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SBA Issues Interim Final Rule Addressing PPP Eligibility of Hedge Funds and Private Equity

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The Interim Final Rule (IFR) issued by the Small Business Administration (SBA) on April 24, 2020, addressed several Paycheck Protection Program (PPP) related matters, including the eligibility of hedge funds and private equity firms for PPP relief.

The key takeaways for these industries are as follows:

Hedge Funds and Private Equity Firms Are Not Eligible for PPP Benefits

In support of this position, the stated rationale is that such firms are primarily engaged in "investment or speculation" and, as such, they are ineligible for benefits under the existing SBA framework. And although the IFR references solely "hedge funds" and "private equity," the rationale put forth appears sufficiently broad to reach fund of funds and family offices, as well as any company in the business of managing investments. (We should add here that in referencing "hedge funds" we assume that the SBA meant the fund managers, since funds themselves typically have no payroll.)

The rationale relied upon in the IFR presumably starts with the list of SBA ineligible businesses which includes "speculative businesses (such as oil wildcatting)," as well as "financial businesses" that are engaged in "lending" or "life insurance."

In the context of a hedge fund management company applicant, a literal reading of the SBA list of ineligible businesses would not appear to support their conclusion. Typically, a management company is neither a fund investor, nor is its fee contingent on the investment performance of the fund portfolio. It is, instead, a stand-alone fee-for-service trade or business and, as such, the logic of the "speculative" reference is suspect. And clearly, such companies are not engaged in lending or life insurance.

With respect to private equity firms, they too are often deemed to be operating trades or businesses for both legal and tax purposes, notwithstanding the fact that they may hold some level of direct ownership in their underlying portfolio companies. So from an analytical standpoint, it can be argued that they stand in the same position as hedge fund management companies.

Perhaps anticipating this scrutiny and thus perceiving the need to backstop its position, the SBA goes on to state that it believes that Congress simply did not intend for these types of businesses to receive PPP benefits. To this we have no response except to say that growing pushback from the media and the public at large may simply have ultimately swayed the government.

In the final analysis, if the stated intent of Congress (as communicated through the SBA in the subject IFR) is to deny PPP benefits to hedge funds and private equity firms, these industries must take heed.

Private Equity Portfolio Companies Are Eligible for PPP Benefits, but Are Subject to the SBA "Affiliation" Rules

The private equity industry had lobbied hard for waiver of the affiliation rules when analyzing the eligibility of private equity investment silos, but it evidently did not prevail. As such, the determination of whether a portfolio company has 500 or fewer employees, as required by the statutory framework, must take into account both horizontal as well as vertical affiliation. This means that the employees of all the companies in a private equity company portfolio could potentially be considered common employees, and therefore kill eligibility.

We must admit that this outcome was not unanticipated.

A Note on Venture Capital

The subject IFR conspicuously avoided the mention of venture capital firms in its otherwise sweeping prohibition(s), and we have already heard this posited as a hopeful sign that favorable guidance may be forthcoming. We recommend caution in this regard, as the rationale cited by the SBA in denying PPP eligibility for private equity firms could certainly be applied with equal force to venture capital.

With respect to their portfolio holdings and similar to the private equity space, the venture capital industry lobbied hard for relaxation of the affiliation rules. The National Venture Capital Association was active in this regard, and it was rumored that Nancy Pelosi herself wrote a letter to Treasury advocating the position. But here again, and absent guidance to the contrary, we believe the assumption must remain that "affiliation" will not be waived.

The IFR Cautions All Applicants to "Carefully Review" the Certification Referencing the Need for the Application

Specifically, the PPP application requires the following certification: "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." The exact meaning of this certification has been the subject of intense debate, not only with respect to financial services related companies but also with respect to applications across the board. The question is: what level of present economic need is actually required in order to sustain a PPP application, *if any*?

And although the IFR cautions all applicants to "carefully review" their application in light of this requirement, it inexplicably offers no further insight with respect to the interpretation or application of the standard.

Various arguments have been put forth in defense of a liberal interpretation of the somewhat oblique phraseology. For example, the certification expressly begins with the phrase "current economic *uncertainty*" (emphasis added). Although a small company may have the financial wherewithal to function today, including the ability to obtain credit and/or collect outstanding receivables, there is no assurance that will be the case as time passes. Applying for funds today could allow a business to operate without having to actively conserve capital. This could forestall or avoid altogether the otherwise prudent course of action to build a cash cushion in the face of uncertainty. If, on the other hand, the subject certification had begun with the phrase "current economic *conditions*," a more restrictive interpretation might be warranted as such language would more strongly tie the application to imminent economic adversity facing the applicant. But as we know, such express language was not chosen.

Another argument put forth in defense of a liberal interpretation of the subject certification is that other entity relief programs in the CARES Act expressly require significant economic distress be present at the time of the application. For example, the Employee Retention Credit program requires that an applicant be experiencing at least a partial shutdown or 50% reduction in revenue in order to be eligible for benefits. Congress instead chose no such requirement as a pre-condition for PPP benefits … the inference being that none was intended.

Reasonable minds can and will likely continue to differ in their interpretations.

May 7, 2020 Safe Harbor for the Return of PPP Funding

Tacitly acknowledging the above-referenced confusion in assessing eligibility for PPP relief, the SBA takes a "no harm, no foul" approach in the IFR. All businesses are given until May 7, 2020 to withdraw applications or return funds already received if guidance in the subject IFR would lead them to reassess their eligibility. In that event, applications will be deemed to have been made in "good faith," any error being further deemed to be the result of "misunderstanding or misapplication" of the intended standard.

Conclusion

In light of the subject IFR, we are now recommending that our management company and private equity company clients withdraw pending PPP applications and/or return PPP funds already received prior to the May 7, 2020 safe harbor deadline.

It appears that private equity portfolio companies can proceed with PPP applications and/or retain funds already received, but only after a thorough analysis of the applicability of the SBA affiliation rules.

And although not specifically mentioned in the subject guidance, we believe that venture capital firms, fund of funds, family offices, and investment management firms in general should tread cautiously in applying for PPP relief.

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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