

IMPLICATIONS OF THE CARES ACT FOR SMALL BUSINESSES AFFECTED BY THE CORONAVIRUS

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WHAT YOU NEED TO KNOW

- The tragic effects of the coronavirus (COVID-19) pandemic on the U.S. economy is especially felt by small businesses, which serve as the economic engine of the U.S. economy by employing approximately half of the domestic workforce.
- In response to the devastating effects of the coronavirus, on March 27, 2020, the federal government urgently passed the Coronavirus Aid, Relief, and Economic Security Act of 2020 (the “CARES Act”), which is the largest economic stimulus package in U.S. history aimed to bolster the U.S. economy by providing over \$2 trillion in relief to individuals and businesses affected by the coronavirus.
- Under the CARES Act, the federal government will infuse funds of over \$350 billion into the Small Business Administration’s (SBA) loan programs to provide qualified business more access to capital. By relaxing loan eligibility requirements to make it easier for small businesses to qualify for assistance and providing additional incentives in the forms of loan deferments and forgiveness, borrowers under these programs will be able to retain their employees and pay their bills for an extended period of time.
- To take full advantage of these federal loan incentives, small businesses will need to understand their options under the CARES Act. Business owners need to engage their lenders, accountants, and legal counsel early and gain a clear picture of the requirements to apply for these loans and take full advantage of the incentives provided therein. Act urgently, be diligent, and utilize relationships; it is reasonably foreseeable that the coming weeks will move at a frenetic pace with respect to the number of businesses around the country that will be applying for loans.

SMALL BUSINESS & THE CARES ACT

The CARES Act is Phase III of the federal government’s comprehensive economic stimulus package to address the detrimental effects of COVID-19 on the U.S. economy. Earlier this month, Congress passed Phase I, known as the Coronavirus Preparedness and Response Supplemental Appropriations Act, 2020 (H.R. 6074), which provided \$8.3 billion in emergency relief funding to government agencies, including the SBA’s Economic Injury Disaster Loans (EIDLs) (see our previous Client Alert on the EIDL Program [here](#)), and Phase II, known as the Families First Coronavirus Response Act (H.R. 6201), which provided further individualized assistance in the forms of increased unemployment benefits, free coronavirus testing, expansion of paid sick leave, and additional food and Medicaid assistance. Phase III is intended to provide more direct support to individuals and businesses by using the \$2.2 trillion appropriated by the government toward direct payments for individuals, forbearance on student loans, tax credits for small businesses, and increased access to capital for small businesses through the SBA loan programs.

More specifically, the CARES Act provides three important relief mechanisms for small businesses through expansions of the SBA loan programs: (1) easier access to capital, by infusing funds into the SBA’s 7(a) loan and EIDL loan programs, while easing eligibility requirements for small businesses to receive immediate assistance under either program; (2) increased flexibility, by allowing borrowers under the SBA’s 7(a) loan program to defer payments on loans for up to one year; and (3) additional incentives, by providing SBA 7(a) loan borrowers the ability to be forgiven on portions or all of the principal of the loan during the eight-week period if the borrower uses the loan proceeds to retain its respective workforce and pay bills of the business incurred during the applicable eight-week period.

ACCESS TO CAPITAL UNDER THE SBA LOAN PROGRAMS

The CARES Act, under its Paycheck Protection Program, infuses approximately \$350 billion into the SBA's existing 7(a) loan program, which is traditionally the SBA's most popular, general purpose loan program for small businesses. Domestic small businesses, non-profit organizations, veterans organizations, and Tribal businesses are eligible to apply for the SBA's 7(a) loan program, also known as the "Paycheck Protection Program loans" or "PPP loans" if they (a) have 500 or fewer employees or meet the SBA's applicable size standards; (b) were operational as of February 15, 2020; and (c) as of February 15, 2020, paid (and continue to pay) employees or independent contractors of the business. The CARES Act also allows sole-proprietors to be eligible to receive these loans.

To be clear, businesses with not more than 500 employees are eligible to qualify for the PPP loans. With respect to larger businesses with more than 500 employees, they still may be able to qualify for PPP loans under the SBA's size standard test. Under the SBA's size standard test, "size" is dependent upon the type of industry the business is engaged in (as classified under the North American Industry Classification System (NAICS)), and (a) the number of employees in the business; or (b) the business's average "annual receipts." "Annual Receipts" is the business's total income plus the costs of the goods sold, averaged over the business's last three completed fiscal years (expressed in millions of dollars). For example, a commercial bakery can qualify as a small business under the SBA if it has no more than 1000 employees, while an industrial commercial construction company may qualify as long as its annual receipts do not exceed \$39.5 million.

