

Alerts & Publications



SBA Affiliation Rules: Funding for Venture-Backed Companies under the CARES Act

March 29, 2020

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The Coronavirus Aid, Relief, and Economic Security (CARES) Act provides for new Small Business Administration (SBA) lending programs that on the face of the legislative language should be available to venture-backed companies.

The Paycheck Protection Program, which is the most highly funded and broadly applicable of the programs, extends the SBA's 7(a) program to provide for up to US\$10 million of financing and is subject to forgiveness if employment levels are maintained.

See O'Melveny's March 26, 2020 [Client Alert](#) for a summary of the Paycheck Protection Program and other lending programs for US businesses.

Venture Capital Industry Engagement on SBA Eligibility

The venture capital industry has actively engaged Congress and the Executive Branch in efforts to enhance availability of SBA funds to venture-backed companies, both in connection with the CARES Act and in the past. With respect to the Paycheck Protection Program, the industry's engagement removed obstacles such as owner guarantees.

However, the SBA's affiliation rules, which aggregate what entities or individuals the SBA considers to be "affiliates" together for purposes of determining SBA eligibility based on size, remain applicable to the Paycheck Protection Program as well as other SBA programs. ***The affiliation rules may make it difficult for many venture-backed companies to be SBA eligible.***

Exemptions from the affiliation rules that cover specific industries such as hotels, food preparation, and franchises were not granted for companies typically backed by venture capital firms. ***The only affiliation exemption that may be available to some venture-backed companies provides that businesses that receive "financial assistance" from a Small Business Investment Company (SBIC) are exempt.***¹ While further engagement to obtain rules or guidance on affiliation as applied to venture-backed companies is ongoing, absent such rules or guidance, an understanding of the historical administrative policies and practices of the SBA remains crucial to the eligibility analysis.

Application Process and Self-Certification Requirement

A new system—including additional lenders, and new rules and guidance—is being created by the government for Paycheck Protection Program applications. While the application process is expected to be more streamlined than for traditional SBA 7(a) loans, **applicants will, at a minimum, have to self-identify any ‘affiliates’ and make a certification as to eligibility.** Fraud and intentional or reckless misstatements may have criminal or civil consequences. Our Client Alert addressing enforcement risks and issues arising out of the CARES Act and other economic stimulus provisions is forthcoming. **Applicants should take care that the application and certification are made in good faith after a careful examination of the facts and circumstances specific to the applicant and its investment structure.**

Highlights of SBA Affiliation Rules for Venture-Backed Companies

While the affiliation rules are based on the concepts of “control” and “being under common control,” the SBA’s administrative law precedents on affiliation take a broad, “totality-of-the-circumstances” approach to affiliation determinations and generally provide that:

- Ownership of 50% or more of voting equity of an applicant creates affiliation with such owner and all other entities found to be affiliated with that owner;
- An investor’s blocking rights (including through board rights) are tested on a **stand-alone** basis (meaning multiple venture investors not otherwise affiliated with one another are **not** grouped together as one in determining whether they have the blocking rights or other controls described below, but are instead looked at separately).
 - Blocking rights over day-to-day business operations and decision making, such as the following, have been found in certain cases to give rise to affiliation:
 - Dividends and distributions
 - Changes to company strategy
 - Employee compensation and senior management changes
 - Budgets and capital expenditures
 - Changes to equity compensation
 - Entering into contracts
 - Joint ventures
 - Incurrence of debt
 - Entering into leases
 - Blocking rights over extraordinary decisions, such as the following, have been found in certain cases **not** to give rise to affiliation:
 - Merger or sale of all or substantially all assets
 - Issuance of equity

- Changes to organizational documents
 - Bankruptcy/dissolution
 - Changes to board structure
 - Changes to line of business
 - Lien on all or substantially all assets
 - Changes to amount or character of capital contributions
 - Changes to authorized capital
 - Settlements of litigation
- Rights to control the management or affairs of a company by contract (beyond those typically contained in a Venture Capital Operating Company (VCOC) management rights letter may give rise to affiliation;
 - Control of other companies by senior management or a director may give rise to affiliation;
 - Identity of interests between two businesses with relationship connections may give rise to affiliation²; and
 - Dominance of management by a small number of investors may give rise to affiliation³.

As you can see from the above, the SBA's administrative practices and policies have historically not been friendly as a general matter toward venture-backed companies, particularly in the context of certain of the blocking rights deemed to give rise to affiliation. To make a good faith self-certification, companies should undertake a careful analysis of the specifics of their investment structure, protective provisions, and venture financing documents, taking available information and precedent into account.

Suggested Steps for Venture-Backed Companies

Venture-backed companies interested in SBA funding should:

- Monitor any new guidance or rulemaking from the SBA or Treasury;
- Monitor application and pre-application portals established by banks in coordination with the SBA;
- Carefully analyze their investment structures for eligibility under the affiliation rules; and
- ***Where feasible, pursue amendments that may cure eligibility issues under the affiliation rules.***

For further updates on the CARES Act and for other legal issues arising out of the COVID-19 pandemic, see O'Melveny's [Coronavirus Resource Center](#).

¹ Implementing rules and regulations may clarify the extent of this exemption and whether it will apply to any business that receives any financial assistance from at least one investor that is an SBIC, or applies more narrowly to a company that solely has SBIC backing or solely to the SBIC itself.

² E.g. two businesses with board overlap that have similar businesses and shared customers.

³ E.g. two or three investors with a close relationship that together hold more than 50% of voting equity.

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