

Chapman Client Alert

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Current Issues Relevant to Our Clients

New Financial Support Programs for Businesses, States, and Municipalities in CARES Act

The CARES Act (Coronavirus Aid, Relief, and Economic Security Act) signed into law by President Trump on March 27, 2020, contains funding for numerous grants and loan or other financing facilities to support businesses and state and municipal entities, as well as individuals. This Client Alert focuses on some major programs established by the Act to financially support, through loans or grants, (1) small businesses, (2) larger businesses, and (3) states and municipalities.

Paycheck Protection Program (PPP)

This is the first program established by the Act and is in Title I, beginning with Section 1101. As has been widely reported, it provides \$349 billion to fund forgivable loans to small businesses to pay employees, rent, and utilities during an 8 week crisis period.

Eligible borrowers

In a large expansion of the Small Business Act, companies (including not-for-profit companies) with not more than 500 employees (plus sole proprietorships, independent contractors, or self-employed persons) will be eligible to borrow¹ up to \$10 million under this program to meet payroll, rent, and utility expenses.² Companies with a larger number of employees can also qualify if the Small Business Administration's (SBA) existing size standards [https://www.sba.gov/sites/default/files/2019-08/SBA Table of Size Standards Effective Aug 19, 2019.pdf](https://www.sba.gov/sites/default/files/2019-08/SBA_Table_of_Size_Standards_Effective_Aug_19_2019.pdf) based on NAIC codes include such company. Those standards generally limit companies to a certain amount of revenues or number of employees, with the SBA covering companies with far more than 500 employees in many industries.³ In addition, hotels and restaurants (and any other NAIC Sector 72 Accommodation and Food Services company) satisfy the Act's 500 employee limit if they do not have more than 500 employees at any single physical location (i.e., they can have more than 500 total employees and still be a eligible borrowers).

Maximum loan amount

Within the \$10 million loan limit, a company's maximum loan is 2.5 times its average monthly "payroll costs"⁴ during the year before the loan is made (or other abbreviated period for

seasonal or new employers). Only wages up to \$100,000 annually⁵ for any employee are included in this calculation.

Forgiveness of loan based on employee and wage level retention

Each loan will be fully forgiven to the extent during the 8 week period after receiving the loan the borrower incurs and pays payroll costs, rent or mortgage obligations, and utility charges,⁶ except such forgiveness will be reduced to the extent the borrower does not retain employment (full time equivalent (FTE) employees) and wages for employees earning \$100,000 or less annually during the 8 week period at the same (or for wages a certain percentage of the same) levels as during specified past periods for employment and wages.

Those specified past periods differ. For employment numbers, a borrower can select the average number of FTE employees either (A) during the first two months of 2020 or (B) during the period between February 15 and June 30, 2019, with special rules for seasonal employers. To the extent the borrower does not retain that FTE employment level during the 8 week period, its loan forgiveness would be reduced (e.g., an employer with only 90 average FTE employees during the 8 weeks following the loan compared to 100 during the relevant previous period would only receive a 90% loan forgiveness or less if the same borrower failed to meet the wage maintenance rule described below).

For wage amounts, the comparison is between what an employee is paid during the 8 week period after the loan is made and what that employee was paid during the most recent full quarter completed before the loan was made. To the extent the pay of such employee is "reduced" during the 8 week period by more than 25% of what the employee was paid during that full previous quarter,⁷ the amount of loan forgiveness is reduced. The only employees for which this

computation would be made are those earning no more than \$100,000, and the reduction in loan forgiveness would be cumulative as the sum of all such employee pay reductions during the 8 week period.

No tax liability for loan forgiveness and zero percent risk weight for lender's loan

The "forgivable" loan feature of the program as the economic equivalent of a grant is supported by the Act's provision that the loan forgiveness described above will not be treated as taxable debt cancellation under the Internal Revenue Code.

The Act provides that, while the loan is outstanding, both credit union and bank lenders will report the loan as having a zero percent risk weight.⁸

Borrower certification that loan is "necessary" to support ongoing operations

The loan forgiveness feature of the program, along with the special tax treatment, should make the program very popular among eligible borrowers. Unlike the Title IV "emergency relief" programs described next, the PPP does not restrict a borrower's employee compensation, dividends, or share buybacks. The only "need" restriction the program imposes is the requirement that a borrower's certificate requesting the loan must state "current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient."

States and municipal entities not eligible borrowers

Aside from not being available to large businesses that do not meet the 500 or other employee number limit applicable to them under the PPP, the PPP will not be available to States or municipal entities. As noted above, however, the Act expands the list of eligible borrowers to include non-profits, which are normally excluded from SBA programs, because those programs are intended to support small for-profit businesses.