However, applicants need to be aware that the SBA's size eligibility test not only measures the number of employees or amount of receipts of the applicant itself, but also those of its "Affiliates." Under the SBA, an affiliation exists when the applicant either exhibits, or has the power to exhibit, control over another entity. Control may arise through common ownership, management, or other contractual interactions between the two entities. No single factor alone may be enough to constitute an affiliation, as the SBA looks at all available information of the applicant's business structure (known as the "totality of circumstances") when determining whether an affiliation exists. For businesses within the restaurant and hospitality industries, this affiliation rule is waived. Unfortunately for businesses who are not in the restaurant or hospitality industry but are owned by private equity firms, the affiliation rule may hinder their ability to qualify under the SBA's size standard threshold if their private equity firm holds many platform companies.

In an effort to make it easier for small businesses to apply for PPP loans, the CARES Act eases a number of traditional requirements under the SBA's 7(a) loan program, including:

- Removing an applicant's creditworthiness as a criteria for approval of a loan;
- Waiving (1) the requirements for collateral and personal guarantees by the owners of the applicant; (2) all standard application and loan processing fees; and (3) the credit elsewhere requirement (traditionally, applicants who were eligible to receive credit from other sources were barred from applying for loans under the SBA 7(a) program);
- Requiring loan applicants to certify only that, due to the detrimental effects caused by the coronavirus to the applicant's business, the funds from the PPP loans are necessary to maintain the business's workforce and will be used to make payroll, lease or mortgage, and utility payments; and
- Increases the federal government's guarantee on all issued PPP loans to 100% through December 31, 2020 (thereafter, the federal government guarantees on these loans revert to their traditional percentages of 75% for loans of more than \$150,000 and 85% for loans of \$150,000 or less).

For each applicant, the size of the PPP loans (which cannot exceed \$10 million) is 2.5 times the applicant's average total monthly "payroll costs" incurred during the one-year period before the

origination date of the loan (note that for seasonal businesses and businesses that were not operational from February 15, 2019 through June 30, 2019, the average total monthly payroll costs are calculated using different periods as defined under the CARES Act). “Payroll costs,” for purposes of determining the maximum loan amount, is the total sum of the compensation a borrower pays to its employees, including: (1) salary, wages, commissions, cash tips, or similar types of compensation; (2) costs of vacation, parental, family, medical, or sick leave; (3) severance payments; (4) group health benefits payments (including premiums); (5) retirement benefit payments; and (6) payment of state or local tax assessed on the compensation of employees. However, payroll costs do not include payroll taxes, any compensation paid to employees who live outside of the U.S., compensation of an employee’s salary in excess of \$100,000 (as prorated over the referenced measuring period), or any credit provided to borrower under the Families First Coronavirus Response Act for qualified sick leave or family medical leave.

The PPP loans will not bear an interest rate that will exceed 4% and will mature 10 years from the date the borrower applies for loan forgiveness under the CARES Act.

Proceeds from the PPP loans may be used to pay (1) employee or independent contractor compensation; (2) costs related to the continuation of group health care benefits during periods of paid sick, medical, or family leave, and insurance premiums; (3) interest payments on any mortgage obligation (which shall not include any prepayment of or payment of principal on a mortgage obligation); (4) rent (including rent under a real or personal property lease agreement); (5) utilities; or (6) interest on any other debt obligations that were incurred before the period beginning on February 15, 2020 and ending on June 30, 2020.

LOAN FORGIVENESS & DEFERMENT

The CARES Act seeks to incentivize employers to maintain their present workforce by providing such businesses the ability to continue the payment of wages during this crisis. To that end, the CARES Act has included multiple incentives that benefit borrowers, including full or partial loan forgiveness with no obligation of the borrower to repay those funds, and the ability to defer payment on the outstanding balance thereafter.

Loan Forgiveness

Under the CARES Act, borrowers may be eligible to have certain portions of their loan forgiven up to a maximum amount equal to the total principal of the loan. In order to receive forgiveness, the borrower must use the loan proceeds to pay specific expenses of the borrower’s business, including payroll costs, interest payments on mortgages incurred before February 15, 2020 (but not prepayment of or payment of mortgage principal), rent obligations due under a lease entered into before February 15, 2020, and electricity, gas, water, transportation, telephone, or internet access utility payments for which service began before February 15, 2020. Applicants should note that, although the CARES Act states that the business expenses and payments made on these obligations must occur during the eight-week period beginning on the date of the loan origination date, it is unclear at this time whether the SBA requires both the business expense to be incurred *and* the payment made *during* that eight-week period to qualify for forgiveness (for example, whether loan forgiveness applies to a borrower who incurs a utility expense on the last day of the eight-week period but uses the loan proceeds to make payment on such expense the following week). Businesses that incur certain expenses quarterly or semi-annually may be somewhat disadvantaged in utilizing the forgiveness benefit under the CARES Act. We expect that the SBA will issue further guidance on this issue shortly.

