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Payroll Protection Program May Provide Relief to Eligible Small Businesses – If You Can Navigate the Workforce Issues

by the Labor and Employment Group

Section 1102 of the Coronavirus Aide, Relief, and Economic Stimulus Act (CARES Act) creates the Paycheck Protection Program (PPP), which is intended to provide funds for small businesses affected by COVID-19 to maintain their workforce. The loans are forgivable under Section 1106 of the CARES Act if the loan is used for permitted payroll, rent, mortgage interest, and utilities expenses and certain workforce and salary maintenance thresholds are met. To apply for the loans, employers must make a number of certifications, including that economic uncertainty due to COVID-19 makes the loan necessary to support ongoing business operations.

The roll out of the program has been marked by uncertainty over how key terms are being interpreted and, despite significant guidance being regularly released by the Small Business Administration (SBA) and posted on the Treasury Department's website, questions remain about the program with guidance still lacking in some areas, including details on how loan forgiveness will be calculated. This has made it challenging for some employers, especially those who have already conducted layoffs or furloughs, to determine if the loan will be forgiven, in whole or in part, and what steps should be taken to maximize forgiveness. Existing guidance lays out how the loan amounts are calculated and how the proceeds can be used with an eye toward helping businesses incorporate the loans into their workforce planning decisions.

With the SBA changing its guidance frequently during the roll out of the program, sometimes in ways that do not clearly follow or that contradict the statutory text of the CARES Act itself, it is important to always confirm the latest guidance before moving forward with any decisions about participation in the program or use of the proceeds.

Who Can Apply?

Small businesses with 500 employees or fewer, including sole proprietorships, independent contractors and self-employed persons, 501(c)3 nonprofits, 501(c)(19) veterans organizations or Tribal business concerns affected by COVID-19 may apply for a covered loan. Accommodation and food services businesses qualify if they employ 500 or fewer employees per physical location.

Businesses with more than 500 employees may be eligible if they meet certain existing size and revenue rules used by the SBA. In addition, businesses who currently have more than 500 employees may be eligible if their number of employees is less than 500 using the calculation rules discussed below.

Eligibility for businesses with related entities is determined using SBA affiliation rules as modified by the CARES Act. For more information on the affiliation rules applicable to PPP, see click here.

How Do I Calculate the Number of Employees?

In its FAQs as of April 10, 2020 (April 10 FAQ), the SBA has given most employers a choice of what time period to use "for the purpose of applying an employee-based size standard." It appears that the SBA is permitting employers to use alternate calculations to make themselves eligible for PPP loans, even though one calculation method would yield more than 500 employees, provided that another permitted method yields fewer than 500 employees.

Determining Who Are Employees. For determining the 500-employee threshold, the term "employee" includes individuals employed on a full-time, part-time, or other basis. Business are required to include the employees of all its "affiliates" in their own count. Affiliates is a defined term under existing SBA regulations, which the CARES Act modified in some ways. The term includes entities controlled by the business or under common control with the business (see link above for more details on the affiliation rules).

Independent contractors of the business cannot be counted as "employees." Rather, independent contractors may apply separately based on their own compensation and benefits expenses.

Alternative Counting Methods. The number of employees may be measured using any of the following methods: (1) average number of employees for the last 12 months; (2) average number of employees for 2019; or (3) average number of employees per pay period in the 12 completed calendar months before the loan application. Seasonal businesses may use the average number of employees from February 15, 2019 or March 1, 2019 through June 30, 2019. Businesses that have been in operation for less than 12 months can use either their average monthly employees for January 1, 2020 through February 29, 2020 or the average number of employees for each of the pay periods the business has been operational.

It has been, at times, difficult to keep up with the evolving guidance. Accordingly, it appears that some lenders are permitting employers to use only the 2019 average or only the last 12 months, rather than giving employers the option that the April 10 FAQ provides. As necessary, borrowers should consider whether to consult legal counsel or other resources to assist lenders with understanding the current guidance from SBA on the program. In addition, borrowers should consult their lenders to understand what documentation the lenders are requiring for the application, as the documentation likely will need to support the number of employees listed on the application.

Employees vs. Full-Time Equivalents (FTEs). In the certifications required of borrowers (discussed further below), the loan application talks about providing lenders with documentation showing the number of FTEs, not employees. However, the application itself does not ask for the number of FTEs, and neither the regulations nor the April 10 FAQ provide any suggestion that employers should be calculating the number of FTEs rather than providing the average number of total employees for the covered period. In fact, the term FTE does not appear in the April 10 FAQ discussing calculation of number of employees at all and only appears in the interim regulations once where the documentation requirements for the application are listed. No explanation or definition is given.

