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PH COVID-19 Client Alert Series: Overview of the Liquidity and Credit Support Programs for Affected Businesses Proposed by Congress and Implemented by the Federal Reserve

By Paul Hastings LLP

As COVID-19 wreaks havoc on the economy of the United States, the U.S. Congress is finalizing adoption of the Coronavirus Aid, Relief and Economic Security Act (the "CARES Act"). Moreover, federal financial regulators are already using their inherent regulatory powers to implement unprecedented programs to stimulate the economy, in addition to providing housing and educational loan assistance. While the legislation is currently fluid and subject to change, we provide below a summary of the key provisions in Title IV (credit support for other affected businesses, including larger businesses) and Title I (small business interruption loans) of the CARES Act. This summary reflects the March 22, 2020 version of the CARES Act as introduced by the Senate Republicans. For a summary of the relevant programs announced by the Federal Reserve, Treasury, and the Federal Banking Agencies to date please see the attached Annex I. The legislation and stimulus programs are subject to change, and we intend to augment and provide updates to this summary as the initiatives are clarified.

TITLE IV – CREDIT SUPPORT FOR AFFECTED BUSINESSES (OTHER THAN SMALL BUSINESSES)

Q: Are larger businesses (or other businesses that do not otherwise qualify for Title I loans described below) eligible for relief under the CARES Act?

A: Under Title IV of the CARES Act ("Economic Stabilization and Assistance to Severely Distressed Sectors of the United States Economy"), the Secretary of the Treasury is authorized to make loans, guarantees, and other investments in support of eligible businesses, states, and municipalities in an amount not to exceed $500 billion pursuant to the Federal Credit Reform Act of 1990. The CARES Act specifically provides for relief to certain specified industries:

- **$50 billion** for passenger air carriers;
- **$8 billion** for cargo air carriers; and
- **$17 billion** for "businesses critical to maintaining national security."

The Secretary also is given broad discretion to disburse the remaining funds to other businesses and may make such disbursements without any consideration for the number of employees of such other businesses.

Q: What terms and conditions will apply to companies receiving these economic stabilization loans and guarantees?

A: The Secretary of the Treasury has a wide mandate to determine which businesses will be beneficiaries of this credit support and in what form, though there are some general guidelines set forth in the CARES Act. Any recipient of Treasury funds, during the term of the loan or guarantee, would be required to maintain its existing employment levels as of March 13, 2020, to the extent practicable, and be prohibited from repurchasing its equity interests. Similarly, businesses receiving loans or guarantees under this provision will also be required to agree to caps on compensation and severance payments for employees whose **compensation exceeded $425,000** in the 2019 calendar year. The caps will apply during a two-year period from March 1, 2020 to March 1, 2022. Interest rates are to be determined by the Secretary based on the risk profile and current average yield on outstanding marketable U.S. Government securities of comparable maturity, and loan terms would be as short as possible, **not to exceed five years**. The Treasury is also authorized to make investments in the form of warrants or common or preferred equity interests in order to share in the upside of any economic recovery and gains, though the Treasury will not exercise voting rights under common stock. Unlike Title I loans, Title IV loans will not be subject to loan forgiveness.

Q: I understand that the CARES Act includes provisions regarding modified Accounting Standards under GAAP for financial institutions. Is this true?

A: Yes, the CARES Act provides relief from:

- Financial Accounting Standards Board Account Standards Update No. 2016-13 (**Measurement of Losses on Financial Instruments**), which was expected to be in full effect for the regulatory reporting period ending March 31, 2020, commonly known as **Current Expected Credit Loss** ("CECL"); and
- **Troubled Debt Restructurings** for borrowers affected by COVID-19.

The revised measurement standard was intended to revise the methodology of expected credit losses and for estimating allowances of credit losses, replacing the long-standing Allowance for Loan and Lease Losses standards. Implementation of the revised standard was expected to result in significant write-downs by banks when fully implemented. CECL was adopted by FASB because it determined that the ALLL standard did not result in timely adjustment of reserve levels based on reasonable expectation of future conditions because ALLL relies on losses that are incurred but not realized when it is known with some certainty that future cash flows will not be collected.

