

April 9, 2020

## ANALYSIS OF SMALL BUSINESS ADMINISTRATION MEMORANDUM ON AFFILIATION RULES AND FAQs ON PAYCHECK PROTECTION PROGRAM

To Our Clients and Friends:

The U.S. Small Business Administration (“SBA”) recently published a memorandum (the “Memorandum”) and new Frequently Asked Questions (“FAQs”) (available [here](#)) clarifying the size standards and affiliation rules applicable to the Paycheck Protection Program (the “Program” or “PPP”). As described in greater detail in our previous client alerts, *SBA “Paycheck Protection” Loan Program Under the CARES Act, Small Business Administration and Department of Treasury Publish Paycheck Protection Program Loan Application Form and Instructions to Help Businesses Keep Workforce Employed, Small Business Administration Issues Interim Final Rule and Final Application Form for Paycheck Protection Program, and Small Business Administration Issues Interim Final Rule on Affiliation, Summary of Affiliation Tests, Lender Application Form and Agreement, and FAQs for Paycheck Protection Program*, the Program provides \$349 billion to help small businesses impacted by COVID-19 keep their employees on the payroll and their businesses solvent.

### **Governing Regulations for Affiliation**

Borrowers of PPP loans must apply SBA’s affiliation rules as spelled out in 13 CFR § 121.301(f), which apply to SBA’s 7(a) program and were adopted for the PPP through the *CARES Act*.<sup>[1]</sup> But there is a catch: borrowers have to look at the 2019 version of § 121.301 (*see* 81 Fed. Reg. 41423) because Section 1102(e) of the *CARES Act* permanently rescinded the SBA’s February 2020 amendment to § 121.301. SBA’s 2020 amendment would have included a “totality of the circumstances” test (as currently is part of 13 CFR § 121.103), affiliation based on a newly organized concern in the same industry under the same management, and additional bases for affiliation based on identity of interest, including common investments and economic dependence.

Under the *CARES Act* and applicable guidance and regulations, an applicant must aggregate its own number of employees or revenue with that of all of its affiliates for the purposes of determining eligibility for a PPP loan. The applicant is eligible if: (1) it qualifies as a small business concern as defined in section 3 of the Small Business Act, 15 U.S.C. 632; (2) it and its affiliates have 500 or fewer employees whose principal place of residence is in the United States; (3) it and its affiliates meet the SBA employee-based size or revenue standards for the industry in which they operate, (including the “alternative standard” detailed below); or (4) it is a nonprofit organization, veterans organization, or Tribal business concern as outlined in Section 1102(a)(i) of the *CARES Act*.<sup>[2]</sup>

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The applicable (2019) version of § 121.301(f) lays out four principles that may establish an affiliate relationship between a PPP borrower and another entity: (1) equity ownership; (2) stock options, convertible securities, and agreements to merge; (3) management; and (4) identity of interest.

## Affiliation Based on Equity Ownership

Any entity that owns or has the power to control more than 50 percent of the borrower's voting equity is considered an affiliate of the borrower.[3] Further, SBA will deem that a minority shareholder exercises "negative control" if it has the ability, under the borrower's charter, by-laws, or shareholder's agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.[4] (See below.) If no such entity owns 50 percent of the equity, SBA will deem the Board of Directors, President, or CEO (or other officers, managing members, or partners who control the management of the concern) to be in control of the borrower.[5]

## Affiliation Based on Stock Options, Convertible Securities, and Agreements to Merge

For purposes of determining whether an entity owns 50 percent of the borrower, SBA will consider stock options, convertible securities, and agreements to merge as though the rights granted have been exercised.[6]

## Affiliation Based on Management

Affiliation arises where the President or CEO (or other officers, managing members, or partners who control the management of the concern) of the applicant also controls the management of one or more other concerns. Affiliation also arises where a single individual, concern, or entity that controls the Board of Directors or management of one concern also controls the Board of Directors or management of one of more other concerns.[7] Thus far, SBA guidance does not further elaborate on what constitutes control over the Board of Directors, so we recommend that applicants disclose their interpretation of "control," in light of their own facts, in an addendum to the PPP loan application.

