

# Many Venture-backed Start-ups May Be Precluded From Small Business Relief Under the CARES Act

March 29, 2020

On March 27, 2020, President Donald Trump signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act of 2020 (the Act). With more than US\$2 trillion in total relief, the Act provides US\$350 billion in support of small businesses.

Among the programs under which these monies will be dispersed is a new Paycheck Protection Program (PPP) under section 7(a) of the Small Business Act, under which as much as US\$10 million per applicant may be available, and a considerable expansion of the Small Business Administration's (SBA) current Economic Injury Disaster Loan (EIDL) program, capped at US\$2 million per applicant.

Unless a given company is in the "accommodation and food" industry; is a franchise operator; or has received assistance from a Small Business Investment Company, the SBA's "affiliation rules," which the SBA uses to determine whether a business affiliation can influence whether a given company qualifies as "small," will determine whether relief under either the PPP (or the EIDL program) will be available to that company.

However, the applicability of these rules to venture-backed start-ups may disable many of them from accessing small business relief under the Act. If, for example, a given start-up has 20 employees, its affiliation with the, perhaps, thousands of other employees at its investors' other portfolio companies could make it unqualified to receive small business loans or grants under the new law.

Basically, the affiliation rule requires a case-by-case, fact-sensitive determination of whether, in this case, a particular investor (or investors) control the other, or have the power to control the other, or whether a third party (or parties) control, or have the power to control, both. Control may be affirmative or negative, with negative control including, but not limited to, instances where a minority shareholder has the ability, under the given start-up's charter, bylaws or shareholder agreement, to prevent a quorum or otherwise block action by the board of directors or shareholders.

If control is established, the given start-up would have to include in its count of employees all of those other employees working in those companies – even those in completely different, unrelated lines of business, in which their venture capital (VC) investor has an equity interest. In many cases, this would result in the portfolio company busting the applicable headcount cap, rendering it unqualified for small business relief under the Act. For the PPP, for example, that cap is 500 employees or the number of employees specified under the SBA's existing regulations, whichever is greater.

The implications for venture-backed start-ups that operate in certain sectors acutely impacted by the coronavirus disease 2019 (COVID-19) outbreak, for example, those in hospitality or travel, and those that support the nation's defense, could be severe. As to the latter category, venture-backed start-ups developing dual-use technologies, such as artificial intelligence/machine learning, quantum and advanced computing, cybersecurity, etc., comprise an important part of the national security innovation base, which as a matter of policy the Department of Defense (DOD) has been relying on as vital sources of innovation needed to maintain technological dominance over future adversaries. From 2014 through 2018, DOD investment in commercial start-ups developing dual-use technologies that align with DOD R&D priorities increased from US\$5.2 billion to almost US\$15 billion, constituting about 20% of overall investment in start-ups in the US. Most of these investments by the DOD have supported Series A and B start-ups. Underestimating the resiliency of such companies, which inherently operate with thin capital structures and limited "runway," carries incalculable – including geopolitical – risk, some industry observers have noted.

At a minimum, requiring the conduct of a potentially complicated "affiliation rules" analysis at the margins for every venture-backed start-up that applies for small business relief under the CARES Act would require time and resources that would unduly delay how quickly they obtain small business relief under the CARES Act and, therefore, potentially debilitate the ecosystem, some experts have noted.

In a letter from March 27, 2020, from the National Venture Capital Association (NVCA) to Treasury Secretary Stephen Mnuchin and Small Business Administration Administrator Jovita Carranza, the NVCA called for Treasury or the SBA to provide clarity or guidance on how the affiliation rules will be interpreted for purposes of the new law's small business programs to provide confidence in venture-backed start-ups that resources will be available and mitigate the layoffs beginning to sweep across the start-up ecosystem.

Possibly impeding the likelihood that policymakers will provide this relief, however, is the political perception that start-ups have access to unlimited capital from their VC investors. In this regard, opponents have cited estimates of "dry powder" available to private equity, including US\$1.5 trillion going into 2020, according to Preqin. However, even as to private equity (an investment class fundamentally different from venture capital), this perception is incorrect, as we describe in our recent alert, [Existing Restrictions May Preclude PE-backed Small Companies From Getting COVID-19 Relief Under the Stimulus Bill](#).

One approach that could address this issue precisely is agency guidance (or legislation in a follow-on COVID-19 stimulus package) that would, at least for the purposes of PPP loans, extend the waiver of the affiliation rules (as the CARES Act does for small companies that operate in the accommodation and food industries) to VC-backed start-ups that operate in NAICS codes that cover sectors important to maintaining the national security innovation base and/or have been acutely impacted by the outbreak.

Depending on for what period of time policymakers have such a waiver cover, such an approach might be perfectly conducive to a ramp-down of current restrictions on social gathering and business operations around the country. It could also reconcile a curious anomaly where the CARES Act was drafted to salvage many low-paying jobs in the hotel and restaurant industries but precludes salvaging jobs with venture-backed (and PE-funded) companies in other sectors that have been at least as severely impacted by the COVID-19 outbreak or are especially salient from a defense and national security perspective.

## Contacts

### **Pablo E. Carrillo**

Of Counsel, Public Policy, Washington DC  
T +1 202 457 6415  
E pablo.carrillo@squirepb.com

### **Danielle Asaad**

Partner, Corporate, Cleveland and New York  
T +1 216 479 8655  
E danielle.asaad@squirepb.com

### **Kirk D. Beckhorn**

Partner, Corporate, Washington DC  
T +1 202 457 7516  
E kirk.beckhorn@squirepb.com