Chapman Client Alert

April 1, 2020
(Updating a March 31, 2020 Client Alert)

Current Issues Relevant to Our Clients

Small Business Administration: The Paycheck Protection Program under the CARES Act

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Stability Act, known as the CARES Act, became law. It is the third piece of federal legislation related to the 2020 coronavirus pandemic and provides approximately $2 trillion in sweeping emergency measures to mitigate the resulting public health and economic crisis facing individuals, families, and businesses. The cornerstone of the CARES Act's relief package for small businesses is the Paycheck Protection Program (PPP), under which the Small Business Administration (SBA) will guarantee up to $349 billion in small business loans. The following questions and answers describe the major features of the PPP as we know them at the current time. Please note that this Client Alert has been updated from our March 31, 2020 Client Alert to reflect guidance from the U.S. Treasury Department and the SBA on March 31, 2020 (Initial PPP Guidance).[1]

What Is the PPP?

In ordinary course, the SBA provides financial assistance to small businesses primarily through its flagship lending program known as the Section 7(a) program, pursuant to which the SBA connects small businesses and SBA-approved private lenders and then typically guarantees a large portion of the resulting small business loans. The PPP is a new Section 7(a) program designed to help small businesses keep their workers employed by providing financial support for payroll and certain other expenses through June 30, 2020.

It significantly expands the SBA's Section 7(a) lending activities to include, among things, a 100% guarantee of PPP loans, a waiver of certain collateral and personal guarantee requirements applicable to other types of Section 7(a) loans, short-term forbearance, and the possibility of loan forgiveness.

Who Can Borrow under the PPP?

The following small businesses that were operational as of February 15, 2020 are eligible for PPP loans:

- a small business with fewer than 500 employees,[2] regardless of revenue
- a small business that otherwise meets the SBA's size requirements
- sole proprietors, independent contractors, and self-employed individuals who regularly carry on any trade or business, including those in the "gig economy"
- a hospitality or food service business (those with an NAICS code beginning with 72) if it has fewer than 500 employees per physical location
- a non-profit entity under Section 501(c)(3) of the Internal Revenue Code of 1986, as amended (Internal Revenue Code), so long as that entity has fewer than 500 employees
- a veterans organization under Section 501(c)(19) of the Internal Revenue Code that meets the SBA's size requirements
- a tribal business entity that meets the SBA's size requirements

It is important to note that the SBA applies complex affiliation requirements, which generally require a business to aggregate all of its parent companies, affiliates, and subsidiaries in determining whether the business meets the small business size requirements and borrowing criteria. These affiliation

1 The Initial PPP Guidance is at https://home.treasury.gov/policy-issues/top-priorities/cares-act/assistance-for-small-businesses

2 In this context, the definition of "employees" includes all employees, whether full-time, part-time, or some other status.

requirements still generally apply under the PPP, except that they are waived for:

- a hotel or food service business classified under an NAICS code beginning with 72
- a business operating as a franchise that is an SBA-assigned franchise identifier code
- any entity that receives financial assistance from a company licensed under Section 301 of the Small Business Investment Act of 1958, as amended

In addition, the CARES Act rescinds the SBA's interim final affiliation rules published on February 10, 2020.

The Initial PPP Guidance notes that additional guidance may be released as appropriate.

What Underwriting is Required for a PPP Loan?

Existing SBA lending programs generally require lenders to, among other things, assess the borrower's repayment ability, require a personal guarantee and collateral to secure the loan, and receive a certification from the borrower that it cannot secure the credit elsewhere. Many of these requirements appear to be significantly relaxed under the PPP, with the Initial PPP Guidance providing the following underwriting verification requirements:

- the business was in operation on February 15, 2020;
- the business had employees for whom the business paid salaries and payroll taxes or paid an independent contractor; and
- the dollar amount of average monthly payroll costs.

In addition, the Initial PPP Guidance requires lenders to comply with applicable Bank Secrecy Act requirements.

