
LEGAL UPDATES AND NEWS

What Financial Institutions Need to Know About the SBA's Paycheck Protection Program (Updated for April 6, 2020 Guidance)

The Coronavirus Aid, Relief, and Economic Security Act, or CARES Act, was signed into law on March 27, 2020 and provides over \$2.0 trillion in emergency economic relief to individuals and businesses impacted by the COVID-19 pandemic, which includes authorizing the Small Business Administration ("SBA") to temporarily guarantee loans under a new 7(a) loan program called the Paycheck Protection Program ("PPP"). Under the PPP, participating SBA and other qualifying lenders can originate up to \$349 billion in loans to eligible businesses that are fully guaranteed by the SBA as to principal and interest, have more favorable terms than traditional SBA loans and may be forgiven if the proceeds are used by the borrower for certain purposes.

Provided below is updated information about the PPP based upon the CARES Act, the interim final rule released by the SBA on April 2, 2020 that is effective immediately (the "Interim Final Rule"), the SBA's associated guidance on applicable affiliation rules dated April 3, 2020, and the U.S. Department of the Treasury's Frequently Asked Questions Memorandum, updated as of April 6, 2020 (the "Treasury FAQ"). The Treasury FAQ provides additional guidance and information to address borrower and lender questions concerning the PPP. Among other topics, the Treasury FAQ clarifies: (1) the eligible businesses that may apply for a PPP loan; (2) the definition of payroll costs; and (3) lender underwriting obligations and process. Financial institutions that processed PPP applications prior to the issuance of the Treasury FAQ may rely on the laws, rule and guidance available to them at the time of the relevant application and are not required to take any further action.

Additionally, lenders should take note of a recent class action lawsuit filed against Bank of America for placing restrictions on and prioritizing access to its PPP program. Notwithstanding compliance with federal and state civil rights and anti-discriminatory laws, neither the CARES Act nor any other supplemental guidance released regarding the PPP to date, including the Interim Final Rule, specifically prevents lenders from imposing eligibility criteria or other conditions related to their PPP program, which we understand many lenders have done for various legitimate business reasons.

I. General Overview of the PPP

Who are eligible businesses that can apply for a PPP loan?

Contrary to the Interim Final Rule and based on the Treasury FAQ, a business will be eligible to participate in the PPP if it satisfies either: (1) the "Employee Threshold Test," or (2) the "Small Business Concern Test."

Employee Threshold Test. A business with a principal place of residence in the U.S and in operation as of February 15, 2020, including nonprofit organizations, with 500 or fewer employees (even if the business does not qualify as a "small business concern," as defined below) can apply for a PPP loan. A business that exceeds the 500-employee threshold is still eligible if it meets the SBA employee-based size standards for the industry in which they operate. The applicable SBA employee-based size standards can be found at www.sba.gov/size. The Interim Final Rule applies the 500-employee threshold on a per location basis for

certain borrowers (e.g., hotels). Sole proprietors, self-employed individuals and independent contractors are also eligible to apply for a PPP loan.

Small Business Concern Test. A business can apply for a PPP loan (even if it does not satisfy the Employee Threshold Test) as long as it was in operation as of February 15, 2020 and qualifies as a “small business concern” as defined under the Small Business Act. Under current SBA rules, a business qualifies as a “small business concern” if it meets the SBA employee-based and/or revenue-based size standard(s) that corresponds to its primary industry. These industry size standards can be found at www.sba.gov/size.

Alternatively, a business can qualify as a “small business concern” if it meets the SBA’s “alternative size standard” if both of the following tests are met as of March 27, 2020: (1) 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 PPP application is not more than \$5 million.

In evaluating an applicant’s eligibility under either test, a lender may consider whether a seasonal business was in operation on February 15, 2020 or for an eight-week period between February 15, 2019 and June 30, 2019.

Do the SBA’s affiliation rules apply in determining whether a business is eligible to participate in the PPP?

Yes. In determining whether a business satisfies the Employee Threshold Test or the Small Business Concern Test, the SBA’s affiliation rules would apply to all businesses applying for a PPP loan except for those expressly excluded by the CARES Act. The excluded businesses are: (1) businesses in the food and hotel industry; (2) businesses operating as a franchise; and (3) businesses receiving assistance from SBA-licensed small business investment companies.

