

SBA Section 7(a) Loans for Venture Capital Backed Growth Companies/Startups Under the CARES Act

By **Matthew J. Moisan**, **Ed Zimmerman**, **Lowell A. Citron**, **Kimberly E. Lomot**, and **Raymond P. Thek**

Background: On March 27, 2020, the U.S. House of Representatives passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act (the CARES Act), which the President subsequently signed it into law. The CARES Act establishes a new type of loan program known as the Paycheck Protection Program (the program) within the U.S. Small Business Administration's (SBA's) 7(a) loan program. The program has several attractive features, including, most notably, forgiveness of a portion of the loan, provided that (i) the proceeds are used for payroll, rent, utilities, and other eligible expenses that are (ii) incurred during the eight-week period immediately following the origination of the loan.¹ Other beneficial features include but are not limited to (i) a maximum interest charge of 4% (subject to adjustment when the SBA regulations come out); (ii) deferred repayment of a minimum of six months and a maximum of one year of all principal, interest, and fees; and (iii) no required personal guarantee.²

For more information on specifics of how forgiveness of SBA 7(a) loans works, including how to calculate the amount forgiven, please see [here](#).

Loan Amount: The maximum principal amount of the SBA 7(a) loan is generally based on a formula that is the lesser of (i) 2.5 times the

applicant's average monthly payroll costs incurred during the one-year period immediately preceding the date of the covered loan and (ii) \$10 million (the limit on conventional SBA 7(a) loans is currently \$5 million).

Eligibility: Generally speaking, a business based in the United States operating for profit that meets certain size or income/receipts requirements is eligible for an SBA Section 7(a) loan.³ Each subject business is eligible to receive a loan, provided that it employs not more than the greater of 500 employees (including full-time, part-time, and those employed on other bases) or, if applicable, the size standard in the number of employees established by the SBA for the industry in which the business operates.⁴ While the CARES Act does not specifically address the SBA's maximum receipt requirements, we expect that the SBA may limit some businesses' eligibility based on receipts in accordance with the SBA's existing receipt requirements for the industry in which the business operates (please see the SBA sizing tool based on number of employees and receipts).⁵

Affiliates: In order to determine an applicant's employee count, the program has adopted certain rules regarding control and affiliates. See 13 CFR §121.103⁶ (we refer to this as Section

¹ Lowell A. Citron, Michael A. "Bux" Buxbaum, Theodore C. Sica, and Kimberly E. Lomot, "SBA Paycheck Protection Program," Lowenstein Sandler LLP (March 29, 2020) (hereafter, "LS SBA PPP Article")

² *Id.*

³ SBA Small Business Compliance Guide: Size and Affiliation, June 2018.

⁴ Noting that this does not apply to NAICS Code 72, franchises and certain businesses receiving financial assistance from a company licensed under Section 301 of the Small Business Investment Act of 1958. LS SBA PPP Article.

⁵ See 13 CFR §121.201.

⁶ See 13 CFR §121.103(a)(8) ("For applicants in SBA's Business Loan, Disaster Loan, and Surety Bond Guarantee Programs, the size standards and bases for affiliation are set forth in §121.301."); and 13 CFR §121.301(f)

103) and 13 CFR §121.301⁷ (we refer to this as Section 301). According to both Section 103 and Section 301, eligibility for these SBA 7(a) loans is governed by Section 301, NOT by Section 103. See Section 103(a)(8) and Section 301(f). The two Sections have similar language but differ in important ways. Review of the SBA Small Business Compliance Guide (the SBA Guide) indicates that these rules were established to aggregate businesses that “control or have power to control” other businesses. For instance, the employees of a wholly or majority-owned subsidiary would be aggregated with those of the parent company (and the other companies that parent “controls”), which could render all of those aggregated companies ineligible for SBA 7(a) loans.⁸ However, because the SBA Guide primarily focuses on Section 103 and not Section 301, the affiliation analysis must be done with extra care.⁹ While certain circumstances establishing control under Section 301 are clear, the regulations allow for flexibility in determining control and therefore affiliation, which results in uncertainty.

One very meaningful difference between Section 301 (and therefore, governing the Section 7(a) Loans) and Section 103 is that Section 103(c)(2) finds affiliation where

“two or more persons ... each owns, controls, or has the power to control less than 50 percent of a concern’s voting stock, and such minority holdings are equal or approximately equal in size, and the aggregate of these minority holdings is large as compared with any other stock holding, SBA presumes that each such person controls or has the power to control”

In contrast, Section 301 does not have an analogue to this part of Section 103. Consequently, Section 7(a) loans do NOT have to clear the hurdle imposed relating to finding “affiliation” based on having two or more persons with roughly equal holdings who together are “large” compared to others. Instead, Section 301 will look to the power to “control” that is held by an equityholder (rather than a fragmented group of several unrelated minority

holders). That is very relevant to venture capital-backed companies that might have three investors who together share a veto of a given set of corporate actions, but who alone cannot control the outcome.