Lenders are encouraged to process and disburse PPP loans that prioritize small businesses and entities:

- in underserved and rural markets, including veterans and the military community;
- owned and controlled by socially and economically disadvantaged individuals and women; and
- in operation for less than two (2) years.

Are There Any Collateral, Personal Guarantee, Origination Fee, or other Similar Requirements for PPP Loans?

No. The CARES Act waives the SBA's ordinary course requirements regarding pledges of collateral, prepayment penalties, personal guarantees, borrower and lender fees, and other traditional SBA loan requirements. Lenders and their agents may not collect any fees from an applicant. The requirement to certify that the borrower could not secure credit elsewhere also is waived.

The Initial PPP Guidance emphasizes, however, that "if the proceeds are used for fraudulent purposes, the U.S. government will pursue criminal charges against" the related borrower.

What Does a Borrower Need to Provide to a Lender to Obtain a PPP Loan?

A borrower must complete the PPP loan application.[3] The application lists a number of factors that could disqualify a small business from the PPP, including:

- whether the related business or any of its owners are presently involved in any bankruptcy
- whether, in connection with federal government contracting activities, the related business or any of its owners are presently suspended, debarred, proposed for debarment, or declared ineligible
- whether the related business or any of its owners were voluntarily excluded from the PPP by a federal agency
- whether the related business or any of its owners, or any business owned or controlled by any of them, have ever taken a loan from the SBA or another federal agency that is currently delinquent or that has defaulted in the last seven (7) years and caused a loss to the government

3 A sample application can be found at https://www.sba.gov/document/sba-form--paycheck-protection-program-ppp-sample-application-form

- whether the related business or any 20% owner thereof is currently subject to criminal charges, incarcerated, on probation, or on parole
- whether the related business or any 20% owner thereof have, within the last seven (7) years, been convicted or otherwise punished for a felony or misdemeanor crime against a minor

The loan application and supporting payroll documentation must be submitted to an approved lender by June 30, 2020, which is when the PPP closes. However, the Initial PPP Guidance encourages businesses to apply as quickly as possible due to concerns that high demand will cause the PPP to reach its funding cap of $349 billion prior to that date. It also notes that time needed by lenders to process applications is another reason to apply as quickly as possible.

In addition to the application and payroll documentation, a borrower must make the following good-faith certifications:

- current economic uncertainty makes the loan necessary to support its ongoing operations;
- the funds will be used to retain workers and maintain payroll or make mortgage, lease, and utility payments;
- it has not and will not receive another loan under the PPP;
- it will provide to the lender documentation that verifies the number of full-time equivalent employees on payroll and the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight (8) weeks after receiving the PPP loan;
- loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities. Due to the likely high subscription in the PPP, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs;
- all the information it provides in its application and in all supporting documents and forms is true and accurate. Knowingly making a false statement to obtain a loan under the PPP is punishable by law;
- it acknowledges that the lender will calculate the eligible loan amount using the tax documents it submitted, and it affirms that the tax documents are identical to those it submitted to the IRS; and
- it understands, acknowledges, and agrees that the lender can share the tax information with the SBA's authorized representatives, including authorized representatives of the SBA's Office of Inspector General, for the purpose of compliance with SBA loan program requirements and all SBA reviews.

What Are the Terms of a PPP Loan, Including Principal, Interest, and Maturity?

The Initial PPP Guidance emphasizes that "***[a]ll loan terms will be the same for everyone.***"

The CARES Act provides that PPP loans may be up to $10 million. An eligible borrower may receive (a) the lesser of (i) $10 million and (ii) 2.5 times its "payroll costs" plus (b) any outstanding amount owed by the borrower under an SBA Economic Injury Disaster Loan (EIDL) received by it between January 31, 2020 and the date that PPP loans become available.