The CARES Act will also suspend generally accepted accounting principles for reporting loan modifications related to COVID-19 that otherwise would be reported as a troubled debt restructuring ("TDR"). TDRs, through loan modifications such as a forbearance arrangement, interest rate modification, repayment plan, or any similar plan that defers or delays the payment of principal or interest, when conducted in a prudent manner, are considered to be in the best interest of both the institution and borrower, leading to improved loan performance and reduced credit risk. However, a bank engaging in a TDR has reporting obligations, including downgrades to a loan's regulatory classification and potential impacts on loan loss allowances. Accordingly, the CARES Act provides for TDR reporting relief for loan modifications for loans that were not more than 30 days past due as of December 31, 2019 and where a borrower was affected by COVID-19.

This relief applies from March 1, 2020 until 60 days after the termination of the public health emergency declared on January 31, 2020.

Q: Will deposits in banks over the $250,000 insurance limit be insured by the FDIC?

A: The CARES Act brings back the FDIC's Transaction Account Guarantee Program ("TAG"), initially implemented in the 2008 financial crisis, to provide that noninterest-bearing transactional accounts are not subject to the current standard deposit insurance limit of $250,000. The TAG prevents bank-runs and liquidity crises, by eliminating any need for depositors to move funds for payroll and other business transactions from smaller banks to banks considered too big to fail. This temporary relief will terminate on December 31, 2020.

Q: Given the broad discretion granted to the Secretary of the Treasury, how will this program be implemented as a practical matter?

A: The Secretary is authorized to designate financial institutions to act as financial agents of the United States to administer these programs. Within 10 days following enactment, the Secretary will publish procedures for application and minimum eligibility requirements. Clearly, implementation of this program will be complex, and we intend to provide further updates and guidance as the situation develops.

TITLE I – SMALL BUSINESS INTERRUPTION LOANS

Q: Which businesses will be eligible to receive "small business interruption loans" under the CARES Act?

A: Under Title I of the CARES Act ("Keeping American Workers Employed and Paid"), qualifying businesses that have suffered significant disruption as a result of COVID-19 will be able to receive no-fee "small business interruption loans." Qualifying small businesses are generally defined as:

- businesses;
- not-for-profits (except those receiving Medicaid funds); and
- veterans organizations

in each case, either:

- have fewer than 500 employees (subject to the exceptions described in the following question); or
- meet The Small Business Administration's ("SBA") industry-based "size standard" requirements for the applicable NAICS code, which are based either on number of employees or annual receipts.

Q: What are the exceptions to the "500 employees" rule? How do the SBA's affiliation rules come into play?

A: In order to determine an applicant's number of employees, each applicant can generally expect that it must aggregate all employees on an affiliate basis,[1] including subsidiaries and, in the context of private equity-backed businesses, portfolio companies. Statutory exceptions are made in the legislation for:

- franchises and hospitality businesses (NAICS code 72 "accommodation and food services") with multiple locations, whereby the 500 person limitation is tested on a per location business; and
- any business receiving financial assistance from a Small Business Investment Company ("SBIC").

Q: Who will provide and administer the loans?

A: Loans will be administered pursuant to SBA's section 7(a) loan program, as modified by the CARES Act. Loans will be made and serviced by existing banks and lenders enrolled in the SBA 7(a) program, as well as any other lenders determined by the SBA and the Secretary of the Treasury "to have the necessary qualifications to process, close, disburse and service loans made with the guarantee of the Administration." While the original March 19 version of the bill was clear that loans would be 100% guaranteed by the SBA through December 31, 2020 (and thereafter, revert to standard SBA guarantee percentages of 85% for loans up to $150,000 and 75% for loans greater than $150,000), the March 22 draft removed the reversion language. While we expect there to be further guidance on this point from Treasury and the SBA on this point, the revised language suggests that the 100% guarantee would survive for the life of the loan.

Q: What is the maximum loan size? Any other restrictions on loan terms?

A: The maximum loan amount **is the lesser of (x) $10 million** and (y) **2.5 times the average monthly payroll costs for the one-year period** before the loan is made (giving effect to any seasonality-based adjustments and based on a shorter period for business less than a year old) for the applicable borrower. Loans can have a **maximum term of up to ten years**. The Secretary of the Treasury, in consultation with the SBA, will issue additional regulations and guidance with respect to interest rates and other terms and conditions of the program.