The statute itself specifically includes part-time employees in the definition of employees and says that the loans are for businesses with less than 500 employees, not FTEs. Typically, absent any other definition, FTEs are calculated by dividing the total number of hours worked during the covered period by 40. For employers with work forces working part-time or variable hours, the difference between the number of employees and the number of FTEs may be significant. Borrowers should confirm with their lenders whether they need documentation of the number of employees or FTEs given this lack of clarity. This issue also has implications for loan forgiveness which are discussed below.

Why Does the Calculation Method Matter?

Selecting the number of employees to include on the application is important. As discussed below, loan forgiveness may be measured against that number, even though the statute suggests different measuring periods can be used, at the election of the borrower, for determining the number of FTEs for loan forgiveness. Businesses may want to run the calculations using the different methods discussed above and choose the one that best fits their business needs. Employers, especially those whose workforces vary over time, should consider how the different results for the number of employees align not only with workforce changes they have already made, but also with their workforce plans between now and June 30, 2020 (which is the end date used for certain loan forgiveness calculations). For example, employers that already have reduced their workforces before receiving the loan proceeds may want to choose an employee number that is as low as possible to increase the likelihood that some or all of the loan may be forgiven. Businesses with growing employee counts may want to choose an earlier period.

It is worth noting that, although the April 10 FAQ permits the same periods to be used to calculate payroll costs for determining the amount of the loan, the guidance suggests that employers could use two different methods for determining the number of employees and the amount of payroll costs. This is particularly important for employers that already have done workforce reductions (prior to applying for the loan), as the time period selected for calculating payroll costs may determine whether they can use the proceeds in accordance with the program's mandates. Employers with growing workforces, by contrast, may want to use the method that leads to the highest number so that they can use the proceeds to cover as much of their payroll costs as possible. This is discussed further below.

What are the Application Windows?

The following dates determine when to apply for a PPP loan:

- April 3, 2020 – Applications opened for small businesses and sole proprietorships
- April 10, 2020 – Applications opened for independent contractors and self-employed individuals

- June 30, 2020 – Application deadline

The SBA recommends applying as soon as possible because there is a funding cap and the money is being allocated on a first-come, first-served basis. Although, as of the date of this publication, there are efforts underway to increase the funding of this program, we recommend that interested parties submit their applications without delay.

In addition, it is unclear what happens to companies that do not receive loan proceeds until after the beginning of May. The April 10 FAQ defines the period for purposes of determining payroll costs for loan forgiveness as the eight weeks beginning on the date the lender makes the first disbursement of the PPP Loan to the borrower, which must occur within 10 calendar days from the date of loan approval. Although not yet discussed in any detail in guidance issued by the SBA, the CARES Act ends the period for which payroll and other costs can be covered on June 30, 2020. Therefore, absent expansion of those deadlines, employers may not be able to cover the full eight weeks of payroll costs with the loan proceeds for loans not funded by the beginning of May.

What Must Borrowers Certify?

In addition to obligations to answer questions within the application truthfully, an applicant must explicitly certify in good faith, among other things:

- that "current economic uncertainty makes this loan request necessary to support the ongoing operations of the applicant";
- that "funds will be used to retain workers and maintain payroll or make mortgage interest payments, lease payments, and utility payments, as specified under the Paycheck Protection Program Rule";
- that the applicant understands that "if the funds are knowingly used for unauthorized purposes, the federal government may hold [the applicant] legally liable, such as for charges of fraud";
- that the applicant will provide the lender documentation of the number of FTEs on the payroll as well as documentation for the permissible uses of the loan proceeds; and
- that the applicant has not received or applied for another SBA loan for similar reasons during the covered period.

Sole proprietors, independent contractors, and self-employed individuals must submit documentation, including payroll tax filings, Forms 1099-MISC, and income and expenses. For borrowers that do not have any such documentation, they must provide other supporting documentation, such as bank records, sufficient to demonstrate the qualifying payroll amount.

If PPP funds are used for unauthorized purposes, the borrower will be required to repay those amounts. Additional penalties will be charged if funds are knowingly used for unauthorized purposes. Further, the SBA fact sheet states, "if the proceeds are used for fraudulent purposes, the U.S. government will pursue criminal charges against you."

