
LEGAL UPDATES AND NEWS

What Financial Institutions Need to Know About the SBA's Paycheck Protection Program

The Coronavirus Aid, Relief and Economic Security Act, or CARES Act, was signed into law on March 27, 2020, 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, SBA and other qualifying lenders participating can originate up to \$349 billion in loans to eligible businesses that would be 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 information about the PPP based upon the CARES Act, the interim final rule released by the SBA on April 2, 2020 (the “Interim Final Rule”) and the SBA’s associated guidance on applicable affiliation rules dated April 3, 2020. The Interim Final Rule is effective immediately.

I. General Overview of the PPP

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

500-Employee Threshold. U.S. businesses in operation as February 15, 2020, including nonprofit organizations, with 500 or fewer employees that meet the definition of “small business concern” (as discussed below) can apply for a PPP loan. Businesses that exceed the 500-employee threshold are still eligible if they meet the size standard in number of employees established by the SBA for the industry in which the applicant operates. Sole proprietors, self-employed individuals and independent contractors are also eligible to apply for a PPP loan. The Interim Final Rule applies the 500-employee threshold on a per location basis for certain borrowers (e.g., hotels).

Small Business Concern. Unless the applicant is a nonprofit organization, the Interim Final Rule further restricts eligibility by requiring the applicant to be a “small business concern” as defined under the Small Business Act. The SBA uses size standards (i.e., numerical thresholds) matched to each industry described in the North American Industry Classification System (“NAICS”) to determine whether a business entity is “small.” For most industries, the size standards are based on the total number of employees and total receipts of the business. An applicant can check these thresholds for each type of business [here](#), which is provided on the SBA’s website. Accordingly, a business with 500 or fewer employees would be ineligible to apply for a PPP loan if its total receipts exceeded its applicable NAICS size standard because it would not qualify as a “small business concern.”

SBA Affiliation Rules. Except for certain businesses expressly waived by the CARES Act, such as businesses in the food and hotel industry, businesses operating as a franchise and businesses receiving assistance from SBA-licensed small business investment companies, all eligible businesses are subject to the SBA’s affiliation rules. In this regard, an applicant must include the employees of any affiliated entity when counting its employees in determining PPP eligibility. The applicant must also include the employees, total receipts and/or any other applicable size standard of any affiliate entity in determining whether the applicant qualifies as a small business concern. Entities are considered affiliates under the

SBA's affiliation rules based on certain factors, including stock ownership, overlapping management and identity of interest.

Ineligibility. The Interim Final Rule provides that a business satisfying the criteria above would nonetheless be ineligible for a PPP loan if it is either: (1) a household employer; (2) engaged in any illegal activity under federal, state or local law; (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 13 CFR Section 120.110 are ineligible for a PPP loan.

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. The Interim Final Rule provides that the SBA intends to promptly issue additional guidance regarding the applicability of its affiliation rules. 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 due its affiliation with an ineligible business (i.e., the parent financial institution). The SBA affiliation rules specify several factors that define an "affiliate," including 50% or more equity ownership.

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 for a PPP loan because a bank controls 50% or more of its voting power - (not even from an unaffiliated lender).

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. While prospective borrowers have been following the instructions in the Borrower Application Form to calculate payroll costs, further guidance from the SBA to resolve this inconsistency is warranted.

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 applicant may not include their independent contractors in determining payroll costs since the independent contractors 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.

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 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.

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.

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 re-verification under applicable BSA requirements, 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.

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.

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 PPP loan borrower. 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.

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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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