

Expansion of SBA Loan Program under the CARES Act: Implications for Private Equity Sponsors

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Executive Summary

The Coronavirus Aid, Relief, and Economic Security Act ([CARES Act](#)) that was signed into law by the President on March 27 provides for a new Paycheck Protection Program ([PPP](#)) that expands an existing Small Business Administration ([SBA](#)) loan guarantee program for eligible small businesses. The expansion includes, among other things, an increase in the maximum loan amount the SBA can guarantee, an increase in the size of businesses that can take advantage of the program and forgiveness of the loan under certain conditions.

The CARES Act does not appear to have overridden the general applicability of the broad affiliation rules that apply to the existing SBA loan programs, other than in three circumstances described below. If the affiliation rules apply to PPP loans generally, most portfolio companies controlled by private equity sponsors – even though each such company may be an eligible small business when considered on its own – are likely to be aggregated with the other controlled portfolio companies of the sponsor, such that they would exceed the size limitations for participation in the PPP.

However, there is some ambiguity in the text of the CARES Act as to whether the affiliation rules apply generally to PPP loans and it is possible that the SBA will issue interpretive guidance. If the SBA were to adopt the interpretation that the affiliation rules do not apply to PPP loans extended under the CARES Act, then many controlled portfolio companies that would otherwise be ineligible for loans because of the application of the affiliation rules would become eligible.

The CARES Act provides an explicit waiver of the affiliation rules under the PPP for:

- any business with not more than 500 employees that is assigned a North American Industry Classification System ([NAICS](#)) code beginning with 72 (*i.e.*, accommodation and food services businesses);
- any business operating as a franchise that is assigned a franchise identifier code by the SBA; and
- any business that receives financial assistance from a company licensed under Section 301 of the Small Business Investment Act (a small business investment company, or [SBIC](#)).

Accordingly, portfolio companies falling within one of these three exceptions, as well as portfolio companies that are not controlled by the sponsor (*e.g.*, certain minority investments), may be able to take advantage of the PPP. Indeed, as discussed in more detail below, portfolio companies that are eligible for SBIC loans may want to consider obtaining an SBIC loan in order to qualify for loans under the PPP.

For our sponsor clients that may be unfamiliar with the existing SBA loan program, this memorandum first provides an overview of the existing SBA loan program on which the PPP is based and then summarizes the key features of the PPP.

OVERVIEW OF EXISTING SBA PROGRAMS

Existing Programs

Section 7(a) Loan Program

The Section 7(a) loan guarantee program is the SBA's primary program for providing financial assistance to small businesses.

- There are nine types of loans with different terms and conditions (*e.g.*, a standard loan, a loan for borrowers who are exporters, a loan for veterans, etc.).
- The loans generally are made by private participating lenders and guaranteed in part by the SBA. Most Section 7(a) loans are guaranteed by the SBA for 75% or 85% of the loan, depending on the loan amount.
- Most Section 7(a) loans have a maximum loan amount of \$5 million. There is also an express loan, which accelerates the turnaround time for SBA review to within 36 hours but limits the maximum loan amount to \$350,000.

- Section 7(a) loans can generally be used for most business purposes, including long-term fixed assets and operating capital, but certain loans have restrictions on the use of funds.
- Section 7(a) loans may not be extended to applicants who are able to obtain credit elsewhere.

Economic Injury Disaster Loan (EIDL) Program

Following a disaster declaration, the SBA may provide loans of up to \$2 million to small businesses that have suffered substantial economic injury.

- Small businesses in all U.S. states, Washington D.C. and U.S. territories are currently eligible to apply for EIDL assistance due to COVID-19.
- EIDL loans may not be extended to applicants who are able to obtain credit elsewhere.

SBIC Program

Under the SBIC program, investment funds that are licensed and regulated by the SBA use their own capital and leverage provided and guaranteed by the SBA to make equity and debt investments in qualifying small businesses.

Eligibility Requirements

To be eligible for the above three programs, the applicant is required to be:

- organized for profit;
- with a place of business located in the United States; and
- operate primarily within the United States or make a significant contribution to the U.S. economy through payment of taxes or use of American products, materials or labor.

In addition, the size of the applicant, combined with its affiliates, must not exceed the **size standard designation**, generally stated in terms of either receipts or 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.¹

Affiliation Rules

The SBA programs have broad **affiliation rules**. As a general principle, entities are deemed to be affiliates “when one controls or has the power to control the other, or a third party or parties controls or has the power to control both.” If a private equity sponsor is deemed to control a portfolio company, the portfolio company will be deemed to be affiliated with, and therefore aggregated with, all other controlled portfolio companies of the sponsor for purposes of determining its size.