What Are the Loan Period, Interest Rate and other Terms of the Loans?

Applicants should view this as a loan program with the possibility, but not the guarantee, of forgiveness. Any loan amounts not forgiven will have a maturity of two years, with a 1% interest rate. Payments are deferred for six months, but interest does accrue during the deferral period. The loan is guaranteed by the federal government so there is no requirement for a personal guarantee or collateral. In addition, the borrower is not subject to any loan fees and there is no prepayment penalty.

Assuming proper use of proceeds, loan amounts, including both principal and deferred interest, are 100% forgivable subject to the limitations discussed below.

How is the Loan Amount Calculated?

Businesses can borrow a maximum of 2.5 times their average monthly payroll costs up to $10 million. The SBA's Interim Final Rule, as modified by the April 10 FAQ, provides the following steps for calculating payroll costs:

> Step 1: Aggregate payroll costs (defined below) for employees whose principal place of residence is the United States. Most borrowers can choose to aggregate their payroll costs for either the 12 months before the loan application or calendar year 2019. Seasonal businesses may use average monthly payroll for February 15, 2019 or March 1, 2019 through June 30, 2019. Borrowers who were not in business from February 15, 2019 to

June 30, 2019 may use their average monthly payroll costs for January 1, 2020 through February 29, 2020.

Step 2: Subtract any cash compensation paid to an employee in excess of $100,000 annualized. For independent contractors or sole proprietors, subtract any cash compensation earned in excess of $100,000 per year.

Step 3: Calculate average monthly payroll costs (divide the amount from Step 2 by 1).

Step 4: Multiply the average monthly payroll costs from Step 3 by 2.5.

Step 5: Add the outstanding amount of an Economic Injury Disaster Loan (EIDL) made between January 31, 2020 and April 3, 2020, less the amount of any "advance" under an EIDL COVID-19 loan (because it does not have to be repaid).

Payroll costs includes the following compensation and benefits paid to employees or on behalf of employees—

- the gross amount of salary, wage, commission, or similar compensation (presumably, this includes bonuses, although they are not mentioned in the statute, regulations or FAQs);
- payment of cash tips or equiva¬lent (based on employer records of past tips or, in the absence of such records, a reasonable, good-faith employer estimate of such tips);
- payment for vacation, parental, family, medical, or sick leave;
- allowance for dismissal or sepa¬ration;
- payment required for the provi¬sions of group health care benefits, including insurance premiums;
- payment of any retirement ben¬efit; and
- payment of State or local tax assessed on the compensation of employees.

For independent contractors and sole proprietors, includable payroll costs are the sum of payments of any com-pensation or income that is a wage, commission, income, net earnings from self-employment, or similar compensation and that is in an amount that is not more than $100,000 in one year, as prorated for the covered period.

The following are expressly excluded from the payroll cost calculation:

- the cash compensation paid to an individual employee in excess of an annual salary of $100,000, prorated for the period to be covered by the loan (i.e. amounts in excess of $8,333.33 per month);
- payments made by a business to its independent contractors;
- payroll, FICA and other federal taxes imposed or withheld from employee compensation (the April 10 FAQ explains that borrowers should not deduct federal taxes withheld from their payroll calculations, but also cannot add the employer tax amounts to their calculations);
- any compensation of an employee whose principal place of residence is outside of the United States;
- qualified sick leave wages for which a credit is allowed under section 7001 of the Families First Coronavirus Response Act ("FFCRA"); or
- qualified family leave wages for which a credit is allowed under section 7003 of the FFCRA.

What Can The Loan Be Used For?

The loan may be used to pay for the following costs incurred during the eight-week period after disbursement of the loan proceeds:

- payroll costs using the definition above;
- costs related to the continuation of group health care benefits during periods of paid sick, medical, or family leave, and insurance premiums;
- employee salaries, commissions, or similar compensation which is not in excess of $100,000 per year annualized;
- interest on mortgage obligations that were in place before February 15, 2020 (but not mortgage premiums);
- rent under lease agreements in force before February 15, 2020; and
- utilities for which service began before February 15, 2020.

In addition, borrowers who received EIDL loans between January 31, 2020 and April 3, 2020 may use PPP loan proceeds to refinance those loans, and must refinance any amounts of the EIDL loan used to cover payroll costs.