In sum, an affiliation under Section 301 may be found in the following circumstances (representing a nonexclusive list, but this is the portion of the rules under Section 301 that are most pertinent to venture-backed startups and growth companies):¹⁰

1. Affiliation based on ownership—any person that has control of 50% or more of the voting equity is deemed an affiliate (this is an irrefutable presumption), and the “SBA will deem a minority shareholder to be in control, if that individual or entity has the ability, under the concern’s charter, by-laws, or shareholder’s agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.”
2. Affiliation based upon convertible securities and those that are subject to exercise—the SBA considers any convertible securities on an as-converted/as-exercised basis when determining whether control exists, noting that when convertible securities are subject to a condition precedent that is incapable of fulfillment or speculative, they are exempted from being included.
3. Affiliation based on management—affiliation may arise where a President or CEO controls two entities.
4. Affiliation based on totality of the circumstances—the “SBA may consider all connections between the concern and a possible affiliate. Even though no single factor is sufficient to constitute affiliation, SBA may find affiliation on a case-by-case basis where there is clear and convincing evidence based on the totality of the circumstances. However, where an SBA Lender has made a determination of no affiliation, SBA will not overturn that determination as long as it was reasonable when made given the information available to the SBA Lender at the time.” (Emphasis added.)

(“Affiliation under any of the circumstances described below is sufficient to establish affiliation for applicants for SBA’s Business Loan. ... For this rule, the Business Loan Programs consist of the 7(a) Loan Program ...”).

⁷ See, SBA Guide at pp. 3-4 (“For the SBA’s Business Loan, Disaster Loan, and Surety Bond programs, the affiliation regulation can be found at 13 C.F.R. § 121.301(f). The Business Loan programs consist of the 7(a) Loan program ... Differences in the treatment of affiliation in these programs are noted below.”). The SBA Guide does not fully detail the differences between Section 301 and Section 103.

⁸ SBA Small Business Compliance Guide: Size and Affiliation, June 2018.

⁹ See SBA Guide at pp. 3-4 (“For the SBA’s Business Loan, Disaster Loan, and Surety Bond programs, the affiliation regulation can be found at 13 C.F.R. § 121.301(f). The Business Loan programs consist of the 7(a) Loan program ... Differences in the treatment of affiliation in these programs are noted below.”). The SBA Guide does not fully detail the differences between Section 301 and Section 103.

¹⁰ See 13 CFR §121.301(f)(6). Contrast that language with 121.103(a)(5), which does not include a heightened burden of proof but instead states in its entirety, “In determining whether affiliation exists, SBA will consider the totality of the circumstances, and may find affiliation even though no single factor is sufficient to constitute affiliation.”

It is noteworthy that Section 103 omits the “clear and convincing” standard of proof under totality of circumstances. “Clear and convincing” is a higher standard than would apply to Section 103 analysis. That means that the SBA would have an easier time finding control under the “totality of circumstances” provision of Section 103 than it would under the analogous provision in Section 301. This is important for venture-backed companies, because this “totality of circumstances” provision of Section 301 governs whether the SBA would consider the “protective provisions” in a given venture deal to confer control on an investor. See Section 301(f)(1) and (f)(6).¹¹

Guidance: While we understand that the affiliation analysis, in some circumstances, will deem a venture-backed company ineligible for the program, we believe that a number of venture-backed startups and growth companies should be found eligible. More specifically, the statute and legislative history tend to indicate that a large ownership stake or control over day-to-day management are at the heart of the affiliate inquiry. Thus, while certain negative controls or negative covenants may give rise to an affiliate relationship, many will not. Further supporting this conclusion is the heightened standard of proof required to find affiliation when leveraging the totality of the

circumstances test (which is unique to Section 301). This is clear guidance that the net of “affiliation” should not be cast broadly; had the SBA intended to find affiliate relationships in companies that failed to meet the specific provisions of Section 301, it would have lowered the standard of proof in the catch-all provisions (as it did in Section 103).¹² In totality, we therefore believe that the many venture-backed and growth companies will be eligible under the program.

In light of the foregoing and the heightened demand SBA lenders are confronting, we encourage potential borrowers to contact their SBA lender as soon as possible to help determine eligibility. As always, we are here to continue to support the venture, startup, and growth communities and encourage you to contact us if you have any questions or comments.

To see our prior alerts and other material related to the pandemic, please visit the Coronavirus/ COVID-19: Facts, Insights & Resources page of our website by clicking [here](#).

¹¹ Section 301(f)(1) provides “SBA will deem a minority shareholder to be in control, if that individual or entity has the ability, under the concern’s charter, by-laws, or shareholder’s agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.” Section 301(f)(6) provides “In determining whether affiliation exists, SBA may consider all connections between the concern and a possible affiliate. Even though no single factor is sufficient to constitute affiliation, SBA may find affiliation on a case-by-case basis where there is clear and convincing evidence based on the totality of the circumstances. However, where an SBA Lender has made a determination of no affiliation, SBA will not overturn that determination as long as it was reasonable when made given the information available to the SBA Lender at the time.”

¹² Notably, Section 301 also differs from Section 103 because 301 then adds a statement of deference to the determination made by the lender: “However, where an SBA Lender has made a determination of no affiliation, SBA will not overturn that determination as long as it was reasonable when made given the information available to the SBA Lender at the time.”

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

MATTHEW J. MOISAN

Counsel

T: 646.414.6855

mmois@lowenstein.com

ED ZIMMERMAN

Partner

Chair, The Tech Group

T: 212.204.8696

ezimmerman@lowenstein.com

LOWELL A. CITRON

Partner

Chair, Debt Financing

T: 646.414.6819

lcitron@lowenstein.com

KIMBERLY E. LOMOT

Counsel

T: 973.597.2430

klomot@lowenstein.com

RAYMOND P. THEK

Partner

Vice Chair, The Tech Group

T: 646.414.6795 / 973.597.2574

rthek@lowenstein.com

NEW YORK

PALO ALTO

NEW JERSEY

UTAH

WASHINGTON, D.C.

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