Proskauer

Small Business Administration Gets (Very) Big — SBA Loan Programs Under Title I of the CARES Act

March 31, 2020

The Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") approved by Congress and signed by the President on March 27, 2020 will provide approximately $2 trillion in financial assistance to businesses and individuals to combat the effects of the COVID-19 pandemic. This client alert focuses on key provisions of Title I of the CARES Act (Keeping American Workers Paid and Employed Act) that we believe are particularly relevant for asset managers and other businesses able to meet the small business eligibility requirements for the Small Business Administration (the "SBA") loan programs that have been expanded under the CARES Act.

These programs are: (i) the Paycheck Protection Program ("PPP"), which is an expansion of the SBA's 7(a) loan program, and (ii) the Economic Injury Disaster Loan program (the "EIDL") of the SBA. Up to $359 billion of loans are expected to be made available under the PPP and EIDL. While the SBA eligibility standards have been relaxed for these programs, a number of noteworthy limitations apply, in particular the apparent continued applicability of the SBA's affiliation rules (which, in their current state, are likely to make it challenging for many private equity-backed companies to take advantage of the PPP and/or the EIDL).

For more information about the Federal Reserve System's $500 billion liquidity program that is geared toward certain larger businesses under Title IV of the CARES Act, see here.

Paycheck Protection Program (PPP)

Expanded Eligibility and Uses for 7(a) Loans

Title I of the CARES Act expands the existing 7(a) SBA loan program, which is the SBA's primary program for providing financial assistance to small businesses. Under the PPP, the following businesses (including certain not-for-profits) will generally be eligible until June 30, 2020 for loans to cover operational costs such as payroll, group health benefits, mortgage interest payments, rent, utilities, and interest payments on pre-existing debt obligations:

- businesses that generally have, together with their affiliates: (i) not more than 500 employees (or if the employee head count set forth in a list provided by the SBA in respect of the NAICS industry code of such business is higher, such higher number); [1]
- hospitality businesses with not more than 500 employees per location;
- independent contractors; and
- other businesses that meet the existing SBA small business size standards (based on employee headcount or average annual receipts for the prior 3 completed fiscal years as set forth in a list provided by the SBA in respect of the NAICS industry code of such business).

Employees are included in total head counts whether they are engaged on a full, part-time, or other basis.

Certain businesses – including real estate investment firms holding property for investment purposes, financial businesses primarily engaged in the business of lending (such as banks, finance companies, and factors), and gaming companies with one-third or more of their annual gross income derived from gambling operations – are ineligible to receive standard 7(a) loans under the existing SBA rules. While it appears that such businesses are likewise ineligible to receive PPP loans, the SBA's impending rules and regulations implementing PPP may ultimately provide clarity.

Affiliation Rules

When determining whether the applicable size standards are met for SBA loan eligibility, SBA affiliation rules require a business to aggregate the number of its employees (or receipts), together with all employees (or receipts) of its domestic and foreign affiliates.

Affiliates in this context means any entities controlled by, or under common control with, the applicant business. The SBA affiliation rules broadly define "control", and historically, the SBA has broadly construed its affiliation rules. In determining affiliation, the SBA exercises its judgment on a case-by-case basis and considers a number of factors and circumstances set forth in the SBA regulations when assessing control including ownership, management, previous relationships with or ties to another concern, and contractual relationships. Further, in determining affiliation, the SBA applies an unrebuttable presumption that a person owning 50 percent or more of the voting stock of a business is an affiliate of that business. In addition, any entity owning a large block of voting stock, or otherwise having governance rights, negative or positive, enabling it to exercise control over the business, may also be an affiliate.

In the context of an applicant business with a private fund investor, the affiliation rules will generally require an analysis of the affiliate relationship between the investing fund and the applicant business, as well as the private fund and its other portfolio companies to determine if the employee head-count and/or receipts of the sponsor and/or other portfolio companies of the sponsor will potentially cause the applicant to exceed the SBA size thresholds. The CARES Act waives these rules for only three specified types of businesses: (i) businesses in the accommodation and food services sector (NAICS code beginning with 72), (ii) franchises assigned a franchise identifier code by the SBA, and (iii) businesses receiving financial assistance from an approved Small Business Investment Company (e.g., from an SBIC fund).

PPP Loan Size & Terms

The CARES Act provides that the maximum size of a PPP loan is 2.5 times the average monthly "payroll cost" during the year prior to the loan (plus the amount of any EIDL being refinanced that was received prior to availability of PPP loans), subject to a cap of $10 million. In addition to employee compensation, payroll costs include certain paid vacation and leave, cash tips, severance payments, group healthcare benefits, retirement benefits, payroll taxes, and payments to independent contractors. Payroll costs do not include the amount of an employee's compensation that exceeds $100,000.

The loans will carry a maximum annual interest rate of 4%, waive all SBA fees, and offer complete deferment of principal and interest payments for at least six months (but no more than one year). The CARES Act does not require collateral or personal guarantees for a PPP loan and, importantly, waives the standard 7(a) loan requirement that applicants be unable to obtain credit elsewhere. Further, PPP loans will be unsecured, non-recourse to the borrower, and are effectively junior to any existing secured debt instruments.

