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Business & Finance Legal Update – CARES Act Implications for Businesses and Lenders

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On March 25, 2020, the United States Senate unanimously approved the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act"). The bill will be taken up by the United States House of Representatives on March 27, 2020 where it is expected to pass and be immediately signed by the President.

The CARES Act is a $2.2 trillion dollar measure aimed at battling the immense economic impact that COVID-19 has had on the United States economy. In addition to providing a large cash infusion to hospitals and broader access to COVID-19 testing to individuals, the CARES Act aims to boost the economy with individual rebates and small business loans, increased unemployment benefits, and a wide variety of tax breaks.

Our Business Transactions Group is available to answer your questions and to provide guidance on these rapidly evolving issues, challenges and opportunities. In addition to the following, we are closely following the regulations on a state by state level defining essential business and other related matters. Please contact us if we may be of assistance.

This legal update is aimed to shed some light on the various borrowing and lending provisions available for both our small business and financial institution clients.

SMALL BUSINESSES

Immediate relief is available to small businesses in the form of increased loan availability from lenders partnering with the U.S. Small Business Administration ("SBA"). Under the CARES Act, Congress expanded the permitted uses of SBA 7(a) loan proceeds and reduced or eliminated prerequisites for the same. These measures are in place from February 15, 2020 through June 30, 2020. The loans, intended to address reduced cash flow necessary to meet payroll and other operating expenses, are available in amounts up to $10 million each to small businesses impacted by the COVID-19 pandemic. Loan amounts are determined by payroll needs.

Which businesses are eligible for the loans?

If your business has less than 500 employees, including full-time and part-time employees, then you are eligible for a payroll costs loan under the CARES Act. Not-for-profit corporations may also be eligible for the loan program. Additionally, businesses in certain industries – such as restaurant, foodservice, hotels – may calculate their employees by physical location for purposes of SBA loans extended under the CARES Act. Finally, certain businesses with more than 500 employees may be eligible if such business' size complies with the industry-specific size standard established by the SBA.

How are loan amounts calculated?

A business may borrow an amount equal to two and a half times (2.5X) its monthly payroll, but no more than $10 million. "Monthly payroll" is calculated by taking the average total monthly payments by the business for payroll costs incurred during the 1-year period before the date on which the loan is made. Included in the calculation of "monthly payroll costs" are the following: (1) compensation, including wages, commissions, salary, or similar compensation to an employee or independent contractor, (2) payment of a cash tip or equivalent, (3) payment for leave, including vacation, parental, family, medical or sick leave, (4) allowance for dismissal or separation, (5) payment for group health care benefits, including premiums, (6) payment of any retirement benefits, and (7) payment of state or local tax assessed on the compensation of employees. The following may **not** be included in the calculation of "monthly payroll costs": (1) annual salaries exceeding $100,000, (2) payroll taxes, (3) compensation of employees residing outside of the U.S., and (4) qualified sick leave wages under the Families First Coronavirus Response Act.

When will the loans be available, and when may a business submit an application?

Immediately. In fact, loans are available from February 15 to June 30 of this year. The retroactive date is to permit laid off or furloughed employees to return to payroll. Submit your application to a financial institution that has partnered with the SBA.

What may the business use the loan for?

The loan proceeds may be used for, among other expenses: (1) payroll, (2) mortgage payments for loans in place before February 15, 2020, (3) rent on any lease in force before February 15, 2020, and (4) utilities for which service began before February 15, 2020.

Does the business have to evidence that it is unable to receive a non-SBA loan?

Small businesses do not have to evidence that they were unable to obtain loan funds from alternative lenders. This prerequisite has been removed by the SBA for the extension of payroll costs loans under the CARES Act.

Is a personal guarantee or collateral required to qualify?

No. Under the CARES Act, the SBA's standard requirements of a personal guarantee or collateral to secure repayment of the loan have been eliminated.

What are the repayment terms?

All loans under the program have a maximum maturity of 10 years, and the interest rate may not exceed four percent (4.00%).

What options does a small business have if it is unable to repay all or part of the loan?

Small businesses may seek deferment of repayment of the loans made under the CARES Act for a period of 6 months. However, deferment may not exceed 1 year.

There is a possibility of loan forgiveness in an amount equal to the borrower's permitted use of loan proceeds during the initial eight-week period after origination. Loan forgiveness is only permitted to small businesses that retain employees and/or rehired employees laid off. The forgiven amount may not exceed the principal extended to the borrower, and the borrower's reduction in the number of employees or salary of any employees will reduce the amount that may be considered forgiven. Loan forgiveness may be requested by submitting to the participating lender a detailed application including supporting materials that verify, among other things, the use of the loan proceeds.

How are "payroll costs loans" similar to and different from "Disaster Loan Assistance"?

The CARES Act "emergency grants" under the Economic Injury Disaster Loans ("EIDL Loans") program is separate from the expansion of SBA 7(a) loans to cover payroll costs loans. Under the CARES Act, an "emergency grant" program is established in connection with EIDL Loans program. The new regulations permit SBA partners to disburse loan advances in amounts not to exceed $10,000. Such advances must be distributed within 3 days of any request after an application is submitted. Any amount under $10,000 need not be repaid, even if the applicant is later denied an EIDL Loan after review of the application.

