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COVID-19 U.S.: Managing the impact of COVID-19 on the media and entertainment sector - through the CARES Act loan program

The entertainment industry has been severely impacted by COVID-19. While demand for content has surged under stay-at-home orders, television and film production has ceased. New content that is being delivered is sourced from productions that were completed prior to the current shutdown. COVID-19 has also disrupted those businesses that provide in-person events and entertainment – theme parks, concert and sporting venues, movie houses, and museums. Business spending on advertising has also materially declined. Revenues at many print media outlets that rely on small businesses for ads have dried up. The absence of live sports, trade shows, and other big events has dramatically affected advertising spend.

On the flip side, certain sectors in the entertainment industry have experienced an increase in business. Companies that deploy new technologies that closely replicate the pre-COVID-19 experience are in demand. esports and other providers of online simulated events are satisfying the surge in customer demand. Companies with access to capital are taking advantage of depressed valuations of high upside/financially strapped entertainment businesses. Streaming businesses and those companies that offer products or services ancillary to streaming may also be benefiting from the recent enormous jump in viewership of streaming services.

If your entertainment company is experiencing a downturn in business you should look to the availability of government backed loans under the Paycheck Protection Program (PPP). This program is potentially available to both companies and individuals directly in each of the aforementioned businesses as well to those companies and individuals that indirectly support such businesses.

Government-provided stimulus incentives

On Friday, March 27, 2020, President Trump signed into law H.R. 748, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), a US\$2.2 trillion stimulus package, to address the catastrophic impact of COVID-19 on the U.S. economy. Among the most consequential measures for entertainment companies that are adversely affected by COVID-19 is the significant expansion of the 7(a) Loan Guarantee Program facilitated by the Small Business Administration (SBA).

On April 2, 2020, SBA issued its [initial interim regulations](#) (the Initial SBA Regulations) that govern the loans provided pursuant to the expansion of the 7(a) program. Borrowers began applying for the loans beginning on Friday, April 3, and the initial program was fully funded on April 16, 2020. The program was replenished on April 24, 2020.

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 U.S. Department of the Treasury jointly released [additional FAQs guidance](#) (the SBA/Treasury FAQs), which have been updated periodically, that provide greater clarity to several ambiguous points 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. SBA and Treasury are expected to issue additional regulations governing or clarifying certain aspects of the expansion of the 7(a) Loan Guarantee Program from time to time.

On April 24, 2020, President Trump signed into law H.R. 266, the PPP 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.

Paycheck Protection Program: Expansion of 7(a) Loan Guarantee

The PPP under the CARES Act and the additional April stimulus legislation has now apportioned US\$659 billion to 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 and paid sick, medical, and family leave. Through the program, loans are administered by financial institutions. A significant portion of the loans are eligible for forgiveness. Any part of a loan that is not forgiven can be prepaid without penalty.

Is my business eligible for a PPP loan? Eligible businesses for PPP loans include (i) small businesses that meet the traditional definition of “small business concern” or (ii) any “business concern” that employs up to the greater of (a) 500 employees whose primary residence is in the U.S. 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, and each applicant must certify in good faith that current economic uncertainty makes this loan request necessary to support the ongoing operations of the applicant (see below for further detail on this certification).

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. An entertainment company may be considered a manufacturer (e.g., a production company), a service provider (e.g., a web platform) or both (e.g., a studio). Which test applies is determined by industry North American Industry Classification System (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.

Entertainment companies need to pay particular attention to guidance provided in the SBA Memo and the SBA/Treasury FAQs. This guidance confirms that “small business concerns” can be eligible borrowers for PPP loans even if they have more than 500 employees whose primary residence is in the U.S., so long as they otherwise meet the existing statutory and regulatory definition of a “small business concern.” The guidance also clarifies 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.

“Business concerns” are businesses that are (i) organized for profit; (ii) have a place of business located in the U.S.; and (iii) make a significant contribution to the U.S. economy through the payment of taxes or use of American products, materials, or labor. Most “for profit” entertainment companies should qualify as “business concern” and, therefore, need to review whether they meet the size standard in order to qualify for a PPP loan.

Certain businesses of entertainment companies are ineligible for a PPP loan. These include, among other types of businesses, businesses located in a foreign country. However, a foreign business that has business activities in the U.S. may be eligible. Although there has been no specific SBA guidance on this point in the context of the PPP, SBA’s Standard Operating Procedure 50 10 5(k) clarifies that the U.S. subsidiaries of a business headquartered outside of

the United States would be eligible for a standard 7(a) loan if it has business activities in the United States, provided that such business meets the other PPP eligibility requirements, including having no more than 500 U.S. employees. Additional conditions will apply if the business is majority-owned by foreign nationals. Non-U.S. businesses that conduct certain activities (e.g. nuclear energy activity) are not eligible for 7(a) loans under various other U.S. laws.

