

The CARES Act Paycheck Protection Program: Key Features for Lenders and Small Business Borrowers

April 7, 2020

Executive Summary

The Coronavirus Aid, Relief, and Economic Security Act (**CARES Act**) established a new Paycheck Protection Program (**PPP**) that launched on Friday, April 3—one week after its enactment. The PPP is backed by \$349 billion in new funding and is a cornerstone of the CARES Act stimulus for American small businesses. The fast rollout of the program by the Small Business Administration (**SBA**) and Treasury Department, with regulations, guidance, fact sheets, and forms released online over the last week, has made it more challenging for both lenders and small business borrowers to track, understand, and implement the terms and requirements of the program. This memorandum summarizes the key features and mechanics of the PPP for lenders and small business borrowers.

We expect to update this memorandum from time to time as additional guidance is released. We also are collecting and posting PPP program materials and resources on the Government Support for Business page of our website [here](#), under the “Small Business Relief” tab.

Program Background

The PPP expands the existing SBA Section 7(a) loan guarantee program for eligible small businesses. Among other things, it increases the size and percentage of the loan principal guaranteed by the SBA, expands the scope of small businesses that are eligible to participate, and provides for forgiveness of significant portions of the loan principal, subject to conditions on the use of loan proceeds, with a focus on payroll expenses.

The SBA is responsible for administering the PPP, with Treasury and the SBA responsible for issuing guidance. Treasury and the SBA have now released initial guidelines (the **Guidelines**), interim final rules (the **Rules**), and application forms, including a borrower loan application, for the PPP. The Rules state that the “program requirements of the PPP . . . temporarily supersede any conflicting” requirement in the existing Section 7(a) loan program. These materials are available on our website, at the link provided in the previous section. Even though the Rules are effective immediately, there is a 30 day comment period starting April 2 and the SBA will consider these comments and any need for additional rulemaking.

Loan Terms

The Guidelines and Rules set key loan terms, which apply to all loans made under the PPP. The loans will be made at an interest rate of 1.0%, with a loan maturity of two years. No collateral or personal guarantee is required from the borrower. The borrower is also not required to be unable to find credit elsewhere.

Lenders must defer all loan payments—principal and interest—for six months, during which time interest will continue to accrue. Under the CARES Act, the SBA is required to issue guidance to lenders on deferment within 30 days of enactment. This guidance has not yet been issued.

Loan Amount

The maximum loan amount under the PPP is the lesser of:

- \$10 million; and
- 2.5 times average monthly payroll costs, plus the amount of any Economic Injury Disaster Loan (EIDL) made on or after January 30, 2020, net of any advance.

Under the CARES Act, average monthly payroll costs are measured by reference to the one-year period prior to the date the loan is made.¹ The loan application suggests, however, that applicants generally will base this calculation on 2019 payroll costs.

If the applicant received an EIDL between January 31, 2020 and April 3, 2020, the PPP loan proceeds must be used, in part, to refinance the existing EIDL. The amount of the refinanced EIDL also counts as payroll costs for purposes of loan forgiveness (see below).

Authorized Uses of Loan Proceeds and Loan Forgiveness

Under the CARES Act and the Rules, PPP loan proceeds can be used for the following permissible uses:

- Payroll costs, including benefits;²
- Payment of interest on any mortgage obligation (principal payments are excluded) incurred before February 15, 2020;
- Rent, under lease agreements in force before February 15, 2020;
- Utilities, for which service began before February 15, 2020;
- Interest on any debt obligations incurred before February 15, 2020; and
- Refinancing an EIDL made between January 31, 2020 and April 3, 2020.

The Rules require a borrower to use at least 75% of PPP loan proceeds for payroll costs. The amount of any EIDL refinanced by the PPP loan will be included as payroll costs.

The SBA will direct any borrower who uses PPP funds for unauthorized purposes to repay those amounts. If a borrower knowingly uses funds for unauthorized purposes, SBA may bring action against the borrower, including for fraud. The SBA states in the Rules that it will seek recourse against a shareholder, member, or partner of a borrower that uses PPP funds for unauthorized uses.

Loan Forgiveness

A borrower is eligible for **forgiveness** on a PPP loan in an amount equal to the first four of the six types of permissible uses set out above—though only up to 25% of the forgiven amount can be for non-payroll expenses—as incurred and paid during the eight-week period beginning on the date of origination of the

¹ Seasonal businesses and businesses not in operation from February 15, 2019 to June 30, 2019 are subject to a different measurement period for purposes of determining average monthly payroll. The CARES Act also increased the maximum loan amount available under the express loan program from \$350,000 to \$1 million.

