Alert

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COZEN O'CONNOR

Major Changes in the Paycheck Protection Program

The Paycheck Protection Program Flexibility Act of 2020 (the Flexibility Act) was signed into law today. The Flexibility Act makes significant changes in the Paycheck Protection Program (PPP) originally adopted as part of the CARES Act in March 2020. This alert describes the main provisions of the Flexibility Act.[1]

Extension of Loan Maturity

The CARES Act allows PPP loans to have up to a 10-year maturity. By rule, the SBA established that all loans would have a two-year maturity, which has been seen as creating potential cash flow difficulties for many borrowers. The Flexibility Act requires a minimum maturity of five years, in addition to the 10-year maximum. The change applies only for PPP loans made on or after the Flexibility Act's effective date. However, borrowers and lenders may agree to modify the terms of an existing PPP loan to extend the maturity.

The Flexibility Act does not address the interest rate for a PPP loan. The CARES Act establishes a maximum interest rate of 4 percent, and by rule the SBA decided that all PPP loans would have a 1 percent interest rate. The SBA originally proposed a rate of 0.5 percent, but the lending industry pushed back. In the final rule, the SBA increased the rate to assure that lenders would participate in the program. It remains to be seen if lenders will originate five-year loans, or amend existing loans to a five-year maturity, at a 1 percent interest rate.

Duration of "Covered Period"

The CARES Act provides that the maximum amount of a PPP loan that may be forgiven is the amount of loan proceeds spent for permitted purposes within an eight-week "covered period." There have been widespread concerns that eight weeks is not long enough to spend loan proceeds. The loan amount was based on 2½ months average payroll during 2019, whereas the covered period is only eight weeks. Some borrowers are subject to mandatory closure orders and could not restart businesses. Others have smaller operations or workforces today than in 2019, and thus were able to borrow more money than they can spend during the covered period. To address these concerns, the Flexibility Act provides for a covered period ending on the earlier of 24 weeks from the date of origination of the loan or December 31, 2020. However, a borrower with a loan originated prior to the effective date of the Flexibility Act may elect to use an eight-week covered period instead of the new 24-week period.

Use of Loan Proceeds

The CARES Act permits a PPP loan to be used for payroll costs, mortgage interest, rent and utilities. By rule, the SBA limited the amount that can be used for non-payroll costs to 25 percent and required that at least 75 percent of proceeds be used for payroll costs. In the forgiveness application form, this limit is implemented by capping the amount of forgiveness at an amount equal to payroll costs divided by 0.75. Thus, in practice the 75 percent limitation applies to the portion of the loan for which forgiveness is sought rather than to the entire loan.

The Flexibility Act provides that at least 60 percent of loan proceeds must be used for payroll, and up to 40 percent may be used for mortgage interest, rent, and utilities. Thus, the 60 percent limit applies to the entire loan, not only to the forgiven portion. The SBA may clarify this to relate only to the forgiven portion of the loan, as it did with the original 75 percent requirement. However, in the absence of additional SBA guidance, borrowers who wish to seek forgiveness should be prepared to demonstrate to their lenders that they spent at least 60 percent of their total loan proceeds on payroll to qualify for any forgiveness. Borrowers with existing loans that are unable to meet this

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standard may wish to shift to the applicable longer covered period as provided for in the Flexibility Act to gain more time to meet the 60 percent threshold, assuming they are permitted to do so by the terms of their loan documents or the lender agrees to suitable amendments.

FTE Calculation

Under the CARES Act, forgiveness is determined based on the ratio of (i) the number of average monthly full-time equivalent employees (FTEs) during the covered period divided by (ii) the number of average monthly FTEs during one of two reference periods, at the option of the borrower. However, it is not considered a reduction in FTEs if there was a reduction in FTEs between February 15 and April 26, 2020, and that reduction is restored by June 30, 2020. Similarly, there is a reduction in forgiveness to the extent the borrower had reduced the cash compensation of an employee by more than 25 percent between February 15 and April 26, 2020, but that reduction is disregarded if the compensation decrease is restored by June 30, 2020. Both of these safe harbors had been criticized because many companies legally or practically will not be able to return to the same level of operations by June 30. The Flexibility Act changes the restoration date from June 30 to December 31, 2020.

