SBA Paycheck Protection Program: Key Provisions and Related Fed Secured Lending Facility

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A separate Davis Polk deck covers other Key CARES Act Provisions and Fed Programs for Corporates.

Introduction

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Why is This Relevant?

The Federal Reserve has announced a number of programs, both in connection with the CARES Act and separate and apart from the CARES Act, that may be relevant to:

This deck focuses on the Paycheck Protection Program (PPP) and the Fed's related secured lending facility.

- The Fed has announced a number of other programs, both in connection with the CARES Act and separate from the CARES Act, including:
  - Main Street New Loan Facility
  - Main Street Expanded Loan Facility
  - Municipal Liquidity Facility
  - Primary Market Corporate Credit Facility
  - Secondary Market Corporate Credit Facility
  - Term Asset-Backed Securities Loan Facility
  - Commercial Paper Funding Facility
- These Fed facilities are discussed in further detail in our deck on Key CARES Act Provisions and Fed Programs for Corporates.

Additional COVID-19 Davis Polk Resources

Government Support for Business

- Our **Government Support for Business** page centralizes all of the government materials related to the numerous support programs announced by the Federal Reserve and others enacted as part of the CARES Act in one convenient place.
- You can also contact any of Davis Polk's Government Support for Business Task Force members at stimulus.taskforce@davispolk.com.

Coronavirus Updates

- Our **Coronavirus Updates page** contains a compendium of Davis Polk content related to the pandemic's economic fallout and government responses, organized by topic.

FinReg Tracker

- Our morning FinReg Tracker email is a simple list, with hyperlinks, of all developments from the day before from Congress and the federal financial agencies. View a recent FinReg Tracker and sign up to receive the Tracker at 7:00 a.m. ET Monday-Saturday.

Paycheck Protection Program

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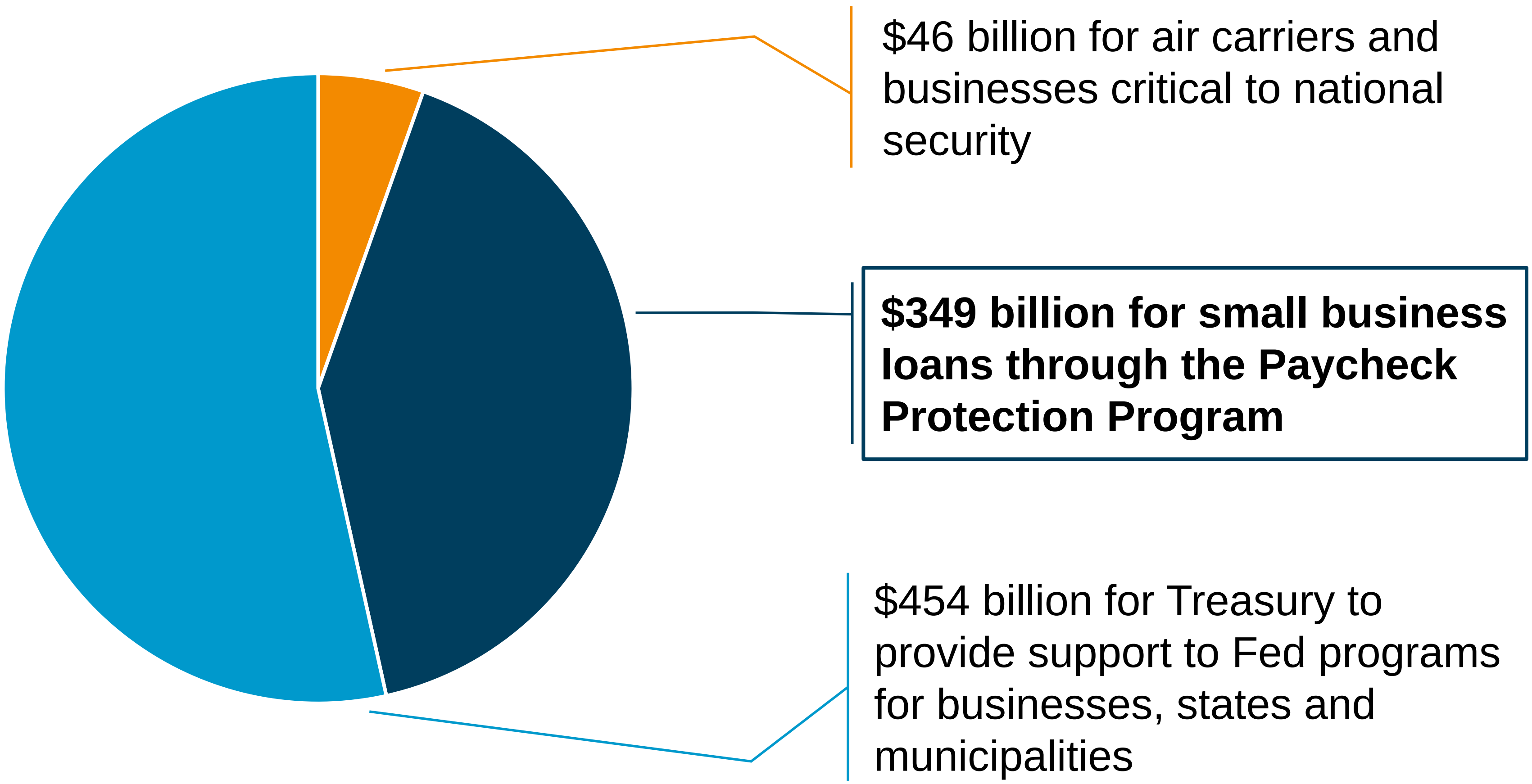
CARES Act Support for Businesses