The affiliation rules will generally require an analysis of the relationship between the sponsor and its portfolio companies, although there are certain bright line rules. For instance, a private equity sponsor will be deemed to control any portfolio company of which it owns 50% or more of the voting equity. However, the SBA will also deem a minority shareholder to control an entity if that shareholder has the ability to prevent a quorum or otherwise block action by the board of directors or shareholders of the entity. There are also many other fact patterns where the SBA will deem affiliation to exist based on the facts and circumstances. As a result of these broad affiliation rules, most portfolio companies controlled by private equity sponsors are not eligible to participate in the Section 7(a) loan and EIDL programs.

As a practical matter, a portfolio company applying for a Section 7(a) loan or EIDL in the gray zone where

¹ 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.

the application of the affiliation rules is unclear should disclose all applicable facts to the SBA lender. The SBA program provides that once an SBA lender has made a determination of no affiliation, the SBA will not overturn that determination as long as it was reasonable when made given the information available to the SBA lender at the time.

There are important exceptions to the affiliation rules for the SBIC program. In particular, an applicant will not be deemed to be an affiliate of certain investors, and therefore will not be deemed to be affiliated with any companies controlled by such investors, including the following investors:

- venture capital operating companies, which many private equity funds are likely to be;
- investment companies registered under the Investment Company Act of 1940; or
- investment companies that are not registered under the Investment Company Act of 1940 because they are beneficially owned by less than 100 persons, if the company's sales literature or organizational documents indicate that its principal purpose is investment in securities rather than the operation of commercial enterprises (*i.e.*, 3(c)(1) funds).

Given these exceptions, a portfolio company controlled by a private equity fund may qualify for a loan or equity investment under the SBIC program even though it is ineligible to receive a Section 7(a) loan.

PAYCHECK PROTECTION PROGRAM: EXPANSION OF SBA SECTION 7(A) LOAN PROGRAM

The PPP expands the SBA Section 7(a) loan program described above.

- The CARES Act provides approximately \$349 billion in additional funding for loans under the PPP.
- Loans available under the PPP will be available to eligible recipients through June 30, 2020.
- The interest rate on these loans is capped at 4% and the loans have a maximum maturity date of 10 years.
- 100% of the loan is guaranteed by the SBA.
- Lenders are required to defer payments on PPP loans for between six months and one year, with the SBA directed to issue deferment guidance to lenders within 30 days of enactment.

Loan Amount

The maximum loan amounts are higher under the PPP than under the existing SBA Section 7(a) loan program. The maximum loan amount is the lesser of:

- \$10 million; and
- 2.5 times average monthly payroll costs (measured over the one-year period prior to the date the loan is made).²

In addition, to the extent a borrower received an EIDL loan on or after January 31, 2020, the borrower may borrow an additional amount up to the then-outstanding amount on the EIDL loan and repay the EIDL loan.

The maximum loan amount available under the express loan program has also been raised to \$1 million (from \$350,000).

Eligibility

Size Restrictions

In addition to "small business concerns," which are already eligible for Section 7(a) loans, the PPP is available to any other business concern if it employs not more than the greater of:

- 500 employees; and

² 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 number of employees in the **size standard designation** for the industry in which the applicant operates.

Any individual employed on a full-time, part-time or “other basis” is counted as an employee for purposes of the size determination.

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 eligible to participate in the PPP.

Affiliation

The CARES Act specifically waives the application of the SBA affiliation rules for the following:

- **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.

The CARES Act does not appear to have overridden the general applicability of the affiliation rules, other than in the three circumstances described above. However, there is some ambiguity in the text of the bill as to whether the affiliation rules apply generally to the expanded SBA lending program under the CARES Act.³ It is possible that the SBA will issue formal or informal interpretive guidance on this point. If the SBA were to adopt the interpretation that the affiliation rules do not apply to PPP loans extended under the CARES Act, then many controlled portfolio companies that would otherwise be ineligible for loans because of the application of the affiliation rules would become eligible.

Portfolio companies that are ineligible to receive PPP loans but are eligible for SBIC loans or equity investments (and not already recipients of such loans or equity investments) may want to consider an SBIC loan or equity investment so as to become eligible for loans under the PPP. As described above, there are exceptions to the affiliation rules for SBIC loans that will enable certain portfolio companies to qualify for a loan or equity investment under the SBIC program even though they are ineligible to receive a Section 7(a) loan.

