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REVISED (Update #3): COVID-19 U.S.: Navigating the Paycheck Protection Program (PPP) under the CARES Act and recent SBA guidance

On Friday, March 27, 2020, 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 are programs designed to bolster small businesses, including, and most notably, the Paycheck Protection Program (PPP), a significant expansion of the 7(a) Loan Guarantee Program facilitated by the Small Business Administration (SBA), as discussed in more detail below.

On April 2, 2020, SBA issued its [initial interim regulations](#) (the Initial SBA Regulations) that will govern the loans provided pursuant to the expansion of the 7(a) program. Borrowers began applying for the loans beginning on April 3.

On April 3, 2020, SBA issued its [affiliation guidance](#) (the Affiliation Guidance) described below and in a memorandum dated Saturday, April 4, SBA provided [additional guidance](#) on size eligibility and affiliation (the SBA Memo). On Monday, April 6, SBA and the Treasury Department jointly released [additional FAQs guidance](#), which have been updated periodically (the SBA/Treasury FAQs) and which provide greater clarity

to several ambiguous points about the PPP under the CARES Act. SBA and Treasury jointly issued [additional interim regulations](#) (the Second SBA Regulations) on April 14, 2020, and they issued [further interim regulations](#) (the Third SBA Regulations) on April 24, 2020.

PPP loans have proven incredibly popular across the United States with small businesses, and SBA reported that the initial US\$349 billion apportioned to the program was exhausted as of April 16, 2020 despite demand still running high nationwide for additional funding.

Accordingly, on April 24, 2020, President Trump signed into law H.R. 266, the Paycheck Protection Program and Health Care Enhancement Act, an approximately US\$484 billion supplemental relief package that authorizes an additional US\$310 billion in funding to the PPP. In addition, the legislation doubles the amount available to SBA to provide emergency Economic Injury Disaster Loans from US\$10 billion to US\$20 billion (EIDLs). Despite this infusion, demand for PPP loans remains so high that we expect that this amount will also be rapidly depleted.

In a bid to diversify the institutions that process PPP loans and to reach small businesses that may be under-banked or unbanked altogether, the new legislation sets aside (i) US\$30 billion of the new PPP funding to be dispersed by banks and credit unions with consolidated assets of less than US\$10 billion and/or certain community financial institutions (including minority depository institutions) and (ii) an additional US\$30 billion in PPP funding to be dispersed by banks and credit unions with consolidated assets of between US\$10 billion and US\$50 billion.

The SBA/Treasury FAQs clarify that, notwithstanding the fact that additional guidance may be released, borrowers and lenders previously acting on the basis of the Initial SBA Regulations (on April 2) are permitted to rely on the laws, rules, and guidance available at the time of the relevant application except with respect to the certification of economic need (as described below). Borrowers whose previously submitted loan applications have not yet been processed may, however, revise their applications based on clarifications reflected in the SBA/Treasury FAQs.

SBA and the Treasury Department are expected to issue additional regulations governing or clarifying certain aspects of the PPP 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 now been apportioned an aggregate US\$659 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 and other forms of compensation (with the cash component capped at US\$100,000 on an annualized basis), 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 SBA’s existing Section 7(a) Loan Guarantee Program. Through the program, loans will be administered by financial institutions, and SBA will guarantee 100% of any loan amounts. As detailed further below, a significant portion 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.

The Initial SBA Regulations clarify that PPP loans will be dispersed on a “first-come, first-served” basis, though lenders themselves are not obligated to process PPP loans on a “first-come, first served” basis. There is a possibility, but no guarantee, that Congress in any future stimulus or relief legislation may appropriate a third round of funding for PPP loans if there is overwhelming demand, given that demand is already

so high for the second, US\$310 billion wave of PPP funding.

The Initial SBA Regulations also state that borrowers will not be permitted to apply for more than one PPP loan and, accordingly, SBA encourages borrowers to consider applying for the maximum amount (as outlined below in further detail).

Qualification: Eligible businesses include (i) small businesses that meet the traditional definition of “small business concern” or (ii) any “business concern,” 501(c)(3) nonprofit, veterans organization, or tribal business concern, in each case that employs up to the greater of (a) 500 U.S. employees or (b) if applicable, the size standard in number of employees established by SBA for the industry in which the business concern operates. Each applicant business must have been in operation as of February 15, 2020 to be eligible.

