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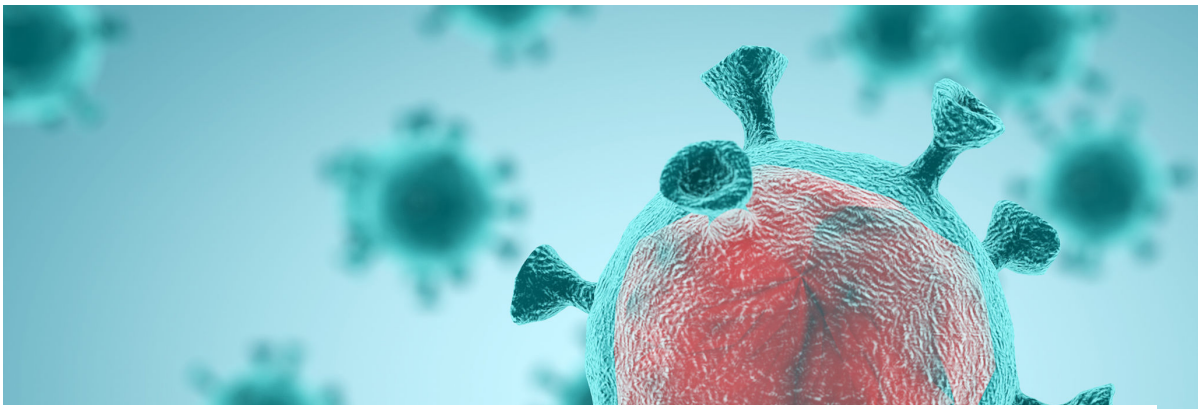

The CARES Act: SBA Size and Affiliation Issues for Loan Programs

ALERTS
March 30, 2020

On March 27, 2020, the President signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), a $2 trillion stimulus package thought to be the largest in U.S. history.

The CARES Act expands or establishes multiple loan programs for qualifying businesses. Our separate Client Alert describes the Paycheck Protection Program (PPP) and the Economic Injury Disaster Loans (EIDL) program, both administered by the U.S. Small Business Administration (SBA). The SBA's size and affiliation rules, however, might make it challenging for companies that have taken venture capital, private equity or other investments to take advantage of these programs.

This alert provides an overview of the SBA's size and affiliation rules.

Size Matters When Determining Eligibility

In order to be eligible for the PPP loans and EIDL program, as well as the Emergency EIDL grant program, a company must meet the SBA's existing "small business concern" standards, as modified by the CARES Act.

The size qualification for a "small business concern" under the SBA rules is currently based on a company's applicable 6-digit North American Industry Classification System (NAICS) code, which sets a maximum number of employees (including all full-time, part-time, and other employees) or maximum annual receipts in millions of dollars, or some other qualifier, for all companies under the applicable industry code, which is specified in this linked table. For example, companies in the "Research and Technology in Biotechnology" category must have less than 1,000 employees; companies in the "Semiconductor and Related Device

Manufacturing" category must have less than 1,250 employees; companies in the "Solar Electric Power Generation" category must have less than 250 employees; and companies in the "Data Processing, Hosting, and Related Services" must have less than $35 million in annual receipts.

The CARES Act modifies the employee threshold, to indicate that the applicant (together with its affiliates, as determined under the SBA rules) must have no more than the greater of:

500 employees, and

the number of employees designated in the applicable NAICS code size standard.

The CARES Act has not modified the annual receipts threshold. As a result, companies with fewer than 500 employees classified under NAICS codes with employee limits of less than 500 employees, such as companies in the "Solar Electric Power Generation" category, may now qualify. By contrast, the conditions for other companies, such as those in "Research and Technology in Biotechnology", "Semiconductor and Related Device Manufacturing", and "Data Processing, Hosting, and Related Services" categories, may remain subject to existing conditions.

