (e.g., parent and child); and
- franchise and license agreements.

Even if an affiliation rule would apply to a portfolio company seeking a PPP loan, SBA's traditional affiliation rule exceptions apply. **If no exception applies, portfolio companies may still be eligible for a PPP loan based on the CARES Act's affiliation rule waivers.**

3 Parties are affiliates for purposes of SBA's rules when one party controls, or has the power to control, the other, or when a third party or parties controls, or has the power to control, both parties, in each case regardless of whether the power to control is actually exercised. This standard will be satisfied if any one of those bases apply.

4 As a result, according to SBA, the affiliation rules that apply to PPP loan applicants are the rules that were in effect in 2019 (presumably as of December 31, 2019).

5 Depending partly on the suite of investor, and investor board member, approval rights, a venture investment may give the investor negative control. Those rights should be analyzed in connection with any PPP loan application by a venture-backed company. **Relatedly, SBA FAQ responses released on April 6, 2020, indicate that if an investor irrevocably waives or relinquishes rights that would give it negative control of a party, it will no longer be deemed to be an affiliate of such party as a result of such rights.**

CARES Act Affiliation Rule Waivers and Portfolio Companies

The CARES Act waives some affiliation rules for purposes of the PPP. **Portfolio companies in particular—especially private equity backed portfolio companies—should benefit from these waivers.** Those waivers apply even if SBA's affiliation rules would otherwise make a portfolio company ineligible for a PPP loan.

The waivers should apply to the following portfolio companies:

- Those with no more than 500 employees whose NAICS code begins with "72" (which includes the entire "Accommodation and Food Services" (as defined in the 2017 NAICS)) sector, e.g., full-service and fast-food restaurants, bars, hotels, food service providers, among others);
- Those operating as a franchise to which SBA has assigned a franchise identifier code (e.g., Orange Theory Fitness, Homewood Suites by Hilton, Ace Hardware, The UPS Store, Great Clips, GNC, Homewatch Caregivers); and
- Those that receive financial assistance from a company licensed under section 301 of the Small Business Investment Act of 1958 (i.e., from a Small Business Investment Company ("SBIC")). **The waiver applies regardless of the amount of such assistance and regardless of whether the portfolio company has non-SBIC investors.**

Conclusion

In determining whether portfolio companies are eligible for PPP loans, the private equity and venture capital communities may be overlooking the significant changes in CARES Act, and waivers of SBA's affiliation rules. Those may make many portfolio companies eligible for a PPP loan.

See our "Questions and Answers Regarding the CARES Act PPP Loan" Client Alert for additional information about the PPP and the principal terms of PPP loans, among other things.

Authors and Contributors

Tenley A. Carp
Partner, DC Office
202.677.4066
tenley.carp@agg.com

Joel N. Gossner
Associate, Atlanta Office
404.873.8648
joel.gossner@agg.com

not *if*, but *how*.®

About Arnall Golden Gregory LLP

Arnall Golden Gregory (AGG) is an Am Law 200 law firm with offices in **Atlanta** and **Washington, DC**. Our client-service model is rooted in taking a "business sensibility" approach of fully understanding how our clients' legal matters fit into their overall business objectives. We provide industry knowledge, attention to detail, transparency and value to help businesses and individuals achieve their definition of success. Our transaction, litigation and regulatory counselors serve clients in healthcare, real estate, litigation and other dispute resolution, business transactions, fintech, global commerce, economic development, public finance, government investigations and logistics and transportation. With our rich experience and know-how, we don't ask "if," we figure out "how." Visit us at www.agg.com.

Atlanta Office
171 17th Street, NW
Suite 2100
Atlanta, GA 30363

Washington, DC Office
1775 Pennsylvania Avenue, NW
Suite 1000
Washington, DC 20006

To subscribe to future alerts, insights and newsletters: **http://www.agg.com/subscribe/**