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COVID-19 U.S.: Navigating the Paycheck Protection Program (PPP) under the CARES Act

On Friday, March 27, President Trump signed into law H.R. 748, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to address the catastrophic impact of COVID-19 on the U.S. economy. The CARES Act is a US\$2.2 trillion stimulus package, consisting of two sections. Division A contains a range of stimulus measures, including direct assistance to families and workers, expanded unemployment insurance, funding for hospitals and health care providers, financial assistance to small businesses, and loans and guarantees for other severely distressed sectors of the economy. Division B provides over US\$339 billion in an emergency supplemental appropriations package, more than 80% of which is for state and local governments and communities.

Among the most consequential measures for many of our clients will be programs designed to bolster small businesses, including, and most notably, a significant expansion of the 7(a) Loan Guarantee Program facilitated by the Small Business Administration (SBA), as discussed in more detail below.

SBA and the Treasury Department may issue additional regulations governing or clarifying certain aspects of the expansion of the 7(a) Loan Guarantee Program from time to time. Hogan Lovells is monitoring this closely and will continue to publish updated guidance.

Paycheck Protection Program: Expansion of 7(a) loan guarantee

The Paycheck Protection Program (PPP) under the CARES Act (located at Division A, Title I, Section 1102), which has been apportioned US\$349 billion, will provide loans of up to US\$10 million per business for qualifying businesses to fund payroll costs, interest on mortgage obligations, utilities, salaries (of up to US\$100,000 on an annualized basis), other forms of

compensation, interest on other debts incurred before February 15, 2020, and other payroll expenses—including group healthcare benefits, paid sick, medical, and family leave. The program will be implemented through an expanded version of the SBA's existing Section 7(a) Loan Guarantee Program. Through the program, loans will be administered by financial institutions, and the SBA will guarantee 100% of any loan amounts. As detailed further below, a significant amount of the loans contemplated under the program will be eligible for forgiveness. It is possible that for certain loans, the entirety of the loan will be eligible for forgiveness, and as noted below, any part of a loan that is not forgiven can be prepaid without penalty.

Qualification: Eligible businesses include (i) small businesses that meet the traditional definition of “small business concern” and (ii) any “business concern,” nonprofit, veterans organization, or tribal business concern that employs up to the greater of (a) 500 employees or (b) if applicable, the size standard in number of employees established by SBA for the industry in which the business concern operates.

In addition, businesses that participate in the expanded 7(a) program will not be eligible to take advantage of the employee retention tax credit (under Section 2301(j)) or the delay of employer payroll tax payments (under Section 2302(a)(3)) under the CARES Act. In addition, businesses that participate in the Economic Injury Disaster Loan (EIDL) program (created under Division A, Title I, Section 1110) may not participate in the expanded 7(a) program for the same set of expenses, and should think carefully about the interaction between these two programs.

As each business analyzes whether it will be eligible for the program, it will be useful to consider definitions and guidelines from existing SBA regulations:

- **Small business concerns.** Generally, if the small business concern is in the manufacturing industry, a number-of-employees test applies; if the small business concern is in the services industry, a revenue threshold applies. Which test applies is determined by industry NAICS codes, to which SBA has assigned certain numerical thresholds under the [Table of Small Business Size Standards](#). An applicant's NAICS code can be found on its most recent tax filing, but note that SBA is not bound to accept a business's self-assessment of its NAICS code. For the purpose of meeting SBA revenue thresholds, the calculation is based on an average of the preceding three fiscal years of "Annual Receipts." Annual Receipts are calculated by adding "Total Income" and "Cost of Goods Sold," as defined and reported on IRS tax return forms (13 CFR § 121.104(c)(4)).
- **Business concerns.** "Business concerns" are businesses that are (i) organized for profit; (ii) have a place of business located in the United States; and (iii) make a significant contribution to the U.S. economy through the payment of taxes or use of American products, materials, or labor.
- **Employees.** For the purpose of meeting the small business or business concern thresholds, the number of employees in a business is calculated as the average number of people employed for each pay period over the business's latest 12 calendar months (13 CFR § 121.106(b)). The term "employee" includes individuals employed on a full-time, part-time, or other basis. This definition is not limited to employees within the United States. SBA could apply its existing guidance under 13 CFR § 121.106(a) to this definition. This includes employees obtained from a temporary employee agency, professional employee organization, or leasing concern. SBA will consider the totality of the circumstances, including criteria used by the IRS for federal income tax purposes, in determining whether individuals are employees of a concern. Volunteers (i.e., individuals who receive no compensation, including no in-kind compensation, for work performed) are not considered employees.

