

COVID-19 Alert #9 – The Paycheck Protection Program: Considerations For Businesses

Dated: April 6, 2020

In this alert we address the following questions regarding the Paycheck Protection Program (“PPP”) for small businesses:

- What are the basics?
- Who is eligible?
- What are the affiliation rules?
- What can the proceeds of PPP loans be used for?
- How should eligible borrowers calculate the maximum amount of loans to which they may be entitled?
- How do eligible businesses apply for PPP loans?
- How much of the loan will be forgiven?
- How do PPP loans work with my existing debt documentation?
- What are the risks of taking assistance if ineligible?

Introduction

On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security Act, or the “CARES Act,” following approval by the House of Representatives and the Senate. The CARES Act is the biggest economic rescue package in U.S. history. The law is lengthy and complicated, with new developments occurring often as the government continues to issue guidance to assist with the implementation of the law.

In an effort to better serve our clients during this turbulent time, we have created a COVID-19 Client Service Task Force. In addition to monitoring frequent developments, our intent is to help boards of directors, management, in-house counsel, lenders, investors, entrepreneurs and founders successfully navigate this very fluid environment. For additional guidance and a list of some of the Stradling attorneys who are knowledgeable about the Act and monitoring developments closely, please visit: <http://www.sycr.com/COVID-19-Client-Service-Resource-Center/>.

Our lawyers can help on a wide range of issues, including labor and employment, healthcare, real estate, litigation, tax and the various lending provisions of the Act. Please note that as government pronouncements, interpretations and clarifications are happening frequently, we encourage you to contact the Stradling attorneys in the above link and note that this memorandum only represents information available to us at the time of writing.

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This memo is designed to highlight some of the key components of the Paycheck Protection Program. In short, the Paycheck Protection Program temporarily permits the Small Business Administration (“SBA”) to guarantee 100% of small business loans to eligible borrowers and provides for forgiveness of up to the full principal amount of qualifying loans so guaranteed. The goal is to provide relief to America’s small businesses quickly in light of the devastating impact of the COVID-19 emergency, utilizing banks, credit unions and possibly other lenders to facilitate funding.

Paycheck Protection Program

What are the basics?

In short, the Federal government is, through loans made by banks and credit unions, covering payroll and certain other expenses for 8 weeks for small and medium-sized companies that employ less than 500 people, and if at the end of that period, the employer hasn’t reduced payroll numbers and continues to pay its employees making less than \$100,000 at least 75% of their historical wages, then the Federal government will repay the amount spent over such 8 week period on payroll and other permitted expenses up to the full amount of the loan. Additional summary points include:

- \$349,000,000,000 has been allocated for these loans during the period February 15, 2020 to June 30, 2020
- The program is first come, first served. Borrowers have been inundating lenders with requests even before April 3, 2020 (the first official date for lenders to process applications) and the SBA has indicated that it anticipates that the funding cap will be reached quickly.
- 1% interest rate (the CARES Act provides for a maximum 4% interest rate, which was then announced to be 0.5%, and which, as per SBA guidance on April 2, 2020, settled at 1%, which is indicative of how quickly things can change from day to day in this space)
- 2 year maturity (the CARES Act provides for up to a 10 year maturity, but as per SBA guidance on April 2, 2020, the maturity was announced to be 2 years)
- No personal guarantees
- No collateral required
- No prepayment penalties or fees
- No principal or interest payments required for six months following the date of disbursement
- Loan forgiveness, subject to conditions (see *“How much of the loan will be forgiven?”* below)

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Who is eligible?

- Must have 500 or fewer employees whose principal place of business is the United States, or, if applicable, the number of employees established by the SBA for the industry in which the applicable entity operates. See below under “Affiliation Rules” for issues troubling VC-backed borrowers and PE-backed borrowers regarding the “500 or fewer employees” test, and “Employee Counting Rules” relevant to completed acquisitions and dispositions in the last twelve months.
- Must also have been in business since February 15, 2020.
- Sole proprietors, independent contractors and certain self-employed individuals may also be eligible.