According to the Initial PPP Guidance, however, PPP loans may be "up to two months of [a borrower's] average monthly payroll costs from the last year plus an additional 25% of that amount," subject to the $10 million cap. There is no reference in this provision of the Initial PPP Guidance to EIDLs. Whether this different formulation or exclusion of EIDLs has a meaningful impact on the PPP remains unclear, but we will provide updated guidance in this area as it becomes available.

Payroll costs are generally defined as the borrower's average monthly payroll for the 12 months before the PPP loan is made. They broadly ***include***:

- salary, wages, commissions, or tips (capped at $100,000 on an annualized basis for each employee);
- employee benefits;[4]
- state and local taxes assessed on compensation; and
- for a sole proprietor or independent contractor, wages, commissions, income, or net earnings from self-

4 These include (i) costs for vacation, parental, family, medical, or sick leave, (ii) allowance for separation or dismissal, (iii) payments required for the provisions of group health care benefits including insurance premiums, and (iv) payment of any retirement.

employment, capped at $100,000 on an annualized basis for each employee.

The Initial PPP Guidance does not address the following two additional CARES Act's exclusions to payroll costs:

- compensation for employees residing outside the U.S.
- certain other leave benefits with respect to which credits are otherwise available under the CARES Act.

The Initial PPP Guidance also does not clarify the CARES Act's special rules relating to the calculation of payroll costs for seasonal businesses and those that were not in operation on February 15, 2020.

The Initial PPP Guidance sets the interest rate for a PPP loan at 0.50%, which is significantly lower than the maximum interest rate of 4% established by the CARES Act.

As noted above, many traditional SBA requirements are waived, including the collateral and personal guarantee requirements and the need to show that credit is unavailable elsewhere.

Pursuant to the CARES Act, PPP loans have a maximum maturity of 10 years, although the Initial PPP Guidance provides that PPP loans will have two-year maturities. There are no prepayment penalties. As discussed in more detail below, PPP loans may be deferred and, in some cases, forgiven.

PPP loans are non-recourse to the borrower and are 100% guaranteed by the federal government (as compared to the SBA's 75% guarantee of traditional Section 7(a) loans).

When Will PPL Loan Applications Be Accepted?

Starting **April 3, 2020**, ***small businesses and sole proprietorships*** can apply for and receive PPP loans to cover their payroll and certain other expenses ***through existing SBA lenders***.

Starting **April 10, 2020**, ***independent contractors and self-employed individuals*** can apply for and receive PPP loans to cover their payroll and other certain expenses ***through existing SBA lenders***.

Other regulated lenders will be available to make these loans as soon as they are approved and enrolled in the PPP.

The Initial PPP Guidance encourages businesses to consult with their local lenders to find out if those lenders are participating in the PPP.

What Is the Deadline to Apply for a PPP Loan?

June 30, 2020.

Although the PPP closes on that date, the Initial PPP Guidance encourages businesses to apply as quickly as possible due to concerns that high demand will cause the PPP to reach its funding cap of $349 billion prior to that date. It also notes that time needed by lenders to process applications is another reason to apply as quickly as possible.

How Many PPP Loans Can a Borrower Obtain?

Only one.

Who Can Be a PPP Lender?

- existing SBA-approved lenders
- federally insured depository institutions
- federally insured credit unions
- Farm Credit System institutions

The Initial PPP Guidance further notes that "[a] broad set of additional lenders can begin making loans as soon as they are approved and enrolled in the [PPP]" and that new lenders should submit their application to delegatedauthority@sba.gov to apply with the SBA.

As discussed more fully below, however, it remains unclear whether "additional lenders" refers only to federally insured institutions listed above that are not existing SBA-approved lenders.

The Initial PPP Guidance does not fully resolve who can be a PPP lender or whether every lender (other than existing SBA lenders) require prior approval from the SBA to make PPP loans. Phrases in the guidance such as "other regulated lenders" and "broad set of additional lenders" contribute to this ambiguity, but, after assessing the full context of the Initial PPP Guidance, we believe the following represents how different categories of lenders will be treated with respect to the PPP:

- ***Existing SBA lenders***: have delegated authority "to speedily process PPP loans," starting on April 3, 2020 for some borrowers and April 10, 2020 for others.