The Flexibility Act also creates two new exemptions in the FTE calculation. The SBA had previously issued guidance that allowed borrowers to exclude employees that turned down good faith written offers to be rehired. Under the Flexibility Act, the amount of loan forgiveness will also be determined without regard to a proportional reduction in FTEs if the borrower in good faith is able to document (1) an inability to rehire individuals who were employees on February 15, 2020, and inability to hire similarly qualified employees for unfilled positions by December 31, 2020, or (2) an inability to return to the same level of business activity as the business was operating at February 15, 2020, due to compliance with requirements established or guidance issued by the U.S. Department of Health and Human Services, the Centers for Disease Control, or the Occupational Health and Safety Administration issued between March 1 and December 31, 2020, and relating to sanitation, social distancing or other worker or customer safety requirement relating to COVID-19.

Loan Deferral Period; Timing of Forgiveness Application

Under the CARES Act, interest on a PPP loan accrues from the date of the loan, but the SBA is allowed to require lenders to allow borrowers to defer payments of principal or interest during a period of between six and 12 months from the making of the loan. In its rules, SBA set the deferral period at six months for all loans. As noted in our previous alert, it is possible that a borrower might start making payments before the forgiveness amount is determined, and SBA rules require in that event any amounts paid and subsequently forgiven would be refunded to the borrower. The Flexibility Act addresses this by striking the one-year limit and substituting the date on which the forgiveness amount on the loan is remitted to the lender by SBA. However, a change in SBA rules will be needed to implement the longer deferral period.

The CARES Act does not specify a date by which a borrower must apply for forgiveness of the loan. Given the change in the duration of the deferral period discussed in the previous paragraph, in theory a borrower could avoid ever having to make loan payments if it never filed a forgiveness application. The Flexibility Act addresses this by providing that if a borrower does not apply for forgiveness within 10 months following the end of the covered period, the borrower must repay the loan in full, beginning on the day that is 10 months after the end of the covered period. Thus, there is now a time limit on filing a forgiveness application.

Coordination Between Payroll Tax Deferral and PPP Loan

The CARES Act allows an employer to defer making deposits of employment taxes for 2020 and 2021. One-half of the deferred amounts must be paid by December 31, 2021, and one-half by December 31, 2022. However, the deferral is not available for an employer that has had a PPP loan forgiven in whole or in part. The Flexibility Act strikes this exclusion, with effect from the original date of the CARES Act. As a result, PPP borrowers will be eligible for both PPP loan forgiveness and for the payroll tax deferral.

Implementation of the Changes; Unresolved Issues

Although these changes may favorably impact many borrowers, they are not a panacea.

Some changes will require SBA to amend existing rules to implement them or to avoid conflicts between changes in the law and other aspects of the rules. Certainly, the loan forgiveness application and accompanying rules will need to be modified, and those modifications might raise additional questions or concerns.

One of the most significant changes — the maturity date extension — is, by its terms, prospective only, although borrowers and lenders may voluntarily agree to implement it for existing loans. Absent an SBA rule change to allow higher interest rates, lenders may be unwilling to originate new five-year loans or to lengthen the maturity of existing loans.

The other provisions of the Flexibility Act are effective immediately. However, it is unclear that all borrowers will benefit from the changes. Many lenders incorporated the SBA's covered period rules into the loan documents, either by express terms of the documents or by reference to the SBA rules. Whether the change in the law will also effect a change in the terms of the contracts will depend on the wording of the contract. Of course, the borrower and the lender may agree to a modification of the contract, but the passage of the law itself will not necessarily modify the contract without mutual agreement.[2]

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[1] Previous Cozen O'Connor PPP alerts are available here.

[2] Congress is not prohibited from passing laws that impair existing contracts, because the impairment of contracts clause in the U.S. Constitution, Article I, Section 10, only applies to the states. Under some circumstances, a party to a contract affected by a change in federal law may assert a claim for money damages against the federal government, usually on the basis that it is a "taking" without compensation under the Fifth Amendment.