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CLIENT ALERT

PAYCHECK PROTECTION PROGRAM 2.0

On Sunday, December 27, 2020, the Consolidated Appropriations Act, 2021 (the "CAA") was signed into law, which expands certain provisions of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"). Title III of the CAA, titled the Economic Aid to Hard-Hit Small Businesses, Non-Profits, and Venues Act (the "Act"), provides for a second round of lending under the Paycheck Protection Program ("PPP") administered by the Small Business Administration ("SBA"). This client alert summarizes and provides some preliminary analysis of certain provisions of the Act relating to the PPP.

Borrower Interest in PPP 2.0

Due to the steady increase in COVID-19 infections throughout the U.S. during the third and fourth quarters of 2020 and renewed efforts by state and local governments to combat the spread, and with the prospect of common inoculation still several months away, many small businesses impacted by the pandemic have not yet turned the corner toward recovery. Such ongoing financial stress coupled with the government's latest relief efforts, including certain of the Act's borrower-friendly provisions, some of which are summarized below, are likely to result in strong borrower participation in the second round of the PPP.

Expansion of Allowable Uses of Loan Proceeds

The Act expands the permitted uses of PPP loan proceeds to include the following items:

- covered operations expenditures (e.g., payment for software, cloud computing and other human resources and accounting needs);
- covered property damage resulting from public disturbances in 2020 that are not covered by insurance;
- covered supplier costs (e.g., expenditures pursuant to a contract or purchase order in effect prior to the new PPP loan for goods that are essential to the borrower's operations at the time the expenditures were made); and
- covered worker protection (e.g., personal protective equipment and related expenditures related to complying with federal and state health and safety requirements and guidelines in response to the COVID-19 outbreak between March 1, 2020 until the end of the national emergency declaration).

These new covered uses are in addition to the permitted uses provided under the CARES Act (e.g., payroll costs and covered mortgage, rent and utility payments). This broadening of the permitted uses category gives borrowers the opportunity to recoup more of their costs and expenses resulting from or generally related to the pandemic, which is likely to increase customer demand for PPP loans.

We note, however, that the Act limits covered property damage to such damage resulting from civil unrest in 2020, which arguably was unrelated (at least in a direct and proximate way) to the ongoing health crises. Property damage, regardless of its cause, whether riots, acts of terrorism, hurricanes or wildfires, exposes small businesses to operational and other risk. There is nothing in the language of the Act to suggest the scope of covered property damage will be broadened through the rulemaking process to capture other causes unrelated to COVID-19.

Simplified Forgiveness for Small Loans ($150,000 or less)

The Act simplifies the forgiveness process for all PPP loans of $150,000 or less, regardless of whether the loan was originated during the first PPP round in 2020 or pursuant to the upcoming second round. To receive forgiveness, a borrower would only be required to submit a one-page certification to the lender, which would include the number of the borrower's employees retained as a result of the loan, the estimated total amount of the loan spent on payroll costs and the total loan amount. The Act directs the SBA to publish a form for this purpose within 24 days following the enactment of the Act. This simplified process likely will be one of the primary drivers of borrower, as well as lender, participation. It will also promote one of the purposes of the Act to include a more diverse applicant group for participation in the PPP, including first-time borrowers with 10 or fewer employees, borrowers in low-income areas, and minority-owned businesses.

Flexible Covered Period for Loan Forgiveness

The Act provides greater flexibility to borrowers for the "covered period" of a new PPP loan. Under the Act, a borrower may select any date between 8 weeks and 24 weeks after the date of origination to be the expiration of the covered period for determining costs that are eligible for forgiveness by the SBA. This provision will allow borrowers, with the assistance of lenders, to tailor the loan facility specifically to address that borrower's anticipated financial needs.

Economic Injury Disaster Loans ("EIDL") Advances

The Act repeals the CARES Act provision that required borrowers to deduct the amount of their EIDL advance from the PPP forgiveness amount. The Act also directs the SBA to issue rules within 15 days after the enactment of the Act to ensure that borrowers are made whole if they received forgiveness net of their EIDL advance prior to the enactment of the Act. However, the Act does not specify how quickly the reimbursement of EIDL advances must be made.

"PPP Second Draw" Loans

The Act establishes a "PPP second draw" option for borrowers who participated in the first PPP round to obtain additional PPP funding. To be eligible, a borrower must (i) not employ more than 300 employees, (ii) have used or will have used all funds disbursed to the borrower under its first PPP loan before the origination of the PPP second draw, and (iii) demonstrate at least a 25% reduction in gross receipts in any quarter of 2020 as compared to the same quarter of 2019. For loans of $150,000 or less, the borrower may submit only a certification that it meets the revenue loss requirement without having to provide proof of such revenue loss until the borrower applies for forgiveness.

While a PPP second draw opportunity is good news to many, there's a question of whether the 25% reduction in gross receipts criterion is an appropriate measurement of financial hardship for businesses that really need the help. In view of the politicized nature of the PPP, one can envision news coverage of second draw borrowers that recovered quickly to have a strong 2020 but are still eligible for a second draw loan given a single bad quarter. While the retrospective standard is likely better than the "uncertainty" standard that led to a windfall for many businesses that remained operational throughout 2020, we except negative media coverage surrounding the fairness of PPP 2.0.