- ***Federally insured depository institutions, federally insured credit unions, and Farm Credit System institutions***: explicitly eligible under the Initial PPP Guidance to participate in the PPP, but it appears that these entities may first need to apply to become an SBA-approved lender. Once approved by the SBA and enrolled in the program, these entities would have the same delegated authority as existing SBA lenders, so they can make and process PPP loans without a separate SBA review.

- ***Any other type of lender***: not explicitly eligible under the Initial PPP Guidance to participate in the PPP. The Initial PPP Guidance does not specify whether such lenders may nevertheless apply to be SBA-approved lenders.

In addition, the Initial PPP Guidance does not indicate whether the SBA will employ a streamlined approval process for PPP lenders, or whether the traditional approval process will be used.

The CARES Act further provides that the U.S. Treasury Department, in consultation with the SBA, and the Farm Credit Administration will establish criteria for insured depository institutions, insured credit unions, insured Farm Credit System institutions, and other lenders not already participating in SBA lending programs to make PPP loans until the expiration of the COVID-19 national emergency. The U.S. Treasury Department will establish the terms and conditions of participating in this additional loan program, but participation cannot compromise a lender's safety and soundness and the program's terms and conditions generally need to be consistent with those applicable to PPP loans made under Section 7(a). The Initial PPP Guidance does not reference this CARES Act provision.

We expect that lender eligibility requirements will continue to be addressed in upcoming guidance by the relevant federal agencies and we will provide updated information to you as it becomes available.

Can Agents Be Used to Assist with PPP Activities?

Yes. The Initial PPP Guidance provides that an agent can be, among other examples, "[s]omeone who assists a lender with originating, disbursing, servicing, liquidating, or litigating SBA loans" or "[a]ny other individual or entity representing an applicant by conducting business with the SBA."

Agents may not collect any fees from an applicant. Instead, agents will be compensated by the lender, out of the lender fees paid to it by the SBA. Under the Initial PPP Guidance, an agent's fee appears to be, based on the disbursed loan amount: 1.00% for PPP loans up to $350,000; 0.50% for PPP loans greater than $350,000 to $2 million; and 0.25% for PPP loans greater than $2 million.

How Can PPP Loans Be Used?

A PPP loan may be used for the following:

- payroll costs, including benefits;

- ***interest*** on mortgage obligations incurred before February 15, 2020;

- rent payments under lease agreements in force before February 15, 2020; and

- utilities for which service began before February 15, 2020.

In this regard, there are some differences between the Initial PPP Guidance and the related CARES Act provisions. Most notable is that the CARES Act provides that PPP loan proceeds may properly be used for the following:

- to pay interest on existing debt; and

- to repay or refinance an EIDL incurred by the borrower between January 31, 2020 and the date on which PPP loans become available.

We will provide updated guidance in this area as it becomes available.

Can PPP Loans Be Deferred and/or Forgiven?

Yes, PPP loans may be deferred and, in some cases, forgiven.

The CARES Act presumes that a business will have been adversely impacted by COVID-19 if it was in operation on February 15, 2020 and has a pending or approved PPP loan application on or after enactment of the CARES Act. Accordingly, for any such business, lenders are required to defer payments of principal, interest, and fees on PPP loans for six (6) months and up to one (1) year. The SBA is required to provide guidance on such deferments within 30 days of enactment of the CARES Act.

The Initial PPP Guidance directs lenders to defer all payments on PPP loans for six (6) months, but notes that interest will continue to accrue on the PPP loan during the deferral period. It is unclear whether the SBA will provide additional deferment guidance in the future.