Generally, EIDL Loans are available to businesses with fewer than 500 employees that have been in continuous operation since January 31, 2019. To apply for the EIDL Loan, a business must show it has been adversely affected by COVID-19. Hardship may be evidenced by certification alone.

For EIDL Loans, unlike payroll costs loans, the SBA's waiver of personal guarantees required for loans is only applicable to loans under $200,000 for the covered period. In other words, if a borrower seeks an EIDL Loan over $200,000, a personal guarantee will be required. The CARES Act also waives the maximum loan maturity that is applicable to standard SBA loans. Like the payroll costs loans, the interest rate shall not exceed four percent (4.00%) per year. Further, proceeds of the EIDL Loans are limited to the same uses as the payroll costs loans.

Payment deferment and loan forgiveness are assessed pursuant to the same standards identified above for payroll costs loans.

The EIDL Loan program and "emergency grants" thereunder provide the fastest cash flow relief for small business under the CARES Act.

FINANCIAL INSTITUTIONS

Upon passage of the CARES Act, financial institutions that already partner with the SBA will be immediately available to make payroll costs loans up to $10 million to small businesses impacted by the COVID-19 pandemic. Additionally, all other FDIC backed lenders will be able to immediately apply to partner with the SBA. The loans are available from February 15, 2020 through June 30, 2020, and are 100% guaranteed by the federal government through December 31, 2020. Here are some key questions and answers for financial institutions. Additional details are expected to be released on the SBA and Department of Treasury website shortly after passage.

What financial institutions will be eligible to lend?

Financial Institutions are qualified to participate as lenders if they meet the qualifications of Section 7(a) of the Small Business Act (15 U.S.C. 636 (a)). The SBA's 7(a) program is the agency's primary loan offering. The 7(a) program is a partnership between private financial lenders, which issue the loans, and the SBA, which guarantees them.

Approximately 1,800 private financial institutions are already approved to issue 7(a) loans, and at a press briefing Wednesday, Treasury Secretary Steven Mnuchin said the department plans to issue new regulations that will make it possible for almost all banks insured by the Federal Deposit Insurance Corporation ("FDIC") to make SBA loans. The CARES Act provides authority to include additional financial institutions including insured depository institutions, insured credit unions, and Farm Credit System. Under the existing 7(a) program, a lender must meet the following requirements to partner with the SBA:

- Have a continuing ability to evaluate, process, close, disburse, service, and liquidate small business loans;
- Be open to the public to issue loans (and not be a financing subsidiary, engaged primarily in financing the operations of an affiliate);
- Have continuing good character and reputation, and otherwise meet and maintain the ethical requirements as identified in 13 CFR Part 120.140;
- Be supervised and examined by a state or federal regulatory authority, satisfactory to the SBA.

SBA Lender applications are available on and may be submitted through the SBA Website here.

The SBA currently guarantees about $25 billion in 7(a) loans to small businesses, and the CARES Act adds an additional $350 billion in lending authority.

Will the SBA guarantee 100% of the loan?

The SBA will provide a 100% government guarantee of 7(a) loans given under the CARES Act through December 31, 2020, at which point guarantee percentages will return to 75% for loans exceeding $150,000 and 85% for loans equal to or less than $150,000. Financial Institutions will need to factor this into their underwriting process, as it is anticipated that 7(a) loans under the CARES Act will have loan terms that extend beyond December 31, 2020.

What are the loan and repayment terms?

As discussed above, the legislation temporarily raises the maximum 7(a) loan amount to $10 million from $5 million[1], and instructs lenders to determine the proper loan amount by using a formula that takes into account a business's past payroll expenses.

The bill also sets the maximum interest rate for these loans at four percent (4%) and allows borrowers to defer payments for six months to a year.

Further term revisions for lending consideration include: (1) no prepayment penalty, (2) the maturity date may not exceed 10 years from origination, (3) no borrower or lender fees, and (4) no personal or collateral guarantee will be required.

What documents shall lenders require for underwriting?

The 7(a) loan documentation is accessible on the SBA's website. Lenders will need to obtain payroll records for the preceding twelve (12) months, financials for the prior year and year to date, and evidence that the borrower paid its payroll taxes. Lenders will also need to verify that the borrower has not already accessed SBA funds for the same use.

What must a lender consider in approving SBA loans?

The CARES Act deputizes financial institutions with approval power to extend 7(a) loans in compliance with the Act. It specifically provides delegated authority for lenders to make determinations on borrower eligibility and creditworthiness without having to submit conditional certification. This will apply to all current 7(a) lenders who make these loans to small businesses, and provides that same authority to lenders who join the program and make these loans.

It also provides for relaxed guidelines in determining such approval. A lender will not have to determine ability to pay – as borrowers are not able to. Instead, it must obtain documentation to determine whether a business was operational on March 1, 2020, and had employees for whom it paid salaries and payroll taxes.

