

March 26, 2020

CARES Act to Expand Access to the SBA Loan Program

Late Wednesday night, the Senate unanimously passed the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act” or the “Act”). The Act, which now moves to the House for approval, is intended in part to help individuals and small businesses navigate the economic difficulties brought on by COVID-19. In Section 1102 of the Act, the legislation provides for a new Small Business Act (“SBA”) § 7(a) loan program, which offers forgivable loans and waives certain affiliate aggregation requirements maintained by other SBA programs. These new provisions have been of particular interest to private equity firms. We will shortly be issuing a memo more fully describing the Act.

Forgivable Loans Under the Paycheck Protection Program

Paycheck Protection Program (Section 1102 of the CARES Act)

Section 1102 of the CARES Act would amend the § 7(a) loan program to include a new loan offering called the Paycheck Protection Program (the “Program”). Key features of the Program include:

- *Increased loan eligibility for certain small businesses and organizations.* From February 15, 2020 through June 30, 2020 (the “covered period”), in addition to small business concerns, any business concern, nonprofit organization, or veterans organization would be eligible to receive a loan under the Program (a “covered loan”) if it employs not more than the greater of:
 - 500 employees; or
 - If applicable, the size standard in number of employees for its industry established by the Small Business Administration.
- *Waiver of affiliation rules.* Under existing SBA legislation, applicant business concerns with affiliates are generally subject to affiliate aggregation requirements under section 121.103 of title 13, Code of Federal Regulations (“13 CFR § 121.103”). The Act contains an explicit waiver of these requirements with respect to eligibility for a covered loan for:
 - Any business concern with not more than 500 employees and that is assigned a North American Industry Classification System code beginning with 72 (at the time the loan is disbursed) — this code relates to the accommodation and food service industry;

- Business concerns within this “72 category” that employ not more than 500 employees per individual physical location may also be eligible.
- Any business concern operating as a franchise that is assigned a franchise identifier code by the Administration; and
- Any business concern that receives financial assistance from a company licensed under Section 301 of the Small Business Investment Act of 1958.
- *Loan amount tied to payroll costs.* The maximum amount of a covered loan would be based on a formula where certain payroll costs are multiplied by 2.5, but in no event would be more than \$10,000,000.
- *Permitted use.* Proceeds of covered loans may be used for payroll, salary, rent, utilities and payment of interest under mortgages and preexisting debt.

Forgiveness of Covered Loans (Section 1106 of the CARES Act)

Under Section 1106 of the CARES Act, a recipient of a covered loan would be eligible to receive forgiveness of a portion of the loan. Section 1106 specifies the following conditions and allowances among others:

- *Amount of loan forgiveness.* In general, forgiveness is available for a covered loan amount equal to the sum of the following costs and payments incurred during the covered period:
 - Payroll costs (not including costs for compensation above \$100,000 annually as prorated for the covered period);
 - Payment of interest on mortgages incurred before February 15, 2020;
 - Payment on rent obligated by a leasing agreement in force prior to February 15, 2020; and
 - Any utility payment for which the utility service began before February 15, 2020.
- *Tax Treatment.* A covered loan recipient can exclude any canceled indebtedness it receives under Section 1106 from its gross income for the purposes of the Internal Revenue Code of 1986.
- *Reductions in the amount of loan forgiveness.* Section 1106 provides for a certain reduction in a borrower's loan forgiveness amount, if the borrower decreases the number of its full-time employees during the covered period (special rules apply for seasonal employers). The amount of loan forgiveness may also be reduced if, during the covered period, the borrower reduces employee compensation for any employee (who did not make more than \$100,000 on an annualized basis during 2019) in excess

of 25% of that employee's compensation during their most recent full quarter as an employee before the covered period.

- *Savings clause.* Notably, both of these reduction conditions are subject to a savings clause. Specifically, under Section 1106, there would be no reduction in a borrower's loan forgiveness amount if: (1) the borrower decreased the number of its full-time employees or reduced the compensation of any applicable employee between February 15, 2020 and 30 days after the enactment of the Act, and (2) the borrower eliminates the reduction in the number of its full-time employees or employee compensation before June 30, 2020.

Implications for Portfolio Companies

Current Legal Framework

Under current law, affiliate aggregation requirements have prevented many portfolio companies from being successful in obtaining § 7(a) loans. Applicant portfolio companies, like any other applicant, have had to meet certain employee size standards designated by the Small Business Administration. While perhaps not always enforced in practice, applicant portfolio companies have been subject to specific affiliate aggregation requirements under 13 CFR § 121.103 (as discussed more generally above). After aggregating their employee numbers with those of other companies in their sponsor's portfolios, applicant portfolio companies have typically not been able to satisfy their respective employee size standard as set by the Administration.

Changes under the CARES Act

The Program allows at least some portfolio companies to obtain a forgivable covered loan without having to meet the affiliate aggregation requirements of 13 CFR § 121.103.

- The meaning of "control" for purposes of determining affiliation is broadly defined in the Act and would likely include the typical ownership structure of a private equity fund.
- The Act waives the affiliate aggregation requirements of 13 CFR § 121.103 for the types of business concerns summarized above. It has been reported that the private equity industry sought a broader waiver and that this was not granted. However, the precise words of the statute could be read to imply that business concerns that qualify for loans based on the expanded eligibility rules described above might not be subject to aggregation requirements. We are in the process of obtaining more information on this point and will circulate an update once we get greater visibility into the finalized Act.
- To the extent aggregation is not required, rather than being assessed together with its affiliated portfolio companies, a company can be assessed individually. In practice, this would greatly relax the eligibility requirements for loans under the SBA.

- What's more, a portfolio company that successfully obtains a loan under the Program is potentially eligible for complete forgiveness of at least a portion of the loan, subject to the conditions of Section 1106.
- Under Section 1106, as noted above, the forgiven amount would count as canceled indebtedness and would be excludable from gross income for the purposes of the Internal Revenue Code of 1986.

Ongoing Updates

While reports suggest that the House will approve the Act, the lower chamber may seek to make amendments. We will continue to monitor any revisions to the bill and provide our clients with timely information on how the legislation may affect their business.

* * *

This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content. Questions concerning issues addressed in this memorandum should be directed to:

Matthew W. Abbott
+1-212-373-3402
mabbott@paulweiss.com

Robert A. Atkins
+1-212-373-3183
ratkins@paulweiss.com

Jonathan S. Kanter
+1-202-223-7317
jkanter@paulweiss.com

Jeffrey D. Marell
+1-212-373-3105
jmarell@paulweiss.com

Jean M. McLoughlin
+1-212-373-3135
jmcloughlin@paulweiss.com

Carl L. Reisner
+1-212-373-3017
creisner@paulweiss.com

Counsel Justin D. Lerer and law clerks Anderson S. Christie and Caroline S. Williamson contributed to this Client Memorandum.