

CARES Act Small Business Loan Program: Update for Venture-Backed Companies and their Investors

Insights

March 30, 2020

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OVERVIEW

The **Coronavirus Aid, Relief and Economic Security Act** (the “CARES” Act) was signed into law this past Friday, March 27, 2020. The CARES Act, estimated at approximately \$2 trillion, is the largest and most comprehensive of the U.S. government stimulus packages passed to date in response to the COVID-19 pandemic.

The CARES Act sets aside \$349 billion for loans to certain small businesses and nonprofits under a new “Paycheck Protection” loan program that will be administered by the Small Business Administration (SBA). The period to receive a loan under the program extends through June 30, 2020.

This update provides:

- An overview of the Paycheck Protection loan program;
- An overview of how the SBA’s affiliation rules may affect the eligibility of venture-backed companies to participate in the program; and
- Certain risks and other considerations venture-backed companies should consider when applying for a Paycheck Protection loan.

We expect the SBA to provide greater clarity on the affiliation rules and the process for applying for Paycheck Protection loans in the coming days.

LOAN TERMS

- **Maximum Loan Amount:** 2.5 months of payroll based on the company's average monthly payroll over the 12 months prior to the date the loan is made (excluding any individual employee's or independent contractor's annual compensation that is in excess of \$100,000 and any compensation of an employee whose principal place of residence is outside of the U.S.), up to a maximum of \$10 million
- **Maximum Term:** 10 years
- **Maximum Interest Rate:** 4%
- **Recourse:** No personal guarantees and no collateral. Nonrecourse, except to the extent the loan proceeds are used other than for a permitted use (see "Permitted Uses of Proceeds" below)
- **Loan Forgiveness:** Available for some permitted uses of proceeds (see "Loan Forgiveness" below)
- **Fees:** No loan fees or prepayment fees, and the SBA will cap lender application fees and reimburse lender processing fees at certain levels
- **"Credit Elsewhere" Requirement:** For other SBA loan programs, the SBA requires that borrowers must be unable to obtain credit elsewhere; this requirement is waived for Paycheck Protection loans
- **Government Backing:** 100% of the loan amount is guaranteed by the SBA
- **Payment Deferral:** If not forgiven, lenders are required to defer payments on the loans for between six months and one year (deferral timing will be determined based on forthcoming SBA guidance)

PERMITTED USES OF PROCEEDS

- Payroll costs (excluding any individual employee's or independent contractor's annual compensation that is in excess of \$100,000, prorated for the covered period, and any compensation of an employee whose principal place of residence is outside of the U.S.)
- Costs related to the continuation of group health care benefits during periods of paid sick, medical or family leave, and insurance premiums

- Employee salaries, commissions, or similar compensations
- Payment of interest on any mortgage obligation
- Rent
- Utilities
- Interest on any other debt obligations incurred prior to the covered period

IMPORTANT NOTE: Not all permitted uses of proceeds are forgivable. See below under “Loan Forgiveness.”

LOAN FORGIVENESS

Borrowers are eligible for loan forgiveness in an amount equal to the sum of the following costs incurred and payments made during the **8-week period** following loan origination:

- **Payroll:** Payroll costs (excluding any individual employee's or independent contractor's annual compensation that is in excess of \$100,000, prorated for the covered period, and any compensation of an employee whose principal place of residence is outside of the U.S.)
- **Mortgage Interest:** Interest payments on real or personal property mortgage obligations that were incurred before February 15, 2020
- **Rent:** Rental obligations under leases in force before February 15, 2020
- **Utilities:** Utility payments where service began prior to February 15, 2020

Loan forgiveness is **reduced proportionately** by:

- Any reduction in employees retained compared to either the prior-year period or the first two months of 2020 (there is no reduction if a borrower hires (or rehires) additional employees to return headcount to the previous levels); and
- By the reduction in pay of any employee beyond 25% of prior year compensation (reductions in pay for any employee with an annualized salary of more than \$100,000 are not considered for this purpose).

LOAN ELIGIBILITY

To be eligible for Paycheck Protection loans, businesses must have:

- Fewer than (counting employees of all **affiliates**—see “Affiliation” below):
 - 500 employees; or
 - The **applicable size standard** in number of employees for the North American Industry Classification System (NAICS) for the industry as provided by the SBA (if greater than 500 employees); and
- Been in operation since February 15, 2020.