"Emergency relief and taxpayer protections" programs

Section 4003 in Title IV of the Act provides the \$500 billion "bailout" that will be used to finance airlines, cargo air carriers, "national security" businesses, and Federal Reserve programs to lend to, or otherwise support financing for, large and small businesses and State and municipal entities.

Emergency airline, air cargo, and national security industry support

Section 4003(b)(1) provides for up to \$25 billion in "loans and loan guarantees" to air carriers, inspection, repair, and other air services, and ticket agents.

Section 4003(b)(2) provides for up to \$4 billion in loans and loan guarantees for cargo air carriers.

Section 4003(b)(3) provides for up to \$17 billion in loans and loan guarantees for "businesses critical to maintain national security" (which is widely reported to mean at least Boeing).

Conditions to loans or guarantees

Each of these three emergency loan or loan guarantee programs is subject to numerous conditions, some of which also apply to the Federal Reserve programs described in more detail below.

Dividend, buyback, employment, and compensation restrictions

First, the borrower or recipient of the loan guarantee must agree to pay no dividends or purchase any of its or its parent's traded equity securities except to the extent required under a previous contractual obligation, so long as the loan or guarantee is outstanding and for 12 months thereafter.

Second, the company must agree not to reduce employment levels by more than 10% until September 30, 2020.⁹

Third, the company must agree to compensation limits for the period from the date it receives the loan or loan guarantee until 12 months after it fully repays the loan or guaranteed loan. During that period, no officer or other employee (other than an employee paid under an existing collective bargaining agreement) who received more than \$425,000 in total compensation in calendar year 2019 may receive more than that amount of compensation during any rolling 12 month period. If such officer or employee (even if unionized, which presumably would never be the case) received more than \$3 million in total compensation during the 2019 calendar year, the rolling 12 month limit on that officer or employee's total compensation would be \$3 million plus 50% of the 2019 compensation above \$3 million (i.e., that officer or other employee would be required to receive a pay cut on compensation over \$3 million).

US presence, factual findings, and instrument terms

The borrower or recipient of the loan guarantee must be a US corporation with “significant operations in and a majority of its employees based” in the US.

Before issuing the loan or loan guarantee the Treasury Secretary must determine the “eligible business” has “incurred or is expected to incur covered losses such that the continued operations of the business are jeopardized,” “credit is not reasonably available” to the eligible business “at the time of the transaction,” and the emergency assistance must reflect “the risk of the loan or loan guarantee;” “to the extent practicable” bear interest at “not less than an interest rate based on market conditions for comparable obligations prevalent prior to” the COVID-19 crisis; and have a duration “as short as possible and in any case not longer than 5 years.”

Required warrant or senior debt instrument

The borrower or recipient of the loan guarantee must provide the Treasury a warrant or equity interest in its business, if it has traded securities on an exchange. If it does not have such traded securities, it must provide (A) a warrant or equity interest or (B) a senior debt instrument, at the discretion of the Treasury Secretary.

Federal Reserve programs

Section 4003(b)(4) provides up to \$454 billion (plus any unused amounts authorized under Section 4003(b)(1)-(3)) for Treasury to lend, provide loan guarantees, or “other investments” in “programs or facilities” established by the Federal Reserve to provide “liquidity to the financial system that supports lending to eligible businesses, States, or municipalities.”

The Federal Reserve programs can (A) purchase “obligations or other interests directly from issuers;” (B) purchase “obligations or other interests in secondary markets or otherwise;” or (C) make loans.

As it did in 2008 during the last financial crisis, the Federal Reserve has already established during the current COVID-19 crisis several lending programs to purchase various types of securities to support the liquidity of those securities and of money market funds or other investors. The Federal Reserve is expected to use the new “equity” investments from Treasury authorized by Section 4003(b)(4) to establish direct lending programs to borrowers such as small and large companies and State and municipal entities, as well as possibly programs to support markets for certain securities.

Restrictions on recipients of direct loans

Any such “direct loans” from a Federal Reserve lending vehicle to a borrower would be subject to the same dividend and stock repurchase prohibitions and officer and other employee compensation limits as described above for loans under the first three emergency loan programs (i.e., no dividends or stock repurchases, frozen compensation above \$425,000, and reduced compensation to the extent above \$3 million), unless (under Section 4003(c)(3)(A)(iii)) the Treasury Secretary waives such requirement for a particular “program or facility” “upon a determination” that “such waiver is necessary to protect the interests of the Federal Government.”¹⁰

Programs for businesses can only make loans to, or purchase securities of or interests in, US businesses

Section 4003(c)(3)(C) provides that any Section 4003(b)(4) program supported by the US Treasury through a loan, loan guarantee, or other investment can only purchase obligations or other interests¹¹ of, or make loans or other advances to, businesses organized or created under US law with significant US operations and a majority of employees based in the US.