As a result, each affiliate of the applicant (unless an excluded business) must be considered in determining whether the Employee Threshold Test or the Small Business Concern Test is satisfied. Entities are considered SBA affiliates based on certain factors, including 50% or more equity ownership, overlapping management and identity of interest. The SBA has stated that additional guidance would be forthcoming regarding the application of its affiliation rules.

Could a business that satisfies either the Employee Threshold Test or the Small Business Concern Test be disqualified from participating in the PPP?

Yes. The Interim Final Rule provides that a business satisfying the Employee Threshold Test or the Small Business Concern Test above would nonetheless be disqualified from participating in the PPP if it is either: (1) a household employer; (2) engaged in any illegal activity under federal, state or local law (this includes marijuana-related businesses, subject to certain exceptions); (3) has a 20% or more owner who is incarcerated, subject to criminal indictment or has been convicted of a felony within the last five years; or (4) defaulted on an SBA or federal loan or guarantee and caused a loss to the government in the last seven years. Additionally, ineligible businesses set forth in 13 CFR Section 120.110 are not eligible for PPP loans.

Are financial institutions or their affiliates eligible to apply for a PPP loan?

Financial Institutions. No. Under current SBA rules, financial businesses, such as banks and finance companies, are ineligible for SBA loans. The Interim Final Rule confirms that neither banks, credit unions nor any other lending institutions are eligible to receive a PPP loan because of this restriction.

Affiliates of Financial Institutions. Subject to additional guidance and based upon current SBA affiliation rules, even if an affiliate of a financial institution is not engaged in the business of lending and qualifies as

a “small business concern,” it may nonetheless be ineligible to receive a PPP loan from an unaffiliated lender due its affiliation with an ineligible business (i.e., the parent financial institution).

A practical example of the foregoing would be an insurance agency that is 51% owned by a bank and 49% owned by individual agents that meets the SBA revenue tests. Despite otherwise qualifying for the PPP loan, the insurance agency would not be eligible to receive a PPP loan from an unaffiliated lender because a bank controls 50% or more of its voting power.

Regardless of the SBA affiliation rules, current SBA rules prohibit a lender from originating a loan (which would include a PPP loan) to a business in which the lender has any equity interest.

Is the business in which a financial institution director, officer, key employee or 20% shareholder has an equity interest eligible to receive a PPP loan from his or her own financial institution?

No. Current SBA rules prohibit a lender from originating a loan to a business in which a director, officer, key employee or 20% shareholder of the lender has any equity interest. However, it is our understanding that Treasury has said during informal discussions that this would be permitted. We are hoping for official guidance in the coming days.

How much can an eligible business borrow under the PPP?

An eligible business can apply for a PPP loan up to the greater of: (1) 2.5 times its average monthly “payroll costs;” or (2) \$10.0 million. The Interim Final Rule provides that average monthly payroll costs would be determined during the 12-month period before the date the PPP loan is made. However, the PPP Borrower Application Form (SBA Form 2483, available [here](#)) (the “Borrower Application Form”) provides alternative time periods to determine average monthly payroll costs for existing, new and seasonal businesses. Notwithstanding such inconsistency, the Treasury FAQ confirmed that following the instructions in the Borrower Application Form to calculate payroll costs is appropriate.

Payroll costs for the maximum PPP loan calculation (“Payroll Costs”) include: (1) salary, wages, commissions or tips, up to \$100,000 on an annualized basis for each employee); (2) employee benefits, including paid time off, allowance for separation or dismissal, health insurance premiums and retirement benefits; and (3) state and local taxes assessed on compensation (excluding federal employment taxes, such as the employer and employee-portion of FICA taxes, imposed or withheld between February 15, 2020 and June 30, 2020). The Treasury FAQ clarifies that only the employee-side federal payroll taxes should be considered Payroll Costs during the applicable time period. Employer-side payroll taxes would be excluded.