In addition, businesses that participate in the 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.

The Third SBA Regulations state that SBA believes providing PPP loans to debtors in bankruptcy would present an unacceptably high risk. Accordingly, the Third SBA Regulations confirm that if a PPP applicant or the owner of an applicant is the debtor in a bankruptcy proceeding, either (i) at the time it submits the application or (ii) at any time before the loan is disbursed, the applicant is ineligible to receive a PPP loan. Moreover, the applicant has an obligation to notify the lender and request cancellation of an application if, after submitting an application, the applicant or owner becomes the debtor in a bankruptcy proceeding.

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

- **Small business concerns.** In determining whether a small business concern fits the industry size standards described above, it is generally the case that if the small business concern is in the manufacturing industry, a number-of-employees test applies, and 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](#). Businesses include their NAICS code on their annual 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)).
- The SBA Memo and the SBA/Treasury FAQs confirm that small business concerns can be eligible borrowers for PPP loans even if they have more than 500 employees, so long as they otherwise meet the existing statutory and regulatory definition of a "small business concern."
- The SBA Memo and the SBA/Treasury FAQs also clarify that borrowers will qualify if, as of March 27, 2020, such borrowers meet the "alternative size standard," whereby 7(a) loans are generally available to businesses with (i) a net worth of US\$15 million or less and (ii) average net income (after federal income taxes) of US\$5 million or less; the standard is technically a temporary standard that remains in effect from an interim rulemaking in September 2010 under the Small Business Jobs Act of 2010.
- **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 may be calculated through one of three methods, per the SBA Memo and the SBA/Treasury FAQs: (i) SBA's standard calculation, *i.e.* the average number of people employed for each pay period over the business's latest 12 calendar months

(13 CFR § 121.106(b)), (ii) average employment over the previous 12 months, or (iii) average employment over calendar year 2019. The term "employee" includes individuals employed on a full-time, part-time, or other basis. 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.

- **Independent contractors.** Significantly, the Initial SBA Regulations indicate that because independent contractors have the ability to apply for a PPP loan on their own, they do not count as "employees" for purposes of either (i) PPP loan calculations or (ii) PPP loan forgiveness.

Certification of economic need: As part of the application process, applicants must certify "in good faith" that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the [a]pplicant." Though the analysis for making this certification will be different for different companies, we believe it will be prudent for applicants to document the potential COVID-19 impact on sales, operations, workforce, and other factors that applicants believe could be adversely affected by the current economic uncertainty, both over the eight-week term of the PPP loan and beyond.

Following heightened media scrutiny over the amount of PPP loans approved to larger companies and public companies during the first US\$349 billion phase of the PPP, updated guidance, in both the SBA/Treasury FAQs issued on April 23, 2020 and the Third SBA Regulations issued a day later, address how borrowers should assess their economic need.

In particular, while the CARES Act suspends the traditional 7(a) program requirement that borrowers must be unable to obtain credit elsewhere, the guidance suggests that in reviewing economic need, borrowers should take into account "their current business activity and their ability to access other sources of liquidity

sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business.” Notably, the SBA/Treasury FAQs state “it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith, and such a company should be prepared to demonstrate to SBA, upon request, the basis for its certification.” This may be especially noteworthy for companies that are currently engaged in a stock repurchase program and that are contemplating a PPP loan application (though we note that, unlike other parts of the CARES Act, Congress has now twice decided not to condition PPP loans on any restrictions on stock buybacks).

Large privately-held companies should take equal care. In particular, while the Third SBA Regulations do not prohibit portfolio companies of a private equity fund from PPP eligibility, SBA (i) reiterated that borrowers must apply the affiliation rules in 13 CFR § 121.301(f) (as discussed below), and (ii) reinforced that borrowers should carefully review the certification of economic need. Furthermore, on April 28, 2020, the SBA/Treasury FAQs were updated to include specifically in their economic need analysis “businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations.”