Why Affiliation Rules Can Be Problematic

For purposes of size determination, with a few narrow exceptions,[1] the SBA looks to the number of employees of the company *as well as* the employees of all its domestic and foreign affiliates, regardless of whether the affiliates are organized for profit (or the aggregate receipts or other criteria, if applicable, depending on the applicant's NAICS category). For simplicity, the remainder of the alert discusses aggregation of employees, but the same analysis is applicable to aggregation of receipts or the other applicable criteria.

The SBA definition of "affiliate" is different and generally broader than other typical definitions of affiliates.

This may make it challenging for companies that have taken venture capital, private equity or other investments to be considered "small business concerns" under the SBA rules because the employee numbers of the applicant may be aggregated with the employee numbers of other portfolio companies of the applicant's investors, if the investor is determined to be an affiliate of the applicant, even if those portfolio companies are otherwise unrelated.

Under SBA rules, affiliation exists "when one business controls or has the power to control another or when a third party (or parties) controls or has the power to control both businesses." The SBA has found that control in this context may:

arise through ownership, management, or other relationships or interactions between the parties, and

be affirmative or negative.

Factors that may affect whether control for this purpose is found include:

Control of 50 percent or more of voting stock;

Options or agreements in principle to acquire such a controlling interest;

Common management, such as if one or more officers, directors, managing members, or general partners of a business control the board of directors and/or the management of another business;

Positive contractual control, such as where a single individual or entity controls the management of the applicant through a management agreement;

Negative contractual control, including instances where a minority shareholder has the ability, under the certificate of incorporation, bylaws, or stockholder's agreement, to prevent a quorum or otherwise block action by the board of directors or stockholders, including certain protective provisions in an applicant's certificate of incorporation;

Identity of interest, such as where several companies that have identical (or substantially identical) business or economic interests may be treated as one party unless they can demonstrate otherwise; and

Newly organized applicants that are spinouts that have overlapping management and business with the original entity.

Additionally, the SBA considers the totality of the facts and circumstances when determining whether affiliation exists. It may, for example, find affiliation based on the totality of the circumstances even though no single factor alone is sufficient to constitute affiliation.

If the number of employees of the applicant when added with the employees of its affiliates (as defined by the SBA), including other portfolio companies of investors that are deemed to control the company under the SBA rules above, exceeds the applicable size for the company, it would not meet the definition of "small business concern" under the SBA rules and accordingly would not be eligible for SBA loans, including the EIDLs (and corresponding the emergency EIDL grant) or the Paycheck Protection Program under the CARES Act.

In fact, the application process requires the applicant to certify, under penalty of perjury, that they are in fact eligible for the program, including under the affiliation rules.

Investor industry groups, including the National Venture Capital Association (NVCA), lobbied for the affiliation rules to be explicitly waived, relaxed or clarified in the CARES Act, but the final version of the Act only made exceptions from the affiliation rules for small businesses in the restaurant, restaurant supply chain, and hospitality sectors and for companies that receive funding from a Small Business Investment Company (SBIC). The NVCA and other industry groups are continuing to lobby for a relaxation of the affiliation rules, and we will continue to monitor developments in this regard.

For more information regarding the SBA's affiliation rules and their application to your company, please contact your Wilson Sonsini emerging companies attorney.

Wilson Sonsini continues to monitor the global impact of COVID-19 on various industries. Wilson Sonsini's COVID-19 Client Advisory Resource is a collection of alerts, advisories, and programs—all of which are intended to help the management, boards of directors, and in-house counsel of our clients maintain key operational and business functions, despite pressing challenges related to the COVID-19 outbreak.

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[1] The CARES Act exempts companies classified under NAICS Sector 72 (Accommodation and Food Services) and who employ not more than 500 employees per physical location, as well as any business that receives "financial assistance" from a Small Business Investment Company (SBIC).

CONTRIBUTORS

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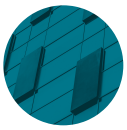

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