Generally, borrowers may receive a single loan in an amount of up to 2.5 times the average monthly payroll costs based on, at the election of the borrower, the year immediately prior to the origination of the loan or the calendar year 2019, subject to a cap of $2.0 million. Entities in industries assigned to NAICS code 72 (Accommodation and Food Services) may receive up to 3.5 times average monthly payroll costs, but are still subject to the $2.0 million cap.

Borrowers of PPP second draw loans are eligible for loan forgiveness with respect all eligible costs, including the new covered costs discussed above. However, the current requirement that at least 60% of loan proceeds be used to fund payroll costs for full forgiveness will apply to PPP second draws.

Tax Treatment of PPP Loans

The CAA clarifies that a borrower's gross income does not include any PPP loan forgiveness amount. In addition, under the CAA, deductions are now allowed for otherwise deductible expenses satisfied with PPP loan forgiveness amounts. This change to the treatment of deductible expenses, which is retroactive to the date of the CARES Act, reverses the position previously taken by the Internal Revenue Service that deductible expenses satisfied with PPP loan forgiveness amounts are not deductible. We anticipate that the Internal Revenue Service will update its guidance consistent with the CAA.

Lender Benefits and Protections

Although lender participation in the first round had mixed results, the Act offers certain enhancements intended to drive lender participation. It's difficult to predict whether these improvements will be enough to bring certain lenders back to the program, especially as some economic indicators provide a relatively optimistic outlook given the commencement of widespread vaccination. But such enhancements, when combined with strong customer demand, likely will persuade banks to respond in kind for the benefit of their communities and customers.

Lender Fee Income

Lenders will still be entitled to fees from the SBA associated with the origination of PPP loans. However, the Act enhances these provisions for lenders with respect to loans up to $50,000. For those loans, a lender will be entitled to reimbursement of the lesser of 50% of the principal amount of the loan or $2,500, which is a change from 5% of loans up to $350,000 under the CARES Act. Thus, for illustrative purposes, for a $25,000 loan, a borrower would be entitled to $1,250 (5% x $25,000) in reimbursed fees under the CARES Act as compared to $2,500 under the Act. For loans greater than $50,000 up to $350,000, lenders will be entitled to reimbursement of 5% of the principal amount. The SBA's reimbursement to the lender will be 3% for loans in principal amount greater than $350,000 up to $2.0 million, which is the same as under the CARES Act.

Lender Hold Harmless

The Act provides lenders with a liability safe harbor, which should give lenders comfort and encourage participation in the second round. Under the Act, a lender may rely on any certification or documentation submitted by a borrower for an initial or second draw PPP loan. No enforcement action may be taken under the Act against the lender, and the lender will not be subject to penalties, for relying on any such certification or documentation if (i) the lender acts in good faith relating to loan origination or forgiveness and (ii) all relevant federal and state statutory and regulatory requirements are satisfied. Importantly, this provision is retroactive to the date of the CARES Act and applies to all PPP loans.

Limited Agency Fees

As a direct response to disputes that arose regarding the payment of agent fees and the guidance from the Department of the Treasury that agent fees will be paid out of lender fees, the Act places limits on a lender's exposure to such fees. The Act provides that a lender will be responsible for paying fees to an agent only if the lender directly contracts with the agent for services. This provision is retroactive to the enactment of the CARES Act and applicable to all PPP loans, which generally should render any pending claims moot. In addition, the Act provides that a borrower who knowingly retained a loan agent may not pay agent fees out of the PPP loan proceeds. What is left unclear is how agents will be paid if the lender does not directly contract with the agent. The language seems to imply that the borrower would be obligated for those fees out-of-pocket.

Increase PPP Loan Amounts

The Act provides that borrowers who returned all or part of their PPP may reapply for the maximum amount applicable so long that they have not received forgiveness. Similarly, borrowers who did not accept the full amount of their PPP loans may request a modification to increase the amount of their loans up to the maximum amount applicable so long that they have not received forgiveness. Additionally, borrowers who are entitled to greater loan amounts due to changes in interim final rules may request a modification of their loans to increase the aggregate principal amount regardless of whether the loan has been fully disbursed or if the lender has filed an initial Form 1502 report related to the original loan. The Act directs the SBA to publish guidance within 17 days following the Act detailing the application process for such loan modifications.

This provision may be a mixed bag. On the one hand, it provides an opportunity for borrowers to access additional funding, which may be critical to ongoing operations, and banks to deploy excess capital with relatively little risk. On the other hand, the extent of the burden imposed on lenders to comply with this provision is not yet clear. That will depend on the details set forth in the SBA's regulations, once they are promulgated. One potential drawback is that the recalculation and verification requirements that may accompany this provision could materially divert lenders who are working toward operational normalcy in 2021.

Timing of the Roll Out

The Act directs the SBA to take certain actions, including the adoption of new rules, related to the implementation of the next round of PPP funding within an abbreviated timeframe. The Act specifically directs the SBA to issue regulations within 10 days following enactment for the purposes of carrying out the Act. Even with the experience and foundation of the first PPP round, the limited time given the SBA to execute its directives is likely to result in a bumpy second round, at least at the outset. The SBA will need to leverage its lessons learned from round one and provide clear and consistent guidance so that borrowers and lenders understand the risks, rewards and expectations of the program.

Conclusion

While there are many details to be addressed in the language of the Act and further clarifications to be made as the above-described programs are implemented and rules are promulgated by the SBA, the Act provides important enhancements to the PPP.