We view the most recent guidance as requiring both (i) publicly-traded companies and (ii) large privately-held companies with access to other sources of liquidity to strongly consider whether they can make this particular certification when applying for loans through PPP. That is, borrowers must be able to certify in good faith that obtaining credit through other sources of liquidity would, in fact, be “significantly detrimental to the [borrower’s] business.” This new guidance certainly raises more questions than it answers and we strongly suspect that clarifying guidance may become necessary.

With respect to private-equity and venture-capital-backed borrowers under the PPP, it is not clear the extent to which such borrowers should apply the new guidance. We believe, however, that at the very least it requires a re-examination of the need certification that was made in connection with any PPP loan taken by a private-equity or venture-capital-backed borrower. We also believe that it will be both necessary and appropriate to consider the particular facts relevant to each such borrower when doing this re-examination.

The additional guidance on this point reiterates that lenders may rely on a borrower’s certification regarding the necessity of the loan request. In addition, borrowers should note:

- If any company that applied for a PPP loan before April 23, 2020 repays the loan by May 7, 2020, it will be deemed to have made the needed certification in good faith. Essentially, those borrowers are being given “no harm, no foul” treatment.
- The treatment for prospective applicants going forward is not the same. A company that applies for a PPP loan after April 23, 2020 could face governmental and public scrutiny on whether it “needed” the loan and to possible material consequences, even if the borrower repays the PPP loan in full next month.

Self-employed individuals and partnerships:

The Second SBA Regulations set forth the process for self-employed individuals (such as independent contractors and sole proprietors) and partnerships to apply. Self-employed individuals are eligible to apply if they (i) were in operation on February 15, 2020, (ii) have a principal place of residence in the United States, and (iii) filed or will file an IRS Form 1040 Schedule C for 2019 (and note that additional guidance will be forthcoming for newly self-employed individuals who will file an IRS Form 1040 Schedule C in 2020). The Second SBA Regulations provide that partners in partnerships are not eligible to apply as self-employed individuals and must apply collectively as a partnership. On the partnership’s PPP application, the self-employment income of active partners may be reported as a payroll cost, up to US\$100,000 annualized.

Lender matters: The Initial SBA Regulations provide that each lender’s underwriting is limited to the items enumerated in the Initial SBA Regulations, including (i) confirming receipt of borrower certifications contained in the PPP application form; (ii) confirming receipt of information demonstrating that a borrower had employees for whom the borrower paid salaries and payroll taxes on or around February 15, 2020; (iii) confirming the dollar amount of average monthly payroll costs for the preceding calendar year by reviewing the payroll documentation submitted with the borrower’s application; and (iv) following the

applicable requirements under the Bank Secrecy Act, including anti-money laundering compliance.

The Second SBA Regulations relax existing conflict of interest rules so that businesses owned in whole or in part by an outside director or holder of less than 30% of a lender (excluding any officer or key employee of the lender) are not prohibited from obtaining a PPP loan from the related lender. The SBA/Treasury FAQs clarify that it is the responsibility of borrowers to determine which entities (if any) are its affiliates and determine the employee headcount of the borrower and its affiliates; lenders will be permitted to rely on borrowers' certifications. For the above reasons, we believe that the risks of mistake regarding eligibility and loan amount rest significantly on borrowers.

The SBA/Treasury FAQs clarified on April 17, 2020 that a lender may sell a PPP loan into the secondary market at any time after the loan is disbursed. A PPP loan sold into the secondary market, at either a premium or a discount to par value, does not require SBA approval but nevertheless remains 100% SBA guaranteed.

Ineligible businesses: The Initial SBA Regulations clarify that certain categories of businesses that are typically ineligible for 7(a) loans under 13 CFR § 120.110 will also be ineligible for PPP loans, though many of the categories include various exceptions.

Such businesses include: (i) passive businesses, (ii) life insurance companies, (iii) businesses located in a foreign country or owned by undocumented aliens, (iv) business selling through a pyramid plan, (v) businesses engaged in legal gambling activities (except as noted below), (vi) businesses engaged in any illegal activity, (vii) businesses which restrict patronage (*e.g.* men-only or women-only), (viii) government-owned entities (excluding, to be clear, Native American tribes), (ix) businesses engaged in promoting religion, (x) businesses engaged in SBA loan packaging, (xi) businesses with an associate of poor character, (xii) any equity interest by a lender or associates in applicant concern (except as noted above), (xiii) businesses providing prurient sexual material, (xiv) prior loss to the government and delinquent federal debt, (xv) businesses primarily engaged in political or lobbying activities, and (xvi) businesses engaged in speculation. Absent specific guidance to the contrary, we believe that SBA's position will be that each of these limitations continues to apply (including with respect to passive

companies that own one or more hotels and have a NAICS code beginning with 72).