Additionally, affiliation arises where a single individual, concern, or entity controls management of the borrower through a management agreement.[8]

## Affiliation Based on Identity of Interest

Where close relatives share 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), those concerns are affiliated.[9]

## **Waivers to Affiliation Rules**

The *CARES Act* waives SBA's affiliation rules for an applicant's eligibility for a PPP loan for: (1) any business concern with not more than 500 employees that is assigned a North American Industry Classification System ("NAICS") code beginning with 72;[10] (2) any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and (3) any business concern that

receives financial assistance from a company licensed under section 301 of the *Small Business Investment Act of 1958*.

The SBA's existing affiliation exclusions, including the exclusions under 13 CFR 121.103(b)(2), also apply to the PPP. These exclusions include: (1) business concerns owned in whole or substantial part by investment companies licensed, or development companies qualifying, under the *Small Business Investment Act of 1958* are not considered affiliates of such investment companies or development companies; (2) business concerns which lease employees from concerns primarily engaged in leasing employees to other businesses or which enter into a co-employer arrangement with a Professional Employer Organization ("PEO") are not affiliated with the leasing company or PEO solely on the basis of a leasing agreement; and (3) additional exclusions delineated in 13 CFR § 121.103(b)(2).[11]

## **Negative Control**

As discussed above, negative control over a concern exists when a "minority shareholder . . . 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." [12] The Memorandum notes that there is SBA Office of Hearings and Appeals' ("OHA") case law "interpreting the rule." [13] We would note that OHA case law on negative control interprets 13 CFR § 121.103, not § 121.301. That said, § 121.103(a)(3) states that negative control exists where a minority shareholder "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," which is language identical to § 121.301(f)(1). Hence, while the SBA's interim final rule on affiliations states that "the detailed affiliation standards contained in section 121.103 currently do not apply to PPP borrowers," OHA precedents interpreting negative control *under the aforementioned language found in both § 121.103 and § 121.301* is instructive and should be viewed by applicants as likely controlling. [14]

## **SBA Office of Hearings and Appeals Case Law**

OHA case law describes two sets of actions for the purposes of determining whether a minority shareholder can exercise negative control over an entity: "extraordinary" actions and "essential" actions. "Extraordinary" actions are actions that a minority shareholder may be given the power to block in order to protect its investment, but do not interfere with the day-to-day operations of the company. [15] OHA case law indicates that the ability to block extraordinary actions will not result in a finding of negative control. [16] These actions include:

- Amending the bylaws; [17]
- Issuing additional capital stock; [18]
- Changing the amount or character of the concern's contribution to capital; [19]
- Entering into any substantially different business; [20]
- Changing the character or business of the concern; [21]
- Committing any act that would make it impossible to carry on ordinary business; [22]

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- Selling all or substantially all of a firm’s assets;[23]
- Mortgaging or encumbering all or substantially all of a concern’s assets;[24]
- Committing any act in contravention of the operating agreement;[25]
- Approving the addition of new members or withdrawing old members;[26]
- Increasing or decreasing the size of the Board;[27]
- Increasing or decreasing the number of authorized interests;[28]
- Reclassifying interests;[29] or
- Filing for bankruptcy.[30]

OHA case law also indicates that, if a minority owner has the power to block actions that are “essential to the daily operation of the company,” the minority owner will be found to have negative control over the company. These essential actions include:

- Controlling the budget;[31]
- Hiring and firing officers;[32]
- Setting employee compensation;[33]
- Borrowing money or creating debt;[34]
- Encumbering assets;[35]
- Paying dividends;[36]
- Purchasing equipment;[37]
- Making changes to a budget;[38]
- Incurring expenses over a threshold limit;[39] or
- Amending or terminating leases.[40]

If a minority shareholder holds negative control over the PPP loan applicant, the borrower will be considered an affiliate of the minority shareholder and an affiliate of any concern that the minority shareholder controls.