Specific small business and municipal facilities contemplated by Congress

Although Section 4003(b)(4) provides the Treasury Secretary and the Federal Reserve discretion to establish programs, the Act specifically:

- (1) directs the Treasury to “endeavor to seek the implementation of a program or facility...that provides financing to banks and other lenders that make direct loans to eligible businesses including, to the extent practicable, nonprofit organizations, with between 500 and 10,000 employees, with such direct loans being subject to an annualized interest rate that is not higher than 2 percent per annum;” (Section 4003(c)(3)(D)(i))
- (2) clarifies that “nothing in this” preceding direction “shall limit the discretion of the” Federal Reserve to “establish a Main Street Lending Program or other similar program or facility that supports lending to small and mid-sized businesses on such terms and conditions as the Board may set” consistent with Section 13(3) of the Federal Reserve Act, “including any such program in which the Secretary makes a loan, loan guarantee, or other investment under subsection (b)(4);” (Section 4003(c)(3)(D)(ii)) and
- (3) directs the Secretary to “endeavor to seek the implementation of a program or facility” under Section

4003 (b)(4) that “provides liquidity to the financial system that supports lending to States and municipalities.” (Section 4003(c)(3)(E))

We can assume these special small business and State or municipal loan or securities support facilities will be established. In particular, the small-and-medium sized business facility for companies with 500 to 10,000 employees is specified in great detail.

PPP type program for employers of 500-10,000

While similar to the PPP, the terms for this facility specified in the Act will be much less attractive for borrowers. First, the loans will not be forgivable. Second, the borrower will be prohibited from paying dividends or repurchasing shares while the loan is outstanding. Third, while the loan is outstanding and for two years after that, the borrower can not outsource jobs or abrogate a collective bargaining agreement. In addition, the borrower is required to use the loan proceeds to retain at least 90 percent of its workforce at full compensation and benefits until September 30, 2020, and must certify it intends to restore not less than 90% of its February 1, 2020, workforce, and to restore all compensation and benefits to such employees, no later than 4 months after the end of the COVID-19 emergency declaration.

Main Street Business Lending Program

On March 23, 2020, the Federal Reserve announced its intent to establish such a program “to support lending to eligible small-and-medium sized businesses, complementing efforts by the SBA.” The Act cites this program to indicate support and to clarify that the PPP type program described above was not intended as a substitute.

Municipal programs

Beyond the language quoted above to provide “liquidity to the financial system that supports lending to States and municipalities,” the Act provides no details for this program. So far, the Federal Reserve also has not provided any indication of the nature of such a program, which it presumably will announce soon.

Additional client alerts as Federal Reserve programs are announced

The Treasury Secretary and many others expect that the Federal Reserve facilities to be established will provide several trillion dollars in loans and other support. We will issue

additional Client alerts describing those Federal Reserve programs as they are announced.

Direct Grants to States for Coronavirus Expenses

\$150 billion grant of funds to pay COVID-19 expenses, with \$139 billion for States

Title V of the Act, Section 5001, provides for the distribution of \$139 billion to the States, excluding the District of Columbia, from the Coronavirus Relief Fund (a new Title VI to the Social Security Act). The Fund receives \$150 billion, but \$3 billion of that is distributed to the District of Columbia and the US territories¹² and \$8 billion is distributed to Tribal governments. That leaves \$139 billion to be distributed to the States, proportionate to their respective populations, but subject to a minimum \$1.25 billion distribution to each State.¹³

State shares

Because the minimum \$1.25 billion distribution to each State is a larger proportion of \$139 billion than the proportion of the population of many sparsely populated states compared to the total US population minus the District of Columbia, a group of States with small populations will receive a disproportionately larger share of the \$139 billion (compared to their share of total US population minus DC) and the remaining States will receive less than their proportionate share of total US population minus DC.

Potential local government share from its State's allocation

Section 601(b)(2) of the Coronavirus Relief Fund permits a “local government” to present a certificate that it will use funds for the authorized purposes described below and, thereby, to receive a direct disbursement of part of the funds that would otherwise be distributed to the State in which that local government is located. The only political units within a State that can make such request are units of local government, such as counties or towns, that have a population of 500,000 or more.¹⁴

The amount of such direct funding a local government could receive is based on its proportion of the State's total population applied to only 45% of the State's total allocation from the Coronavirus Relief Fund.¹⁵

Authorized uses of funds

Each State (and DC, each US territory, and each Tribal government) is only authorized to use its share of the \$150

billion Coronavirus Relief Fund to pay non-budgeted, COVID-19 related necessary health emergency expenses incurred from March 1, 2020, through December 30, 2020.