At least 75% of the loan proceeds must be used to pay for permissible payroll costs. The April 10 FAQ could be read to suggest that a borrower will not be eligible for forgiveness at all if this 75% threshold is not met. More significantly, it suggests that the borrower may be considered to have used the loan for improper purposes, subjecting the borrower both to civil and criminal penalties. The borrower must document the proceeds used for payroll costs in order to determine the amount of forgiveness.

How Does the Loan Forgiveness Work?

The details of how loan forgiveness will be calculated and subject to reduction is one of the biggest areas of uncertainty. Because of this uncertainty, applicants, particularly those who have already made reductions in their workforces, should understand that partial or no forgiveness of the loan is a possibility. Ultimately, this lack of clarity is making it extremely difficult for companies who want to maximize their opportunity for loan forgiveness to plan workforce strategies for the coming weeks and months around rehiring laid off or furloughed employees, reducing salaries, conducting additional layoffs or furloughs, or hiring new employees.

The discussion below is based on what appears in the CARES Act itself and in the limited guidance on loan forgiveness provided so far by the SBA in the interim regulations and the April 10 FAQ. SBA has promised more guidance will be forthcoming on loan forgiveness, and the CARES Act obligates SBA to issue regulations within 30 days of enactment of the law, or by April 26, 2020. As of the publication of this Alert, we do not know whether guidance will come before that date, and at this juncture it may come too late for the workforce decisions employers need to make now, given the limited window for the loan (eight weeks) and the difficulties they may face in getting laid off or furloughed employees back to work in time. SBA has said that the decisions on forgiveness will be made by the lenders, further increasing the uncertainty as lenders may apply different interpretations.

Use of Loan Proceeds. PPP loans are 100% forgivable if all the proceeds are used for qualifying payroll and benefit costs (using the definitions above), and permitted mortgage interest (but not principal), rent and utility payments during the eight-week period following disbursement of the loan proceeds, provided that at least 75% of the proceeds are used for qualifying payroll and benefit costs during that period.

Deduction of EIDL Advances. If the borrower also received an EIDL loan advance up to $10,000, the amount of that advance is deducted from the forgivable amount of the loan.

Workforce Measures. The amount of loan forgiveness is proportionally reduced if employers reduce their FTEs or reduce employees' compensation by more than 25% (not including compensation for employees who earn more than $100,000) against certain pre-loan measures unless those reductions are restored by June 30, 2020. There are a number of open questions about how these provisions will be implemented, discussed below.

FTE Reduction and Forgiveness. The CARES Act first provides that the amount of forgiveness will be reduced by multiplying the otherwise forgivable loan amount (i.e., the amount spent on permissible expenses less any EIDL advance) by the proportion of employment loss. That employment loss is calculated by taking the average number of FTEs the employer has per month, which is the average number of FTEs each pay period in the month, during the eight-week period covered by the loan divided by its pre-loan FTEs. To calculate its pre-loan FTEs, an employer can use either (a) its average number of FTEs from January 1, 2020 to February 29, 2020, or (b) its average number of FTEs from February 15, 2019 to June 30, 2019. Seasonal employers can only use the latter method to determine their pre-loan FTEs.

Therefore, if an employer's FTEs are 50% lower during the eight-week loan period than they were during the selected pre-loan measuring period, the amount of loan forgiveness is reduced by 50%, subject to the additional reductions and the savings provision described below. Because of the significant impact that it may have on determining the amount of forgiveness, employers should carefully consider how to structure both any changes in their workforce related to the loan period and which measuring period to choose. For example, subject to guidance to the contrary from the SBA, employers could decide to consolidate part-time positions into full-time positions to maintain or increase their number of FTEs, even as they reduce total headcount and, potentially, benefit costs. From the text of the CARES Act, doing so would not appear to trigger any reduction in forgiveness, although it remains to be seen how SBA will interpret these provisions.

Notably, the loan forgiveness provisions in the law are specifically tied to FTEs, not headcount. FTEs remains an undefined concept. Moreover, as noted above, eligibility for the loan under both the CARES Act itself and the April 10 FAQs is tied to the number of employees, not FTEs. It is not clear whether, when guidance is issued, SBA will try to tie the loan forgiveness provisions to employee numbers, rather than FTEs. Doing so could have a significant impact on the amount of loan forgiveness available to some employers, particularly those trying to reduce expenses or trying to take advantage of the savings provisions discussed below by consolidating positions.

