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Small Business Administration Affiliation Rules Relaxed Under Coronavirus Aid, Relief, and Economic Security Act

What were the affiliation rules prior to the enactment of the Coronavirus Aid, Relief, and Economic Security Act?

The Small Business Administration (SBA) Section 7(a) loan guarantee program provides financial assistance to eligible small businesses with 500 or fewer employees, or a greater number depending on the relevant SBA Size Standard for the industry. Broad affiliation rules apply when determining if a business is eligible for a Section 7(a) loan, and typically businesses under direct or indirect common control must be aggregated in determining the number of employees employed by a particular business. Historically, this has limited access to Section 7(a) loans for businesses that are sponsored by private equity funds.

However, a business that is otherwise ineligible for a Section 7(a) loan may be eligible to receive funding under the small business investment company (SBIC) program. Under the SBIC program, the SBA will guarantee equity and debt investments by private funds that are licensed and regulated by the SBA. A business is eligible to seek funding under the SBIC program if it is a “small business” (as defined by the SBA), which does not engage in foreign activities (i.e., more than half of employees and assets must be located within the United States) and is not engaged in a “prohibited business” (e.g., re-lenders or re-investors, passive businesses, real estate businesses, farmland purchases, project financings, foreign investments, associated suppliers, financing licensees or businesses contrary to the public interest).

Applicants of the SBIC program will not be deemed to be affiliated with the following entities or other businesses under their control: (a) venture capital operating companies, which would include many private equity funds, (b) investment companies registered under the Investment Company Act of 1940 (the 1940 Act) or (c) investment companies not required to be registered under the 1940 Act because they are beneficially owned by less than 100 persons and whose principal purpose is investing in securities.

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Does the Coronavirus Aid, Relief, and Economic Security Act change or waive the affiliation rules?

The recently enacted Coronavirus Aid, Relief, and Economic Security (CARES) Act established the Paycheck Protection Program (PPP), which expands the existing Section 7(a) loan guarantee program. The PPP provides forgivable loans of up to $10 million to eligible small businesses and other businesses with 500 or fewer employees (or a greater number based on the relevant SBA Size Standard for the industry).

The CARES Act provides an explicit waiver of the affiliation rules for: (a) businesses in the accommodation and food service sectors (i.e., companies assigned an NAICS code beginning with 72) that have 500 or fewer employees per physical location, (b) franchise businesses and (c) any business that receives financial assistance from a company licensed under the Small Business Investment Act (the SBIC exception). The SBIC exception may allow private equity-sponsored businesses, which would have otherwise been excluded by the existing affiliation rules, to receive loans under the PPP. Given that the SBIC exception applies to businesses that currently receive funding under the SBIC program, it is likely that any business seeking to fit within this exception would need to (x) be a current recipient of funding under the SBIC program or (y) seek funding under the SBIC program. Note that the SBIC program is subject to a different regulatory scheme than the Section 7(a) program and related PPP loans, and, therefore, a business seeking funding under the SBIC program is subject to different eligibility requirements (as described above). It is unclear if businesses that are not currently participating in the SBIC program can become eligible for PPP loans simply by acquiring new funding under the SBIC program. The SBA is required to implement the PPP provisions of the CARES Act by April 11, 2020, and we anticipate that the SBA will be providing guidelines in connection therewith, which may provide greater clarity on this point.

How do Borrowers determine whether they currently receive funding from an SBIC?

Borrowers who currently receive funding from an SBIC will likely have specific representations, warranties and covenants regarding the SBIC program contained in their credit agreements. Borrowers should coordinate with counsel to conduct a review of the existing funding documentation to determine whether such provisions are included. Additionally, Borrowers can also search the SBIC Directory to determine if they are currently receive funding from an SBIC. Finally, Borrowers are encouraged to reach out to their current lenders to determine whether any such lender providing funding is an SBIC.