² "Payroll costs" include (i) salary, wage, commission or similar compensation, (ii) payments with respect to tips, (iii) vacation, parental, family, medical or sick leave, (iv) allowance for dismissal or separation, (v) payments required for group healthcare benefits, including premiums, (vi) payment of any retirement benefit, and (vii) state or local tax imposed on the compensation of employees, and excludes (A) compensation of any individual employee in excess of \$100,000 in one year, as prorated for the period between February 15, 2020 and June 30, 2020, (B) any FICA tax or withheld income tax, (C) compensation of any individual whose principal residence is outside the United States, and (D) qualified sick leave and family leave wages for which a credit is allowed under the Families First Coronavirus Response Act. For an independent contractor or sole proprietor payroll consists of wage, commissions, income, or net earnings from self-employment or similar compensation.

loan (the **covered period**). The loan forgiveness amount can be up to the full principal amount of the loan and any accrued interest. A borrower will need to document the proceeds used for payroll costs, and other permissible uses, to determine the amount of forgiveness.

To incentivize the borrower's retention of employees at existing salaries, the amount of loan forgiveness is reduced by:

- Any reduction in the ratio of (1) the average number of monthly full-time equivalent (**FTE**) employees during the covered period; versus (2) those employed during either of two reference periods: February 15 to June 30, 2019; or January 1 to February 29, 2020; plus
- The amount of any reduction in total salary or wages of any employee during the covered period in excess of 25% during the most recent full quarter during which the employee was employed (taking into account only employees who earned \$100,000 or less on an annual basis).³

To encourage borrowers to rehire employees and restore salaries by June 30, 2020, a borrower that reverses any reduction in FTE headcount or restores salary levels by that date will not have its loan forgiveness amounts decreased as described above.

The **forgiven amount is non-taxable**. The forgiven amount and any balance remaining on the loan after the loan forgiveness continue to be 100% guaranteed by the SBA.

The CARES Act sets out application and documentation requirements for any borrower seeking loan forgiveness, including a requirement to provide documentation to verify the number of FTE employees (including payroll tax filings and state, payroll, and unemployment insurance filings) and the payment of the above obligations. Lenders must make a determination on any such application within 60 days. The SBA is expected to issue additional guidance on loan forgiveness.

Secondary Markets

PPP loans are eligible to be sold on the secondary market, and no fees are required to be paid to the SBA when these loans are sold. PPP loans may be sold at a premium or discount to par. The SBA is expected to issue guidance regarding advance purchases by the SBA for loans sold in the secondary market.

Fed Term Lending Facility

On April 6, 2020, the Fed **announced** that it would establish a new facility to provide term financing backed by PPP loans. We will provide a separate update as soon as the details of this new facility are announced.

Borrower Eligibility

Size Standards

PPP loans are available to "small business concerns" that are eligible for Section 7(a) loans and any other business concern, employing not more than the greater of:

- 500 employees in the United States; and
- The number of employees in the **size standard designation** for the industry in which the applicant operates.

³ There are several points of ambiguity with respect to how the CARES Act describes the reduction amount. In particular, for purposes of determining the reduction in loan forgiveness as a result of reductions in salary or wages, it is not clear whether, if an employee's salary or wages are reduced by 30%, the entire 30% of salary reduction reduces the available loan forgiveness or only 5% (the excess above 25%) of the salary reduction reduces the available loan forgiveness. We are hoping that the SBA will issue formal or informal interpretive guidance on this point.

The **size standard designation** is generally stated in terms of employees, for either the primary industry of the applicant alone or the primary industry of the applicant and its affiliates, whichever is higher. The size standards are designated according to NAICS codes. The SBA has established a **size standards tool** to help businesses determine whether they qualify as a small business concern.⁴

Any business that does not employ more than 500 employees per physical location and that is assigned an NAICS code beginning with 72 (i.e., accommodation and food services businesses) at the time of the loan disbursement is also eligible for a PPP loan. Any individual employed on a full-time, part-time or “other basis” is counted as an employee for purposes of the size determination.

Application of the SBA affiliation rules, which generally require an applicant to aggregate employees or receipts with companies under common control, is waived for the following categories of potential borrowers:

- **Accommodation and Food Service Providers:** any business with not more than 500 employees that, as of the date on which the loan is disbursed, is assigned an NAICS code beginning with 72;
- **Franchises:** any business operating as a franchise that is assigned a franchise identifier code by the SBA; and
- **SBIC-Funded:** any business that receives financial assistance from an SBIC.

There does not appear to be any further waiver of the SBA’s existing affiliation rules, which has important implications for private equity sponsors, among others, although the SBA may issue additional guidance on the applicability of affiliation rules. A more detailed discussion of these affiliation rules is included in Davis Polk’s Client Memorandum on PPP considerations for private equity sponsors, found [here](#).