The applicant may not include amounts paid to independent contractors or sole proprietors in determining payroll costs since independent contractors and sole proprietors have the ability to apply for a PPP loan on their own. For sole proprietor or independent contractor applicants, Payroll Costs include their wages, commissions, income or net earnings from self-employment, up to \$100,000 on an annualized basis.

The Treasury FAQ confirm that the exclusion of compensation in excess of \$100,000 only applies to cash compensation, not to non-cash benefits, including (1) employer contributions to defined-benefit or defined-contribution retirement plans; (2) payment for provision of employee benefits consisting of group health care, including insurance premiums; and (3) payment of state and local taxes assessed on compensation of employees.

What are the basic PPP loan terms, including loan forgiveness?

General Terms. PPP loans will have: (1) an interest rate of 1.0%, an increase from 0.5% previously stated by Treasury; (2) a two-year loan term to maturity, decreased from the maximum term of 10 years under the

CARES Act; and (3) principal and interest payments deferred for six months from the date of disbursement; however, interest will continue to accrue over the deferred period.

The SBA will guarantee 100% of the PPP loans made to eligible borrowers.

Borrowers are not required to pledge any collateral or provide any personal guarantee in order to obtain their PPP loans and no prepayment penalties or fees may be charged if PPP loans are repaid earlier than the two-year maturity date.

Use of Loan Proceeds. Borrowers must use the PPP loan proceeds for: (1) the Payroll Costs; and (2) other authorized non-payroll costs (the “Authorized Non-Payroll Costs”), including: (a) costs related to group health benefits during periods of paid sick, medical or family leave, and insurance premiums; (b) mortgage interest payments (but not mortgage prepayments or principal payments); (c) rent payments; (d) utility payments; (e) interest on debt incurred prior to February 15, 2020; and (f) refinancing of SBA Emergency Industry Disaster Loans that are made between January 31, 2020 and April 30, 2020.

The Interim Final Rule requires that at least 75% of the PPP loan proceeds must be used for Payroll Costs. This is inconsistent from the CARES Act, which does not have such 75% threshold.

If the PPP loan proceeds are used for unauthorized purposes, the loan will not be forgiven (as discussed below) and the SBA will direct the borrower to repay the loan. If the proceeds are used knowingly for unauthorized purposes, the borrower, including its shareholders, members or partners for their unauthorized use, may be subject to additional liability.

Loan Forgiveness. The SBA, as noted by the Interim Final Rule, intends to issue further guidance on loan forgiveness. Subject to further guidance, the entire principal amount of the borrower’s PPP loan, including any accrued interest, is eligible to be reduced by the loan forgiveness amount under the PPP so long as employee and compensation levels of the business are maintained. The loan forgiveness amount is equal to the sum of all Payroll Costs and Authorized Non-Payroll Costs incurred by the borrower during the eight-week period following the date of the PPP loan, provided, however, that not more than 25% of the loan forgiveness amount may be attributable to Authorized Non-Payroll Costs (or, in other words, at least 75% of the loan forgiveness amount must be attributable to Payroll Costs). The Interim Final Rule explains that limiting Authorized Non-Payroll Costs to 25% of the loan forgiveness amount helps ensure that a predetermined amount of the PPP loan is directed toward payroll protection for employees. The Interim Final Rule, unlike the CARES Act, does not specify whether compensation or employee reductions during the eight-week period would reduce the loan forgiveness amount, which we anticipate will be addressed in any SBA further guidance on loan forgiveness.

Borrowers seeking loan forgiveness must submit an application to their lenders and include sufficient documentation verifying their Payroll Costs and Authorized Non-Payroll Costs for the eight-week cover period. Lenders must make their determination on loan forgiveness within 60 days after receipt of the application. Any loan forgiveness amount would be excluded from the borrower’s gross income for IRS purposes.

The borrower’s remaining PPP loan balance, if any, after reduction of the loan forgiveness amount would remain subject to the terms and conditions described above.

What is the borrower application process for obtaining a PPP loan?

Eligible businesses may start applying for PPP loans on a first-come, first-served basis, commencing on April 3, 2020. The last day to apply is June 30, 2020 or, if earlier, until funds made available for the PPP have been exhausted. No borrower may receive more than one PPP loan.