Q: Will interest payments be deferred for any period?

A: Loans will be entitled to complete deferment of interest payments for a period of one year.

Q: Will portions of the loans used for specified purposes be eligible for forgiveness?

A: The loan will be eligible for forgiveness in an amount (not to exceed the principal amount of the loan) equal to the sum of: (i) payroll costs, (ii) rent, (iii) utilities payments, and (iv) interest payments on secured debt obligations (including mortgages) incurred in the ordinary course of business prior to February 15, 2020, in each case, paid during the eight-week period commencing on the date of origination of the loan. The amount of any loan forgiveness will be reduced by any reductions in employee wages (in excess of 25% for any employee) or a reduction in the number of employees during the covered period in accordance with the terms of the program. Borrowers will not recognize any cancellation of indebtedness income upon forgiveness of any portion of the loan for tax purposes. A borrower will be required to submit a fulsome application in support of loan forgiveness directly to the lender. The lender will make a determination on the application (subject to a statutory safe harbor) within 60 days of receipt; within 90 days after the loan forgiveness amount has been determined, the SBA will reimburse the lender directly for the principal amount of any forgiven debt, plus interest accrued through the date of repayment. SBA will issue additional implementation guidance and regulations regarding the loan forgiveness process within 30 days after enactment of the CARES Act.

Q: Are there any restrictions on use of proceeds? Can the proceeds of loans be used to pay interest on pre-existing third-party debt instruments?

A: Yes. Payroll, rent, utilities, and sick leave are among permitted uses of proceeds. In addition, proceeds of loans may be used to make interest payments on other debt obligations that were incurred prior to February 15, 2020.

Q: Will these loans be secured? Where would these loans rank in security and priority as compared to any pre-existing third-party debt instruments?

A: The loans will be unsecured and will not prime existing debt instruments in terms of payment priority. The loans will also not require personal guarantees from owners of borrowers.

Q: Will the SBA provide guarantees or other credit support for pre-existing debt instruments provided by third-party lenders?

A: No. The credit support contemplated by the CARES Act will only apply to new financing provided pursuant to the program.

Q: What is the deadline to apply to the program?

A: June 30, 2020.

Q: Will these loans trade on the secondary market?

A: Yes, but only after the applicable loan forgiveness amount has been determined by the SBA.

Q: Are the small business interruption loans the same as the small business "disaster" loans I have read about?

A: No. Under existing authority, the SBA will also provide smaller "Economic Injury Disaster Loans" ("EIDLs") in an amount **up to $2 million** to certain small businesses, agricultural cooperatives, and private nonprofit organizations that meet the SBA's industry-specific business size limitations in declared disaster areas (a growing list of states) and have suffered substantial economic damage as a result of COVID-19. EIDLs can be used for working capital purposes and have terms of up to 30 years, with maximum **interest rates of 3.75% per annum for for-profit companies and 2.75% per annum for non-profits**. In addition to the federal loan programs contemplated by the CARES Act, prospective applicants may also look to state and local relief programs as they become available.

ANNEX I

Overview of Federal Reserve Actions

The following is a summary of key federal programs adopted by the Federal Reserve, Treasury, and the Federal Banking Agencies, which may be of interest.

Primary Market Corporate Facility

Information as of March 23, 2020

Federal Reserve/Treasury

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Funding Backstop for Corporate Debt	Eligible issuers: U.S. companies headquartered in the United States and with material operations in the United States. Cannot be receiving assistance under other pending federal legislation; unclear yet whether that includes the CARES Act. The scope of eligible issuers may be expanded in the future.	Secondary Market Program operated by the Federal Reserve Bank of New York. Eligible Issuers to sell eligible corporate bonds and loans Eligible Bonds: Issuer is rated at least BBB-/Baa3 by a major nationally recognized statistical rating organization ("NRSRO") and if rated by multiple major NRSROs rated at least BBB-/Baa3 by two or more NRSROs; and • Have a maturity of four years or less.	Limit: Not to exceed the applicable percentage of the eligible issuer's maximum outstanding bonds and loans on any day between March 22, 2019 and March 22, 2020: • 140% for eligible assets/eligible issuers with a AAA/Aaa rating from a major NRSRO; • 130% for eligible assets/eligible issuers with a AA/Aa rating from a major NRSRO; • 120% for eligible assets/eligible issuers with a A/A rating from a major NRSRO; or • 110% for eligible assets/eligible issuers with a BBB/Baa rating from a major NRSRO.