## Waiver of Negative Control

Minority shareholders may irrevocably waive or relinquish negative control over the applicant in order to avoid affiliation, so long as affiliation does not exist under a different provision.[41] While SBA/Treasury FAQs refer to waiving “existing rights specified in 13 CFR 121.301(f)(1),” the application of OHA’s negative control precedent to § 121.301(f) suggests that minority shareholders may also irrevocably waive rights that OHA precedent recognizes as conferring negative control to avoid affiliation.[42]

## **PPP Loan FAQs**

In addition to the Memorandum and FAQs related to affiliation, the recently-issued FAQs provided the following new information regarding the PPP:

- *Eligibility.*<sup>[43]</sup> Small business concerns can be eligible borrowers even if they have more than 500 employees, as long as they satisfy the existing statutory and regulatory definition of a “small business concern” under section 3 of 15 U.S.C. 632. A business can qualify if it meets the SBA employee-based or revenue-based size standard corresponding to its primary industry. A business can also qualify for the PPP as a small business concern if it and its affiliates met both tests in SBA’s “alternative size standard” as of March 27, 2020: (1) maximum tangible net worth of the business is not more than \$15 million; and (2) the average net income after Federal income taxes (excluding any carry-over losses) of the business for the two full fiscal years before the date of the application is not more than \$5 million.<sup>[44]</sup>
- *Seasonal Businesses.*<sup>[45]</sup> In evaluating a borrower’s eligibility, a lender may consider whether a seasonal borrower was in operation on February 15, 2020 or for an 8-week period between February 15, 2019 and June 30, 2019.
- *Professional Employer Organizations.*<sup>[46]</sup> SBA recognizes that eligible borrowers that use PEOs or similar payroll providers are required under some state registration laws to report wage and other data on the Employer Identification Number (“EIN”) of the PEO or other payroll provider. In these cases, payroll documentation provided by the payroll provider that indicates the amount of wages and payroll taxes reported to the IRS by the payroll provider for the borrower’s employees will be considered acceptable PPP loan payroll documentation. Relevant information from a Schedule R (“Form 941”), Allocation Schedule for Aggregate Form 941 Filers, attached to the PEO’s or other payroll provider’s Form 941, Employer’s Quarterly Federal Tax Return, should be used if it is available; otherwise, the eligible borrower should obtain a statement from the payroll provider documenting the amount of wages and payroll taxes. In addition, employees of the eligible borrower will not be considered employees of the eligible borrower’s payroll provider or PEO.
- *Lender Forms.*<sup>[47]</sup> Lenders may use their own online systems and a form they establish that asks for the same information (using the same language) as the Borrower Application Form. Lenders are still required to send the data to SBA using SBA’s interface.
- *Number of Employees.*<sup>[48]</sup> Borrowers may use their average employment over the previous 12 months or from calendar year 2019 (or the period between February 15, 2019, or March 1, 2019, and June 30, 2019 for seasonal employers; or the period January 1, 2020 through February 29, 2020 for borrowers not in business from February 15, 2019 to June 30, 2019) to determine their number of employees, for the purposes of applying an employee-based size standard. Alternatively, borrowers may elect to use SBA’s usual calculation: the average number of employees per pay period in the 12 completed calendar months prior to the date of the loan application (or the average number of employees for each of the pay periods that the business has been operational, if it has not been operational for 12 months).
- *Accounting for Federal Taxes.*<sup>[49]</sup> Payroll costs are calculated on a gross basis without regard to (e., not including subtractions or additions based on) federal taxes imposed or withheld, such as the employee’s and employer’s share of *Federal Insurance Contributions Act* (“FICA”) and income taxes required to be withheld from employees. As a result, payroll costs are not reduced by taxes

imposed on an employee and required to be withheld by the employer, but payroll costs do not include the employer's share of payroll tax. For example, an employee who earned \$4,000 per month in gross wages, from which \$500 in federal taxes was withheld, would count as \$4,000 in payroll costs. The employee would receive \$3,500, and \$500 would be paid to the federal government. However, the employer-side federal payroll taxes imposed on the \$4,000 in wages are excluded from payroll costs under the statute.[50]

