Affiliation in the Context of SBA Loans – Guidance for Venture Capital Investors[1]

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Key Takeaways:

- Companies must generally (i) have fewer than 500 employees or (ii) be a "small business" under the applicable NAICS code employee size standard to be eligible for the new CARES Act SBA loans, and importantly for most companies, **in both cases the applicable employee number includes the employees of the company's "affiliates" as defined by SBA rules**.

- A venture fund (and some or all of its portfolio companies) may be affiliated with the applicant if the fund has certain control rights, or owns 50% or more of the company, and so the **"employee" count for a company may include employees of the venture fund and employees of some or all of its portfolio companies**.

- Companies will have to identify affiliates and make certain eligibility certifications in the loan application, and eligibility determinations should therefore be made carefully and thoughtfully.

- There will be enforcement attention on distribution of the loans, and false statements, fraud, or knowing or reckless misrepresentations could have civil and criminal consequences.

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The U.S. Small Business Administration's loan programs (including those created under the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act")) generally provide financial assistance to "small businesses." The CARES Act expanded the availability of two of those programs – 7(a) loans under the new Payroll Protection Program ("PPP") and 7(b)(2) economic injury disaster loans – to businesses with either (1) fewer than 500 employees, or (2) fewer than the number of employees the SBA has designated as the size standard based on a company's applicable 6-digit North American Industry Classification System ("NAICS") Code, whichever is greater.

In either case, the number of employees of the company itself is aggregated with *the number of employees of all of the company's domestic and foreign affiliates, as defined in the SBA's regulations*, except in specific carved-out circumstances, such as restaurants and hotels with fewer than 500 employees per location. The SBA's affiliation rules are broader than most common understandings of the affiliation concept, and will play a large role in determining whether or not a particular business is

[1] This article discusses the current status as of publication on the evening of March 27, 2020. We are actively monitoring developments, including with respect to SBA guidance on the application and implementation of the SBA's rules in the context of the new CARES Act programs.

eligible for an SBA loan. They could have a particular impact on venture capital-backed companies because of how they operate to potentially "affiliate" otherwise unrelated businesses. This guidance is intended to assist venture capital firms and their portfolio companies in understanding the SBA's affiliation rules and identifying how affiliation issues may impact eligibility for SBA loans.

Power to "control" is king

Under the SBA construct, business entities are considered to be affiliates of one another when one controls or has the power to control the other, or when a third party or parties controls or has the power to control both. Control through the lens of these rules may arise based on equity ownership or control rights.

As a basic rule, ownership of 50% or more of the voting securities of a business will constitute control based on ownership alone and thus trigger affiliation between the business and its majority owner.[2] **Notably, this affiliation will also extend to any other businesses deemed to be controlled by the same majority owner**, whether due to majority ownership or positive/negative controls.

Where a venture capital firm owns less than a majority of the voting securities of a business, close analysis of the positive and negative controls that the VC firm enjoys in the investment and governing documents of the company will be necessary in determining whether the VC's minority position triggers affiliation and, accordingly, further affiliation among other portfolio companies.

Control Rights of Minority Investors that will Result in "Affiliation"

In the context of CARES Act SBA loans, **a minority stockholder will be deemed to be affiliated with the company** if it has the ability to prevent a quorum or otherwise block board or stockholder actions. While the SBA's rules do not specify the exact circumstances that will or will not give rise to impermissible controls by a minority owner, **relevant administrative case law will help guide an analysis of the types of covenants and investor rights that are likely to create affiliation** (and therefore jeopardize a company's small business status and attendant eligibility for an SBA loan).

Because each small business size determination is highly dependent on the unique facts and circumstances at issue, what has been observed to work (or not work) in prior cases may not be permissible for another investor in a different scenario, but we discuss general guideposts that may be helpful in the following sections.[3] This determination is important because, **to the extent a venture capital firm is "affiliated" with the applicant and other of the firm's portfolio companies, all such companies will be deemed to be affiliated with one another – and therefore the employee counts aggregated** (which may move a company that has substantially fewer than 500 employees to be deemed to be ineligible as over 500).

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[2] Note that outside of the SBA's loan programs, affiliation can also be found solely by virtue of certain minority interest holdings. This affiliation based on minority holdings does ***not*** apply in the context of the SBA loan programs. A minority investor my still be affiliated with a company, however, based on the control that the investor has the right to exercise over the actions and decision-making of the business, discussed in the next section.

[3] Note that the OHA case law discussed here is in the context of the SBA's general affiliation rules under 13 C.F.R. § 121.103. Since 2016, the SBA has used separate affiliation rules specifically tailored to its loan programs under 13 C.F.R. § 121.301. Many of the rules under these two regimes are very similar, so we would expect a comparable analysis of negative controls to apply in the context of SBA loans, although it is possible that the SBA would apply a different standard in evaluating affiliation resulting from negative controls for the purpose of loan eligibility.

