# Are Hedge Fund Managers Eligible for CARES Act Benefits?

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The nation waited anxiously to see what the legislative response to the coronavirus would be and even the most optimistic observers were not disappointed. On March 27, 2020, Congress passed the Coronavirus Aid, Relief, and Economic Security (CARES) Act (Act) which fired a $2.2 trillion bazooka at the virus hobbling the U.S. economy. The Act was followed on April 9th by an additional $2.3 trillion salvo fired by the Federal Reserve, highlighted by funding of the "Main Street Lending Program".

Although requirements for benefits are fairly lenient, eligibility issues exist for entities operating in various sectors of the financial services space.

This article will address the eligibility of hedge fund managers for benefits under the most popular and easily accessible program, the Paycheck Protection Program (PPP). We expect to follow with additional articles focusing on the eligibility of family offices and private equity/venture capital firms.

## Background

There are now six separate programs whereby business entities can obtain cash now to assist in maintaining operations, and, most importantly, payroll. Five of them reside within the Act signed into law on March 27th. See *The CARES Act – Five Ways Businesses Can Receive Cash Right Now*. A sixth program, dubbed the Main Street Lending Program, was rolled out by the Federal Reserve on April 9th.

Four of these programs provide for either tax deferrals or low interest loans. The remaining two, the Paycheck Protection Program and the Employee Retention Credit (ERC), both contained within the Act, provide for cash without the obligation to repay. (Yes, free money.)

The ERC program is drastic medicine for dire circumstances, as eligibility is contingent on the subject business experiencing a full or partial shutdown. Since the overwhelming majority of our management companies are not experiencing that level of operational stress, we have been assisting them almost exclusively in applying for benefits under the PPP.

Although a detailed analysis of the PPP is beyond the scope of this discussion, in general terms it provides for a low interest loan to business enterprises in an amount based upon two and a half months of average qualified payroll over the prior 12-month period. To the extent that the loan proceeds are then expended within eight weeks on payroll, rent, utilities, and interest, the loan is forgiven (the free money part).

When crafting the elements of the PPP, Congress intended that small businesses, the backbone of the U.S. economy, were the primary beneficiaries of direct monetary relief. In order to save time and not start from scratch drafting complex legislation, Congress borrowed heavily from the existing statutory framework of the Small Business Administration (SBA). In fact, application for PPP benefits is made directly to, and funds are disbursed initially as loans directly from, approved SBA lenders.

## The Four Main Eligibility Requirements of PPP

The roadmap for PPP eligibility contains four foundational requirements outlined immediately below. Applicant enterprises must be:

- **An operating trade or business** – The enterprise must constitute a trade or business, and have been operational as of February 15, 2020.
- **Not ineligible by statute** – The enterprise must not appear on the SBA list of ineligible businesses and/or activities.

- **A "small business"** – The enterprise must meet the SBA statutory definition of "small."
- **Have a perceived need for relief** – The application should be tied to the pandemic in some way.

### Do Fund Managers Meet These Four Eligibility Requirements?

As one might imagine, the structure, facts and circumstances of each hedge fund group are unique, and unfortunately there is currently no "one size fits all" rule, analysis, or guidance that would apply to all hedge fund managers. The legal ownership structure, aggregate number of employees of all affiliated entities, and the makeup of the underlying investment portfolio constitute key inputs into the analysis.

That being said, let's proceed to examine the four foundational requirements outlined above, through the lens of a hedge fund manager:

1. This first requirement is fairly straightforward. Relief targets businesses as opposed to passive investments, and "operational" means the enterprise must have paid employees and/or independent contractors prior to February 15, 2020.

2. The SBA regulations contain a list of businesses and/or activities that are ineligible for SBA loans. There is currently no prohibition against financial enterprises other than businesses engaged in lending or life insurance.

3. The SBA generally defines a "small business" as employing 500 or fewer workers, including those workers employed by all affiliates. The statutory affiliation tests are numerous and complex, but the Act waived two of the most potentially problematic for hedge fund managers: "common investment" and "economically dependent" affiliation.

   Typically, a hedge fund has no employees of its own (as opposed to the manager). So where the fund portfolio consists of derivatives, currencies, non-original issue debt, publicly traded long/short equity, etc., the affiliation rules are often moot. (See further discussion of affiliation below.)

4. This is arguably the most subjective of the requirements, and to shed light on what is required we quote from the application: "Current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." It seems safe to say that no matter how secure its present circumstances, there is not a business in the U.S. that is not currently faced with significant economic uncertainty looking forward.

   And who can say what level of liquidity cushion a company should have in order to ensure it does not have to scale back operations or lower headcount in the intermediate future? In addition, staffing challenges, working remotely, handling paper, etc. have clearly added logistical hurdles and additional costs to running businesses.

Many believe the broad wording of this requirement was intentional … inviting a liberal interpretation to maximize approvals.

### Further Discussion of Affiliation (#3 above)

The two affiliation tests not waived and most relevant to the context of a hedge fund manager are "ownership" and "common management".

> **Ownership affiliation** – An applicant is deemed affiliated with any owner that owns or controls more than 50% of the voting equity (referred to as "vertical affiliation"). Where the management company is the applicant, this should only be an issue if it, in turn, is owned by another enterprise with employees of its own, or perhaps if it manages a fund of funds portfolio consisting of over 50% ownership in lower tier operating companies.
>
> **Common management affiliation** – An applicant is deemed affiliated with other enterprises that are under common ownership or control (referred to as "horizontal affiliation"). This could conceivably occur where a management company applicant is owned or controlled along with other companies by a common parent, but this would be atypical for a hedge fund manager. This problem occurs more frequently in the context of lower-tier portfolio company applicants owned or

controlled by private equity or venture capital firms. (The eligibility of private equity and venture capital firms for benefits under the Act will be addressed in a future article.)

We wrap up the discussion of affiliation with the observation that most management companies are straight “service for fee” businesses, with any equity in the fund (arising from either direct investment or accumulated carried interest) held in a separate general partner or managing member entity. The overall analysis must take into account common ownership of these two referenced entities, in addition to the situation where the management fee and the carried interest reside in the same entity.

### A Note on the Application

Ultimately, the decision whether to extend a PPP loan to a hedge fund manager resides with the SBA lender taking the application. As such, it is strongly recommended that each application for subject benefits contain full disclosure and transparency with respect to the nature and extent of the applicant’s operations. Anecdotally, we already know of hedge fund management company applications that have been approved.

### The Privacy Issue

Applicants should be aware that names and financial data submitted may be reachable through future Freedom of Information Act requests or potentially from other sources. Consequently, some of our management company clients have expressed trepidation in applying for benefits out of privacy concerns, or even from fear of adverse publicity or other reprisal from the news media. Our experience has been that the weight given to this potentiality varies considerably across our universe of clients.

### Conclusion

One can see that the analysis of eligibility for benefits under the Act can be complex, and there is room for reasonable minds to differ with respect to interpretation and/or outcome.

But notwithstanding the vagaries, and absent future guidance to the contrary, a solid footing exists in support of a hedge fund managers’ statutory right to PPP benefits.

### Contact Us

The Financial Services Group at PKF O’Connor Davies is available to assist with all aspects of the federal CARES Act stimulus programs. For more information, please visit our COVID-19 Resource Center or contact:

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### About PKF O'Connor Davies