While borrowers applying for 7(a) loans under the CARES Act need not aver that it is unable to obtain credit elsewhere, they must: (1) provide a good faith verification that the loan is necessary because of the COVID-19 pandemic, (2) aver that the funds will be used for a permitted purpose, and no other use, and (3) certify that they are not receiving funds from another SBA program (such as an SBA EIDL Loan) for the same purpose.

Will lenders be reimbursed for processing by the SBA?

The SBA Administrator will reimburse a lender authorized to make a covered loan at a rate, based on the balance of the financing outstanding at the time of disbursement of the covered loan, of:

> "(I) 5 percent for loans of not more than $350,000;
>
> (II) 3 percent for loans of more than $350,000 and less than $2,000,000; and
>
> (III) 1 percent for loans of not less than $2,000,000."

What about borrowers with existing 7(a) loans?

For borrowers with existing 7(a) loans, the SBA will pay the principal interest, and any associated fees on existing loans for six (6) months starting the next date. If the loan is already being deferred, then the SBA would defer the six (6) months after the end of the deferment.

When would loans be eligible for repayment forgiveness to borrowers? Will the SBA be responsible for repayment?

There is a loan forgiveness component included in the bill for businesses that retain their workers or rehire ones that were laid off. Not later than 60 days after the date on which a lender receives an application for

loan forgiveness from an eligible recipient, the lender shall issue a decision on the application.

Businesses would only be eligible for forgiveness on portions of their loans used for certain costs—including payroll, additional wages paid by businesses to tipped employees (as defined in the Fair Labor Standards Act), rent payment, mortgage obligations and utilities—that are incurred during an eight-week period starting on the loan's origination date, according to the legislation draft. The amount of forgiveness will take into account the number of workers retained or rehired.

With respect to a covered loan that has that has a remaining balance after reduction based on the loan forgiveness, the remaining balance shall continue to be guaranteed by the Administration. The covered loan shall have a maximum maturity of 10 years from the date on which the borrower applies for loan forgiveness under that section.

A borrower may also defer loan repayments for six to twelve months due to hardship. Thereafter, subject to the loan forgiveness amounts, equal installments of principal and interest shall be collected through maturity.

What will a lender be expected to obtain for a borrower to qualify for loan forgiveness?

Lenders will need to obtain documentation from borrower's regarding use of loan proceeds. The verification and documentation provided by a borrower will not subject the lender to any enforcement action or penalties by the SBA related to the ineligibility of a borrower. Any loan amounts not forgiven at the end of 1 year will be carried forward as an ongoing loan in which the borrower will pay principal and interest on a monthly basis.

What happens if a borrower defaults?

If a default occurs, a loan will be classified as in liquidation allowing the lender to seek reimbursement of the guarantee. The SBA Loan Liquidation process is described in detail here.

Will any FDIC regulations or regulatory standards be relaxed to allow financial institutions to make such loans?

Yes, the CARES Act relaxes several regulatory provisions from the FDIC in order to allow all size banks to enter into these loans.

First, the Act authorizes the FDIC to implement the transaction account guarantee program. The FDIC will provide insurance for noninterest transaction accounts, such as checking accounts up to an amount to be determined by the FDIC.

Second, the Act the Act authorizes the Office of the Comptroller of the Currency ("OCC") to permit national

banks to exceed their legal lending limit to any borrower to the extent it finds it to be in the public interest. It appears that OCC approval will be required, but this waiver will exist until December 31, 2020.

Third, the Act provides regulatory relief for community banks. The Act lowers the threshold under the Community Bank Leverage Ratio from 9 percent to 8 percent through December 31, 2020. It further requires regulators to adopt a rule that provides for a grace period for a community bank regain compliance thereafter.

Fourth, the Act provides temporary relief for banks to restructure debt for borrowers affected by the COVID-19 pandemic. Specifically, banks working with their borrowers facing hardships will **not** be required to report such concession as a Troubled Debt Restructuring. Interagency guidance from the FDIC provides:

Modifications of loan terms do not automatically result in TDRs. According to U.S. GAAP, a restructuring of a debt constitutes a TDR if the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider. The agencies have confirmed with staff of the Financial Accounting Standards Board (FASB) that short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief, are not TDRs. This includes short-term (e.g., six months) modifications such as payment deferrals, fee waivers, extensions of repayment terms, or other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented

Finally, the Act eases a financial institution's expected compliance with respect to the Financial Accounting Standard Board's current expected credit loss methodology. This compliance standard was otherwise to go into effect for the largest public bank holding companies at the end of the first fiscal quarter 2020. This has been postponed until December 31, 2020

The entire text of the CARES Act can be found here.

Visit our COVID-19 Hub for Ongoing Updates.

This Article was authored by Jonathan Boulahanis, Kent Carter, Craig Heryford, and Tyler Duff, with assistance from Nicole Rhim and Ama Gyimah.

Please contact any of the attorneys listed above, or your Gordon & Rees contact, with any questions or for guidance on these matters.

[1] The CARES Act also increases the maximum SBA Express loan from $350,000.00 to $1 million through December 31, 2020.