Note that businesses located in a foreign country (under 13 CFR § 120.110(e)) are on their face ineligible. SBA's Standard Operating Procedure 50105(k) (the "SOP") clarifies that such a business would be eligible if it has business activities in the United States. Therefore, although there has been no specific guidance on this point in the context of the PPP, it would appear that the U.S. subsidiaries of a business headquartered outside of the United States would still be eligible for PPP relief, provided that the business meets the other PPP eligibility requirements (including having no more than 500 U.S. employees). Note that there are additional conditions if the business is majority-owned by foreign nationals or foreign entities. Certain businesses listed in Appendix 1 of the SOP that conduct certain activities are not eligible (*e.g.* businesses engaged in nuclear energy activity).

Under 13 CFR § 120.110(g), businesses that receive revenue from legal gambling are typically ineligible under the 7(a) program if more than one-third of its gross annual revenue comes from legal gambling. The Second SBA Regulations attempted to create a more lenient test, such that if, in addition, the business's legal gambling revenue (net of payouts and not other expenses) did not exceed US\$1 million in 2019 and such legal gambling revenue comprised less than 50 percent of the business's total revenue in 2019, such businesses would nevertheless be eligible for a PPP loan. The Third SBA Regulations, however, suspend these tests altogether, providing that neither test is applicable and any business that is otherwise eligible for a PPP loan is not rendered ineligible due to receipt of legal gaming revenues, providing relief to businesses, like hotels and restaurants, that otherwise derive significant revenues from gaming.

The Third SBA Regulations clarify that because hedge funds and private equity firms are primarily engaged in investment or speculation, SBA believes that they are ineligible to receive a PPP loan, though they do not prohibit portfolio companies of private equity firms (as discussed above).

Applicability of affiliate rules: The eligibility of borrowers of Section 7(a) loans is determined by taking into account the employees and revenue, as applicable of both the borrower itself and also the employees and revenue, as applicable, of affiliates of the borrower

(subject to the waivers and carve-outs discussed below). The Affiliation Guidance confirmed that those rules apply to the PPP.

The 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 Affiliation Guidance did not provide relief to private-equity or venture-capital-backed businesses that are excluded from the PPP by these rules. Nevertheless, the SBA/Treasury FAQs clarify that if a minority shareholder in a business irrevocably waives or relinquishes all of the existing rights that cause such shareholder to be an affiliate of the business, such minority shareholder will no longer be an affiliate of the business (assuming no other relationship triggers the affiliation rules).

This clarification could be a significant opportunity for some private-equity or, especially, venture-capital-backed businesses, though each such business (and its minority owners or other stakeholders) will have bespoke facts and circumstances to consider prior to amending any governing documents.

Affiliation waivers and carve-out: The CARES Act eases the affiliation 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, revenue, and if applicable, other characteristics of the borrower itself

(and not by taking into account the employees, revenue, and if applicable, other characteristics of any affiliates of the borrower). It is important to note that these waivers apply only to the eligibility of the borrower that itself is the subject of the waiver (*e.g.*, the entity that has an SBIC investor). Affiliates of such a borrower must still include that borrower as their affiliate when they determine their own eligibility. In essence, these waivers make the PPP a dual-track program designed to provide payroll relief not only to small businesses, but also businesses in the hospitality sector, regardless of size.

We also note that there is an explicit carve-out 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 (whose place of residence is in the United States) per physical location at the time of disbursement shall automatically be eligible to receive a PPP loan. Generally, the SBA/Treasury FAQs, as updated April 13, 2020, clarify that the US\$10 million loan amount cap (described under "Maximum Loan Amount" below) applies to the entire business entity and not to each individual location; nevertheless, for franchise brands listed on the SBA Franchise Directory each franchisee that otherwise meets the applicable size standard can apply for a PPP loan (*i.e.* a franchisor does not apply on behalf of its franchisees). Franchise brands previously denied listing because of affiliation rules may nevertheless apply anew for purposes of receiving PPP loans.