The CARES Act authorized funding for a variety of programs to assist businesses impacted by the coronavirus pandemic



Pre-CARES Act SBA Lending

The SBA administers a small business loan guarantee program under Section 7(a) of the Small Business Act.

- Key borrower eligibility requirements:
  - Borrower must be a "business concern":
    - For-profit business;
    - Place of business in the United States; and
    - Operate primarily within the United States or make a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor
  - Borrower must be a "small business concern" measured under size standard designations based on North American Industry Classification System (**NAICS**) codes for the number of employees or annual receipts based upon the borrower's primary industry
    - Each NAICS code has its own size limitation based on employees and/or receipts
  - Alternatively, a borrower can qualify as a small business concern if it met both tests in the SBA's alternative size standard as of March 27, 2020: (1) the maximum tangible net worth of the business is not more than $15 million; and (2) the average net income after federal income taxes (excluding any carry-over losses) of the business for the two full fiscal years before the date of the application is not more than $5 million.
  - **Affiliation test**: determination of whether a borrower is a "small business concern" is measured by the size of the borrower combined with its affiliates

Paycheck Protection Program

The PPP temporarily expands the pre-CARES Act SBA 7(a) loan guarantee program.

- $349 billion appropriation for the PPP in the CARES Act
- The program is available through June 30, 2020; congress may increase the size of the program and lengthen its term
- The SBA and Treasury have released interim final rules, fact sheets, FAQs and loan application and related documents setting:
  - loan terms (1.0% interest rate, 2 year term, no personal guaranty),
  - small business eligibility requirements including size conditions,
  - conditions on use of proceeds and for loan forgiveness, and
  - lender underwriting standards, liability limitations, and compensation through processing fees.

Key Features of New Paycheck Protection Program

Expanded Borrower Eligibility

To be eligible, a borrower must be:

- A business concern that is a "small business concern" under existing SBA rules; or
- A business concern, 501(c)(3) nonprofit, 501(c)(19) veterans association or tribal business concern that employs not more than the greater of:
  - 500 employees; and
  - the number of employees in the size standard designation for the industry in which the applicant operates.
- Only employees whose principal place of residence is in the US are included in this determination.
  - **Independent contractors** are not considered employees.
- **Special Rule for Hotels and Restaurants**: Any business with fewer than 500 employees per physical location that is assigned an NAICS code beginning with 72 (i.e., accommodation and food services businesses).
- **Passive vs. Active Real Estate**: With limited specified exceptions, passive businesses owned by developers and landlords that do not actively use or occupy real property are ineligible for SBA business loans; this would include property owning special purpose vehicles. However, property, development or construction management companies that otherwise qualify (subject to the affiliation rules) would be eligible borrowers.

Ineligible Borrowers

Certain entities are ineligible for the PPP because they are ineligible for SBA 7(a) loans under SBA rules:

- Non-profit businesses, **other than 501(c)(3) and 501(c)(19) organizations as specifically permitted by the PPP**;
- Financial businesses primarily engaged in the business of lending, such as banks, finance companies, and factors;
- Passive businesses owned by developers and landlords, subject to limited exceptions;
- Life insurance companies;
- Businesses located outside of the U.S.;
- Pyramid sale distribution plans;
- Businesses deriving more than one-third of gross annual revenue from legal gambling activities;
- Businesses engaged in any activity that is illegal under state or federal law;
- Private clubs and businesses which limit the number of memberships for reasons other than capacity;
- Government-owned entities (except for businesses owned or controlled by a Native American tribe);
- Loan packagers earning more than one third of their gross annual revenue from packaging SBA loans;
- Businesses with an officer, director, owner of more than 20% of the equity, or key employee who is incarcerated, on probation, on parole, or has been indicted for a felony or a crime of moral turpitude;
- Businesses in which the lender, or any of its officers, directors, owners of more than 20% of the equity, or key employees owns an equity interest;
- Businesses which present live performances of a prurient sexual nature or derive revenue through the sale of products or services, or the presentation of any depictions or displays, of a prurient sexual nature;
- Unless waived by SBA for good cause, businesses that have previously defaulted on a federal loan or federally assisted financing;
- Businesses primarily engaged in political or lobbying activities; and
- Speculative businesses (such as oil wildcatting).