In addition, a business is typically ineligible for a traditional 7(a) loan if more than one-third of its gross annual revenue comes from legal gambling. The SBA initially tried to broaden this test. But in light of the fact that many businesses, in both the hospitality and the entertainment sectors, derive significant revenues from gaming, the Third SBA Regulations suspend all revenue tests with respect to legal gambling. Any business that is otherwise eligible for a PPP loan is not rendered ineligible due to receipt of legal gaming revenues.

How does my business determine if it can make a certification of economic need? As part of the application process, applicants must certify in good faith that current economic uncertainty makes a loan request necessary to support the ongoing operations of the applicant. 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 privately-held and public companies during the first US\$349 billion phase of the PPP, both (i) the SBA/Treasury FAQs update issued on April 23, 2020 and (ii) the Third SBA Regulations issued a day later address how borrowers should assess their economic need.

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.”

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 like any other applicant, and (ii) reinforced that borrowers should carefully review the certification of economic need.

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.

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 need 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.

How many employees do I have? How do I determine my revenues? For the purpose of meeting the “small business concern” or “business concern” thresholds, the number of employees in a business may be calculated through one of three methods: (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, (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. For entertainment businesses, freelancers, and others hired for a specific production or activity will count as employees. SBA could apply its existing guidance (under 13 CFR § 121.106(a)) to include 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.

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.

The eligibility of borrowers 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 which generally are not available to entertainment companies). 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 percent 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. 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.

If I am self-employed or a partnership, am I eligible for a PPP loan? Eligible businesses include those carried out by 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.

What is the maximum amount I may borrow? For Section 7(a) loans under the PPP taken out between February 15, 2020 and June 30, 2020, the maximum 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.

Prospective borrowers should contact their lender prior to making this calculation to confirm which approach they will be using.

For self-employed individuals, the owner's compensation is determined by reference to the 2019 net profit shown on IRS Form 1040 Schedule C.

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; 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 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 assessed on compensation of employees.

What is the interest rate and other payment terms on a PPP Loan? Although under the CARES Act, loans could bear interest of up to 4 percent and terms of up to 10 years, the Initial SBA Regulations provide that all PPP loans will be made at a 1.0 percent fixed interest rate loan and 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.

How do the loan forgiveness provisions work? To the extent Section 7(a) loan amounts are used for (i) payroll costs (and owner compensation of 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 percent of the loan forgiveness amount may be attributable to items (ii) through (iv) above, while 75 percent of the forgiveness amount must be attributable to payroll costs. Note that the Initial SBA Regulations also suggest that 75 percent 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.

Furthermore, 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.

What else should I know about the PPP loan program? A business that obtains a PPP loan will not be eligible to take advantage of the employee retention tax credit (i.e., a refundable payroll tax credit of up to US\$5,000 for "qualified wages" paid to each retained employee between March 13 and December 31, 2020) or the delay of employer payroll tax payments (i.e., the deferral of the payment of employer Social Security taxes that are otherwise owed for wage payments made after March 12, 2020, through the end of 2020) provisions of the CARES Act. 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.

Are there any further items of the PPP loan program that may be of particular interest to entertainment businesses? The broad scope of PPP means that many kinds of entertainment businesses should be able to avail themselves of a PPP loan as long as they meet the size or revenue requirements of the CARES Act and interpretative guidance that has (and will continue) to ensue. Loan-out companies should also be eligible for PPP loans (but the US\$100,000 compensation (and other “payroll costs”) cap per employee may restrict the value to such a loan-out company borrower).

Last, the requirement that the PPP loan be used for limited purposes (i.e., payroll costs, costs related to the continuation of health care benefits and insurance premiums, commissions, interest on mortgage obligations, rent and utility payments, interest on debt incurred before February 15, 2020, and refinancing a SBA Economic Injury Disaster Loan made between January 31, 2020 and April 3, 2020) may be problematic where the borrower’s operating costs are covered/guaranteed/reimbursed by another party (e.g., a studio, distributor, streaming platform, etc.). Note that the latest guidance from SBA and Treasury require the PPP loan applicant to certify that “current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.” In such cases, the use of PPP funds for any unauthorized purposes or the making of a knowingly false certification may result in criminal liability in addition to an obligation to repay the misused amounts.

Additional Hogan Lovells resources on government provided stimulus incentives

Hogan Lovells is monitoring this closely and will continue to publish updated guidance. Read our latest article on [Navigating the Paycheck Protection Program \(PPP\) under the CARES Act and recent SBA guidance](#).

To help our clients stay on top of the latest developments, we have created a user-friendly comparison chart outlining the key components and qualifications for the Primary Market Corporate Credit Facility, Main Street Lending Program, and Paycheck Protection Program U.S. federal loan relief programs. [Please click here to view our COVID-19 comparison of U.S. federal loan relief programs chart](#).

The above represents our latest thinking in “real time” and will likely evolve over the coming weeks and months. 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 to below.

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