Borrowers will need to understand that there are limits on the amounts of forgiveness offered. Since the purpose of these loans is to provide the borrower the ability to retain its workforce during a stop-gap period, the CARES Act provides that the amount of forgiveness a borrower may receive can be reduced if the borrower decreases its number of full-time equivalent employees or

reduces the wages of any of its full-time equivalent employees (who make less than \$100,000) by more than 25% during the prescribed eight-week period (with certain exceptions).

Additionally, the SBA has not yet given clear guidance on what evidence will be required to demonstrate appropriate spending for loan forgiveness eligibility, so it is important that each borrower keep diligent records of what has been spent on the aforementioned for presentation to their SBA approved lender at the appropriate time.

Small businesses should be cognizant of maintaining their workforces and payroll obligations during the eight-week period in order to take full advantage of the loan forgiveness provisions of the CARES Act.

Deferment

While it is expected that many small businesses will be able to pay most, if not all, of their loan proceeds on items eligible for loan forgiveness, many other small businesses (including those that do not have significant mortgage, rent, or utilities obligations) will have to repay at least some portion of their PPP loan. The CARES Act provides flexibility to small businesses facing repayment obligations in the form of deferred loan payments.

Borrowers may seek deferment on repayment of the loans made under the CARES Act for a period of six months; however, deferment may not exceed one year and will be pursuant to a deferment process set by the SBA in guidance anticipated in approximately 30 days. Additionally, lenders on existing issued SBA-backed loans are encouraged to provide payment deferments and extend maturity dates to borrowers to avoid balloon payments or requirements that would increase debt as a result of deferment.

OTHER SBA LOAN PROGRAMS MODIFIED BY THE CARES ACT

Express Loans

The CARES Act increases the maximum loan for an SBA Express loan from \$350,000 to \$1 million through December 31, 2020, after which point the Express loan will have a limit of \$350,000. (Fees for veterans under the 7(a) Express loan program have been permanently waived.)

Changes to the EIDL Program

The CARES Act also expands eligibility and monetary benefits given under the disaster loans program (EIDL) under the SBA. Under the CARES Act, EIDL applicants (1) no longer need to provide personal guarantees on advances or loans of not more than \$200,000 during the period of January 31, 2020 to December 31, 2020; (2) no longer need to be in business for the one-year period before the underlying disaster, except that no waiver may be made for a business that was not in operation as of January 31, 2020; and (3) are not precluded from being eligible to apply for a disaster loan even if they are able to obtain credit elsewhere.

Furthermore, under the CARES Act, an eligible applicant may request that the SBA provide an advance on a potential loan, up to a maximum of \$10,000, which will be provided to the applicant within three days of the loan submission date. This advance does not need to be repaid, even if the applicant is denied an EIDL loan. Additionally, applicants who are issued disaster loans between January 31, 2020 and March 31, 2020 may refinance under the PPP loans, and those applicants who received advances while awaiting approval for a disaster loan may apply for a PPP loan, and, if approved for a PPP loan, the advance amount is reduced from the loan forgiveness amount allowed under the PPP loan.

However, advances must be spent on providing paid sick leave to employees unable to work due to the direct effect of COVID-19; maintaining payroll to retain employees during business

disruptions or substantial slowdowns; meeting increased costs to obtain materials unavailable from the applicant's original source due to interrupted supply chains; making rent or mortgage payments; and repaying obligations that cannot be met due to revenue losses.

BEST PRACTICES TO PREPARE FOR APPLYING FOR AN SBA LOAN

Given that the COVID-19 pandemic has economically affected the entire United States, a vast number of small businesses will be applying for SBA loans in the next couple of weeks. Small businesses should anticipate some delay and confusion in the application process. Therefore, it is important for prospective applicants to begin their preparation process immediately and consult with their legal, lending, and accounting representatives to ensure that the loan application process will proceed smoothly. Additional steps that small businesses should take as soon as possible include:

- Preparing any necessary updates and/or changes to their corporate governing documents, conducting necessary affiliation analysis, and identifying their businesses' suitability under the eligibility requirements of the offered SBA loan programs in consultation with their legal representatives;
- Preparing and organizing necessary payroll, tax, and financial information that will be required in the SBA loan application process in consultation with their accounting representatives; and
- Contacting their lenders (and authorized SBA lender if applicable) early to understand which SBA loan program is best suited for their situation and particularities.

ADDITIONAL INFORMATION

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