Eligible Lenders

Under the PPP, all existing SBA-certified lenders have delegated authority by the SBA to make loans, beginning on April 3, 2020.

Federally insured depository institutions and credit unions are eligible upon transmission to the SBA of a Lender Agreement (**SBA Form 3506**). To qualify for the program, these institutions must not be currently designated as in Troubled Condition by their primary federal regulator or be subject to a formal enforcement action by their primary federal regulator that addresses unsafe or unsound lending practices.

The Guidelines also provide that a broad range of non-bank lenders are eligible to make loans under the PPP, subject to detailed conditions set out in the Rules, including compliance with the Bank Secrecy Act customer identification program (**CIP**) and anti-money laundering program (**AML**) requirements. New non-bank lenders will need to apply to the SBA (DelegatedAuthority@sba.gov) for delegated lending authority; authorization procedures for these new lenders are not yet clear.

Loan Guarantee and Lender Compensation

The SBA will guarantee 100% of the outstanding loan balance of a PPP loan, with all guaranty-related fees waived.⁵

⁴ An applicant for SBIC loans may also satisfy the eligibility requirement through an alternative test—if it and its affiliates’ tangible net worth is not in excess of \$19.5 million, and it and its affiliates’ average net income after federal income taxes (excluding carry-over losses) for the preceding two completed fiscal years is not in excess of \$6.5 million. If the applicant is not required to pay federal income taxes at the enterprise level, but is required to pass through income to its shareholders, the applicant’s net income after federal income taxes will be reduced in accordance with a formula.

⁵ Neither the SBA nor Treasury has clarified the process by which lenders or secondary market investors can claim against this guaranty in the event of a borrower default.

The SBA will reimburse lenders for processing fees as follows, within five days of the disbursement of a PPP loan. These origination fees are the primary economic incentive for lenders:

- 5.0% for loans of up to \$350,000;
- 3.0% for loans between \$350,000 and \$2,000,000; or
- 1.0% for loans of \$2,000,000 or more.

Lenders are not permitted to collect these fees from borrowers; instead, they must seek reimbursement from the SBA.

Agent Fees

The Guidelines also set agent fees that may be paid by lenders to authorized agents who help identify, solicit, or assist PPP loan applicants. These fees must be paid by the lender, from lender processing fees:

- Loans \$350,000 and under: 1.00%
- Loans greater than \$350,000 to \$2 million: 0.50%
- Loans greater than \$2 million: 0.25%

Agents may not collect fees from applicants, but instead must be compensated by lenders.

Lender Reimbursement for Forgiven Amounts

The CARES Act sets out two ways lenders may be reimbursed for forgiven amounts:

- **Post-forgiveness:** After a lender makes a formal determination on a forgiveness application and processes the forgiveness payment accordingly, the SBA must pay the lender 100% of the forgiven amount within 90 days of the date of forgiveness (with interest from the date of forgiveness through the date of payment).
- **Pre-forgiveness:** A lender may request that the SBA purchase the expected forgiveness amount of a PPP loan, or a pool of PPP loans, at the end of week seven of the covered period (that is, seven weeks after origination of the relevant PPP loans). The Rules set out a detailed list of documentation and analysis that must be included in the lender's request. The SBA must purchase these reported forgiveness amounts within 15 days of the report. These pre-forgiveness payments are a potential source of liquidity for lenders making PPP loans.

The CARES Act and the Rules expressly provide that a lender will not be subject to claims or penalties by the SBA for forgiving payments on a PPP loan if the lender bases a forgiveness determination on full documentation received by the lender from the borrower evidencing forgivable payments. A lender also "does not need to conduct any verification if the borrower submits documentation supporting its request for loan forgiveness and attests that it has accurately verified the payments for eligible costs."⁶ As noted above, Treasury and the SBA have not yet issued guidance or instructions governing the loan forgiveness process.

Regulatory Capital Treatment

PPP loans will receive a 0% risk weight from federal banking agencies or the National Credit Union Administration Board for the purposes of their respective risk-based capital requirements.

⁶ See Section 3.c of the Rules ("Can lenders rely on borrower documentation for loan forgiveness?").

Application and Underwriting Process

The Guidelines and the Rules set out a relatively streamlined application and underwriting process. As described further below, a lender will be held harmless for borrower failure to comply with program criteria, but only if it fulfills the specified underwriting requirements.

