White and Williams LLP

Private Equity and Other Businesses Need Not Apply: SBA Issues Fourth Paycheck Protection Program Interim Final Rule

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On April 25, 2020, the U.S. Small Business Administration (SBA) released a fourth interim final rule (the Fourth Rule) providing additional formal guidance regarding the eligibility of private equity funds and their portfolio companies and certain other types of businesses to participate in the Paycheck Protection Program (PPP)[1][2][3][4]. The PPP is one of the principal small business support programs implemented under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) to help them weather the severe economic shocks caused by the COVID-19 pandemic.

To recap, the PPP's primary objective was to keep employees of small businesses on their payroll for eight (8) weeks after receipt of the funding to allow these businesses to remain viable during lockdowns ordered to minimize the health consequences of COVID-19. While certainly well-intentioned, the scope and speed of implementation of the PPP is unprecedented and, as a result, there have been issues and unevenness. And, since it has been built on an existing SBA Program, the 7(a) Program – which has very different objectives – and since Congress only modified a few parts of that program, navigating the intersection of the PPP and the 7(a) Program has created confusion as to eligibility, among other issues. The Fourth Rule answers additional lingering questions regarding eligibility and, importantly, provides for a "safe harbor" mechanism for those that may have applied and received funds under the PPP, but misunderstood or misapplied the so-called "necessity standard."

This alert outlines the key points addressed in the Fourth Rule and its impact on would-be PPP applicants and current PPP participants.

BORROWER ELIGIBILITY CLARIFICATION

The Fourth Rule includes the following clarifications regarding PPP borrower eligibility:

- **Private Equity Funds & Hedge Funds.** Hedge funds and private equity funds primarily engaged in investment or speculation are not eligible to receive a PPP loan. So, while fund management companies typically have employees that support investor relations and management of their investments, those companies are not eligible to receive PPP funds.
- **Private Equity Portfolio Companies.** Portfolio companies of a private equity fund remain eligible to receive a PPP loan, provided that they satisfy the size requirements after application of SBA's affiliation rules. But, as noted above, the Fourth Rule advises that private equity-owned portfolio companies should "carefully review" the "necessary to support ongoing operations" certification. As a practical matter, a portfolio company that is majority owned by a fund will not be eligible unless it either still qualifies after applying the affiliation rules or is exempt from the affiliation rules.

- **Government-Funded Hospitals.** A hospital that is otherwise eligible to receive a PPP loan as a business concern or 501(c)(3) nonprofit organization is able to receive PPP funding as long as the hospital receives less than 50% of its funding from state or local government sources (exclusive of Medicaid).
- **Legal Gaming Businesses.** The Fourth Rule revises the Third Rule to clarify that an otherwise eligible business is not rendered ineligible to receive a PPP loan because it receives legal gaming revenues. This clarification is interesting because businesses that derive more than one-third of gross annual revenue from legal gambling activities are categorically not eligible to participate in other 7(a) loans, but are now able to participate in the PPP, and may portend other ineligible businesses to be able to participate (but see the decision to keep private equity management companies ineligible). Businesses that receive illegal gaming revenue are categorically ineligible for PPP participation.
- **Employee Stock Ownership Plan (ESOP).** A business's participation in an ESOP does not result in affiliation between the business and the ESOP.
- **Bankruptcy.** Applicants that are the debtor in a bankruptcy proceeding (either at the time the application is submitted or any time before the loan is disbursed) are not eligible to receive a PPP loan. It is the applicant's obligation to notify the lender and cancel its PPP application if it becomes a debtor after submitting the application but before the loan is disbursed. Failure to do so will be regarded as use of PPP funds for unauthorized purposes.

PPP NECESSITY CERTIFICATION SAFE HARBOR

For purposes of PPP eligibility, the CARES Act eliminated the standard 7(a) loan requirement that a borrower is unable to access other sources of credit (commonly referred to as the "credit elsewhere test"). Instead, PPP applicants are simply required to certify "that the uncertainty of current economic conditions makes [the PPP loan] necessary . . . to support the ongoing operations of the eligible recipient." But neither the CARES Act nor any of previous interim final rules articulated a standard for evaluating whether a PPP loan is "necessary" for continued operations.

