

SBA Paycheck Protection Program

By **Lowell A. Citron**, **Michael A. "Bux" Buxbaum**, **Theodore C. Sica**, and **Kimberly E. Lomot**

Certain provisions of the Coronavirus/Covid-19 economic stimulus legislation are subject to the issuance of government regulations and other government action, thus certain details regarding the legislation may be clarified or added.

One of the critical components of the Coronavirus Aid, Relief, and Economic Security Act of 2020 (the "CARES Act") is a new type of US Small Business Administration (SBA) loan program known as the Paycheck Protection Program (the "Program"). This program, which has been added as a new program under Section 7(a) of the Small Business Act, encourages employers to keep employees on the payroll and keep the doors open by providing loans (called "covered loans") with several attractive features:

- interest on covered loans is capped at 4% per annum (although, based on a bank call with the SBA, we understand that this cap may change);
- the commencement of the repayment period is deferred for a minimum of six months and a maximum of one year;
- the maturity of the loans are up to 10 years but the guidance is that the maturity on most loans will be much shorter than 10 years;
- the maximum principal amount is generally based on a formula that is the lesser of (i) 2.5 times average monthly payroll costs (which includes salary, commission, cash tips, vacation, family, medical, sick leave, separation payments, group health care insurance premiums, retirement benefits and state and local tax assessed on employee compensation, however, excluding any compensation to an employee in excess of an annual salary of \$100,000) incurred

in the one-year period before the covered loan is made and (ii) \$10 million (the limit on conventional Section 7(a) loans is currently \$5 million);

- no personal guaranty or collateral is required (conventional Section 7(a) loans require all available collateral including personal guaranties and blanket asset pledges);
- covered loans will be made on a non-recourse basis, unless proceeds are used for an unauthorized purpose; and
- so long as the proceeds of a covered loan are used by the borrower to pay payroll, rent, utilities, and other eligible expenses incurred during the eight-week period immediately following the origination of the loan, a portion of the covered loan will be *permanently forgiven*.

Notably for lenders, loans made under the Program are eligible to be sold in the secondary market consistent with rules under the current SBA Section 7(a) program, and the CARES Act mandates a zero percent risk-weight of these loans for purposes of banking regulators' risk-based capital requirements. The CARES Act also has provisions regulating lender compensation upon loan origination.

Prior to the CARES Act, the SBA was authorized to provide loans in an original principal amount not exceeding \$2,000,000 to small businesses with fewer than 500 employees ("disaster loans") as part of the Disaster Loan Program. In addition to the Program described in this Alert, the CARES Act also expands the SBA's existing Disaster Loan Program. Covered loans and disaster loans may be applied for at the same time, but a borrower is only permitted to close one of the loans.

This alert provides guidance on the following topics relating to the Program:

- What is a covered loan?
- Who is an eligible recipient?
- What expenditures count toward the amount of loan forgiveness?
- How is the amount of loan forgiveness calculated?
- How is a covered loan obtained and loan forgiveness granted?

What is a covered loan?

A covered loan is a loan by an authorized SBA 7(a) lender to an eligible recipient¹ made during the "covered period." The "covered period" began on February 15, 2020 and extends until June 30, 2020. Covered loans must be originated by June 30, 2020 and, considering that 7(a) lenders may face a flood of applications, every effort should be made to apply for a covered loan as soon as possible. We anticipate that businesses will be able to apply for a covered loan approximately a week after the CARES Act becomes law.

Who is an "eligible recipient"?

Eligible recipients include any business concern, non-profit organization, veterans organization, sole proprietor, independent contractor, and self-employed individual, among others (each a "subject business"). Each subject business is eligible to receive a covered loan provided that it employs not more than the greater of 500 employees (includes full-time, part-time, and those employed on other bases) or if applicable, the size standard in number of employees established by the SBA for the industry in which the business operates. While the CARES Act does not specifically address the SBA's maximum revenue requirements, we expect that the SBA may limit some businesses eligibility based on revenue in accordance with the SBA's existing revenue requirements for the industry in which the business operates (**please see the SBA sizing tool based on number of employees and revenue**). Additionally, the CARES Act is silent on whether or not the existing list of ineligible types of businesses for SBA 7(a) loans (as outlined in 13 C.F.R. §120.110) remain applicable to the PPP. We expect to hear further guidance on this issue from the SBA in the coming week. For businesses in the hospitality and dining industries (NAICS Class 72) with more than one physical location, if the business

employs 500 or fewer employees *per location*, the business will be an eligible business.

The SBA Section 7(a) program of which the Program is now a part contains affiliation and common control rules (found in 13 CFR §121.103) that will in many circumstances cause the employees of any particular business to be aggregated with the employees of all other businesses that are deemed to be under common control with that business. This will be particularly important for portfolio companies of investment funds and will disqualify some otherwise needy businesses from eligibility under the Program. *However*, the SBA affiliation rules are waived for businesses in the food service sector (NAICS Class 72), certain franchises, and businesses receiving financial assistance from a company licensed under Section 301 of the Small Business Investment Act.

What expenditures count toward the amount of loan forgiveness?

Consistent with the purposes of the CARES Act to help keep businesses open and employees on the payroll beginning as soon as possible, the expenses outlined below that count toward loan forgiveness are those that are incurred during the eight-week period immediately following the date the covered loan is originated. The amount of any loan forgiveness will not be considered gross income under the Internal Revenue Code, although state and local taxing authorities may or may not follow this rule. Note that the eight-week period may run past June 30, 2020 as long as the covered loan is originated before that date.