Some businesses are seeking to manage these affiliation rules by exploring new "rescue" investments from SBICs. The SBA Memo clarifies that there is no minimum amount of financing assistance from an SBIC, nor does a business need to receive financial assistance exclusively from SBICs to rely on the waiver from the affiliation rules. Furthermore, the Third SBA Regulations state that the waiver of the affiliation rules applies to "any type of financing listed in 13 CFR § 107.50, such as loans, debt with equity features, equity, and guarantees," and notes that affiliation is waived "even if the borrower has investment from other non-SBIC sources."

Nevertheless, the Small Business Investor Alliance (SBIA), a leading trade association representing SBICs and other small business investors, has warned SBICs against "renting" their SBIC license privileges by

making token investments in businesses. Moreover, the SBIA also advises, among other things, that SBICs must always (i) make investments consistent with their underlying governing documents and (ii) comply with the statute and regulations of the SBIC program generally. It is not known whether SBA will issue additional guidance on SBIC investments that enable a company to access a PPP loan, but as an informal matter, we know that SBA is concerned about abuse.

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 one-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. Under the CARES Act and Initial SBA Regulations, average monthly payroll costs are calculated based on the last 12 months of payroll costs. But the SBA/Treasury FAQs clarify that borrowers can calculate aggregate payroll costs using data from either (i) the previous 12 months or (ii) from calendar year 2019. We recommend that prospective borrowers contact their lender prior to making this calculation to confirm which approach they will be using.

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. The SBA/Treasury FAQs clarify that seasonal businesses that were not in business from February 15, 2019 to June 30, 2019 may use the average monthly

payroll costs for the period January 1, 2020 through February 29, 2020.

For self-employed individuals, the maximum loan amount is the product of x and y, with (x) being one twelfth of the sum of (A) the 2019 net profit from such individual's IRS Form 1040 Schedule C (the Owner Compensation), (B) wages and tips paid to employees who principal place of residence is in the United States, and (C) employer health insurance contributions, retirement contributions, and state and local taxes assessed on employee compensation, and (y) being 2.5. In addition, the loan proceeds for self-employed individuals can only be used for those types of allowable uses for which the borrower made expenditures in 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; for the costs of 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; and payments of state or local tax assessed on the compensation of employees, and (solely with respect to independent contractors or sole proprietors seeking PPP loans) the sum of any compensation to or income of an independent contractor or sole proprietor.

The SBA/Treasury FAQs clarify that payroll costs are, generally speaking, calculated on a gross basis (and not net of taxes payable during the covered period). Accordingly, payroll costs should *not* be reduced by taxes imposed on an employee and required to be withheld by the employer, including (i) federal taxes and (ii) the employee's share of Federal Insurance Contributions Act (FICA). Payroll costs should not, however, include the employer's share of payroll tax.

As noted above, the Initial SBA Regulations clarify that businesses should include in their payroll costs only the amount of compensation paid to employees, not to independent contractors. For purposes of this calculation, payroll costs exclude, among other things, (i) the salary 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. The SBA/Treasury FAQs clarify that the US\$100,000

limit applies solely to cash compensation in excess of US\$100,000, and not to non-cash benefits, including (i) employer contributions to defined-benefit or defined-contribution retirement plans; (ii) payment for the provision of employee benefits consisting of group health care coverage, including insurance premiums; and (iii) payment of state and local taxes accessed on compensation of employees.

The SBA/Treasury FAQs also state that providing an accurate calculation of payroll costs is the responsibility of the borrower, which must attest to the calculations' accuracy; lenders are expected to perform a good faith review in a reasonable time, of the borrower's calculations and supporting documents.

PPP loan terms: Although under the CARES Act, loans could bear interest of up to 4% and terms of up to 10 years, the Initial SBA Regulations provide that all PPP loans will be made at a 1.0% fixed interest rate loan and a term of two years. While SBA and Treasury guidance earlier this week quoted a 0.5% rate, the Initial SBA Regulations explain that the 1.0% rate is designed to provide, in addition to SBA's 100% guarantee, ample inducement for lenders to participate in the PPP. 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 million; and
- 1% for covered loans over US\$2 million.