To apply, an eligible business must submit: (1) the Borrower Application Form (which is permitted to be signed by a single individual who is authorized to sign on behalf of the borrower) and (2) supporting documentation to establish eligibility and the PPP loan amount, such as payroll tax processor records, payroll tax filings or Form 1099-MISC or income and expenses for a sole proprietorship. Pursuant to the Treasury FAQ, payroll documentation provided by the payroll provider that indicates the amount of wages and payroll taxes reported to the IRS by the payroll provider for the applicant's employees will be considered acceptable PPP loan payroll documentation.

The applicant must also make good faith certifications in the Borrower Application Form (the "Borrower Certifications"), including that: (1) it was in operation on February 15, 2020 and had employees and independent contractors that received taxable compensation; (2) the current economic uncertainty makes the PPP loan necessary to support ongoing operations; (3) the PPP loan proceeds will be used for Payroll Costs and Authorized Non-Payroll Costs; and (4) all supporting documentation provided is true and accurate in all material respects.

Pursuant to the Treasury FAQ, an applicant that satisfies the Small Business Concern Test may truthfully attest to its eligibility on the Borrower Application Form, unless otherwise ineligible.

II. Aspects of the PPP Significant to Lenders

Who is eligible to be a lender under the PPP?

All SBA 7(a) lenders are automatically approved to make PPP loans.

Federally insured depository institutions and federally insured credit unions not currently approved to be SBA 7(a) lenders are qualified to participate in the PPP, so long as there is no pending enforcement action addressing unsafe or unsound lending practices or troubled conditioned designation from their primary federal regulator. These institutions will be enrolled in the PPP upon completing the CARES Act Section 1102 Lender Agreement (SBA Form 3506, which is available [here](#)) and the Certificate of Incumbency of Officers (FS Form 1014, which is available [here](#)) and sending the forms via email to the SBA at DelegatedAuthority@sba.gov.

What underwriting is required?

Underwriting Obligations. The lender's underwriting obligations under the PPP are limited to: (1) reviewing the Borrower Application Form; (2) confirming receipt of the Borrower Certifications and supporting documentation to establish eligibility and how the PPP loan was calculated; and (3) following applicable BSA protocols. For depository institutions and credit unions, PPP loans made to existing customers will not require: (1) re-verification under applicable BSA requirements; or (2) the collection of beneficial ownership information on an existing customer to the extent it has not been provided, unless otherwise indicated by the institution's risk-based approach to BSA compliance. However, PPP loans to non-existing customers will need to go through the institution's BSA/AML onboarding process.

In evaluating the applicant's eligibility, the Interim Final Rule confirms that the lender is not required to consider whether the applicant is unable to obtain credit elsewhere pursuant to the SBA's credit elsewhere test. The Treasury FAQ also clarifies that lenders are not required to make an independent determination whether the SBA's affiliation rules were applied correctly by the applicant.

Lenders are also permitted to use their own online systems and a form they establish that requests the same information (using the same language) as the Borrower Application Form. However, Lenders are still required to send the data to the SBA using the SBA's interface.

Lender Reliance and Limited Liability. The SBA will allow lenders to rely on Borrower Certifications to determine eligibility and use of loan proceeds and supporting documentation to determine the borrower's

PPP loan amount and eligibility for loan forgiveness. Although lenders must comply with its PPP underwriting obligations, they will not be liable for the borrower's failure to comply with PPP requirements.

Processing Loan Forgiveness. Lenders do not need to conduct any loan forgiveness verification if the borrower submits documentation supporting its request and attests that it has accurately verified its eligible payments.

SBA Form 2484. Lenders must also submit a PPP Lender's Application for 7(a) Loan Guaranty (SBA Form 2484, available [here](#)) electronically to the SBA with respect to each PPP loan made, which includes a certification that the underwriting obligations above were satisfied.

Will Lenders receive processing fees for making PPP loans?

Yes. Processing fees will be paid by the SBA to a lender within five days after the disbursement of the PPP loan. The processing fee amount will be based on the balance of the PPP loan at the time of disbursement, calculated as follows: (1) 5.0% for loans \$350,000 and under; (2) 3.0% for loans greater than \$350,000 to \$2 million; and (3) 1.0% for loans greater than \$2 million.

