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PH COVID-19 Client Alert Series: Availability of SBA Care Act Loans to Venture- and Private Equity-Backed Businesses

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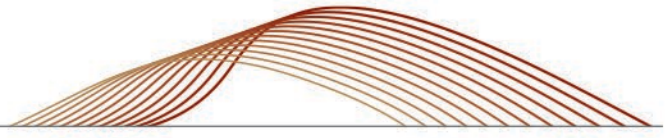
The $2 trillion stimulus Care Act enacted on Friday, March 27th, has venture- and private equity-backed companies and their investors scrambling to digest the 883-page text of the Act.[1] A centerpiece of the Act is the allocation of $349 billion for loans on very attractive terms to small businesses through Title I of the bill, known as the Keeping American Workers Paid Act. Venture- and private equity-backed businesses want to know whether they will be eligible for those loans.

The loans will be administered by the Small Business Administration ("SBA") and originated by third party lenders. Eligible companies (and sole proprietorships and eligible self-employed individuals) will be able to borrow up to $10 million, and loans will bear interest at a rate not to exceed 4%, will not require personal or shareholder guarantees or the posting of collateral, and in some cases will be entitled to being forgiven with no adverse tax consequences. Proceeds of the loans may be used to pay payroll costs, continuation of healthcare benefits and premiums, employee salaries and commissions, interest on mortgage obligations, rent, utilities, and interest on debt incurred before February 15, 2020.

The eligibility requirements for the loans are, on their face, clear. Title I of the Care Act allows (i) any business with fewer than 500 employees and (ii) any business for which the Small Business Act or the SBA, through rule-making authority, has established a size standard, to obtain a loan. A critical question becomes how the number of employees employed by a business is calculated.

Under the Small Business Act, affiliated businesses, including other businesses owned by a controlling entity, are aggregated for purposes of counting employees, calculating revenue, or otherwise testing the size of a small business. The affiliate test used by the SBA is based on the concept of "control." When one business controls, is controlled by, or is under common control with, another, the businesses are considered "affiliates."[2] The rules are designed to ensure that the benefits intended to reach small businesses, in fact, reach small businesses and not businesses that appear small as a result of creative governance structures.

The Act waives SBA "affiliation" rules for three types of businesses: (1) businesses with fewer than 500 employees at any one location in the accommodation and food service NAICS Code, including hotels, restaurants, bars, and other similar businesses; (2) businesses that operate as franchises; and (3) businesses that receive assistance from a Small Business Investment Corporation.[3] Assuming a venture- or private equity-backed business does not fall into one of those three categories (and most



will not), the question becomes how do the SBA "affiliation rules" apply for purposes of determining whether the business and its affiliates has 500 employees?

The key "control" test for purposes of venture- and private equity-backed businesses is the stock ownership test.[4] At the outer ends of the spectrum, i.e., where on one end, a business is wholly owned by a single individual or firm or on the other end, where ownership is widely distributed, the answer under this test is clear. If a person or entity owns more than 50% of the voting stock of the business (as is the case with many private equity-backed businesses), the owner will be deemed to control the business. If the voting stock of a business is sufficiently distributed that no block can be said to control it, the board of directors of the business along with the CEO or President will be found to control the business.[5]

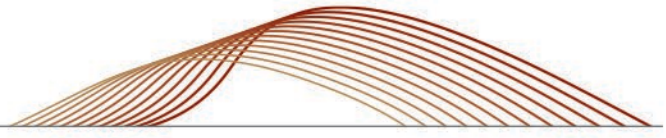
At the core, the question of control is analyzed by looking at the facts and circumstances of the business and is intended to focus on the reality of the economic situation. The SBA has accepted that certain customary negative commitments—*i.e.*, the power to block certain decisions contained in so-called "protective provisions"—do not in and of themselves give shareholders control. Minority shareholders often seek certain protections when investing in privately owned companies. For example, they often seek to prevent the owner-operator from issuing new stock, amending by-laws, or changing the line of business in which the firm operates. The SBA has recognized that such actions to do not necessarily constitute "negative control" and simply protect the minority shareholders' investment.[6] The SBA is more likely to be concerned with negative controls that give a shareholder the ability to prevent a quorum of directors from meeting or limit a board's ability to approve an operating budget or conduct normal business operations without approval of the shareholder.

