COVID-19: UPDATED Q&A FOR SBA EMERGENCY LOANS

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The following questions and answers are based on Title I to the Coronavirus Aid, Relief, and Economic Security ("CARES") Act, Pub.116-136, which was signed into law by President Trump on March 27, 2020, as supplemented by further clarification and regulations promulgated by the U.S. Small Business Administration (the "SBA") including: (i) Paycheck Protection Program Loans, Frequently Asked Questions dated as of April 13, 2020 (the "FAQs"), (ii) Interim Final Rule dated as of April 2, 2020 ("IFR-1"); (iii) Interim Final Rule dated as of April 3, 2020, regarding application of the affiliation rules ("IFR-2") and (iv) a letter from John W. Klein, Associate General Counsel for Procurement law of the SBA dated April 4, 2020, regarding "Size Eligibility and Affiliation Under the CARES Act" (the "AGC Letter"). The CARES Act amends the Small Business Act (15 U.S.C. Section 636(a)) ("SBA Act") to provide emergency loan relief to certain eligible borrowers via the Paycheck Protection Program ("PPP").

QUESTION: WHAT ARE THE SBA PPP LOANS?

Answer: SBA emergency loans are being offered pursuant to a new "Paycheck Protection Program" added to Section 7(a) the SBA Act as a new paragraph (36). This program is specifically designed to get cash to small and medium-sized businesses to cover immediate losses resulting from government-mandated closures, supply chain interruption, and lack of staffing. These loans, referred to herein as "PPP Loans," are to be disbursed by current SBA lender participants (including banks, community credit capital corporations, credit unions, and other newly-approved SBA-approved lenders (collectively, "SBA Lenders"). The proceeds of the PPP Loans may be used only for certain specified purposes during the "Covered Period," which begins on February 15, 2020, and ends on June 30, 2020. The total amount of loans to be supported by the SBA, including the loans for the PPP, is $349 billion.

QUESTION: HOW MUCH CAN BE BORROWED UNDER THE PAYCHECK PROTECTION PROGRAM?

Answer: There will be limits to the maximum amount of each loan, which is generally determined by (i) taking the average of monthly payroll costs for such business and multiplying it by a factor of 2.5[1] and (ii) adding in the proceeds of any SBA Emergency Injury Disaster Loan ("EIDL") provided between January 30, 2020, and April 3, 2020 (less the amount of any EIDL grant, which is expressly forgiven),[2] relating to the COVID-19 outbreak. To the extent this formula would arrive at an amount in excess of $10 million, the PPP Loan is capped at $10 million.

QUESTION: WHAT CAN THE PAYCHECK PROTECTION PROGRAM PPP LOANS BE USED FOR?

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Answer: The PPP Loans are to be utilized by businesses to offset immediate and direct costs relating to COVID-19 closures and staffing depletions. The permitted uses for SBA loan proceeds are payroll costs, rents (for leases entered into prior to February 15, 2020), interest on mortgages for office space entered into prior to February 15, 2020 (but not any payment of principal), utilities, interest on any other debt obligations that were incurred prior to February 2020, and, refinancing of the proceedings of an SBA EIDL loan utilized for payroll costs (this refinancing is mandatory).[3] It is clarified that at least 75 percent% of the PPP loan proceeds must be used for payroll costs, and that this 75 percent is not just for purposes of loan forgiveness (discussed below): "As with the similar limitation on the forgiveness amount explained earlier, the Administrator, in consultation with the Secretary [of Treasury], has determined that 75 is an appropriate percentage that will align this element of the program with the loan amount, 75% of which is equivalent to eight weeks of payroll."[4]

QUESTION: HOW ARE PAYROLL COSTS DEFINED UNDER THE PAYCHECK PROTECTION PROGRAM?