Please note that businesses that do not qualify for PPP loans may still be able to obtain loans pursuant to the Coronavirus Economic Stabilization Act of 2020 (“CESA”), which is also part of the CARES Act. While CESA urges the Secretary of the Treasury to utilize a portion of the \$454 billion of funding available to support loans to businesses with 500-10,000 employees, how exactly companies will qualify for such loans is not yet clear. CESA guidance is expected to come, according to the CARES Act, by April 6, 2020. For additional information on CESA prior to such guidance, please see our COVID-19 Alert #6—“The CARES Act: Businesses in the Middle Market Face Uncertainty” published on our website.

Affiliation Rules

- For purposes of determining whether a borrower has 500 or fewer employees, understanding the SBA’s affiliation rules are critical. The affiliation rules have been the subject of intense lobbying on the part of venture capital firms, private equity firms and the companies in which the foregoing have invested (including startups) since the CARES Act was signed into law on March 27, 2020 and a primary source of concern and frequent questions for many of Stradling’s clients.
- The concern that borrowers have is that even if they have less than 500 employees and could benefit greatly from PPP funds due to the COVID-19 emergency, if they are deemed affiliated with other companies by virtue of common ownership by, for example, a private equity investor or a venture capital investor, a borrower might be required to aggregate its employees with those of other companies (rather than be treated as a standalone business) and exceed the 500 employee test and thus be ineligible for PPP funds.
- General principles of affiliation for this purpose focus on control. Businesses are affiliates of each other when one “controls” or has the “power to control” the other, or a third party or parties “controls” or has the “power to control” both. It does not matter whether control is

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exercised, so long as the power to control exists. The SBA considers factors such as ownership, management, previous relationships with or ties to another concern, and contractual relationships in determining whether affiliation exists. Control may be affirmative or negative. Negative control includes, but is not limited to, instances where a minority shareholder 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.

- On Friday, April 3, 2020, the SBA released further guidance regarding affiliation. Of note is that for determining affiliation based on equity ownership, an entity is automatically deemed to be an affiliate of another entity that owns or has the power to control more than 50% of the entity's voting equity. This will be of some comfort to VC-backed borrowers, who were previously concerned about the applicability of 13 CFR § 121.103, pursuant to which shareholders with less than 50% could count for purposes of affiliation with the borrower if such shareholder owns or has the power to control a block of voting stock which is large compared to other outstanding blocks of voting stock (even if less than 50%). This doesn't mean that holding less than 50% is a cure-all; a minority shareholder can still be in control and thus implicate the affiliation rules 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. Control still matters, but now the rules are clear that a plurality is not *de facto* problematic.
- The CARES Act also expressly waives the affiliation rules for purposes of PPP loans for businesses (a) with less than 500 employees that, as of the date that a PPP loan is disbursed, is assigned a North American Industry Classification System code ("NAICS") beginning with 72, which is the accommodation and food services sector, (b) operating as a franchise that is assigned a franchise identifier code by the SBA and (c) that are getting financial assistance from SBIC lenders. Also, businesses with a NAICS code beginning with 72 with multiple locations but that employ not more than 500 persons per location are exempt from the affiliation rules.

What can the proceeds of PPP loans be used for?

- Payroll costs, including benefits
- Interest on mortgage obligations, incurred before February 15, 2020 (excluding prepayments)
- Rent, under lease agreement in force before February 15, 2020
- Utility payments under service agreements dated before February 15, 2020
- Interest payments on other debt obligations, incurred before February 15, 2020

While the PPP loans can be used for the foregoing purposes, not more than 25% of the loan forgiveness amount may be attributable to non-payroll costs. The rule is called the Paycheck Protection Program for a reason, with the primary goal to support payroll payments and keep people employed.

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How should eligible borrowers calculate the maximum amount of loans to which they may be entitled?

