

Existing Restrictions May Preclude Private Equity-backed Small Companies From Getting Relief Under the COVID-19 Stimulus Bill

As we start this week, lawmakers on Capitol Hill continue their efforts to overcome differences on the proposed legislation to provide emergency assistance to individuals, families and businesses affected by the coronavirus disease 2019 (COVID-19) pandemic.

The legislation proposed by the Senate includes approximately US\$300 billion in small business interruption loans, as well as up to US\$500 billion in assistance to distressed businesses, states and localities, either in the form of a direct loan or backstop of losses in lending facilities launched or expanded by the Federal Reserve.

The goal of the proposed legislation is to protect millions of US jobs and businesses in distress due to the COVID-19 pandemic. However, because the proposed legislation would preclude certain small companies that are affiliated with private equity funds, its enactment may likely result in the bankruptcy of many of these small companies and the loss of many US jobs.

The proposed legislation would amend the Small Business Act, which was originally created to support small companies. According to the proposed legislation, in order for a small company to qualify for assistance under the economic stimulus, it must have fewer than 500 employees. But even if a small company has fewer than 500 employees, if it has a majority owner that is a private equity fund, then it must also satisfy the "affiliation rules" under the Small Business Act. The affiliation rules require this small company to add together its employees and the employees of all other companies that the private equity fund also controls or has the power to control (the controls need not actually be exercised to qualify if the power to control exists).

For example, if a private equity fund owns majority interests in three separate and distinct companies that each employs around 200 employees, then according to the affiliation rules, none of these companies would be eligible for a loan under the economic stimulus. The reason is that these companies would be considered affiliates of each other by virtue of having a common owner and, for purposes of the affiliation rules, the number of employees for each company would be deemed to be 600 (and, therefore, over the threshold).

Under the proposed legislation, the affiliation rules would only be waived for companies that: (1) operate hotels, motels or restaurants or provide traveler accommodation or catering services (i.e., companies assigned NAICS industry codes beginning with 72); (2) are franchises; or (3) receive financial assistance from a small venture investment company licensed under the Small Business Investment Act. The proposed waiver of the affiliation rules is limited and would not cover many of the companies that will likely need assistance under the economic stimulus, including, for example, small technology companies and companies that provide oilfield services.

When it comes to private equity funds, there is a misconception that these funds currently have a record amount of cash or "dry powder" that could be used to assist their struggling companies. Dry powder refers to the commitments made by investors to private equity funds to provide cash over a number of years when investment opportunities arise. But dry powder is not cash sitting in the bank accounts of private equity funds because private equity funds work differently than other investment vehicles. Instead, dry powder remains in the accounts of institutional investors, such as pension funds and university endowments, and wealthy individuals who have signed up to invest in the private equity funds.

Investors do not pay private equity funds the money they commit to invest on the first day these investors sign up to be part of these private equity funds. Instead, when a private equity fund finds a suitable investment opportunity, it sends its investors a capital call request and asks its investors to pay a certain amount of cash so that the private equity fund can take advantage of this investment opportunity. Typically, the private equity fund must provide its investors a minimum of 10 business days' notice before these investors are obligated to pay. If these investors fail to satisfy the capital call request, then the private equity fund can resort to various remedies, but these remedies require time and capital to enforce.

Even though the goal of the proposed legislation is to protect US workers impacted by the COVID-19 pandemic, due to the limited waiver of the affiliation rules under the Small Business Act, the proposed legislation may likely preclude many small companies who employ these US workers from getting economic relief because of their affiliation with private equity funds.

Contacts

Danielle Asaad

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

Pablo E. Carrillo

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

Kirk D. Beckhorn

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