Affiliate rules, waivers, and carveout: The eligibility of borrowers of Section 7(a) loans is determined by taking into account both the employees and revenue of the borrower itself and also the employees and revenue of affiliates of the borrower.

Under standard conditions (as set out in 13 CFR § 121.301), affiliation rules apply in a number of circumstances, including when an entity has (i) a shareholder who has the right to control more than 50% of the entity's voting equity or (ii) a minority shareholder that has the ability to unilaterally prevent a quorum or otherwise block action by the entity (13 CFR § 121.301(f)). Under earlier guidance by SBA that is likely to apply here, only the ability to unilaterally block day-to-day operational actions are likely to create affiliation under clause (ii) above. SBA has previously ruled that the right to block the adoption of an annual budget, the incurrence of debt, and employment decisions including hiring, firing, and establishing compensation creates affiliation. On the other hand, a right to block a sale, merger, issuance of stock, or bankruptcy has been ruled to not create affiliation.

The CARES Act eases these rules by waiving the requirement to take into account the employees and revenue of affiliates of: (i) any business assigned a NAICS code beginning with 72 (generally, businesses in the hospitality and food services industries); (ii) any business operating a franchise within the [SBA Franchise Directory](#); and (iii) any business that receives financial assistance from a small business investment company (SBIC). If any of these three waivers apply, then the eligibility of a borrower is determined by reference only to the employees and revenue of the borrower itself (and not by taking into consideration the employees or revenue of any affiliates of the borrower). Some businesses are seeking to manage these affiliation rules by exploring new investments from SBICs. As of the date of this writing, SBA has not issued guidance regarding any such "rescue" investments, but the Small Business Investor Alliance, a leading trade association in the SBIC space, has warned SBICs against "renting" their SBIC license privileges.

We also note that there is an explicit carveout that is particularly pertinent to hospitality and food industry properties. Between February 15, 2020 and June 30, 2020, businesses with (a) NAICS codes beginning with 72 and (b) not more than 500 employees per physical location at the time of disbursement shall automatically be eligible to receive a PPP loan.

Maximum loan amount: With respect to a Section 7(a) loan under the PPP taken out between February 15, 2020 and June 30, 2020, the maximum loan amount is the lesser of:

1. The sum of A and B: (A) = The product of x and y, with (x) being the average total monthly payments by applicant for payroll costs incurred during the 1-year period before the disbursement of loan (subject to the limitations discussed below) and (y) being 2.5; (B) = The outstanding amount of a non-duplicative EIDL loan made during the period beginning on January 31, 2020 and ending on the date on which the PPP loans are made available to be refinanced under the terms of the respective PPP loans; and
2. US\$10 million.

In essence, the loan amount is the lesser of US\$10 million or 2.5 months of the business's average monthly payroll costs.

For seasonal employers, the maximum loan equals the product of a and, at the discretion of the employer, b or c, with (a) equaling 2.5, (b) equaling the average monthly payments for payroll costs for the 12-week period beginning February 15, 2019, or (c) the period beginning March 1, 2019 and ending June 30, 2019.

Note that the definition of "payroll costs" is critical to determining the maximum loan amount and in analyzing amounts of the loan that will ultimately be forgiven. Payroll costs are defined as the sum of salary, wages, and tips; payments for vacation, parental, family, medical, or sick leave; allowance for dismissal or separation; payments associated with group health care benefits (including insurance premiums); payment of retirement benefits; payments of state or local tax assessed on the compensation of employees; and the sum of any compensation to or income of an independent contractor or sole proprietor. For purposes of this calculation, payroll costs exclude, among other things, (i) the compensation of any employee, independent contractor, or sole proprietor in excess of US\$100,000, and (ii) compensation of employees whose principal place of residence is outside of the United States. Recent Treasury and SBA guidance suggests, although it is not perfectly clear, that the US\$100,000 limit is applied to all payroll costs of an individual employee, independent contractor, or sole proprietor (and that an applicant cannot determine the maximum loan amount by including up

to US\$100,000 of compensation plus additional payroll costs such as benefits). The government may issue further guidance to streamline the determination of appropriate loan amounts.

PPP loan terms: Although under the CARES Act, loans could bear interest of up to 4% and terms of up to 10 years, recent Treasury and SBA guidance mandated that all PPP loans will be made at a 0.5% fixed interest rate loan for a term of two years. Payment of any interest and principal on the loan is deferred for six months, though interest will begin accruing from the date of disbursement. There are no fees payable by the borrower associated with the disbursement of the loan, no requirement that the business be unable to obtain credit elsewhere, no personal guarantee or collateral required for the loan, and no prepayment restrictions or penalties.