Secondary Market Corporate Facility

Information as of March 23, 2020

Federal Reserve/Treasury

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Purchase eligible individual corporate bonds and corporate bond portfolios exchange traded funds ("ETFs")	Eligible Issuers: U.S. businesses with material operations in the United States. Cannot be receiving assistance under other pending federal legislation; unclear yet whether that includes the CARES Act.	Secondary market program operated by the Federal Reserve Bank of New York. Eligible Corporate Bonds: • Issued by an Eligible issuer; • Rated at least BBB-/Baa3 by a major NRSO and, if rated by multiple major NRSROs, rated at least BBB-/Baa3 by two or more NRSROs, in each case subject to review by the Federal Reserve; and • Remaining maturity of five years or less. U.S.-listed ETFs with an investment objective is to provide broad exposure to the market for U.S. investment grade corporate bonds.	Limits per Issuer/ETF: • From any one eligible issuer: 10% of the issuer's maximum bonds outstanding on any day between March 22, 2019 and March 22, 2020; or • 20% of the assets of any particular ETF as of March 22, 2020.

Term Asset-Backed Securities Loan Facility

Information as of March 23, 2020

Federal Reserve / Treasury

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Support Asset Backed Securities ("ABS") Market by providing loans for new ABS issuances (after 3/23/2020) Eligible ABS: • Auto loans and leases; • Student loans; • Credit card receivables (both consumer and corporate); • Equipment loans; • Floorplan loans; • Insurance premium finance loans; • Certain small business loans that are guaranteed by the SBA; or • Eligible servicing advance receivables.	Eligible Borrowers: • Entities organized under the laws of the United States or a political subdivision or territory thereof (can have a non-U.S. parent company); or • A U.S. branch or agency of a foreign bank.	Through relationships with primary dealers, Eligible Borrowers can pledge eligible collateral to the Federal Reserve Bank of New York: • U.S. dollar denominated assets; • Credit Rating: highest long-term or the highest short-term investment-grade rating category from at least two eligible NRSROs; does not have a credit rating below the highest investment-grade rating category from an eligible NRSRO.	More terms pending, based on 2008 TALF program.

Commercial Paper Funding Facility

Information as of March 23, 2020
Federal Reserve/Treasury

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments

Funding Backstop for Term Commercial Paper Purchases	Eligible Issuers:
	
	Issuers of U.S. dollar denominated commercial paper (including asset backed commercial paper).
	
	Eligible Paper:
	
	• Three-month commercial paper;
	• Rated at least A1/P1/F1 by a major NRSRO or, if rated by multiple major NRSROs, was rated at least A1/P1/F1 by two or more major NRSROs;
	• If subsequently downgraded, so long as the issuer is rated at least A2/P2/F2 by a major NRSRO or, if rated by multiple major NRSROs, is rated at least A2/P2/F2 by two or more major NRSROs, subject to:
	  o One time sale; and
	  o Review by the Federal Reserve.
		Primary Dealers Eligible Issuers can sell their Eligible Paper through the Federal Reserve Bank of New York.	Limit: per issuer/at any one time: greatest amount of U.S. dollar-denominated commercial paper the issuer had outstanding on any day between March 16, 2019 and March 16, 2020; and
			
			Subject to restrictions if issuer is downgraded.