Key Features of New Paycheck Protection Program (cont.)

Affiliation	• In determining eligibility, borrower size is measured based on the borrower together with its affiliates. • The affiliation rule is specifically waived for: – any business with not more than 500 employees that is assigned an NAICS code beginning with 72 (i.e., accommodation and food services businesses); – any business operating as a franchise that is assigned a franchise identifier code by the SBA; – any business that receives financial assistance from an SBIC; and – under an interim final rule, faith-based organizations where application of the affiliation rules would substantially burden the organization's religious free exercise.
Loan and guarantee amounts	• Funding of $349 billion for this program, with further increase expected. • **The maximum loan amount is the lesser of $10 million and 2.5 times average monthly payroll costs based on either, at the borrower's election, (1) 12 months prior to loan disbursement or (2) 2019 payroll costs, plus the amount of any Economic Injury Disaster Loan (EIDL) made between January 30 and April 3 that was used for payroll costs, net of any advance.** • Interest rate of 1% and maturity of 2 years. • SBA guarantees 100% of outstanding loan balances.

Key Features of New Paycheck Protection Program (cont.)

Use of loan proceeds	• PPP loans may be used for payroll costs (see slide 14); interest on mortgage payments; rent; utilities; interest payments on any other debt obligations that were incurred before February 15; and the refinancing of EIDL loans made between January 31 and April 3. • No less than 75% of loan proceeds may be used for payroll costs for program eligibility • The same rule applies to the amount of loan forgiveness.
Deferrals and forgiveness	• **Deferral**: Lenders must defer payments on PPP loans for six months. The SBA is directed to issue deferment guidance to lenders within 30 days of enactment of CARES Act. • **Forgiveness**: PPP borrowers are eligible for loan forgiveness, subject to the conditions set out on the following slide.

Loan Forgiveness

- A borrower is eligible for forgiveness of a PPP loan in an amount equal to the sum of the following costs incurred and payments made during the 8-week period beginning on the loan origination date**,** which the SBA considers the date the lender makes the first disbursement to the borrower:
  - Payroll costs (see next page).
  - Any payment of interest on any mortgage obligation in place before February 15, 2020 (which shall not include any prepayment of or payment of principal).
  - Any payment of rent under ongoing leases that were put in place before February 15, 2020.
  - Any payment for utilities for ongoing services that were put in place before February 15, 2020.

- Not more than 25% of the forgiven amount may be for non-payroll costs.
- Loan forgiveness amount is reduced by the amount of any emergency grant the borrower receives under the EIDL program.
- Forgiven amount is non-taxable.

- Loan forgiveness amount is reduced by:
  - reduction in average monthly FTE employees during covered period compared to those employed between February 15 – June 30, 2019 or between January 1 – February 29, 2020 (borrower to elect); and
  - reduction in salary of any employee during covered period in excess of 25% of total salary of employee for most recent full quarter in which employee was employed, taking into account only employees who earned $100,000 or less on an annual basis.
  - However, loan forgiveness is not reduced if the reduction in FTEs or salaries between February 15 and April 26, 2020 is eliminated by June 30, 2020.

Loan Forgiveness (cont.)

- Payroll costs are:
  - Salary, wage, commission or similar compensation
  - Payments with respect to tips
  - Vacation, parental, family, medical or sick leave
  - Allowance for dismissal or separation
  - Payments required for group health care benefits, including premiums
  - Payment of any retirement benefit
  - State or local tax imposed on the compensation of employees
- If the borrower is an independent contractor or sole proprietor, payroll costs are:
  - Wage, commissions, income, or net earnings from self-employment or similar compensation

- Payroll costs exclude:
  - Cash compensation of any individual employee for any amount in excess of $100,000 in one year, as prorated for the period between February 15, 2020 and June 30, 2020
  - Any FICA tax or withheld income tax
  - Compensation of any individual whose principal residence is outside the United States
  - Qualified sick leave and family leave wages for which a credit is allowed under the FFCRA (discussed in subsequent slides)
  - Any amounts paid to an independent contractor or sole proprietor other than the borrower

Conditions to Paycheck Protection Program

PPP loans come with conditions:

- Borrowers must make certain certifications, including that the current economic uncertainty makes the loan request necessary to support its operations and that it will use the proceeds for allowable purposes. An applicant that knowingly makes false statements is subject to criminal penalties and fines.
- The loan application also includes a certification that the borrower will, to the extent feasible, purchase only American-made equipment.
- Employers who receive a PPP loan are not eligible for the refundable payroll tax credit provided under the CARES Act.