- *Updated Applications.*[51] Borrowers and lenders who have already submitted applications may rely on the laws, rules, and guidance available to them at the time of the relevant application. If an application has not yet been processed, borrowers may revise their application based on the guidance in the FAQs.
- *FinCen Rule CDD.*[52] If the PPP loan is being made to an existing customer of the lender and the necessary information was already verified, the lender does not need to re-verify the information. Additionally, if federally insured depository institutions and federally insured credit unions eligible to participate in the PPP program have not yet collected beneficial ownership information on existing customers, such institutions do not need to collect and verify beneficial ownership information for those customers applying for new PPP loans, unless otherwise indicated by the lender's risk-based approach to BSA compliance.
- *Promissory Notes.*[53] Lenders may use their own promissory note or an SBA form of promissory note.
- *Eight-Week Forgiveness Period.*[54] For the purposes of PPP loan forgiveness, the borrower must calculate its payroll costs over an eight-week period. That eight-week period begins on the date the lender makes the first disbursement of the PPP loan to the borrower. The lender must make the first disbursement of the loan no later than ten calendar days from the date of loan approval.

The FAQs also clarify certain provisions of the guidance already released by the SBA and Treasury Department.

- *Application Certification.*
  - Since borrowers attest to the accuracy of their calculation of payroll costs on the application, lenders are only required to conduct a good faith review, in a reasonable time, of the borrower's calculations and supporting documents. As stated in the PPP Interim Final Rule, lenders may rely on borrower representations, including with respect to amounts required to be excluded from payroll costs. If the lender identifies errors in the borrower's calculation or a material lack of substantiation in the borrower's supporting documents, the FAQs state that the lender should work with the borrower to remedy the issue.[55]
  - It is the responsibility of the borrower to determine which entities (if any) are the borrower's affiliates and determine the employee headcount of the borrower and its affiliates. Lenders are permitted to rely on borrowers' certifications.[56]
  - Lenders may accept and rely on signatures from a single individual who is authorized to sign on behalf of the borrower. Borrowers should be aware that an individual's signature is a representation to the lender and to the U.S. government that the signer is authorized to make the certifications, including with respect to the applicant and each owner of 20 percent or more of the applicant's equity, contained in the application.[57]



- *Eligibility.*<sup>[58]</sup> Borrowers are not required to qualify as a small business concern as defined in section 3 of the Small Business Act, 15 U.S.C. 632) in order to participate in the PPP. The FAQs state that in addition to small business concerns, a business is eligible for a PPP loan if it has 500 or fewer employees whose principal place of residence is in the United States, or meets the SBA employee-based size or revenue standards for the industry in which it operates, or the alternative standard described above. If the applicant is a tax-exempt nonprofit organization, a tax-exempt veterans organization, or a Tribal business concern with 500 or fewer employees whose principal place of residence is in the United States, or meets the SBA employees based size standards for the industry in which it operates, it is also eligible for a PPP loan.<sup>[59]</sup>
- *Payroll Cost Calculations.*
  - The exclusion of compensation in excess of \$100,000 annually applies only to cash compensation, not to non-cash benefits.<sup>[60]</sup>
  - Payroll costs include costs for employee vacation, parental, family, medical, and sick leave. Payroll costs do not include qualified sick and family leave wages for which a credit is allowed under sections 7001 and 7003 of the Families First Coronavirus Response Act.<sup>[61]</sup>
- *Felonies.*<sup>[62]</sup> Businesses are only ineligible if an owner of 20 percent or more of the equity of the applicant is presently incarcerated, on probation, on parole; subject to an indictment, criminal information arraignment, or other means by which formal criminal charges are brought in any jurisdiction; or, within the last five years, for any felony, has been convicted; pleaded guilty; pleaded nolo contendere; been placed on pretrial diversion; or been placed on any form of parole or probation (including probation before judgment).
- *Independent Contractors.*<sup>[63]</sup> Because independent contractors and sole proprietors are themselves eligible for a PPP loan, eligible borrowers should not include any amounts paid to independent contractors or sole proprietors when calculating the borrower’s payroll costs.

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[1] PPP Loan FAQs, No. 5. While § 121.103 governs the SBA’s general principles of affiliation, § 121.103(a)(8) states that “applicants in SBA’s Business Loan [including the PPP], Disaster Loan, and Surety Bond Guarantee Programs” are to use “the size standards and bases for affiliation . . . set forth in § 121.301.”

[2] PPP Loan FAQs, No. 3. Our understanding of FAQ No. 3 is that it does not expand eligibility beyond the basic eligibility requirements for all applicants for SBA business loans outlined in 13 CFR § 120.100, but we await further guidance clarifying this point.

