SBA RELEASES ADDITIONAL GUIDANCE ON PAYCHECK PROTECTION PROGRAM; FEDERAL REGULATORS PUBLISH MORE INFORMATION ON PPPLF AND REAL ESTATE APPRAISALS

April 15, 2020

On the afternoon of April 14, the SBA provided additional guidance regarding the Paycheck Protection Program ("PPP") in the form of an interim final rule, which supplemented the previously issued interim final rule announcing the implementation of PPP. The rule is effective immediately and provides the following answers to critical questions facing the industry.

Supplemental Interim Final Rule

Loans to Director-Owned Entities

The interim final rule provides that businesses otherwise unaffiliated with the bank are generally eligible to receive a PPP loan from that bank even though such businesses are owned by an outside director of the bank. Under existing SBA regulations, "Associates" of a bank, including directors and businesses owned by directors, are generally ineligible to receive SBA 7(a) loans, and, until the publication of this rule, nothing in the text of the CARES Act or subsequent guidance modified those regulations in the case of PPP loans. In allowing directors to participate in PPP through their businesses, the SBA cited the fact that many bank directors own otherwise eligible small businesses, and that the terms of PPP loans are standardized, with no variability in pricing or creditworthiness, alleviating traditional concerns that directors will receive favorable terms on loans.

Although the guidance is limited to directors of the SBA lender (i.e., the bank), the same reasoning should apply to directors of bank holding companies. Additional clarity on this point will hopefully be forthcoming.

However, loans to director-owned entities remain subject to the following limitations.

- Holders of 30% or more of an equity interest in a bank may not receive a PPP loan from that bank.
  - » Presumably this limitation extends to a 30% owner of a bank holding company.
  - » It is unclear whether ownership by the director's family would be aggregated.
- Directors who are also officers or key employees of the bank may not receive a PPP loan from that bank.
- Loan terms and application processing must be on equal terms as other borrowers.
- All such loans will continue to be subject to compliance with Regulation O, Regulation W, other state and federal laws and regulations, and the bank's internal policies regarding related party transactions.

Loans to Self-Employed Individuals

The interim final rule also provided helpful clarity on self-employed borrowers, summarized below:

Determining Maximum Loan Amount

- If the borrower has no employees, the borrower must calculate the maximum loan amount based on 2019 Schedule C net profit (line 31)
  - » Maximum loan amount will equal this net profit, divided by 12 months, multiplied by 2.5
  - » Rather than "payroll costs," the Interim Final Rule refers to the portion of the loan derived from the Schedule C net profit as "Owner Compensation Replacement."
- If the borrower has employees, the maximum loan amount shall be:
  - » the sum of:
    - the borrower's net profit as calculated above plus
    - eligible payroll costs paid to U.S. employees for 2019 (wages, tips, health insurance, retirement contributions, state and local tax)
  - » divided by 12 months and multiplied by 2.5.
- In either case, the borrower should add the amount of any EIDL being refinanced to the maximum loan amount.
- In either case, the borrower's net profit and the salary/wages paid to each employee are each capped at $100,000.
- If the borrower has not yet filed a 2019 tax return, the borrower must prepare the Schedule C and provide to the bank with its application.
- Borrowers with employees must provide the Form 941 for 2019 as well as payroll records, state tax reporting forms and other evidence of payment of payroll costs.
- Self-employed borrowers who received a 1099-MISC reporting non-employment compensation must also provide those 1099s, although it appears that the loan amount will be based off of Schedule C and not 1099s.
- Presumably, self-employed farmers submitting PPP applications should use their Schedule F instead of Schedule C to determine their maximum loan amount.
- Unlike other businesses, the self-employed do not have the option of determining their loan amount based on the last 12 months; they must use calendar year 2019. The SBA has promised additional guidance for those who were not in business in 2019 but were in business as of February 15, 2020.