- On April 2, 2020, the SBA issued an interim final rule implementing Sections 1102 and 1106 of the CARES Act, which provided a methodology and examples for calculating how much could be borrowed by a borrower. For eligible small businesses existing from February 15, 2019 to June 30, 2019, the amount is the *lesser* of \$10,000,000 and the amount determined using the following methodology (which will be useful for most applicants):
 - a. Aggregate “payroll costs” (see definition below) from the last 12 months for employees whose principal place of residence is the United States;
 - b. Subtract any compensation paid to an employee in excess of an annual salary of \$100,000 and/or, for a sole proprietor or independent contractor, any amounts paid to an independent contractor or sole proprietor in excess of \$100,000 per year;
 - c. Calculate average monthly payroll costs (divide the amount in (b) above by 12)
 - d. Multiply the average monthly payroll costs in (c) above by 2.5
 - e. Add the outstanding amount of an Economic Injury Disaster Loan (EIDL) made between January 31, 2020 and April 3, 2020, less the amount of any advance under an EIDL COVID-19 loan (because it does not have to be repaid).
- Different calculations apply for seasonal employers and for businesses not in existence from February 15, 2019 to June 30, 2019.
- “Payroll costs” is defined broadly to include (i) salary, wage, commission or similar compensation, (ii) payments of cash tips or equivalent, (iii) payment for vacation, parental, family, medical or sick leave, (iv) allowances for dismissal or separation, (v) payments for healthcare benefits, including insurance premiums, (vi) payments for retirement benefits, (vii) State or local tax payroll taxes and (viii) for a sole proprietor or independent contractor, wages, commissions, income, net earnings from self-employment or similar compensation.
- Among other things, “payroll costs” specifically excludes compensation of individual employees in excess of an annual salary of \$100,000, any employees whose principal place of residence is outside the United States, federal employment taxes imposed or withheld between February 15, 2020 and June 30, 2020, including the employee’s and employer’s share of FICA and income taxes required to be withheld from employees, and expenses paid to independent contractors (because an independent contractor can separately apply under the PPP).

How do eligible businesses apply for PPP loans?

The SBA has published a borrower application form on its website, but banks and credit unions may have their own forms. The banks and credit unions will be the entities funding your loan, so it is critical that you contact your bank or credit union to (a) ascertain whether they will be making loans under the program (not all will be) and (b) what documentation they require. Our understanding, based on

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discussions with commercial bankers, is that many banks are prioritizing their existing clients over new clients, so speaking with your existing bank is likely the best place to start.

Among other things, the form requires borrowers to list all owners of 20% or more of its equity, provide its average monthly payroll numbers for the applicable period, certify that to the extent feasible it will only purchase American-made equipment and products, the funds will be used for permitted purposes and that current economic uncertainty makes the loan request necessary to support its ongoing operations. The original form of application required the certification from the listed equity holders, but that requirement has now been dropped.

How much of the loan will be forgiven?

The amount of PPP loan forgiveness can be up to the full principal amount of the PPP loan and any accrued interest if the loan is used for forgivable purposes and employee and compensation levels are maintained. In more detail:

- Borrowers are eligible for forgiveness of indebtedness on PPP loans equal to the sum of the following costs incurred and payments made during the 8-week period beginning on the date of origination of a PPP loan (“Forgivable Costs”): (a) payroll costs (see above for definition), (b) interest payments on mortgages that were incurred before February 15, 2020, (c) rent payments under lease agreements in force before February 15, 2020 and (d) utility payments for which service began before February 15, 2020.
- Not more than 25 percent of the loan forgiveness amount may be attributable to non-payroll costs. This is designed to better ensure that PPP funds are used primarily for keeping workers paid and employed.
- Since the goal of the PPP is to better ensure that small businesses keep their employees, the amount of forgiveness is reduced if a business reduces its employees. To determine the amount by which the amount paid for Forgivable Costs would be reduced, the payments made of Forgivable Costs during the 8-week period beginning on the date of origination of a PPP loan would be multiplied by the quotient of:
 - a. The average number of full-time equivalent employees per month employed by the borrower during the 8-week period beginning on the date of origination of a PPP loan; *divided by*
 - b. The average number of full-time equivalent employees per month employed by the borrower during the period beginning February 15, 2019 and ending on June 30, 2019 (or, in the case of newer businesses, from January 1, 2020 to February 29, 2020)

If the above quotient is greater than one (i.e., the average number of full-time equivalent employees per month during the 8-week period after origination of the loan is greater than the

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average number of full-time equivalent employees per month during the period beginning February 15, 2019 and ending on June 30, 2019), that doesn't increase the amount of loan forgiveness, which in any event must be capped at the amount of the PPP loan disbursed. However, if the above quotient is less than one, that will reduce the amount of loan forgiveness.