In addition, lenders will not owe the SBA any up-front guarantee fee, annual service fee or subsidiary recoupment fee. If an agent is hired to assist a borrower, agent fees must be paid by the lender out of the fees the lender receives from the SBA. Agents may not collect fees from the borrower or collect a portion of the PPP loan proceeds. The total amount that an agent may collect from the lender related to the PPP loan may not exceed: (1) 1.0% for loans \$350,000 and under; (2) 0.5% for loans greater than \$350,000 to \$2 million; and (3) 0.25% for loans greater than \$2 million.

What is the regulatory capital treatment of a PPP loan?

PPP loans have a risk weight of zero due to the 100% unconditional guarantee of the payment of principal and interest provided by the SBA.

What is the treatment under GAAP of a modified PPP loan?

If a PPP loan is modified due to the COVID-19 pandemic, the financial institution may elect to suspend GAAP for loan modifications that would otherwise result in the modified PPP loan being considered a troubled debt restructuring.

Can PPP loans be sold in the secondary market or repurchased by the SBA?

A PPP loan may be sold in the secondary market after the loan is fully disbursed at a premium or a discount to par value. No fee will be payable to the SBA for any guarantee sold in the secondary market.

To better ensure that financial institutions will have sufficient liquidity when participating in the PPP, the Interim Final Rule allows for the lender to request that the SBA purchase the expected loan forgiveness amount of the PPP loan (or pool of PPP loans) in advance of any loan forgiveness request by the borrower(s). Specifically, this request may be made by the lender to the SBA at the end of week seven of the eight-week cover period following the date the PPP loan is made.

For the expected loan forgiveness amount to be purchased, the lender must submit a detailed report to the SBA setting forth the expected loan forgiveness amount that includes: (1) the Borrower and Lender Application Forms, including any supporting documentation; (2) a detailed narrative explaining the assumptions and information used to calculate the expected loan forgiveness amount, the basis for those assumptions, alternative assumptions considered and why alternative assumptions were not used; (3) any information obtained from the borrower since the PPP loan was disbursed that the lender used to determine the expected loan forgiveness amount, including documentation to apply for loan forgiveness; and (4) any

additional information the SBA may require. If the report demonstrates that the expected loan forgiveness amount is reasonable, the SBA will make the purchase within 15 days thereafter.

We anticipate that the SBA will clarify what happens if the report fails to demonstrate reasonableness, particularly since the lender is relying primarily on information and attestations provided by the borrower in preparing the report.

May a participating financial institution limit PPP lending to existing customers only or impose other conditions on a PPP loan borrower?

Yes. Neither the CARES Act nor the Interim Final Rule prevents financial institutions from limiting PPP participation to existing customers only or imposing other conditions on a borrower obtaining a PPP loan. Due to several concerns cited by financial institutions following the launch of the PPP, such as BSA/AML concerns, the volume of applications and expedited application process, uncertainty over the conditions for loan forgiveness and a potentially weak secondary market, it is expected that many participating institutions will prioritize eligibility for their PPP lending to existing customer relationships, limit the amount of loans they will originate and impose conditions on borrowers obtaining a PPP loan.

In light of the Bank of America lawsuit (and related criticism by members of Congress), lenders should be cognizant of potential scrutiny or discrimination claims when designing any PPP participation limitations, exclusions and other conditions, even though there are no such restrictions upon doing so for legitimate business reasons under the CARES Act or any guidance issued to date (other than those limitations being applied in a non-discriminatory manner in compliance with applicable laws).

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While it is welcomed news that the SBA issued the Interim Final Rule to provide additional guidance on how to interpret the PPP provisions of the CARES Act, many important issues remain unsettled and await further clarification from the SBA. In addition to the expected supplementary guidance to be issued on loan forgiveness and the SBA's affiliation rules, the SBA is soliciting comments from interested members on all aspects of the Interim Final Rule, so it is possible that the rule may be further modified. Luse Gorman is closely monitoring these developments and will provide updates as appropriate.

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