Allowable Uses of the Loan Proceeds

In addition to current allowable uses of loan proceeds under the existing SBA Section 7(a) loan program, PPP loan proceeds may be used as follows:

- Payroll costs⁴
- Insurance premiums and the continuation of group health care benefits during periods of paid sick, medical or family leave
- Employee salaries, commissions or similar compensation

³ The affiliation rules apply to determine whether a “business concern” qualifies as a “small business concern,” and only “small business concerns” are eligible for loans under the existing SBA loan programs. The CARES Act states that “any business concern” that meets the size restrictions set forth in the CARES Act is eligible for PPP loans, which could be read to mean that the affiliation rules do not need to be applied to determine whether the size restrictions set forth in the CARES Act are satisfied. The CARES Act also expressly states that the affiliation rules apply to nonprofit organizations and veteran organizations to the same extent as to small business concerns, but is silent as to whether they apply to business concerns generally.

⁴ “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 health care 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.

- Payment of interest on any mortgage obligation (principal payments are excluded)
- Rent
- Utilities
- Interest on any other debt incurred prior to February 15, 2020

Loan Forgiveness

A borrower of a PPP loan is eligible for forgiveness of the loan in an amount equal to the following expenses, which are incurred and paid during the eight-week period beginning on the date of loan origination (the [covered period](#)):

- Payroll costs (see definition in footnote 4)
- Interest payments on real or personal property mortgage obligations that are incurred before February 15, 2020
- Rent payments under leases in force before February 15, 2020
- Utility payments where service began prior to February 15, 2020
- Additional wages paid to tipped employees

The forgiven amount is nontaxable. The forgiven amount and any balance remaining on the loan after the loan forgiveness continue to be guaranteed by the SBA.

There is a detailed application and documentation requirement for any borrower seeking forgiveness, including a requirement to provide documentation to verify the number of full time equivalent ([FTE](#)) employees (including payroll tax filings and state, payroll and unemployment insurance filings) and the payment of the above obligations.

In order to incentivize the retention of employees at existing salaries, the amount of loan forgiveness is reduced by:

- Any reduction in the average number of monthly FTE employees employed by the loan recipient during the covered period as compared to the average number of monthly FTE employees employed by the recipient during, at the recipient's election, either the period between February 15 and June 30, 2019 or the period between January 1 and February 29, 2020 (the [reference period](#)), with special rules for seasonal employers; for example if the recipient had an average of 95 FTE employees during the covered period and an average of 100 FTE employees during the reference period, then the recipient would only be entitled to 95% of the loan forgiveness that would otherwise be available; and
- The amount of any reduction in total salary or wages of any employee during the covered period that is in excess of 25% of the total salary or wages of the employee during the most recent full quarter during which the employee was employed (taking into account only employees who did not receive, during any single pay period in 2019, wages or salary at an annualized rate of pay in an amount more than \$100,000).⁵

In order to incentivize the re-hiring of employees and the reversal of any recent salary reductions, loan forgiveness will be determined without regard to the reduction in the number of FTEs of a loan recipient and any reduction in salary or wages of employees of a loan recipient, in each case in between February 15, 2020 and 30 days after enactment of the CARES Act, that is eliminated prior to June 30, 2020.

Waivers

The CARES Act waives all personal guarantee, collateral and fee requirements that typically apply to

⁵ There are several points of ambiguity in how the bill 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.

Section 7(a) loans.

The PPP loans are generally non-recourse, other than where a shareholder, member or partner of a borrower uses a PPP loan for an unauthorized purpose.

The CARES Act also waives the requirement that the applicant is unable to obtain credit elsewhere.

Procedures

Applicants are required to make the following certifications in good faith:

- the uncertain economic conditions necessitate the loan request to support the ongoing operation of the applicant;
- the funds will be used to retain workers and maintain payroll or make mortgage, lease and utility payments;
- there is no pending application for a Section 7(a) loan that is duplicative or for the same purpose as the requested loan; and
- from February 15, 2020 to December 31, 2020, the applicant has not received an amount under Section 7(a) that is duplicative or for the same purpose.

While these loans are guaranteed by the SBA, existing private SBA lenders and new lenders (determined by the SBA and Treasury to be qualified to process, close, disburse and service the loans) are delegated the authority to make and approve PPP loans.

Lenders must 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.

The SBA is required to issue regulations to implement the PPP within 15 days of the enactment of the CARES Act. Accordingly, until those regulations are released the exact contours of the application process will not be known, although it is expected that the SBA will build on its existing Section 7(a) or EIDL procedures in a manner that expedites the processing of these loans. Notwithstanding that, we expect there to be significant demand for these loans, and it may be advisable for an eligible applicant to apply early.

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

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