In the absence of meaningful SBA guidance, many borrowers reasonably assumed that the elimination of the "credit elsewhere test" set in the backdrop of the congressional intent underlying the CARES Act as a whole and the PPP in particular meant that an otherwise eligible recipient would not have to demonstrate that it could (at least for eight weeks) fund operations substantially at pre-COVID levels (which is what the PPP incentivizes) with cash from operations generated during the COVID-19 pandemic or other capital in order to make this "necessity" certification. In other words, if a business was required to be closed, or its operations were materially altered by the measures taken to minimize the pandemic's spread, it could, in good faith, certify that the PPP was necessary to maintain the pre-COVID *status quo* until pre-COVID operations could re-commence.

However, on April 23rd a PPP Frequently Asked Questions (FAQ) document posted on the Department of Treasury's website was updated with Question 31, which asks whether businesses that are owned by "large companies with adequate sources of liquidity" are eligible to apply for and receive a PPP loan. In the answer to this question, the FAQ advises that applicants should "carefully review" the required certification and determine that it can be made in good faith, taking into account their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business. As an example, the FAQ specifically references "a public company with substantial market value and access to capital markets" as a type of business that is unlikely to be able to make the certification in good faith. Although the FAQ answer was not expressly

limited to the given example, the FAQ was understood to be a response to news that large publicly-traded companies had received PPP loans ahead of many truly small businesses that were less able to weather the COVID-19 storm.

The Fourth Rule does not adopt the standard set forth in the FAQ that a borrower must take into account both current business activity and ability to access other sources of liquidity sufficient to support ongoing operations in a manner that is not significantly detrimental to the business, but does reiterate the FAQ guidance by (i) advising that "all borrowers should carefully review the required certification" and (ii) introducing a related safe harbor. Under the safe harbor, any borrower that applied for a PPP loan prior to the release of the Fourth Rule and "repays the PPP loan in full by May 7, 2020, will deemed to have made the certification in good faith." The SBA explains that this is necessary and appropriate to ensure that borrowers who obtained PPP funds "based on a misunderstanding or misapplication of the required certification standard" promptly return such funds (and, if they do so, the SBA will not consider an improper certification to be in violation of law). Perhaps the lack of guidance is purposeful, but the lack of clarity may have a chilling effect on borrowers or result in other businesses returning funds and cutting personnel rather than tapping out other funding sources to maintain their payrolls.

PROMISSORY NOTES AND AUTHORIZATIONS

The Fourth Rule formalizes guidance for lenders that had previously been reflected in the First Rule, that lenders are permitted to use their own form of promissory note (in addition to an SBA form of PPP promissory note) and may include any terms and conditions (including relating to amortization and disclosure) that are not inconsistent with the CARES Act, any of the interim final rules or the PPP lender application form (SBA Form 2484). A lender does not need a separate SBA Authorization for the SBA to guarantee a PPP loan, provided that it executed a SBA Form 2484.

If you have questions or would like more information, please contact Ryan J. Udell (udellr@whiteandwilliams.com; 215.864.7152), Adam J. Chelminiak (chelminiaka@whiteandwilliams.com; 215.864.7078) or another member of the Corporate and Securities Group.

As we continue to monitor the novel coronavirus (COVID-19), White and Williams lawyers are working collaboratively to stay current on developments and counsel clients through the various legal and business issues that may arise across a variety of sectors. Read all of the updates here.

[1] See Fill 'Er Up!: The Paycheck Protection Program and Health Care Enhancement Act (4/24/20)

[2] See Better Late Than Never(?): The SBA Issues Second Interim Final Rule on Paycheck Protection Program Implementation (4/20/20)

[3] See Are You Confused Yet? The SBA Issues Supplemental Guidance on Paycheck Protection Program Implementation (4/8/20)

[4] See Start Your Engines: SBA Issues Interim Final Rules Implementing Paycheck Protection Program (4/3/20)