As an incentive to retain employees or rehire laid off employees, the CARES Act provides that a PPP loan may be forgiven. Under the Initial PPP Guidance, a PPP loan amount will be forgiven as long as:

- the PPP loan proceeds are used to cover payroll costs (using the same definition used to determine loan eligibility, including with respect to the $100,000 cap on an annualized basis for each employee) and most mortgage interest, rent, and utilities payments that are incurred during the 8-week period after the PPP loan origination date; and

- the borrower's full-time equivalent employee and compensation levels are maintained.

Please note that the above-referenced mortgage payments relate only to mortgage ***interest***, and not to principal payments or prepayments on a mortgage.

The Initial PPP Guidance warns that, "[d]ue to likely high subscription, it is anticipated that not more than 25% of the forgiven amount may be for non-payroll costs." This provision, if implemented, would represent a departure from the CARES Act.

The loan forgiveness amount of a PPP loan cannot exceed that loan's principal amount. Further, any loan forgiveness amount will ***not*** be treated as gross income for federal income tax purposes. Finally, if a PPP loan has a balance remaining after any loan forgiveness, the SBA will guarantee that balance.

To further incent retention of employees at existing salaries, the amount of loan forgiveness calculated above will be reduced if there is a decrease in the number of full-time equivalent employees or a decrease in salaries and wages by more than 25% for any employee that made less than $100,000 on an annualized basis in 2019. If a borrower reduced the number of full-time equivalent employees or salary levels between February 15, 2020 and April 26, 2020, those reductions will not decrease the amount of loan forgiveness ***if*** the borrower restores the number of full-time equivalent employees and the salary levels by June 30, 2020.

With respect to the above provision, the Initial PPP Guidance uses the term "full-time employees" instead of the term "full-time equivalent employees" used in the CARES Act. We will continue to monitor this apparent inconsistency and provide updated information as it becomes available, but we believe it remains most prudent to reference the statutory language.

A borrower must apply for loan forgiveness to the lender servicing the loan, with detailed documentation requirements to verify staffing and salary levels and other eligible expenses, and the lender will have 60 days from receipt of the application to decide whether to grant (and the amount of) the forgiveness. The amount of any such loan forgiveness, including accrued interest, will be remitted by the SBA to the lender within 90 days of the lender determining how much to forgive, thereby limiting exposure to the lender. If a lender requests that the SBA purchase any forgiven amounts on a PPP loan or pool of PPP loans in anticipation of granting forgiveness, then the SBA will remit the forgiven amount within 15 days. Further, if a lender receives verified documentation from a borrower, the CARES Act provides that the lender will be held harmless from enforcement actions or penalties imposed by the SBA.

Are There Any Capital or Other Benefits for Lenders in the PPP?

The CARES Act provides a number of incentives for lenders participating in the PPP, including favorable regulatory treatment and reimbursement for processing fees:

- PPP loans on a lender's balance sheet will receive a 0% risk weight under the risk-based capital requirements applied by the Federal Reserve, the OCC, the FDIC, and the NCUA

- federally insured banks and federally insured credit unions will not have to report a PPP loan that is modified for COVID-19-related reasons as a troubled debt restructuring, until required to do so by the applicable federal financial regulatory agency

- the SBA will reimburse lenders for PPP loan processing fees, based on the disbursed loan amount: 5% for PPP loans up to $350,000; 3% for PPP loans greater than $350,000 and less than $2 million; and 1% for PPP loans of $2 million or more

Can PPP Loans Be Sold on the Secondary Market?

Yes. If a PPP loan is sold on the secondary market, and the related investor does not approve a permitted deferment, the SBA must repurchase that loan and provide the deferral. The SBA will not collect any fee for any guarantee sold into the secondary market.

For More Information

We will be monitoring developments in the PPP, as well as other SBA lending programs to address the coronavirus pandemic, and we will advise you of any changes or updated information.

If you would like further information concerning the matters discussed in this article or any matter related to the COVID-19 pandemic, please visit our COVID-19 Insights webpage or contact the Chapman attorney with whom you regularly work.

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