Answer: The term "payroll costs" is specifically defined to include: (a) compensation to employees in the form of salary, wages, commissions or similar compensation, (b) cash tips (based on records or, in the absence of records, a "good-faith estimate" made by the employer), (c) payment for vacation, parental, family, medical, or sick leave, (d) allowance for separation or dismissal, (e) payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums, payment of state and local taxes assessed on compensation of employees. However, the following are specifically excluded: (1) the compensation of any individual employee, in excess of $100,000 per year as prorated for the measured period (only the excess of cash compensation is excluded and the excess is calculated without taking into account the employer paid non-cash benefits),[5] (2) compensation of any employee whose principal place of residence is outside of the United States, (3) the employer's portion of federal employment taxes, including FICA costs (recently clarified to be excluded over the measured period and not just from February 15, 2020, and June 30, 2020),[6] and (4) sick and family leave wages for which a credit is allowed under sections 7001 and 7003 of the Families First Coronavirus Response Act Employers should not include independent contractors as part of the Payroll Costs, since independent contractors may file separately for their own PPP loans.[7]

QUESTION: ARE THERE ANY SPECIAL CERTIFICATION REQUIREMENTS IN ORDER TO BE A BORROWER UNDER THE PAYCHECK PROTECTION PROGRAM?

Answer: The current draft provides very specific requirements in order for potential borrowers to utilize the PPP, including:

- The borrower must have been in operation on February 15, 2020, and either had (x) employees for whom the borrower paid salary and payroll taxes, or (y) paid independent contractors as reported on IRS Form 1099-MISC, and "current economic uncertainty makes this loan request necessary to support the ongoing operations of the applicant."
- Borrowers must also certify as to the use of covered loan proceeds, retention of employees, and they must also confirm that they do not have duplicative applications pending with the SBA under the PPP.[8]

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QUESTION: WHY ARE THE PPP LOANS FUNDED BY THE SBA LENDERS INSTEAD OF THE SBA FUNDING THE BUSINESSES DIRECTLY?

Answer: SBA loans under Section 7(a) of the SBA Act are funded by the SBA Lenders, but they are supported by the SBA in the form of an SBA guarantee. In the event of a default, the notes of the borrower are assigned from the SBA Lenders to the SBA. This means that if the loans default, the SBA will repay the disbursing SBA Lender and take over the default and enforcement of the loans.

QUESTIONS: WHY IS THE MEDIA DESCRIBING THE PROGRAM AS A GRANT? HOW DOES THE PAYCHECK PROTECTION PROGRAM DIFFER FROM A GRANT?

Answer: It differs from a grant in that repayment of the PPP Loan is expected unless it is forgiven. The CARES Act allows for certain amounts of the PPP Loans to be forgiven (such amount, the "Forgiven Portion") under specified circumstances. When a PPP Loan is forgiven, the SBA remits to the SBA Lender the Forgiven Portion and interest accrued to date thereon.

QUESTION: HOW IS THE FORGIVEN PORTION CALCULATED?

Answer: The CARES Act contains several provisions in order to calculate the Forgiven Portion, and the SBA Lender makes a report and the determination of the Forgiven Portion. The Forgiven Portion is then treated, by the SBA, as if it were subject to an SBA guarantee and this Forgiven Portion (together with interest) is paid by the SBA to the SBA lender.[9]

In order to be eligible for forgiveness, the borrower must evidence that the disbursed funds were used for one of the following purposes: (a) payroll costs over the eight week period from when the PPP Loan is disbursed; (b) interest on mortgage payments (but not principal) incurred prior to February 15, 2020; (c) rent pursuant to a lease entered into prior to February 15, 2020; or (d) utilities pursuant to agreements entered into prior to February 15, 2020; provided that amounts paid to items other that "payroll costs" cannot exceed 25 percent of the total amount forgiven. Additionally, although funds may be utilized for refinancing EIDL amounts and interest on other indebtedness incurred prior to February 15, 2020, unless the EIDL amounts are payroll costs, these amounts are also not forgiven and also subject to the 25 percent limitation.

The borrower must present specified documentation evidencing the use of funds.

The Forgiven Portion can be up to the full principal amount of the PPP Loan and any accrued interest.[10]

The borrower must show that employees were retained and that wages of employees were not reduced by more than 25 percent.[11] If there have been significant layoffs and wage declines, the amount to be forgiven will be reduced. The CARES Act recognizes that certain actions may have been taken during the period from February 15, 2020, until April 26, 2020[12] (the "Crisis Period"). If the reduction in employees and wages have been eliminated by June 30, 2020 (the "Recovery Period"), the layoffs and reductions made during the Crisis Period are disregarded when determining the Forgiven Portion. This is to incentivize borrowers to (i) rehire employees and (ii) reinstate pre-Crisis Period wages during the Recovery Period.

QUESTION: WHAT HAPPENS TO THE PORTION OF THE COVERED LOAN THAT IS NOT FORGIVEN?