The Act directs the Inspector General for the Treasury Department to monitor the disbursement and use of funds from the Coronavirus Relief Fund and directs the Treasury to book a debt owed to the Treasury from any State or local government

in the amount of funds distributed to it under the Coronavirus Relief Fund that it has used improperly.

For More Information

If you would like further information concerning the matters discussed in this article, please contact the Chapman attorney with whom you regularly work.

- 1 Section 1102(a)(1)(P)(iv) of the Act is a “sense of the Senate” that the SBA should issue guidelines to lenders and agents to ensure that the processing and disbursement of covered loans prioritizes small business concerns and entities in underserved and rural markets, including veterans and members of the military community, small business concerns owned and controlled by socially and economically disadvantaged individuals (as defined in section 8(d)(3)(C)), women, and businesses in operation for less than 2 years.” It seems unlikely banks will be required to wait for applications to arrive from such priority borrowers before disbursing loans to eligible borrowers that are not priority borrowers. Any SBA rules issued in response to this “sense of the Senate” may clarify this. In any case, the policies of individual lending banks will be relevant.
- 2 In addition, 500 employee companies will generally qualify for loans under an expansion to the SBA’s economic injury disaster loan program through the Act’s expansion of eligible borrowers through December 31, 2020, for such “loans” that are not repayable (i.e., act as grants). Section 1110 of the Act.
- 3 As just one example, many Section 21 Mining, Quarrying, and Oil and Gas Extraction industry codes cover companies with more than 500 employees, such as NAICS 211120 Crude Petroleum Extraction with a 1,250 employee limit.
- 4 Such costs include wage type compensation, cash tips or equivalent, vacation, parental, family, medical, or sick leave, severance, health insurance, retirement benefits, and State or local taxes on compensation, but exclude federal payroll taxes (i.e., taxes established in chapters 21, 22, and 24 of the Internal Revenue Code) and all compensation paid to employees residing outside the US, as well as the part of an employee’s compensation that represents an annual salary above \$100,000.
- 5 Such annual rate is determined for any period, so that the monthly cap would be \$8,333 and the cap for the period February 15-June 30, 2020, would be roughly \$37,500 based on such period being roughly 37.5% of a year.
- 6 The rent, mortgage, and utility charges must be incurred under contracts in force, or service that began, before February 15, 2020.
- 7 This seems to contemplate that employees working during the 8 week period could receive a substantial pay cut (25% of their entire pay during the most recent calendar quarter) before there would be any reduction in the loan forgiveness. An alternative, less likely, interpretation would be that the employees must receive 75% of what they earned in that previous quarter. If a calendar quarter is 13 weeks, that would mean during the 8 week period after the loan they would need to be paid at a higher weekly rate than during the relevant previous 13 week period. The Act presumably contemplates that pay would be reduced during the crisis period for lack of working hours and that the permitted reduction in aggregate pay per employee before loan forgiveness is reduced is roughly 40.6% (13/8 of 25%). The SBA rules implementing the program may clarify this point.
- 8 Part (ii) of the same clause (O) provides temporary TDR relief for such loans.
- 9 Along with this firm limit, it must agree to “maintain its employment levels as of March 24, 2020, to the extent practicable.”
- 10 The Treasury Secretary has no such authority for the 4003(b)(1)-(3) programs described above (perhaps because they are specified) so that the Secretary may, in practice, be able to provide such waiver to specific Federal Reserve programs under Section 4003(b)(4).
- 11 “other than securities that are based on an index or that are based on a diversified pool of securities.”
- 12 Puerto Rico, the US Virgin Islands, Guam, the Commonwealth of Northern Mariana Island, and American Samoa.

- 13 DC and the Territories similarly share their \$3 billion allocation based on their proportions of the aggregate population of those entities. The Tribal governments, on the other hand, share their \$8 billion allocation based on the proportion of their individual COVID-19 related expenses to their aggregate expenditures. This should mean allocations are based on need (or past expenses incurred for COVID-19).
- 14 “county, municipality, town, township, village, parish, borough, or other unit of general government below the State level with a population of 500,000 or more.”
- 15 Thus, even a local government that represented half of a State’s population would only receive directly 22.5% of that States emergency fund allocation (i.e., 50% of 45% of the State’s funding), if it used this authority rather than just relying on distributions from the State.

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