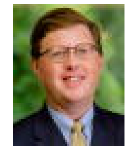
WARD AND SMITH, P.A.
ATTORNEYS AT LAW

Paycheck Protection Program Loans and the Business Affiliation Rules: 'Don’t Wing It'

Written By **James W. Norment** (jwn@wardandsmith.com)
April 3, 2020



We have written a great deal about the CARES Act and the small business loans available to eligible applicants.

New guidance about these loan programs is made available on a frequent basis, and we are advising clients to heed new information as it is announced during the COVID-19 crisis.

One of the areas of concern around the Paycheck Protection Program surrounds the rules about what exactly is an affiliated company. Here are the rules, as stated by the SBA as of today:

Affiliation is based on control of the company

Two companies are affiliated when the same person or company controls or has the power to control both.

Control is more than a technical majority ownership

Affiliation may arise among two or more people with an identity of interest. Individuals or firms that have substantially identical business or economic interests (such as family members, individuals, or firms with common investments, or firms that are economically dependent through contractual or other relationships) may be treated as one party with such interests aggregated. *Where the SBA determines that such interests should be aggregated, an individual or firm may rebut that determination with evidence showing that the interests deemed to be one are in fact separate.*

A minority owner can control a company

If two or more people (including any individual, concern or other entity) each owns, controls, or has the power to control *less than 50 percent of stock or LLC interest, and such minority holdings are equal or approximately equal in size, and the aggregate of these minority holdings is large as compared with any other stock holding, the SBA presumes that each such person controls or has the power to control the concern whose size is at* *issue.* This presumption may be rebutted by a showing that such control or power to control does not in fact exist. This is colloquially called "the minority shareholder rule." This minority shareholder rule does not appear in the SBA's loan affiliation rules, but we should assume that the SBA's general affiliation rules, where the rule does appear, will be applicable to the Paycheck Protection Program.

Control can be either 'affirmative' or 'negative'

Examples of affirmative control include voting or board control, i.e., majority of voting shares or board seats. For example, a person who owns more than 50% of a company's voting stock controls, or has the power to control, the company for SBA loan purposes. Affiliation can also arise from common management, i.e., if one or more officers, directors, managing members, or partners who control the board/management of one entity also control the board/management of another entity.

Negative control includes, but is not limited to, instances in which a minority shareholder "has the ability, under the concern's charter, bylaws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders." Thus, a company that is 49% (or less) owned by a venture capital fund can be deemed to be an affiliate of the fund (and other companies the fund controls) if the fund has the power to block certain actions by the company's board or its executives.

The SBA appeals board has interpreted this rule to mean that negative control arises from a minority shareholder's power to *block ordinary actions* essential to operating the company. The SBA has found that a minority shareholder's ability to prevent ordinary corporate actions, thereby creating affiliation, can include the following:

- Taking on new debt
- Issuing dividends
- Setting officers' compensation
- Purchasing equipment
- Making changes to a budget
- Incurring expenses over $5,000
- Amending or terminating leases

Generally, provisions providing minority owners with the power to block a company's *ordinary* actions are more likely to create negative control and result in affiliation. In contrast, a limited number of protections for minority owners with regard to *extraordinary* actions are allowed. For example, the SBA will not normally find affiliation solely because a minority owner has the power to block:

- Adding new member
- Dissolving the company
- Filing for bankruptcy
- Amending the bylaws
- Issuing additional capital stock
- Entering into a substantially new business
- Selling all or substantially all the company's assets
- Mortgaging or encumbering all or substantially all of the company's assets
- Committing any act that could result in a change in the amount or character of the company's contribution to capital

Before applying for a loan under the CARES Act programs, companies approaching the 500 employee threshold should seek counsel around the particular facts involved. Remember that the affiliation rule applies even to companies not in the same line of business. Our advice is, "Don't just wing it."

--

 For further information regarding the issues described above, please contact James W. Norment.

This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.