[3] 13 CFR § 121.301(f)(1).

[4] *Id.*

[5] *Id.*

[6] 13 CFR § 121.301(f)(2).

[7] 13 CFR § 121.301(f)(3).

[8] *Id.*

[9] 13 CFR 121.301(f)(4).

[10] Industries with an NAICS code beginning with 72 are considered “accommodation and food services” industries, which include hotels, casinos, caterers, restaurants, and drinking places (alcoholic beverages).

[11] These other exclusions include: (1) business concerns owned and controlled by Indian Tribes, or other Native American organizations are not affiliates of such entities; (2) business concerns owned and controlled by Indian Tribes, or other Native American organizations are not affiliates of the affiliates such entities; (3) Business concerns which are part of an SBA approved pool of concerns for a joint program of research and development or for defense production as authorized by the *Small Business Act* are not affiliates of one another because of the pool; (4) Business concerns which lease employees from concerns primarily engaged in leasing employees to other businesses or which enter into a co-employer arrangement with a Professional Employer Organization (“PEO”) are not affiliated with the leasing company or PEO solely on the basis of a leasing agreement; (5) For financial, management or technical assistance under the Small Business Investment Act of 1958, as amended, an applicant is not affiliated with investors including venture capital operating companies, employee benefit or pension plans, charitable trusts, foundations or endowments, and other investment companies; (6) firms with mentor-protégé agreements are not affiliates by virtue of the agreement; and (7) members of a small agricultural cooperative are not affiliates with each other by virtue of the cooperative.

[12] 13 CFR § 121.301(f)(1). Section 121.103(a)(3) also states that “negative control includes . . . instances where a minority shareholder 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.”

[13] Memorandum, pg. 6.

[14] § 121.301 does not include a “totality of the circumstances” affiliation test, while § 121.103 does. To the extent negative control is found under the totality of the circumstances and not under affiliation by ownership under § 121.301(f)(1), OHA precedent would not control.

[15] *Size Appeal of Southern Contracting Solutions III, LLC*, SBA No. SIZ-5956 (2018) (collecting cases).

[16] *Id.*

[17] *Appeal of Carntribe-Clement 8AJV # 1, LLC*, SBA No. SIZ-5357 (2012).

[18] *Id.*



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- [19] *Size Appeal of McLendon Acres, Inc.*, SBA No. SIZ-5222 (2011).
- [20] *Appeal of Carntribe-Clement 8AJV # 1, LLC*, SBA No. SIZ-5357 (2012).
- [21] *Size Appeal of Southern Contracting Solutions III, LLC*, SBA No. SIZ-5956 (2018) (citing *Size Appeal of McLendon Acres, Inc.*, SBA No. SIZ-5222 (2011)).
- [22] *Size Appeal of McLendon Acres, Inc.*, SBA No. SIZ-5222 (2011).
- [23] *Size Appeal of Southern Contracting Solutions III, LLC*, SBA No. SIZ-5956 (2018) (citing *Size Appeal of McLendon Acres, Inc.*, SBA No. SIZ-5222 (2011); *Size Appeal of Dooleymack Government Contracting, LLC*, SBA No. SIZ-5086 (2009)).
- [24] *Size Appeal of Southern Contracting Solutions III, LLC*, SBA No. SIZ-5956 (2018) (citing *Size Appeal of McLendon Acres, Inc.*, SBA No. SIZ-5222 (2011)).
- [25] *Size Appeal of Southern Contracting Solutions III, LLC*, SBA No. SIZ-5956 (2018) (citing *Size Appeal of McLendon Acres, Inc.*, SBA No. SIZ-5222 (2011)).
- [26] *Size Appeal of DHS Systems, LLC*, SBA No. SIZ-5211 (2011).
- [27] *Id.*
- [28] *Id.*
- [29] *Id.*
- [30] *Size Appeal of Dooleymack Government Contracting, LLC*, SBA No. SIZ-5086 (2009).
- [31] *Size Appeal of Team Waste Gulf Coast, LLC*, SBA No. SIZ-5864 (2017); *Carntribe-Clement 8AJV # 1, LLC*, SBA No. SIZ-5357 (2012); *DHS Systems, LLC*, SBA No. SIZ-5211 (2011).
- [32] *Size Appeal of Team Waste Gulf Coast, LLC*, SBA No. SIZ-5864 (2017); *DHS Systems, LLC*, SBA No. SIZ-5211 (2011).
- [33] *Size Appeal of Team Waste Gulf Coast, LLC*, SBA No. SIZ-5864 (2017); *Carntribe-Clement 8AJV # 1, LLC*, SBA No. SIZ-5357 (2012); *DHS Systems, LLC*, SBA No. SIZ-5211 (2011).
- [34] OHA found negative control even when the minority shareholder could only veto the creation of debt over a certain dollar threshold. *See Size Appeal of Team Waste Gulf Coast, LLC*, SBA No. SIZ-5864 (2017) (citing *BR Construction, LLC*, SBA No. SIZ-5303 (2011)).
- [35] *Carntribe-Clement*, SBA No. SIZ-5357 (2012).
- [36] *Team Waste Gulf Coast, LLC*, SBA No. SIZ-5864 (2017); *Carntribe-Clement*, SBA No. SIZ-5357 (2012); *Size Appeal of Eagle Pharmaceuticals, Inc.*, SBA No. SIZ-5023 (2009).