Even with these fees, the compensation to lenders of PPP loans appears modest on a per loan basis.

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) and owner compensation (as defined above) for self-employed individuals, (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 disbursement, the cumulative amount of items (i)-(iv) will be forgiven from repayment.

The Initial SBA Regulations provide, however, that not more than 25% of the loan forgiveness amount may be attributable to items (ii) through (iv) above, while 75% of the forgiveness amount must be attributable to payroll costs, in light of the CARES Act's overarching focus on keeping workers paid and employed and the program's policy goal of payroll protection. Note that the Initial SBA Regulations also suggest that 75% or more of the proceeds of any PPP loan itself must also be applied exclusively to payroll costs.

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. Note, however, that this "safe harbor" curative only applies for employees who were laid off or whose salaries were reduced during the period that began on February 15, 2020 and that ended on April 26, 2020. 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 during the eight-week period beginning on the date of loan disbursement *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. 3

- **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 disbursement to the most recent full quarter during which the employee was employed.

SBA has stated in the Initial SBA Regulations that it also intends to issue additional guidance on loan forgiveness.

In the interim, the SBA/Treasury FAQs were updated on April 29, 2020, echoing earlier comments made by Treasury Secretary Steve Mnuchin, to confirm that SBA will review all loans in excess of US\$2 million, in addition to “other loans as appropriate,” following the borrower’s application for forgiveness. Additional guidance for this procedure is also forthcoming.

Loss of tax and unemployment benefits: A business that obtains a PPP loan will not be eligible to take advantage of the employee retention tax credit (under Section 2301(j)), and it may not be eligible to delay employer payroll tax payments (under Section 2302(a)(3)) under of the CARES Act.

A borrower may defer the employer’s portion of payroll taxes that would otherwise be due between March 27, 2020 and the end of the year without jeopardizing PPP eligibility. Guidance issued by the U.S. Internal Revenue Service on April 10, 2020 clarifies that PPP recipients are eligible to make such deferments until a prospective lender renders a decision on whether a PPP loan is forgiven. Upon the date of forgiveness, the employer is no longer eligible to defer payroll tax payments. For payroll tax payments deferred through

the forgiveness date, the employer may continue deferral of payment until the end of 2021 and 2022 without incurring penalties for failure to deposit and failure to pay. During 2021 and 2022, the employer is responsible for paying 50% of the total amount deferred during the course of each of the respective years.

Self-employed individuals who obtain a PPP loan may no longer be eligible for state-administered employment compensation or unemployment assistance programs, including those programs authorized under the CARES Act.

Misuse: The Initial SBA Regulations provide for penalties if PPP funds are misused. If a borrower (including a borrower’s shareholders, members, or partners) uses PPP funds for unauthorized purposes, SBA will direct that business to repay those amounts. Furthermore, borrowers (including, again, their shareholders, members, or partners) that knowingly use the funds for unauthorized purposes will be subject to additional liability such as charges for fraud.

As part of the application process, an authorized representative of the borrower applicant must certify in good faith that, among other things, (i) the information provided in the application and the information provided in all supporting documents and forms is true and accurate in all material respects and (ii) that the representative understands that knowingly making a false statement to obtain a guaranteed loan from SBA is punishable under the law, including under (A) 18 USC § 1001 and 18 USC § 3571 by imprisonment of not more than five years and/or a fine of up to US\$250,000; (B) under 15 USC § 645 by imprisonment of not more than two years and/or a fine of not more than US\$5,000; and, (C) if submitted to a federally insured institution, under 18 USC § 1014 by imprisonment of not more than 30 years and/or a fine of not more than US\$1 million.

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. Borrowers must submit SBA Form 2483 (Paycheck Protection Program Application Form) and required payroll documentation.

As of the time of this writing, the attempted usage of the PPP has been substantial, and 7(a) lenders have faced a range of 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 are generally addressing the needs of their current customers before seeking to help new customers. The SBA/Treasury FAQs, however, encourage non-bank lenders to apply to become a 7(a) lender for the purpose of increasing the scope and speed of PPP loan disbursement across the country, and the FAQs clarify the process and documentation required for enrolling such non-bank lenders with SBA.

If your lender of choice is not participating in the PPP, 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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