Negative Covenants that <u>are</u> Likely to Create Affiliation between a Company and a Minority Investor

SBA Office of Hearings and Appeals ("OHA") case law generally finds that, **if a minority owner has the ability to block day-to-day operational decisions of the company, the minority owner has negative control over the company and therefore the two are affiliated** (and further creating affiliation between the company and any other entity the investor similarly controls). Current OHA case law indicates that a minority investor's control over or ability to block any of the following decisions or actions of a company, including through a director that is required to approve or holds a veto, will be held to create affiliation:

- Making, declaring, or paying distributions or dividends other than tax distributions.
- Establishing a quorum at a meeting of stockholders (and likely, by extension, at a meeting of the board).
- Approving or making changes to the company's budget or approving capital expenditures outside the budget.
- Determining employee compensation.
- Hiring and firing officers and executives.
- Blocking changes in the company's strategic direction.
- Establishing or amending an incentive or employee stock ownership plan.
- Incurring or guaranteeing debts or obligations.
- Initiating or defending a lawsuit.
- Entering into contracts or joint ventures.
- Amending or terminating leases.

Note that the minority investor is considered standing alone, as opposed to in connection with other, unrelated minority investors, in terms of its rights. <u>**If the operative documents entitle a venture capital firm or its board appointee to any of the foregoing negative controls, there is a high likelihood that it will be considered affiliated with the company (but see CONCLUSION below on amending documents).**</u>

Negative Covenants that are <u>Not</u> Likely to Create Affiliation between a Company and a Minority Investor

Thankfully, **SBA OHA case law recognizes that minority investors must be entitled to some negative controls in order to protect the value of their investment.** In this regard, SBA OHA has permitted minority owners to have control over certain of a company's decisions that are considered to be extraordinary, rather than day-to-day operational decisions. Below is a list of extraordinary decisions over which minority owners have been found to be able to have <u>**but without**</u> triggering affiliation under current OHA case law:

- Selling all or substantially all of the company's assets.
- Placing an encumbrance or lien on all or substantially all of the company's assets.
- Engaging in any action that could result in a change in the amount or character of a company's capital contributions.
- Changing the company's line of business.
- Engaging in a merger transaction.
- Issuing additional stock/equity.
- Amending the organizational documents of a company.
- Filing for bankruptcy.
- Amending the governing documents to materially alter the rights of the existing owners.
- Dissolving the company.
- Increasing, decreasing, or reclassifying the authorized capital of the company.

- Increasing or decreasing the size of the board.
- Entering into a confession of judgment.
- Disposing of the goodwill of the company.
- Committing to take any action that would make it impossible for the company to carry on its ordinary course of business.

It is important to note that, for purposes of making these determinations, the SBA considers options, convertible securities and agreements to merge "as if" the rights have already been exercised, for the most part. Similarly, it is the rights that the investor <u>has</u> that the SBA considers, whether or not those rights are actually <u>exercised</u>.

Other Means of Causing "Affiliation"

While affiliation based on ownership is a large focus for many venture-backed companies, there are other ways in which affiliation can arise under the SBA's regulations. A few of the most significant are addressed below.

Affiliation Based on Common Management or Identity of Interest

If one or more officers, directors, managing members, or general partners of a business **control the board** and/or management of another business, the SBA may consider those companies affiliated based on common management. Note that under the SBA's loan programs, affiliation will also arise based on common management where a single entity or individual controls the management of a business through a management agreement. Two or more businesses with the same or similar business or economic interests may also be considered affiliated, although this determination can be rebutted. Identity of interests can include close relative, firms with common investments, or companies that are economically dependent.

Newly Organized Concerns

A business that has been actively operating for two years or less may be deemed affiliated with another entity if the new business was organized by current or former officers, directors, owners of 20% interest or greater, or managers of the other entity, those individuals serve as the new business's officers, directors, owners or managers, the new entity operates in the same or a related industry or field, and monetary benefits flow back to the original entity.

Totality of the Circumstances

The SBA retains a catch-all affiliation basis that considers the totality of the circumstances, meaning all connections between the two or more entities. Businesses can find affiliation on a case-by-case basis even if no single factor standing alone would otherwise be sufficient.

Conclusion

Before a venture capital firm's portfolio company applies for an SBA loan, we recommend that the firm and company should conduct a close examination of its investment and governing documents (and the documents of its other holdings) to determine whether affiliation issues exist and risk disqualifying the businesses for SBA loan assistance. **Armed with this analysis, it may be possible to <u>amend</u> governing documents to mitigate any control rights that are considered high risk for creating affiliation prior to submitting the SBA loan application.** In applying for an SBA loan, we recommend that companies **highlight for the SBA how its minority investors enjoy only limited control** over certain extraordinary actions that are linked directly to the value of their investments and how other day-to-day and strategic decision making is not subject to the control of the minority investors. Careful attention to other potential bases for affiliation is also warranted.