The SBA does not directly make PPP loans (or 7(a) loans generally) to an applicant business. Rather, SBA-licensed lenders issue the loans and the SBA back-stops such loans through guarantees. PPP loans are fully guaranteed by the federal government, which is an increase to the guarantee percentages under the existing SBA 7(a) loan program.

PPP Loan Forgiveness

Loans are eligible for forgiveness up to the amount of a borrower's payroll, mortgage interest, rent, and utility payments made during the eight-week period following the origination of a loan under the PPP, not to exceed the principal amount of the loan (no forgiveness for interest). Eligible businesses with tipped employees may receive forgiveness for additional wages paid to those employees.

The loan forgiveness amount is subject to reduction as follows in connection with reductions in employment and employee compensation that are not restored by June 30, 2020:

- reduced proportionally to any reduction in the monthly average number of full-time equivalent employees during the eight-week period following PPP loan origination as compared to the monthly average in a prior period selected by the borrower (either February 15 to June 30, 2019 or January 1 to February 29, 2020); and
- with respect to any employee who earned $100,000 or less in 2019, reduced by any reduction in pay during the eight-week period following PPP loan origination in excess of 25% of their compensation during the most recent full quarter in which they were employed prior to the origination of such PPP loan.

Loans forgiven under the CARES Act will not give rise to cancellation of indebtedness income for U.S. federal income tax purposes and will not result in a loss of tax attributes. Amounts not forgiven continue to be guaranteed and will have a maximum maturity date of 10 years from the date the borrower applied for loan forgiveness. (For further insight on the key tax provisions of the CARES Act, please also see the Proskauer blog, *Tax Talks:* https://www.proskauertaxtalks.com/).

50% Employee Retention Credit for Employers Closed Due to COVID-19

The CARES Act provides that the refundable payroll tax credit equal to 50% of "qualified wages" is not available for companies receiving PPP loans under the CARES Act.

Emergency Economic Injury Disaster Loans (EIDLs) and Advances

The CARES Act also expands the SBA's Disaster Loan Program through December 31, 2020 by, among other things, permitting eligible businesses to apply for an EIDL to receive a $10,000 advance from the SBA within three days of submitting their application. There is no obligation to repay the advance, even if the EIDL is subsequently denied (though it will offset permitted loan forgiveness for applicants that receive PPP loans). The advance can be used for any purpose permitted for EIDLs, including payroll expenses to retain employees during business interruptions, meeting increased costs due to supply chain interruptions, making rent, or mortgage payments.

Under the SBA's existing Disaster Loan Program, EIDLs can provide up to $2 million of financial assistance, with actual loan amounts based on the amount of economic injury. The CARES Act waives several SBA requirements for obtaining EIDLs, including personal guaranty requirements for loans of $200,000 or less and the prior "1 year in business prior to the disaster" requirement. As long as the business was in operation as of January 31, 2020, it will be eligible. The CARES Act does not, however, waive collateral requirements which the SBA may impose on EIDLs of greater than $25,000. Further, the SBA's streamlined online "*COVID-19 Economic Injury Disaster Loan Application*" (https://covid19relief.sba.gov/#/), which was released on March 29, 2020, provides that a business owned by another entity will generally be required to provide a guarantee from its parent entity.

Obtaining an EIDL does not preclude a business from also applying for a PPP loan (or vice versa). However, a business may not apply for a PPP loan or EIDL to cover duplicative expenditures already applied for or received under the other covered loan. A business with an outstanding EIDL extended after January 31, 2020 and before the date the PPP loans become available may refinance its existing EIDL with the proceeds of a PPP loan under the CARES Act, but EIDLs obtained *after* PPP loans become available will not to be eligible for such a refinancing.

EIDL eligibility requirements are substantially similar to the eligibility requirements under the SBA's 7(a) loan program (*i.e.*, businesses with not more than 500 employees or existing small business concerns) and are subject to the same affiliation rules. The special waivers of affiliation rules and the "per physical location" standard for hospitality businesses applicable under the PPP do not apply to EIDLs. As with PPP loans, the CARES Act waives the requirement that applicants be unable to obtain credit elsewhere.

In addition to understanding the terms and conditions of the PPP and the EIDL loan programs (not all of which are described above), parties considering applying for a PPP loan or EIDL must review their existing commitments and contractual arrangements, in particular, any existing loan documents to determine (i) what consents may be required under such documents, and (ii) what other actions they may be required to take under such documents (i.e. notice obligations).

Rule Making and Implementation

The SBA must issue regulations to implement Title I (including the PPP) without regard to notice and comment requirements within 15 days from enactment of the CARES Act under emergency rulemaking authority. In order to fully assess how a party may be impacted by and become eligible for assistance under this landmark legislation it will be imperative to review and understand the SBA's rules, regulations and processes implementing the CARES Act, particularly those concerning the PPP.