Lenders will be able to receive the following fees from SBA:

- 5% for covered loans under US\$350,000;
- 3% for covered loans between US\$350,000 and US\$2,000,000; and
- 1% for covered loans over US\$2,000,000.

Loan forgiveness: Under Division A, Title I, Section 1106, to the extent Section 7(a) loan amounts are used for (i) payroll costs (as defined above), (ii) interest payments on covered mortgage obligations incurred prior to February 15, 2020 (not including any prepayments of principal amounts), (iii) payment of covered rent obligations on lease in force prior to February 15, 2020, and (iv) payment on covered utilities for which service began before February 15, 2020 during the eight week period beginning on the date of loan origination, the cumulative amount of items (i)-(iv) will be forgiven from repayment.

However, if a business reduces its (i) workforce or (ii) worker salaries, the loan amount forgiven will be reduced. Companies that re-hire previously laid off employees or restore previously reduced wages by June 30, 2020 will not be penalized in loan forgiveness calculations so long as the curative actions restore employee count and wages to February 15, 2020 levels. Furthermore, we note that any amount of the loan forgiven will not be subject to taxation—the CARES Act specifies that forgiven loan amounts will not be considered cancellation of indebtedness income under the Internal Revenue Code.

Once again, the details are critical to the forgiveness analysis:

- **Workforce reductions.** Reductions in workforce will be calculated by any reduction in full-time employees retained compared to the prior year. To be more specific, the loan forgiveness amount is reduced by multiplication with the quotient obtained by dividing (A) the average number of full-time equivalent employees per month between during the eight week period beginning on the date of loan origination by, at the election of the borrower, either (B) the average number of full-time equivalent employees per month employed between February 15, 2019 and June 30, 2019, or (C) the average number of full-time equivalent employees per month employed between January 1, 2020 and February 29, 2020 (in each of the foregoing cases (A), (B) and (C), the borrower should take into account the average for each pay period within a month). To be clear, if the result is a positive quotient, the loan amount forgiven would not increase. For seasonal businesses, the denominator is (D), the average number of full-time employees per month employed between February 15, 2019 and June 30, 2019.
- **Salary reductions.** Reductions in excess of 25% for employees earning less than US\$100,000 will directly reduce the loan forgiveness amount on a dollar-for-dollar basis. The reduction amount is measured by comparing the salary of the employee during the eight week period beginning on the date of loan origination to the most recent full quarter during which the employee was employed.
- **Potential cap on non-payroll expenses forgiven.** Under the Treasury guidance issued March 31, 2020, due to the anticipation of a high volume of applications under the program, a cap of 25% on non-payroll expenses eligible for forgiveness may be imposed.

Steps to apply: Beginning April 3, 2020, banks may begin accepting applications under the program. In conjunction with the release of the Treasury guidance on March 31, 2020, an [SBA webpage](#) has been made available with application materials and resources to answer frequently asked questions.

We expect the attempted usage of the PPP to be substantial, and 7(a) lenders may face challenges in processing PPP loans. In light of those challenges, we suggest that any interested businesses reach out to an SBA-approved lender promptly. Interested businesses should connect with their existing banking contacts immediately to identify whether they already have an existing relationship with an SBA-approved 7(a) lender. We make this recommendation because 7(a) lenders may be more likely to address the needs of their current customers before seeking to help new customers.

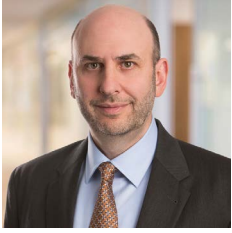
If your lender of choice is not approved by SBA, SBA offers a [Lender Match](#) tool. In the interest of expediency, it may also be helpful to identify banks that are focused on making 7(a) loans in the borrower's geographic region rather than approaching a top volume national lender. For those contacts, we recommend checking the website of the local SBA district office (every state has at least one SBA office) with the following steps:

- Conduct a web search for "SBA district office in [State]";
- Look for the link to the "Resource Guide"; and
- The Resource Guide generally will have a list of lenders who are active in that area – to avoid scrolling, search for "SBA Lenders" within the document.

Our teams of lawyers across the globe are continuing to compile the latest thinking and legal guidance on the coronavirus outbreak. To track our latest updates, which will include more specific discussions of particular contractual concepts, we encourage you to check the Hogan Lovells [COVID-19 Topic Center](#), which covers a wide variety of practice areas across the globe.

These are only general considerations and should not be relied on as legal advice in relation to a particular transaction or situation. If you have any questions or would like any additional information regarding this matter, please contact your relationship partner at Hogan Lovells or any of the lawyers listed below.

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