Use of Loan Proceeds

- The self-employed may use their loan proceeds for:
  - » owner compensation replacement;
  - » payroll costs of employees;
  - » mortgage interest (on real or personal property);

  - » utilities (including vehicle fuel);
  - » rent (of real or personal property); or
  - » interest on other obligations existing on February 15, 2020.
- For mortgage interest, utilities and rent, the interim final rule requires that such amounts must have been claimed on the borrower's 2019 Schedule C or, if not yet filed, the borrower must be entitled to claim them in 2019.
- Examples cited as allowed expenses include lease payments, interest and gas for a vehicle used to perform the borrower's business.
- Examples also include rent and utility of a warehouse used in business; although not explicit, this appears intended to exclude the portion of rent, interest and utilities relating to a home office.

Forgiveness

- At least 75% of loan proceeds must be used for payroll costs, including owner compensation replacement, and any EIDL refinanced is included in the denominator.
- Up to $15,385 of owner compensation replacement and $15,385 of salaries/wages per individual employee may be forgiven (this represents 8/52 of $100,000).
- Benefits for employees (health care expenses, retirement contributions, state and local taxes) are forgivable, but benefits to the owner are not forgivable.
- There is language that could be read to state that rent, utilities and mortgage interest are not forgivable for the self-employed even though these are permitted uses of the loan proceeds. This seems inconsistent with the statute and we hope for clarification that the limitation on forgiveness was intended to explain only the reason for choosing net profit from Schedule C rather than gross receipts.

Loans to Partnerships

The interim final rule clarified that partners in a partnership who receive a K-1 should not apply for a PPP loan as a self-employed borrower; the PPP loan should be made at the partnership level. This guidance will greatly streamline the application process for partnerships. Limited liability companies that are taxed as partnerships for federal income tax purposes are accorded the same treatment as partnerships under the interim final rule.

More to Come

As noted above, the interim final rule promised further guidance on a few issues, and certain portions of the interim final rule are subject to differing interpretations. We expect much more guidance as banks continue to encounter questions that are not answered in the CARES Act, the two interim final rules, or FAQs released thus far.

Federal Reserve PPPLF

On April 14, 2020, the Federal Reserve also posted program documents for the Paycheck Protection Program Liquidity Facility ("PPPLF"). In light of the liquidity and capital relief offered by the PPPLF, many of our clients intend to use the facility on a dollar-for-dollar basis to fund their PPP lending activities. However, the program documents contained a couple of unwelcome surprises for potential borrowers.

Borrower Certification

The PPPLF contains a borrower certification that the borrower is "not insolvent" and also a certification regarding the lack of adequate credit accommodations from other banking institutions. We believe this certification was designed to be relatively easy for the borrower to give in that the instructions indicate that the borrowing bank need only establish that "credit accommodations may be available, but at prices or on conditions that are inconsistent with a normal, well-functioning market." While this standard is admittedly loose, it seems to ignore the terms that Federal Home Loan Banks seem to be considering in regard to financing PPP lending. Borrowing banks will need to get comfortable that they are able to give this certification.

Non-Recourse (sometimes)

While the supply of liquidity and capital relief afforded by the PPPLF were the headline features, we were very intrigued by the supposed non-recourse nature of the facility described in the term sheet. The idea that borrowing banks could offload the risk of SBA performance on its guaranty to the Federal Reserve seemed too good to be true – and it was. The program documents make clear that the non-recourse nature of the facility is only limited to the Federal Reserve's initial collection efforts. To further solidify the limitations on the non-recourse language, the letter of agreement related to the PPPLF states that the loan will be full recourse if the borrower "has breached any of the representations, warranties, or covenants made under the PPPLF Agreement." A representation made under the agreement is that each pledged PPP loan "[c]omplies with all requirements of the PPP, including without limitation any rules or guidance issued by the SBA implementing the PPP, and any requirements set forth in any agreement the Borrower is required to execute by the SBA in connection with the PPP." Clearly, given that language, risks related to compliance with PPP terms in originating PPP loans will remain with the borrowing bank under the PPPLF.

General

While those terms were not as favorable as we had hoped, we still expect many community banks to use the PPPLF to fund PPP lending given its favorable financial and regulatory features.