The following expenditures ("Qualifying Expenditures") incurred during the eight-week period count toward loan forgiveness:

- payroll costs (which includes, among other things, W-2 and 1099 income);
- payments of interest on any mortgage obligation (which shall not include any prepayment of or payment of principal on a mortgage obligation);
- rent (including rent under a lease agreement); and
- utilities.

Notably, "payroll costs" exclude compensation, prorated for the eight-week period, of employees and independent contractors to the extent that

¹ See "Who is an eligible recipient."

compensation exceeds \$100,000.

Use of Covered Loan Proceeds.

Covered loans are a variant of conventional Section 7(a) loans, so proceeds of covered loans under the Program may also be used for working capital, refinancing existing debt, purchases of equipment, and other uses permitted for Section 7(a) loans generally. However, to the extent proceeds of covered loans are not utilized for Qualifying Expenditures during the eight-week period following the origination of the covered loan, loan forgiveness is unavailable. Borrowers applying for covered loans under the Program must certify that "funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments," but the statute does not specify what portion of the funds must be so utilized. Regulations may provide guidance on this question.

How is the amount of loan forgiveness calculated?

The maximum principal amount of a covered loan is the lesser of (i) \$10,000,000 and (ii) 2.5 times the average monthly payroll during the 12-month period ending on the date the covered loan is made (different formulas apply for (A) seasonal employers and (B) employers not in business between February 15, 2019 and June 30, 2019). **This spreadsheet** indicates the maximum principal amount of a covered loan available to a borrower (other than those described in (A) or (B) above) for various employee headcounts and average annual payrolls. Up to 100% of this maximum amount can be forgiven by utilizing the covered loan proceeds solely for Qualifying Expenditures during the aforementioned eight-week period following the origination of the covered loan. However, loan forgiveness is subject to two additional limitations, one based on reduction in number of employees (the "Headcount Adjustment"), the other based on compensation reduction (the "Compensation Adjustment"), each computed with reference to certain specified measuring periods.

The Headcount Adjustment reduces the amount of forgiveness to an amount equal (a) to the amount otherwise available for forgiveness multiplied by (b) a fraction, the numerator of which is the average number of full time equivalent employees (FTEs) during the eight-week period immediately following the origination of the covered loan, and the denominator of which is the average number

of FTEs per month during, *at the borrower's election*, either (i) the period February 15, 2019 through June 30, 2019, or (ii) the period January 1, 2020 through February 29, 2020.

The Compensation Adjustment reduces the amount of forgiveness otherwise available by the aggregate amount of salary reductions (determined on an employee-by-employee basis) effectuated during the eight-week period to the extent a reduction exceeds 25% of an employee's salary or wages during the most recent full quarter prior to the commencement of the eight-week period. Employees who are compensated at a rate in excess of \$100,000 per year are not considered, that is, no amount of salary reduction for employees earning over \$100,000 per year has the effect of reducing loan forgiveness.

The reductions in loan forgiveness attributable to the Headcount Adjustment and the Compensation Adjustment can be mitigated, or even eliminated, to the extent that (i) in the case of a headcount reduction occurring during the period that began on February 15, 2020 and ends April 26, 2020, the borrower reverses that reduction by June 30, 2020 (for example, by re-hiring furloughed employees or hiring new employees), and/or (ii) in the case of a salary reduction occurring in that window period that began on February 15, 2020 and ends 30 days after the enactment of the CARES Act, the reduction is similarly reversed by June 30, 2020. In other words, to the extent that loan forgiveness would otherwise be reduced by a Headcount Adjustment and/or a Compensation Adjustment, the borrower can mitigate the effect of each by re-hiring employees and restoring salary cuts, respectively, before June 30, 2020.

For purposes of computing the Headcount Adjustment and the Compensation Adjustment, independent contractors are not considered employees.

How is a covered loan obtained and loan forgiveness granted?

To obtain a covered loan, a borrower applies to a participating lender, who generally will be the same lenders who currently offer SBA Section 7(a) loans. We recommend that businesses contact their existing banks as soon as possible to see if they offer SBA Section 7(a) loans as many lenders have indicated that their existing customers will receive priority on their applications. Following disbursement of a covered loan and expiration of the eight-week measuring period, the borrower submits

to the lender certain required documentation along with a certification outlining the amount requested to be forgiven together with proof of payment of qualified expenditures and a certification that the application documentation is true and correct whereupon, within 60 days thereafter, the lender should issue a formal decision forgiving the portion of the covered loan set forth in the application.

To see our other material related to the pandemic, please visit the Coronavirus/ COVID-19: Facts, Insights & Resources page of our website by clicking [here](#).

Contacts

Please contact the listed attorneys for further information on the matters discussed herein.

LOWELL A. CITRON

Partner
Chair, Debt Financing
T: 646.414.6819
lcitron@lowenstein.com

MICHAEL A. "BUX" BUXBAUM

Partner
T: 646.414.6820
mbuxbaum@lowenstein.com

THEODORE C. SICA

Partner
T: 212.419.5841
tsica@lowenstein.com

KIMBERLY E. LOMOT

Counsel
T: 973.597.2430
klomot@lowenstein.com