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Answer: Remaining amounts will be reflected in a loan obligation, guaranteed by the SBA, which will have a maximum term of two years from the date on which the borrower applies for loan forgiveness as described above.

QUESTION: ARE THE PPP LOANS SECURED?

Answer: There are no collateral requirements or personal guarantees. The CARES Act does provide for recourse to shareholders, members, and partners of an eligible recipient to the extent that the proceeds of the PPP Loans are used for an unauthorized purpose and for fraudulent applications.

QUESTION: WILL MY BUSINESS QUALIFY?

Answer: Prior to the enactment of the bill, SBA 7(a) loan funding has generally been for small business concerns. "Small business concerns" that satisfy the existing statutory and regulatory definition under section 3 of the SBA Act are eligible to apply for a PPP Loan.[13] The SBA provides an employee-based or revenue-based size standard corresponding to its primary industry.[14] Additionally, a business can qualify for the Paycheck Protection Program as a small business concern if it met both tests in SBA's "alternative size standard" as of March 27, 2020, after applying all applicable affiliation rules.[15]

The PPP, however, expands the eligibility requirements to include as an eligible recipient those business concerns with up to 500 employees or, if greater, the number of employees established by the SBA "in which the business concern, nonprofit organization or veterans' organization operates." The FAQs clarify that Borrowers may use average monthly payroll numbers either (x) from the previous 12 months or (y) from calendar year 2019 for purposes of applying an employee-based size standard.[16] Sole proprietors and self-employed individuals operating without a formal legal entity are expressly included so long as they submit payroll tax filings submitted to the IRS. Specifically excluded are not-for-profits eligible for Medicaid (other than those providing certain addiction services).

QUESTION: DO SBA AFFILIATION RULES APPLY TO THE PAYCHECK PROTECTION PROGRAM? HOW DO I DETERMINE IF MY BUSINESS IS AFFILIATED WITH ANY OTHER BUSINESSES?

Answer: Yes, all Borrowers must apply the affiliation rules set forth in IFR-2.[17] This is the responsibility of the Borrower and the SBA Lenders are not required to do the diligence or make an independent determination. For purposes of the Payroll Protection Program, the SBA considers concerns and entities to be affiliates of each other when one controls or has the power to control the other, or a third party or parties has the power to control both, regardless of whether that control actually is exercised.

Control can be based on equity ownership; stock options, convertible securities, and agreements to merge (including agreements in principle), which will be treated as exercised and given present effect; common management; or an identity of interest between close relatives with identical or substantially identical business or economic interests. A minority shareholder will still be deemed to be in control if that individual or entity has the ability, under the concern's charter, by-laws, or shareholder's agreement to prevent a quorum or otherwise block action by the board of directors or shareholders.[18] If the minority shareholder irrevocably waives such negative control, the shareholder will no longer be deemed an affiliate.[19] An applicant will be considered affiliated with entities or concerns that the individuals or entities that have control over it also control. A Professional Employer

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Organization ("PEO") is not considered for affiliation purposes, even if state law requires the EIN of the PEO to be reported.

The CARES ACT contains three specific exemptions from the affiliation rules:[20] (1) business concerns that are hospitality- and food service-related, reported under Section 72 of the North American Industry Classification System ("NAICS" and such businesses, "72 NAICS Business Concerns"), (2) business concerns operating as a franchise, and (3) business concerns that have received financial assistance from small business investment companies.[21] The FAQs clarify that, with respect to franchises, the PPP loans should be accessed by each franchisee — not the franchisor on behalf its franchises. Additionally, 72 NAICS Business Concerns qualify so long as they employ not more than 500 employees per physical location.[22]

QUESTION: DO SBA BUSINESS LIMITATIONS APPLY TO THE PAYCHECK PROTECTION PROGRAM?

Answer: Yes. Although the CARES Act was silent on this, IFR-1 clarified that "businesses that are not eligible for PPP loans are identified in 13 C.F.R. 110 and described further in SBA's Standard Operating Procedure (SOP) 50 10, except that the nonprofit organizations authorized under the CARES Act (limited to 501 (3) (c) and 501 (3) (19) organizations) are still eligible." Some of the businesses that are prohibited include: passive real estate development companies, financial companies in the business of lending, life insurance companies, businesses engaged in lobbying activities and businesses engaged in illegal activities.[23]

QUESTION: HOW MUCH WILL A COVERED LOAN COST? WHAT FEES ARE PAYABLE TO THE SBA AND THE SBA LENDERS?

