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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 (the 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, containing 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.

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 will soon issue regulations governing this expansion of the 7(a) Loan Guarantee Program, and Hogan Lovells will publish updated guidance at that time.

Paycheck Protection Program: Expansion of 7(a) loan guarantee¹

The Paycheck Protection Program (PPP) under the CARES Act, 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) and 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 amount. 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, all 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”² and (ii) any business concern³, nonprofit, veterans organization, or tribal business concern that employs the greater of (a) 500 employees⁴ or (b) if applicable, the size standard in number of employees established by SBA for the industry in which the business concern operates.

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. See 13 CFR § 121.301.⁵ The CARES Act eases these rules by waiving the requirement to take into account the employees and revenue of affiliates for: (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 account 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. It is not yet known whether SBA will issue regulations regarding any such “rescue” investments.

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.

Applicability: The SBA size and revenue thresholds can be found in the [Table of Small Business Size Standards](#). NAICS codes can be found on IRS tax filings.

Maximum loan amount: With respect to a Section 7(a) loan taken out 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 costs⁶ incurred during the 1-year period before the disbursement of loan 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 payroll.

PPP loan terms: The maximum interest rate that lenders can charge on a PPP loan is 4%. Unlike with other SBA programs, there is no requirement that the business is unable to obtain credit elsewhere, and no personal guarantee or collateral required for the loan. The term of this loan has a maximum maturity of 10 years. SBA will require that lenders defer payments on the PPP loans for a period between 6 months and 1 year and there are no prepayment 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 forgiveness⁷: To the extent Section 7(a) loan amounts are used for (i) payroll costs⁸, (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 8-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) workforce⁹ or (ii) worker salaries¹⁰, 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.

Steps to apply: We expect the attempted usage of the PPP to be substantial, and 7(a) lenders may face challenges in processing PPP loans. In order to identify a potential lender, we suggest that each interested company contact their existing banking contacts immediately to first identify whether they are SBA-approved 7(a) lenders as 7(a) lenders are likely to address the needs of their current customers before seeking to help potentially new customers. SBA also offers a [Lender Match](#) tool. It may also be helpful to identify banks that are focused on making 7(a) loans in the geographic region where the potential borrower is located rather than going to 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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End notes

1. Division A, Title I, Section 1102.
2. 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 (see “Table of Small Business Size Standards”). 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)).
3. “Business concerns” are business that are (1) organized for profit; (2) have a place of business located in the United States; and (3) make a significant contribution to the U.S. economy through the payment of taxes or use of American products, materials or labor.
4. 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 test. That guidance provides as follows: In determining a concern’s number of employees, SBA counts all individuals employed on a full-time, part-time, or other basis. 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.
5. 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 block ordinary daily actions are likely to create affiliation under clause (ii) above.
6. For purposes of this calculation, payroll costs exclude, among other things, (i) the compensation of any employee in excess of a prorated annual salary of US\$100,000 and (ii) compensation of employees whose principal place of residence is outside of the United States.
7. Division A, Title I, Section 1106.
8. Payroll costs are defined as the sum of salary, wages, 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; and payments of State or local tax assessed on the compensation of employees. Payroll costs exclude compensation of any individual employee in excess of US\$100,000, as prorated between February 15, 2020 and June 30, 2020, among other exclusions. We anticipate the government will promptly issue guidance to individual financial institutions to streamline the determination of appropriate loan amounts.
9. 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 (i) the average number of full-time equivalent employees per month between February 15, 2020 and June 30, 2020 by, at the election of the borrower, either (ii) the average number of full-time equivalent employees per month employed between February 15, 2019 and June 30, 2019 or (iii) 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 (i), (ii), and (iii), 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. A different calculation is provided for seasonal businesses.
10. Salary 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 8-week period beginning on the date of loan origination to the most recent full quarter during which the employee was employed.

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