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Small Business Loans and the CARES Act: What PE and VC Investors Need to Know About the SBA's Affiliation Rules

A key feature of the nearly \$2 trillion economic stimulus bill signed into law on March 27, 2020, is the creation of a \$350 billion "Paycheck Protection Program" (PPP) to authorize loans to businesses affected by the COVID-19 crisis. But many companies backed by venture capital (VC) and private equity funds may find themselves ineligible for such relief due to the Small Business Administration's (SBA) affiliation rules, which determine whether a company is a qualified small business by looking at the size of the company and its affiliates.

This update provides an overview of the SBA's affiliation rules, which are highly fact-specific, and how they may be applied to determine eligibility for small business loans under the PPP program. It also offers practical considerations for private equity investors, VC funds, private equity (PE) funds, and other investors in companies interested in obtaining a PPP loan.

The CARES Act and PPP Loans

Section 1102 of the economic stimulus legislation (the CARES Act), authorizes \$350 billion in PPP loans administered under the SBA's existing loan guarantee program known as the 7(a) program. During the "covered period" (February 15, 2020 to June 30, 2020), eligible companies can use the loans to help pay payroll costs, employee benefits, rent, employee salaries, and other essential expenditures during the COVID-19 crisis. PPP loans are 100% guaranteed by the U.S. government. They will be forgiven to the extent they are used for permitted purposes. Also, PPP loans are separate from the SBA's Economic Injury Disaster Loans (EIDLs).

PPP Loans—Who Is Eligible?

To be eligible for a PPP loan, an applicant must:

- Have 500 employees or fewer or meet the size standard established by the SBA for the industry in which it operates, whichever is greater
- Operate as a sole proprietor, independent contractor, or eligible self-employed individual

To determine whether an applicant meets the 500 employee size limit, it must include the employees of all of its affiliates as well as its own employees, unless the applicant fits within one of the following three categories: (1) businesses with 500 or fewer employees and that are assigned a North American Industry Classification (NAICS) code starting with 72; (2) franchises; and (3) businesses that receive financial assistance from a small business investment company licensed under section 301 of the Small Business Investment Act of 1958. Thus, these three types of businesses can be eligible for a PPP loan even if they are affiliated with other companies that, when combined with the business at issue, have more than 500 employees.

Further, a business in the accommodations and food service industry (NAICS code starting with 72) with 500 or fewer employees per physical location is also eligible for a PPP loan.

The SBA's Affiliation Rules

SBA has affiliation rules that apply generally (13 C.F.R. § 121.103) and specifically to its financial assistance programs, including its 7(a) lending program (13 C.F.R. § 121.301).

As a general matter, SBA deems entities to be affiliated with each other when one controls or has the power to control the other, or when a third party controls or has the power to control both. It does not matter whether control is exercised, so long as the power to control exists. SBA's regulations provide that it will consider the "totality of the circumstances," and may find affiliation even though no single factor is sufficient to constitute affiliation.

Under SBA's lending-specific affiliation rules, when an SBA lender has made a determination of no affiliation, SBA will "not overturn that determination" as long as it was reasonable when made given the information available.

Control can be either affirmative or negative.

Affirmative Control

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.

Under SBA's general affiliation rules, if two or more persons own or control less than 50% of a company's voting stock, 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, SBA presumes that each such person controls or has the power to control the business. This rule, however, does not appear in SBA's affiliation rules for its loan programs.

Negative Control

Negative control includes, but is not limited to, instances in which 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."

Thus, a company that is 40% owned by a VC 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 Office of Hearing Appeals (OHA) 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. *See Size Appeal of: Southern Contracting Solutions, LLC*, SBA No. SIZ-5956, 2018 (S.B.A.), 2018 WL 4492382. OHA 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

In *Southern Contracting*, OHA explained that a company giving minority owners the ability to block certain extraordinary actions of the company does not provide negative control to the minority owners, if those supermajority provisions are crafted to protect the investment of the minority owners, and not to impede the majority's ability to control the company's operations or to conduct the company's business as it chooses.

Further, OHA identified numerous extraordinary actions that a minority owner may be given power to block without resulting in a finding of negative control, including:

- Adding new members
- 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

OHA has suggested that a single indication of negative control is not, by itself, sufficient to find affiliation. Thus, whether negative control exists depends on the specific facts of the individual company.

Takeaways: Affiliation Analyses Are Fact-Specific

- In the days leading up to final passage of the CARES Act, some observers expressed concern that companies backed by VC or PE funds may be left out of the PPP program without a broadly applicable waiver of the affiliation rules. The CARES Act did not provide such a waiver except to companies in the three categories mentioned above, so most companies will need to consider the SBA's affiliation rules when determining their eligibility for PPP loans.
- Companies must be prepared to identify all affiliates and be prepared to defend their eligibility and affiliation determinations, taking into account their individual business objectives. As a cautionary note, the False Claims Act has been used against companies that allegedly made false or misleading statements in their size status certifications.
- Before applying for a loan, companies and their counsel should review their capitalization tables, shareholder agreements, and other governing documents to evaluate whether provisions in those documents give minority owners either affirmative or negative control. As a general matter, 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. Each prospective loan applicant needs to determine, based on its own unique circumstances, whether it qualifies after analyzing the affiliation requirements and other eligibility criteria.

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