Further, to be eligible, borrowers must have experienced supply chain disruptions, staffing challenges, a decrease in sales or customers or business closure as a result of COVID-19 and also make a **good faith certification** that the uncertainty of current economic conditions makes necessary the loan request to support ongoing operations.

AFFILIATION

When assessing eligibility for Paycheck Protection loans, borrowers should consider the applicability of the SBA’s affiliation rules in order to appropriately calculate their number of employees. There is significant uncertainty regarding how the SBA and SBA lenders will determine whether venture capital investors (and any of their other portfolio companies that the SBA also deems to be affiliates) are considered affiliates of a venture-backed borrower for purposes of calculating a borrower’s employee headcount.

There are two sets of criteria that the SBA has historically used to determine affiliation:

- A broader affiliation criteria under **13 CFR § 121.103**; and
- A narrower affiliation criteria under **13 CFR § 121.301**.

The narrower criteria typically apply to the SBA’s loan programs, including Section 7(a) business loans and economic injury disaster loans. Shortly after the passage of the CARES Act on March 27, the NVCA released a helpful and detailed memo providing a preliminary analysis of the affiliation rules for venture-backed companies. Among other things, the memo describes certain typical negative control rights that, if held by a VC, may trigger affiliation among different portfolio companies of that VC. The NVCA’s analysis assumes that the SBA will apply the *narrower* affiliation criteria because the new Paycheck Protection loans are being offered as an expansion of the 7(a) business loan program.

However, the text of the CARES Act, as well as FAQs and guidance subsequently released by the Senate Committee on Small Business & Entrepreneurship, suggest that the *broader* criteria may apply. If the broader criteria were to be required, then in addition to considering negative control rights, companies will also need to consider the relative ownership positions of multiple minority VC investors (among other things) when conducting the affiliation analysis.

The CARES Act requires the SBA to issue regulations to carry out the applicable provisions of the law within 15 days following enactment. Notwithstanding, we are seeking clarity from the SBA as to which criteria will be used to determine affiliation for Paycheck Protection loans.

The CARES Act explicitly provides that the SBA's affiliation rules are waived with respect to the following types of companies:

- Restaurants and hotels (NAICS Code Prefix 72) that employ no more than 500 employees per physical location
- Franchisees
- Companies that receive funding through a Small Business Investment Company (SBIC)

CERTAIN RISKS AND OTHER CONSIDERATIONS

There are a number of risks for venture-backed companies that submit applications for Paycheck Protection loans without first having greater clarity on their eligibility due to the application of the affiliation criteria, including:

- Small business fraud enforcement for false statements and false claims (including possible **civil and criminal penalties** for directors, officers and perhaps VC affiliates, as well as possible “**bad actor**” **status** before the SEC)
- If required by the applicable set of affiliation criteria, filing an application without first removing the potentially problematic protective provisions and minority veto rights specified in available guidance could lead to fraud exposure in an enforcement action
- If the company's eligibility is reviewed by the government after disbursement and is found to have been ineligible, even absent fraud, the company may need to repay the full amount of the loan

Companies with a Paycheck Protection loan are not eligible for the employee retention credit (Section 2301) and companies that have had indebtedness forgiven with respect to a Paycheck Protection loan are not entitled to the payroll tax deferral (Section 2302) available under the CARES Act. The NVCA has sent a letter to the Treasury Department and the IRS requesting a 60-day grace period to repay tax benefits for companies that utilize Sections 2301 or 2302 if they subsequently receive a Paycheck Protection loan or loan forgiveness that would render them ineligible for those tax programs. However, until the regulations are clarified, companies that plan to apply for a Paycheck Protection loan may wish to wait to take the retention credit or payroll tax deferral.

In addition, companies with outstanding debt from banks or venture lenders should also review the consent and subordination requirements of their existing credit facilities before receiving a Paycheck Protection loan to avoid breaching existing debt covenants.

Updates:

- See Gunderson Dettmer alert entitled “[Department of Treasury Releases Paycheck Protection Loan Fact Sheets and Application](#),” published March 31, 2020.
- See Gunderson Dettmer alert entitled “[CARES Act: Business Tax Provisions](#),” published April 1, 2020.
- See Gunderson Dettmer alert entitled “[Department of Treasury Releases Updated Paycheck Protection Program Fact Sheet and Loan Application; SBA Publishes Interim Final Rule on Paycheck Protection Program](#),” published April 3, 2020.

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