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On Tuesday evening, March 31, 2020 as this article was going to publication, the U.S. Treasury Department ("Treasury") and the SBA released an information sheet (the "Fact Sheet") and sample application form for the PPP.

The Fact Sheet provides important guidance for the PPP, including key upcoming dates when applicants can begin to apply for PPP loans through participating SBA lenders:[2]

- business and sole proprietorships as soon as **April 3, 2020**; and
- independent contractors and self-employed individuals as soon as **April 10, 2020**.

The guidance and content of the Fact Sheet include some significant deviations from the CARES Act itself which are highlighted below. Although the Fact Sheet provides additional insight into how Treasury and the SBA will apply the CARES Act, it remains to be seen whether the SBA will promulgate additional rules and regulations governing the PPP as previously anticipated.

Maximum Loan Amount. The CARES Act provides that the maximum PPP loan a borrower can receive is equal to the lesser of (i) 2.5x TTM average monthly payroll costs (plus any outstanding amount under a pre-existing EIDLs made on or after January 31, 2020 and before PPP loans are available) and (ii) $10 million. **The sample application indicates that, rather than the trailing twelve month average as of the time of the application, (non-seasonal) applicant businesses will use the average monthly payroll for 2019.**

Loan Forgiveness. Under the CARES Act a PPP loan will be eligible for forgiveness in an amount not to exceed the sum of permitted payroll costs, interest payments on mortgages existing before February 15, 2020, rent with respect to leases in place before February 15, 2020, and payments for utilities for which service began before February 15, 2020, in each case incurred or paid within 8 weeks from the origination of the PPP loan. **The Fact Sheet indicates that "due to likely high subscription, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs." This statement merits additional consideration when applying for PPP loans to cover non-payroll costs during the covered 8-week period as a portion of such costs may not be eligible for loan forgiveness.**

Interest Rate. The CARES Act provides for a maximum interest rate on PPP loans of 4.0% per annum. **The FACT Sheet specifies that the interest rate on PPP loans will be a 0.50% fixed rate.**

Maturity Date. The CARES Act provides that the maximum maturity would be 10 years from the date on which a borrower applies for loan forgiveness. **The Fact Sheet indicates that maturity will be 2 years from the date on which a borrower applies for loan forgiveness.**

Foreign Ownership. **The sample application form states that if any 20% or greater owner of the business is not a U.S. citizen or someone with "lawful permanent resident status," the PPP loan will not be approved.** There is no such restriction on foreign ownership in the CARES Act or under the SBA's existing 7(a) loan program.

Additional Insights.

- *Affiliation* **–** The Fact Sheet and sample application confirm that the SBA's affiliation standards indeed apply to all businesses other than those expressly exempt from those standards under the CARES Act (businesses (1) in the hotel and food services industries, (2) that are franchises in the SBA's Franchise Directory, or (3) that receive financial assistance from SBA-licensed small business investment companies (e.g., an SBIC fund)).
- *Ineligible Industries* – Existing SBA regulations provide that businesses in certain industries (including gambling, investment or lending activities) are not eligible for loans under 7(a) of the Small Business Act (*see* 13 C.F.R. § 120.110 for a list of ineligible businesses). The sample application does not indicate whether such regulations are applicable to PPP loans. The application also does not include any questions aimed at verifying the industry of the applicant. While this may support the argument that the ineligible industries provision does not apply to loans under the PPP, there is nothing in the CARES Act or any other documents issued by the SBA that affirmatively states that this provision would not apply.
- *Application by Owners* **–** The sample application also makes clear that for businesses seeking PPP loans, in addition to the applicant business, an application must also be completed by each owner[3] of 20% or greater of the applicant. The applicant business and each such owner must make certain certifications, including: (i) that current economic uncertainty makes the loan request necessary to support the ongoing operations of the applicant business; and (ii) that the loan proceeds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments.

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Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. We will continue to evaluate the CARES Act, related regulations and any subsequent legislation to provide our clients guidance in real time. Please visit our Coronavirus Resource Center for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

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[1] The SBA's industry size standards (as to both employee headcount and average annual receipts) can be found in 13 C.F.R. §121.201. Note that the highest size standard for number of employees for any industry is 1,500 employees.

[2] A list of active SBA-approved lenders can be found here: https://www.sba.gov/article/2020/mar/02/100-most-active-sba-7a-lenders. In addition to existing SBA-approved participating lenders, businesses can also apply through participating federally insured depository institutions, federally insured credit unions, and Farm Credit System institutions.

[3] The sample application indicates that all of the following are considered owners of the applicant business under 13 C.F.R. § 120.10: (i) for a sole proprietorship, the sole proprietor; (ii) for a partnership, all general partners, and all limited partners owning 20% or more of the equity of the partnership; (iii) for a corporation, all owners of 20% or more of the corporation; (iv) for limited liability companies, all members owning 20% or more of the LLC; and (v) any Trustor (if the applicant is owned by a trust).

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