Application Process and Documentation

The SBA has issued a form PPP loan application, which all borrowers and lenders must use under the program. The form, which may be updated by the SBA, is available on our website [here](#), under the “Small Business Relief” tab. While the application itself is only two pages (plus instructions), an applicant will need to provide the following information, among other data, as part of its application:

- The name, title, ownership percentage, TIN and address of any 20% or greater equity owners of the borrower’s business;⁷
- Whether the applicant or any owner is an owner of any other business or has common management with any other business—if so, the applicant will need to provide a list of all affiliates and describe the relationship;
- The details of any EIDL received between January 31, 2020 and April 3, 2020; and
- Payroll documentation to evidence payroll costs.

Each 20% or greater owner must answer questions about current or historic criminal charges or other enforcement activity against them, as well as their citizenship or lawful resident status.

Borrower Certifications

An applicant is required to make the following certifications, among others, in the standard form PPP application:

- The applicant is eligible to receive a loan under SBA rules in effect at the time the application is submitted;
- To the extent feasible, the applicant will purchase only American-made equipment and products.
- The applicant is not engaged in any activity that is illegal under federal, state or local law.

An applicant must also certify, in good faith, that:

- The applicant was in operation on February 15, 2020, and had employees for whom it paid salaries and payroll taxes or paid independent contractors, as reported on a Form 1099-MISC.
- Current economic uncertainty makes this loan request necessary to support ongoing operations.

⁷ The SBA and Treasury guidance considers as owners:

- For a sole proprietorship, the sole proprietor;
- For a partnership, all general partners, and all limited partners owning 20% or more of the equity of the firm;
- For a corporation, all owners of 20% or more of the corporation;
- For limited liability companies, all members owning 20% or more of the company; and
- Any Trustor (if the applicant is owned by a trust).

- The funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments.
- The applicant understands that, if PPP funds are knowingly used for unauthorized purposes, the federal government may hold the borrower legally liable including by pursuing criminal fraud charges.
- Documentation verifying the number of FTE employees on payroll as well as the dollar amounts of payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities for the eight-week period following the loan will be provided to the lender.
- Loan forgiveness will be provided for the sum of documented payroll costs, covered mortgage interest payments, covered rent payments, and covered utilities. Not more than 25% of the forgiven amount may be for non-payroll costs.
- During the period beginning on February 15, 2020 and ending on December 31, 2020, the applicant has not and will not receive another loan under the PPP.
- The information provided in the application and the information provided in all supporting documents and forms is true and accurate, with an acknowledgment that making a false statement to obtain a guaranteed loan from the SBA is a criminal offense.
- The lender will calculate the eligible loan amount using tax documents submitted by the applicant, with an affirmation that these tax documents are identical to those submitted to the IRS. Applicants must also acknowledge and agree that their lender can share the tax information with the SBA's authorized representatives.

Underwriting Standards

In determining whether to approve a loan for an otherwise eligible applicant, lenders are directed to consider whether an applicant:

- Was in operation on February 15, 2020; and
- Had employees to which it paid salaries and for which it paid payroll taxes, or paid independent contractors.

Specifically, the Rules require lenders to:

- Confirm receipt of borrower certifications obtained in the PPP Application form;
- Confirm receipt of information demonstrating that a borrower had employees to whom the borrower paid salaries and payroll taxes on or around February 15, 2020;
- Confirm the dollar amount of average monthly payroll costs for the preceding calendar year by reviewing the payroll documentation submitted with the borrower's application. An FAQ clarifies that a lender is "expected to perform a good faith review, in a reasonable time" of the submitted payroll documentation and that, for example, "minimal review of calculates based on a payroll report by a recognized, third-party payroll processor would be reasonable"; and

- Follow applicable BSA requirements:
 - Federally insured depository institutions and federally insured credit institutions should continue to follow their existing BSA protocols when making PPP loans to new or existing customers who are eligible, but they are not required to re-verify existing customers unless otherwise indicated by the institution’s risk-based approach.
 - Entities that are not presently subject to the requirements of the BSA must establish a BSA-compliant AML program comparable to that required of banks.

FinCEN recently issued guidance, available on our website [here](#), under the “Small Business Relief” tab, regarding lenders’ BSA obligations with respect to the PPP.

Lender Liability

The PPP is designed to provide relief to small business in the United States as quickly as possible—raising questions about lender liability for underwriting and loan forgiveness decisions made on an expedited bases and under a streamlined application process. To answer this question, the Rules state that, “lenders must comply with the applicable lender obligations set forth in this interim final rule, but will be held harmless for borrowers’ failure to comply with program criteria. . . .” In addition, as noted above, the Rules limit the lender’s underwriting obligation to the requirements set out expressly in the Rules.

As described above, in determining loan forgiveness eligibility, a lender does not need to conduct any verification if a borrower submits documentation to support its request for loan forgiveness and attests that it has accurately verified the payments for eligible costs. The SBA will hold harmless any lender that relies upon borrower-submitted documentation in this respect.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your usual Davis Polk contact.

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