

The CARES Act and Portfolio Companies: Preliminary Guidance on Affiliation Rules

Legal Alert
April 3, 2020

Are you a private equity (“PE”) or venture capital fund (“VC”) with portfolio companies in need of CARES Act funds? Or, are you a brand with PE or VC investors?

Here is some current guidance:

A. The Coronavirus Aid, Relief, and Economic Security Act (the CARES “Act”) , signed into law on March 27, 2020, temporarily expands the loan programs of the Small Business Administration (“SBA”), through an expansion of the Economic Injury Disaster Loan (“EIDL”) Program and the creation of the Paycheck Protection Program (“PPP”). As explained in prior Foster Garvey Alerts on our [COVID-19 Resource Center](#), the Act increases eligibility for certain small businesses to receive financial assistance. However, the Act provides that the SBA’s affiliation rules apply (except for a blanket waiver of those rules for businesses with a [NAICS “72”](#) designation (Accommodation and Food Services) . Because of the affiliation rules, portfolio companies or companies with PE or VC investors in many industries may not meet the size standards to qualify for the SBA programs under the Act.

B. There remain many open issues regarding the application of the SBA affiliation rules to small businesses, particularly with regard to those with PE or VC funding. However, the SBA’s release of guidance on the PPP and the model PPP application form, combined with the release of the [Interim Final Rules \(“IFR”\)](#) on April 3, 2020, has provided some clarity, and the SBA has promised more clarity through additional guidance on the affiliation rules.

Here is some basic guidance:

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1. What are “the affiliation rules” and what constitutes an “affiliate?” The SBA affiliation rules are rules to determine whether a company that appears to be a “small business” for purposes of SBA programs (e.g., financial programs or small business contract set-asides) is really closely related with other businesses or investors, so that, viewing all the related companies together, they create a non-small business. The rules try to ensure that non-small businesses do not receive taxpayer-funded benefits intended for truly small, independent businesses. An entity is deemed to be an affiliate of another entity when it “controls or has the power to control the other, or a third party or parties control or has the power to control both [entities].”

2. Basic principle of affiliation is “power to control.” It matters not whether the control is actually exercised; it is based on the “power to control,” by stock ownership, management, contract, debt, etc. That means, e.g., that even if a VC or PE investor in a company/brand owns less than a majority of the company’s equity, but holds board seats representing a majority of the board or have contractual rights giving it approval rights that constitute “power to control,” such investor and possibly its other portfolio companies, may be deemed to be affiliates of the company/brand that is applying for the program. See further discussion under item 5 below.

3. If affiliation exists, aggregate employees of all affiliates. If an applicant company is deemed to have one or more affiliates, then for the PPP, all the employees of all the affiliates are counted as employees of the applicant company, for the narrow purpose of determining size under the applicable SBA size standard.

4. The affiliation rules appear to apply to “the 500.” The SBA appears to interpret the Act to mean that the SBA affiliation rules apply to the core Section 1102 provision regarding “not more than the greater of (I) 500 employees or (II) if applicable, the size standard “in number of employees” set by the SBA for the business’s industry. The plain language of the Act is not entirely clear on this point, but if the SBA follows this interpretation, then, until further guidance is provided, it makes sense to follow it.

5. The affiliation rules of 121 CFR 301(f) apply. The Act states that the rules of 121 CFR 103 apply, but a sub-section of Section 103 says that Section 301 applies for SBA Business Loan Programs, of which the PPP is a part. The IFR refers us to Section 301(f). Some basics of the Section 301(f) affiliation rules include, roughly:

- Affiliation based on ownership: any person who owns or has control of more than 50 percent of the voting equity is deemed an affiliate (this is an irrefutable presumption).
- Affiliation based on management: affiliation may arise where, say, a President or CEO controls two entities, or a board of one entity is the board of another entity.
- Affiliation based on negative controls: the SBA will deem a minority equity owner to be in control, if that individual or entity has the ability, under the concern’s charter, shareholder

agreement, operating agreement, to prevent a quorum or otherwise block action by the board of directors, managers, shareholders or members (as applicable).

- Affiliation based on convertible/exercisable securities: SBA considers any convertible securities on an as-converted/as-exercised basis when determining control. However, SBA will not count convertible securities when conversion depends on a condition that is “incapable of fulfillment, speculative,” or “unenforceable under law.” (This is a very fact-specific analysis.)
- Affiliation based on identity of interests: Affiliation can be found based on close family relationship or common investments.

6. Some affiliation rules are refutable presumptions. For some affiliation grounds, the SBA’s initial decision need not be final. For such grounds, an applicant may refute the decision, and explain how the grounds do not apply.

7. Be careful! Avoid penalties and possible imprisonment. The PPP and EIDL contain certification requirements. For example, the PPP certification is that “all the information provided in this application and the information I have provided in all supporting documents and forms are true and accurate. I realize that knowingly making a false statement to obtain a guaranteed loan from SBA is punishable . . . by imprisonment . . . and/or a fine . . .” You get the picture. The SBA has been prosecuting false applications and false statements for decades and, when this crisis passes, there may be a huge push to verify that only eligible small businesses received taxpayer-provided financial assistance. Keep calm and take care.

8. More guidance to come! The IFR states that the SBA intends to promptly issue additional guidance with regard to the applicability of the affiliation rules.

We can help. The application of the affiliation rules is very fact-specific. Some situations can be determined quickly. Other situations require an in-depth analysis of the investment documents, the applicant’s charter documents, and information on the PE or VC and its other investments.

For additional resources on how to navigate the business disruptions caused by COVID-19, please visit our [COVID-19 Resource Center](#) and reach out to the Foster Garvey team with any questions.