However, when applied to a typical mid- to late-stage venture-backed company, which may have two or three significant VC stockholders and a founder or two also owning large blocks of stock, the question of who "controls" the company becomes more complicated. The difficult cases under the stock ownership test arise in the intermediate zone—where no one person or business owns more than 50% of the voting stock of the company but where the voting stock is relatively concentrated. In instances where one owner controls a block that dwarfs the voting interests held by other owners (e.g., 40% held by the largest shareholder and 2% by the next largest shareholder), the holder of the largest shareholder will be deemed to control the business.[7]

The most difficult case arises where multiple minority shareholders own roughly equal blocks—e.g., founder A as well as investors X and Y each owns 23% of the company and no other shareholder owns more than 5%. In that instance, there is a rebuttable presumption that A, X, and Y control the firm. In order to rebut the presumption of control (and, thus, aggregation with other firms "controlled" by investors X and Y), the business would need to come forward with information showing that investors X and Y are independent of one another or that the ability of the investors to control the company is somehow constrained by some governance mechanism or combination of factors.

For venture- or private equity-backed businesses that are seeking Care Act loans (or for SBA lenders that are considering extending such loans to venture- or private equity-backed businesses), we recommend being prepared to provide the following information in connection with the application:

- a detailed cap table showing holdings of stock for each individual and institutional owner that owns more than 1% of the company;
- the identities and affiliations of every director; and



- any voting agreements among such shareholders (for instance, many companies provide that the founders are entitled to appoint a majority of directors, which could indicate lack of control by the preferred holders regardless of the size of their ownership stake).

Care should be taken to describe the economic and governance factors that demonstrate no one venture investor controls the company. Again, for most companies, including early stage venture-backed businesses backed by angel investors or small venture or private equity funds, the control tests will be easy to pass. Companies that are majority-owned by founders without a major venture investor (with "major" being something in the range of 20-25%+) will be deemed to be controlled by their founders, and companies the stock of which has been widely distributed with no controlling holders will be deemed to be controlled by their boards and principal officers. For companies that fall in the middle, the information identified above should go a long way to determining whether an affiliate relationship exists with any other firm. The types of protections that minority shareholders typically receive when investing in privately owned businesses will not impact the analysis one way or the other.

Finally, we and others are urging the SBA to exercise its discretion in interpreting the affiliate rules narrowly, or waiving the rules for multiple minority owners in specified circumstances, or by substantially clarifying the facts that are needed to rebut the presumption of control when multiple minority owners exist. The SBA has emergency rule-making authority under the Act,[8] and we hope it will use that authority to fill the major hole inadvertently left in the Act as it relates to a very important segment of the small business community in the United States.

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If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings lawyers:

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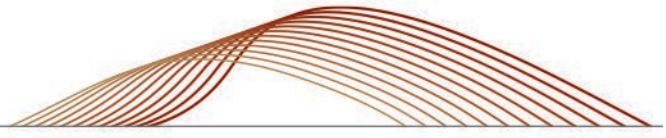
1 Coronavirus Aid, Relief, and Economic Security Act, H.R. 748.

2 *See* 13 CFR § 121.103.

3 Section 1102 (a)(2)(D)(iv) ("[w]aiver of affiliation rules").

4 *See* 12 CFR § 121.103(c).



[5] *See* U.S. Small Business Administration, *Small Business Compliance Guide Size and Affiliation* (March 2014) (available at https://www.sba.gov/sites/default/files/affiliation_ver_03.pdf).

[6] *See Size Appeal of: Carntribe-Clement 8ajv # 1, LLC, Appellant*, SBA No. SIZ-5357 (June 13, 2012).

[7] *See id.* At 7-8.

[8] Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, *Section 1114, Emergency Rulemaking Authority*