- Loan forgiveness can also be negatively affected by the amount of any reduction in total salary or wages of any employee, if during the 8-week period after origination of the loan, that employee's total salary or wages were reduced by more than 25% of the total salary or wages of that employee during the most recent full quarter. Employees who made wages or salary on an annualized rate of more than \$100,000 during 2019 don't count here, which effectively means that employees who made more than \$100,000 in wages or salary in 2019 on an annualized basis can have their salaries reduced without affecting loan forgiveness. Of course, other laws and possibly employment contracts apply to reductions to salary, and an employment lawyer should be consulted before taking that step.
- If a reduction in the number of full-time equivalent employees or the aforementioned salary reduction occurs between February 15, 2020 and April 26, 2020, but the small business borrower rehires or ends the above-referenced salary reduction before June 30, 2020, then the small business has eliminated the layoff or salary cut and its loan amount eligible for forgiveness is not affected.
- To obtain loan forgiveness, the borrower needs to request forgiveness from the lender and include in such request information documenting its full-time equivalent employees on payroll and pay rates as well as payments on eligible mortgage, lease and utility obligations. If no documentation is provided, then there will be no loan forgiveness. Lenders have 60 days after receiving an application for loan forgiveness to make a determination as to the amount forgiven.
- One of the issues raised by the loan forgiveness calculation above is if a business has, through natural attrition or layoffs unrelated to COVID-19, reduced its number of full-time equivalent employees since June 30, 2019, but retains all of its employees during this crisis, it would be unfairly treated under the loan forgiveness provisions as the business would already begin the process by having its loan forgiveness amount reduced. Another frequently posed question is whether laying off one group of employees but hiring a different group of employees resulting in the same net number of employees on the last day of the 8 week loan period affects the total forgiveness amount. On Thursday April 2, 2020, the SBA announced that it would issue additional guidance on loan forgiveness, but it is unclear whether the foregoing issues would be addressed.

How do PPP loans work with my existing debt documentation?

Borrowers need to confirm whether PPP loans are allowed under their existing loan documents, both in the negative covenant limitation on new debt and also in connection with any financial covenants that

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are tied to the level of the borrower's debt (most notably a debt:EBITDA leverage ratio). If a borrower's existing loan documents don't permit the additional level of unsecured PPP debt, borrowers should pursue a waiver with their lenders. Both bank and non-bank lenders that Stradling has been working with have been generally receptive to these sorts of waiver requests, and the documentation for such a waiver can be quick and inexpensive. There are a few issues that lenders and borrowers will need to work out among themselves however; for example, should the amount of PPP loans that are not forgiven count against the leverage ratio and should any unpaid PPP loans trigger cross-default provisions in the loan documents?

Employee Count

To determine the number of employees in a prospective borrower's business, or an affiliated group of employers, use 13 CFR § 121.106. In general this requires the count to be based on the average employee count over a 12 month period, and treats part time and temporary employees as a whole number (so, do not use "full time equivalents"). Companies or groups that have completed acquisitions in the last twelve months should include the acquired business' employee count for the full 12 month period, as if acquired at the beginning of the period.

The averaging concept is important for executives to understand, as there is not an ability to "get under the line" through an immediate change in headcount.

While independent contractors are not included in the count, California employers should recognize that on January 1, 2020, state law (AB 5) significantly narrowed the definition of independent contractor. Companies that may be at risk of disqualification from eligibility for PPP assistance if independent contractors are reclassified as part time employees should seek advice from Stradling's employment team.

There are two unresolved conflicts in the law related to employee count:

- Whether current support from an SBIC lender or investor takes priority over the 500 employee limit; for some industries, particularly manufacturing concerns, the size limits for a traditional SBIC loan are more flexible.
- Whether the CARES Act drafting intended to eliminate non-US employees from the total, for business with international operations.

Risks of Taking Assistance if Ineligible

While Congressional intent was to provide as many businesses as possible the aid necessary to maintain their employment through the shutdown orders and other effects of the COVID-19 virus, please consult

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advisors if unsure whether your businesses is qualified for PPP assistance. The CARES Act incorporates the same criminal penalties as other federally backed lending programs for material misstatements on a loan application. Further, violations could expose businesses to private litigation under the False Claims Act.

Health Care Businesses

Small businesses in the health care, life science and medical device fields are eligible for PPP assistance, but may also have access to other CARES Act incentives. Please consult an advisor on the most appropriate path for your business.

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