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- [37] *Carntribe-Clement*, SBA No. SIZ-5357 (2012).
- [38] *Id.*; *BR Construction, LLC*, SBA No. SIZ-5303 (2011).
- [39] *BR Construction, LLC*, SBA No. SIZ-5303 (2011).
- [40] *Carntribe-Clement*, SBA No. SIZ-5357 (2012).
- [41] PPP Loan FAQs, No. 6.
- [42] *Id.*
- [43] PPP Loan FAQs, No. 2.
- [44] We do not understand this provision to expand the eligibility of businesses under the PPP beyond the *CARES Act* or other guidance released by the SBA.
- [45] PPP Loan FAQs, No. 9.
- [46] PPP Loan FAQs, No. 10.
- [47] PPP Loan FAQs, No. 13.
- [48] PPP Loan FAQs, No. 14.
- [49] PPP Loan FAQs, No. 16.
- [50] The definition of “payroll costs” in the *CARES Act*, excludes “taxes imposed or withheld under chapters 21, 22, or 24 of the Internal Revenue Code of 1986 during the covered period,” defined as February 15, 2020, to June 30, 2020. As described above, the SBA interprets this statutory exclusion to mean that payroll costs are calculated on a gross basis, without subtracting federal taxes that are imposed on the employee or withheld from employee wages. Unlike employer-side payroll taxes, such employee-side taxes are ordinarily expressed as a reduction in employee take-home pay; their exclusion from the definition of payroll costs means payroll costs should not be reduced based on taxes imposed on the employee or withheld from employee wages. Further, because the reference period for determining a borrower’s maximum loan amount will largely or entirely precede the period from February 15, 2020, to June 30, 2020, and the period during which borrowers will be subject to the restrictions on allowable uses of the loans may extend beyond that period, for purposes of the determination of allowable uses of loans and the amount of loan forgiveness, this statutory exclusion will apply with respect to such taxes imposed or withheld at any time, not only during such period.
- [51] PPP Loan FAQs, No. 17.
- [52] PPP Loan FAQs, No. 18.
- [53] PPP Loan FAQs, No. 19.

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[54] PPP Loan FAQs, No. 20.

[55] PPP Loan FAQs, No. 1.

[56] PPP Loan FAQs, No. 4.

[57] PPP Loan FAQs, No. 11.

[58] PPP Loan FAQs, No. 3.

[59] As noted above, we do not understand this FAQ to expand eligibility beyond the basic eligibility requirements for all applicants for SBA business loans outlined in 13 CFR § 120.100, but we await additional guidance on this point.

[60] PPP Loan FAQs, No. 7.

[61] PPP Loan FAQs, No. 8.

[62] PPP Loan FAQs, No. 12.

[63] PPP Loan FAQs, No. 15.



*Gibson Dunn's lawyers are available to assist with any questions you may have regarding these developments. For further information, please contact the Gibson Dunn lawyer with whom you usually work, or the following authors:*

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