
COVID-19 UPDATE ON CARES ACT: Venture Backed Companies Should Consider "Affiliation" With Venture Capital Fund Investors Prior To Applying For CARES Act Loans

As follow-up to Maynard Cooper's [previous Client Alert](#) about the CARES Act and the availability of Small Business Administration ("SBA") Loans, below is specific information about how *venture backed companies should consider "affiliation" with venture capital fund investors prior to applying for loans under the CARES Act.*

Generally, companies must not have more than 500 employees or the number of employees prescribed by the applicable SBA size standard (whichever is greater) to be eligible for loans under the CARES Act. However, under historical SBA regulations, when determining whether a company exceeds the 500 employee threshold, a company must include the employees of a company's "affiliates" as defined by the SBA, and *a venture capital fund, and potentially other venture capital fund portfolio companies, may be "affiliated" with a company if a venture capital fund (i) has certain control rights*, which are described below, (ii) owns fifty percent (50%) or more of the voting equity interests of a company, (iii) owns the largest block of voting equity interests of a company (even if less than 50%), or (iv) owns one of two substantially equal blocks of voting equity interests that are large compared to the holdings of other equity owners. For clarification, the "affiliation" rules give present effect to options, warrants, and convertible securities.

When a venture capital fund's equity holdings do not create "affiliation", a company and the venture capital fund should analyze the controls, covenants, and rights granted to the venture capital fund in the governing documents of a company because certain controls, covenants, and rights will cause a company to be "affiliated" with the venture capital fund.

Specifically, *if a venture capital fund has the ability to block day-to-day operational decisions of a company, then a venture capital fund has control over a company and is "affiliated" with a company.* Based on case law, we anticipate that a venture capital fund's control over or ability to block any of the following actions of a company, including through a director or manager who is required to approve or can veto such actions, will create "affiliation":

- Making, declaring, or paying distributions or dividends, other than tax distributions.
- Approving a budget or approving capital expenditures outside the budget.
- Hiring and firing officers.
- Establishing or amending an equity incentive plan.
- Incurring or guaranteeing debts or obligations.
- Entering into contracts or joint ventures.

For clarity, *venture capital funds are permitted to have control over certain extraordinary actions and decisions of a company*, and such actions and decisions include the following:

- Selling all or substantially all assets.
- Changing a company's line of business.
- Amending organizational documents.
- Filing for bankruptcy.
- Dissolving a company.
- Increasing, decreasing, or reclassifying the authorized capital of a company.

IN CONCLUSION

A venture backed company and the venture capital fund investor should review a company's governing documents for controls, covenants, and rights granted to a venture capital fund that could trigger "affiliation" prior to applying for a loan under the CARES Act. If the rights granted to a venture capital fund in a company's governance documents trigger "affiliation" and increase a company's employee count above the 500 employee threshold of the CARES Act loan program, then a company and a venture capital fund should consider amending a company's governing documents to mitigate any control rights creating "affiliation" prior to applying for the CARES Act loan.

If you have questions about the CARES Act loan program for venture backed companies and venture capital funds, please contact [Jim Pickle](#), [Dale Gipson](#), [David Kinman](#) or your Maynard Cooper relationship partner.

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