Lender Eligibility and Underwriting

Eligible Lenders

- SBA authorized lenders may begin making PPP loans on April 3, 2020
- Federally insured depository institutions, credit unions, and Farm Credit System institutions also are eligible beginning April 3, 2020
  - They must first submit a new lender agreement, Form 3506, to the SBA
- Other depository institutions and non-bank lenders are eligible, subject to detailed conditions set out in the interim final rule—including compliance with Bank Secrecy Act (**BSA**) Customer Identification Program and anti-money laundering (**AML**) program requirements
  - These lenders must submit an application to the SBA to be admitted to the PPP

Underwriting

- The interim final rule sets underwriting standards for lenders:
  - Confirm receipt of borrower certifications in PPP loan application
  - Confirm receipt of information demonstrating that borrower was in operation and had employees for whom the borrower paid salaries and payroll taxes on February 15, 2020
  - Confirm dollar amount of average monthly payroll costs by reviewing submitted payroll documentation
  - Follow applicable BSA requirements
    - An entity not subject to BSA must establish a BSA-compliant AML program comparable to that required of banks

Lender Liability

- The PPP is designed to provide relief to small businesses in the United States as quickly as possible—raising questions about lender liability for underwriting and loan forgiveness decisions made on an expedited basis and under a streamlined application process
- The interim final rule offers some comfort to lenders:

> *"Lenders must comply with the applicable lender obligations set forth in this interim final rule, but will be held harmless for borrowers' failure to comply with program criteria. . . "*

- A lender's underwriting obligation is limited to the requirements specified in the interim final rule (see previous slide)
- A lender also does not need to conduct any verification if a borrower submits documentation that supports its request for loan forgiveness and attests that it has accurately verified the payments for eligible costs
  - The SBA will hold harmless any lender that relies upon borrower-submitted documentation with respect to forgiveness
- This hold harmless provision does not displace the government's existing enforcement toolkit, including under the False Claims Act
  - Davis Polk has published a separate memo addressing oversight and enforcement risks under the CARES Act, including the PPP, which is available on our Government Support for Business page

PPP Lending Facility and Related Capital Rule

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Structure of Fed PPPLF

The PPP lending facility (PPPLF) allows Federal Reserve Banks to make direct non-recourse loans to PPP depository institution lenders* that originate PPP loans equal to the amount of and secured by such loans.

Federal Reserve Banks

Non-Recourse Loans by Federal Reserve Bank →

← Lender Pledges PPP Loans Originated by Lender and Guaranteed by SBA, Valued at Par (No Haircuts)

PPP Depository Institution Lenders

*The term sheet says that the Fed is working on expanding the facility to non-depository institution PPP lenders that originate PPP loans.

Key Terms of PPPLF

Eligible Borrowers	• All depository institutions that originate PPP loans. The Fed is working to expand eligibility to other lenders that originate PPP loans
Lending Reserve Bank	• The Federal Reserve Bank of the district in which the borrower is located
Secured / Non-recourse	• All loans made under the facility will be secured by eligible collateral with no recourse to the borrower.
Eligible Collateral	• Only PPP loans that are originated by the eligible borrower and guaranteed by the SBA are eligible collateral
Collateral Value	• Par value of PPP loans pledged as collateral—i.e., no haircuts
Principal Amount	• Equal to principal amount of PPP loans pledged as collateral
Interest Rate and Fees	• 0.35% interest and no fees
Maturity and Acceleration	• Equal to the maturity date of the PPP loan pledged as collateral, which will be accelerated either (1) if the underlying PPP loan goes into default and the borrower realizes on the SBA guarantee or (2) to the extent of any loan forgiveness reimbursement received by the borrower from the SBA
Facility Termination Date	• September 30, 2020, unless extended by the Fed and Treasury

Regulatory Capital Treatment for PPP Loans Pledged to the Fed under the PPPLF

The banking agencies issued an interim final rule to neutralize the regulatory capital effects of PPP loans pledged under the PPPLF.

- On April 9, 2020, the Fed, OCC and FDIC issued a joint interim final rule to allow banking entities to neutralize the regulatory capital effects of PPP loans pledged under the PPPLF
- For purposes of leverage capital requirements, a banking organization is permitted to exclude PPP loans pledged as collateral under the PPPLF from its total leverage exposure and average total consolidated assets. The latter treatment would also extend to the community bank leverage ratio.
- For purposes of risk-based capital requirements, a banking organization is permitted to exclude PPP Loans pledged as collateral under the PPPLF from its total risk-weighted assets under both the advanced approaches and standardized approach, as applicable
- The rule also implements the CARES Act requirement that PPP loans receive a zero percent risk weight for purposes of risk-based capital requirements.

Davis Polk Contacts

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