Answer: The PPP Loans will bear an interest rate of 1 percent. SBA Lenders will be paid an administration fee by the SBA of (a) 5 percent for loans up to $350,000, (b) three percent for loans up to $ 2 million, and (c) one percent for PPP Loans over $2 million. Administrative fees usually payable to the SBA will be waived.

A link to the latest PPP Term Sheet may be found here.

FOOTNOTES

[1] The formula is adjusted for "seasonal businesses" and businesses that do not have a full operating year of monthly payroll costs. The SBA PPP sample application makes it clear that the 2019 payroll may be used or payroll costs looking back twelve months from the application.

[2] IFR-1, "How do I calculate the maximum amount I can borrow?" pg. 8.

[3] IFR-1, "How can PPP loans be used?" pg. 16.

[4] IFR-1, "How can PPP loans be used?" p. 16.

[5] FAQs, Question 7, "The Cares Act excluded from the definition of payroll costs any employee compensation in excess of an annual salary of $100,000. Does that exclusion apply to all employee benefits of monetary value?" p. 3.

[6] FAQs, Question 16, "How should a borrower account for federal taxes when determining its payroll costs for

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purposes of the maximum loan amount, allowable uses of a PPP loan and the amount of a loan that may be forgiven?" p. 5.

[7] FAQs, Question 15, Should payments that an eligible borrower made to an independent contractor or sole proprietor be included in calculations of the eligible borrower's payroll costs? p. 5.

[8] Knowingly making a false statement to obtain a guaranteed loan from the SBA is punishable under 18 USC 1001 and 3571 and, if such statements are also made to a federally insured institution, under 18 USC 1014.

[9] IFR-1, "Can my PPP loan be forgiven in whole or in part?" pg. 13.

[10] IRF-1, "Can my PPP loan be forgiven in whole or in part?" p. 13.

[11] For purposes of this provision, "employee" does not include any employee making $100,000 or more a year. CARES Act Section 1106 (d)(3)(B).

[12] The CARES ACT specified 30 days following the passage of the CARES Act in Section 1106(d)(5)(B)(i)(I).

[13] FAQs, Question 2, "Are small concerns (as defined in section 3 of the [SBA] Act required to have 500 or fewer employees to be eligible borrowers in the PPP?" p.1; and AGC letter, "Affiliation Exceptions for Business Concerns."

[14] Current industry size standards may be found here.

[15] FAQs, Question 2, "Are small business concerns (as defined in section 3 of the SBA) required to have 500 or fewer employees to be eligible borrower in the PPP?" p.1-2 and AGC letter, "Size Standards."

[16] FAQs, Question14, "What time period should borrowers use to determine their number of employees and payroll costs to calculate their maximum loan amounts?" p. 4.

[17] FAQs, Question 5, "Are borrowers required to apply SBA's affiliation rules under 13 C.F.R. 121.301(f)?", pg. 2

[18] Affiliation Rules Applicable to US SBA Paycheck Protection Program, item (1), IFR-2, "How do SBA's affiliation rules affect my eligibility and apply to me under the PPP?" p. 5.

[19] FAQs, Question 6, "If a minority shareholder irrevocably gives up those rights, is it still considered to be an affiliate of the business?" p.3.

[20] IFR-2, Footnote 1, citing to Section 7(a)(36)(D)(iv)) of the SBA Act, as added by Section 1102 of the CARES Act and AGC Letter, "Affiliation Exceptions for Business Concerns" clarifying that the exemption from affiliation applies to both 13 C.F.R. Section 121.103 and 13 C.F.R. Section 301(f) which governs affiliation in the SBA loan programs (which applies to a PPP loan). The CARES Act only specifically refers to 13 C.F.R. 121.103.

[21] The AGC Letter, in its paragraph "Waiver of Affiliation for SBIC Investment" concludes that "the waiver to affiliation applies to such entities regardless of the amount of investment from an SBIC and regardless of whether there are also non-SBIC investors."

[22] Section 7(a)(36)(D)(iii) of the SBA Act, as added by Section 1102 0f the CARES Act.

[23] IFN-1, "How do I determine if I am ineligible?" p. 7. A link to 13 C.F.R. 110 may be found here.

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