Interagency Interim Final Rule on Real Estate Appraisals

The federal banking regulators also issued an interim final rule to permit financial institutions to temporarily defer the requirements for appraisals and evaluations under existing regulations for residential and commercial real estate financial transactions, except those related to the acquisition, development and construction of real estate. The temporary provision will apply to any transaction closed on or before December 31, 2020, unless further extended. In taking the action described in the interim final rule, the agencies recognized that challenges relating to the timely completion of appraisals were creating delays for borrowers seeking liquidity to meet immediate and near-term financial needs resulting from the impact of COVID-19. Nonetheless, the agencies noted that financial institutions are still expected to conduct their lending activities in a manner consistent with the agencies' Standards for Safety and Soundness and Real Estate Lending Standards that focus on the borrower's ability to repay and other relevant laws and regulations. The deferral of the appraisal requirement is not a waiver of that requirement, as lenders will remain obligated to obtain an appraisal within 120 days after the closing of the transaction, and lenders will still be expected to use their best efforts, based on available information, to estimate the

collateral value of the subject property at the time of the loan. The interim final rule also established the agencies' expectation that lenders develop an appropriate risk mitigation strategy if the appraisal or evaluation reveals a market value significantly lower than estimated.

Given the continuing requirements related to the underwriting of extensions of credit secured by real estate, it is unclear that the temporary relaxation of the prior appraisal requirement for real estate lending transactions will result in significant relief for banks. However, we are aware of numerous banks who have been faced with weighing the prospects of a technical violation of the appraisal requirements against creating a liquidity crisis for a customer, which may thereafter result in a safety and soundness issue for the bank. With the temporary relief provided through the interim final rule, lenders are not presented with such a Hobson's choice.

Contemporaneously with the issuance of the interim final rule, the agencies issued an Interagency Statement on Appraisals and Evaluations for Real Estate Related Transactions Affected by the Coronavirus highlighting the flexibility currently existing in industry appraisal standards and regulations, as well as temporary changes to Fannie Mae and Freddie Mac appraisal standards addressing challenges arising from COVID-19. Together with prior guidance related to loan forbearance and modifications, and the interim final rule permitting the deferral of appraisals and evaluations, we see the agencies' actions today as the continuation of their efforts to support prudent action by banks to work with borrowers impacted by the coronavirus.

PROFESSIONALS

CHET A. FENIMORE
Managing Partner, Austin
CFenimore@fkhpartners.com
Direct: (512) 583-5901

GEOFFREY S. KAY
Partner, Austin
GKay@fkhpartners.com
Direct: (512) 583-5909

LOWELL W. HARRISON
Partner, Austin
LHarrison@fkhpartners.com
Direct: (512) 583-5905

ZONNIE BRECKINRIDGE
Of Counsel, Austin
ZBreckinridge@fkhpartners.com
Direct: (512) 583-5911

STEPHANIE E. KALAHURKA
Partner, Kansas City
SKalahurka@fkhpartners.com
Direct: (816) 292-8141

DEREK W. MCGEE
Partner, Austin
DMcGee@fkhpartners.com
Direct: (512) 583-5902

JONATHAN HIGHTOWER
Partner, Georgia
JHightower@fkhpartners.com
Direct: (770) 282-5112

JEREMY S. LEMMON
Partner, Austin
JLemmon@fkhpartners.com
Direct: (512) 583-5903

PAM G. O'QUINN
Partner, Dallas
POQuinn@fkhpartners.com
Direct: (214) 273-6244

BRENT STANDEFER, JR.
Partner, Austin
BStandefer@fkhpartners.com
Direct: (512) 583-5906

KEVIN STRACHAN
Partner, Georgia
KStrachan@fkhpartners.com
Direct: (770) 282-5117

JOHN T. WILSON
Attorney, Austin
JWilson@fkhpartners.com
Direct: (512) 583-5923

CRYSTAL HUFFMAN
Attorney, Georgia
CHuffman@fkhpartners.com
Direct: (770) 282-5114

NICHOLAS J. GALLION
Attorney, Austin
NGallion@fkhpartners.com
Direct: (512) 583-5915

WILLIAM C. WILSON, JR.
Attorney, Austin
WWilson@fkhpartners.com
Direct: (512) 583-5904