Money Market Mutual Fund Liquidity Facility

Information as of March 23, 2020

Federal Reserve/Treasury

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Loans to Eligible Borrowers to Support Money Market Mutual Funds (State and municipal money market funds)	Eligible Borrowers: • U.S. depository institutions; • U.S. bank holding companies (parent companies incorporated in the United States or their U.S. broker-dealer subsidiaries); or • U.S. branches and agencies of foreign banks.	Through Federal Reserve Bank of Boston: Eligible Funds: • Prime; • Single State; or • Other Tax Exempt identified at item A.10 of SEC Form N-MFP. Loans secured by the following types of Eligible Collateral: • Maturity date of an advance less than 12 months; • U.S. Treasuries & Fully Guaranteed Agencies; • Securities issued by U.S. Government Sponsored Entities; • ABCP issued by a U.S. issuer and is rated at not lower than A1, F1, or P1 by at least two major rating agencies or, if rated by only one major rating agency, is rated within the top rating category by that agency; • Unsecured commercial paper that is issued by a U.S. issuer, is rated not lower than A1, F1, or P1 by at least two major rating agencies or, if rated by only one major rating agency, is rated within the top rating category by that agency; • U.S. municipal short-term debt that: (i) Has a maturity that does not exceed 12 months; and (ii) At the time purchased from the	Regulators also provided capital relief to participating banks.

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
		Fund or pledged to the Reserve Bank: (1) If rated in the short-term rating category, is rated in the top short-term rating category (e.g., rated SP1, MIG1, or F1, as applicable) by at least two major rating agencies or if rated by only one major rating agency, is rated within the top rating category by that agency; or (2) If not rated in the short-term rating category, is rated in the top long-term rating category (e.g., AA or above) by at least two major rating agencies or if rated by only one major rating agency, is rated within the top rating category by that agency; BS Receivables from certain repurchase agreements. Other classes of assets to be considered.	

Purchases of Treasury Securities and Agency Mortgage-Backed Securities

Information as of March 23, 2020

Federal Reserve's Federal Open Market Committee

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Purchase: • **Treasury Securities,** • **Agency Mortgage-Backed Securities and** • **Agency Commercial Mortgage-Backed Securities**	Federal Reserve	Federal Reserve Open Market	Week of March 23, 2020: $75 billion of Treasury Securities; $50 billion of agency MBS each business day this week, subject to reasonable prices. CMBS to be purchased this week.

Discount Window Usage

Information as of March 15, 2020

Federal Reserve

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Loans to Depository Institutions for up to 90 days (prepayable and renewable)	Depository Institutions	Collateralized loans	Lowered credit rate to 0.25%

<u>*Loan Modifications/Working with Customers Affected by COVID-19*</u>

Information as of March 22, 2020

Federal Reserve, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Consumer Financial Protection Bureau and Conference of State Bank Supervisors

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Provides guidance to Depository Institutions to work with Customers Affected by COVID-19	Depository Institutions	Assist affected customers; Making short-term modifications made on a good faith basis in response to COVID-19 to borrowers who were current prior to any relief Short-term modifications (*e.g.*, six months) modifications such as: • payment deferrals, • fee waivers, • extensions of repayment terms, or • other delays in payment that are insignificant. Borrowers considered current are those that are less than 30 days past due on their contractual payments at the time a modification program is implemented.	The agencies will not criticize financial institutions that mitigate credit risk through prudent actions consistent with safe and sound practices

Use of Capital and Liquidity Buffers

Information as of March 22, 2020

Federal Reserve, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Authorizes U.S. Banking Organizations to access their Dodd-Frank Act mandatory capital and liquidity buffers intended for adverse situations to address the effects of COVID-19	U.S. Banking Organizations	Lend and undertake other supportive actions in a safe and sound manner. The agencies expect banking organizations to continue to manage their capital actions and liquidity risk prudently	Frees up $1.3 trillion in common equity and $2.9 trillion in high quality liquid assets (HQLA) Agencies published Related Capital Relief to account for the buffers

Disaster Assistance Loans for Small Business

Economic Injury Disaster Assistance

Information as of March 12, 2020

Small Business Administration

What Does the Program Do?	Who Can Participate?	How to Participate?	Comments
Provides Economic Injury Disaster Loans of up to $2.0 million to pay fixed debts, payroll, accounts payable and other bills that can't be paid because of the disaster's impact.	Small Businesses suffering substantial economy injury due to COVID-19; Private and non-profit organizations	Small business must be located in state/territory subject to an Economic Injury Disaster Declaration	The interest rate is 3.75% for small businesses without credit available elsewhere; businesses with credit available elsewhere are not eligible. The interest rate for non-profits is 2.75%.

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[1] The SBA “affiliation rules” require that in determining size, a company include all affiliates controlled by, controlling or under common control with the business. Control can be measured by equity interests, economic dependence or other factors.