Compensation Reduction and Forgiveness. The CARES Act also provides that the amount of forgiveness is reduced by the amount of reduction in total salary or wages for each employee of more than 25% during the eight-week loan period compared to the pre-loan baseline wages and salary. The baseline is the total salary and wages earned by the employee during the last completed calendar quarter before the loan period (i.e., first quarter 2020). Employees who earned the equivalent of $100,000 annualized ($8333.33 per month) during any pay period in 2019 are not included in this calculation. Employers may receive forgiveness for additional wages paid to tipped employees to make up for the lack of tips being earned. The statute has no limitation on the amount of that additional compensation (other than the general $100,000 limitation), and it is not addressed in any guidance issued by SBA to date.

To further complicate this calculation for salary reductions, it is not clear if the reference in the statute to total salary or wages means that only wages and salary will be considered or if total cash compensation will be used in the measurement. No guidance by the SBA has yet addressed this question. For employers that provide significant amounts of compensation through bonuses, commissions, or other revenue sharing measures, this distinction may be critical depending on the amount of this variable compensation and its timing. The fact that the measuring period for reductions in salary will be the first quarter of 2020 for all or nearly all employees may further exacerbate this problem, as many employers pay annual bonuses for the prior year in the first quarter of the succeeding calendar year, thereby inflating people's compensation if such bonuses must be included.

The reductions based on decreased FTEs and on pay reductions are cumulative, which can limit employer options to account for costs that are not covered by PPP while facing revenue reductions. For example, businesses that are struggling to pay for insurance costs, inventory, and other fixed and variable expenses may need to reduce expenses that PPP loans do not cover. Yet, seeking to reduce those expenses by reducing employee compensation or headcount may threaten the ability to receive loan forgiveness and, therefore, add to the financial strain on the business.

Savings Provision for Reduction Window. The CARES Act includes a "savings" provision that allows businesses that conduct layoffs or furloughs or salary reductions for one or more employees between February 15, 2020, and April 26, 2020 (the reduction window) to receive the full amount of forgiveness to which they would otherwise be entitled provided that: (i) any reduction in FTEs that occurs during the reduction window is restored by June 30, 2020. to at least to the number of FTEs employed on February 15, 2020; and (ii) the reduction in salary or wages for each employee compared to February 15, 2020, has been restored by June 30, 2020.

There are a few important things to note about this savings provision. First, it only applies to reductions in FTEs or salary or wages that occur during the February 15, 2020, to April 26, 2020, reduction window. Absent guidance from the SBA to the contrary, reductions that occur after April 26, 2020, cannot be "saved," which is consistent with the expectation that PPP funds will be use to preserve employment and compensation for employees. Second, both the restoration in FTEs and the restoration in compensation must occur to qualify for the savings provisions. According to the statute itself, an employer cannot partially qualify. No SBA guidance has addressed this issue to date. Third, there is no level in the amount of salary or wage reduction that triggers this provision (unlike the 25% threshold for the proportional loan reduction discussed above), and it appears to operate on an individual (as opposed to cumulative) basis. From the text of the statute, any amount of salary or wage reduction that occurs in the February 15, 2020, to April 26, 2020, reduction window, compared to an individual's pay on February 15, 2020, has to be restored by June 30, 2020, in order to avoid having the amount of loan forgiveness reduced. Finally, the statute provides that SBA can issue regulations that create a *de minimis* exception for these requirements (not yet issued).

Open Questions. The way that both the loan forgiveness and saving provisions are drafted, without further guidance, leaves a number of open questions, including the following:

- For purposes of counting the number of FTEs and determining the applicability of the salary restoration portion of the savings rule, does it matter whether employees have been laid off (i.e. separated from employment) or furloughed (i.e. employed in a non-paid status but potentially receiving health care and other benefits)?

- If an employer lays off or furloughs employees during the reduction window and offers to rehire such employees, but they refuse to return, can the employer still take advantage of the savings provision?
- If an employer lays off or furloughs employees during the reduction window, is it permissible if the requisite number of FTEs are restored on June 30, 2020, even if they have only been employed for one day?
- What does it mean to restore the salary or wages of an employee who suffered a salary or wage reduction in the reduction window? Does that mean the actual amount the employee would have earned during that period must be paid by June 30, 2020, or just that the employee's wage rate must be restored by that date, even if they have not actually earned the money?
- If employees are laid off or furloughed during the reduction window, do those same employees need to be returned to work by June 30, 2020, to take advantage of the savings provision or is it enough to restore the number of FTEs among all employees?
- If the employer does not have to restore the same employees, can it bring in different employees at whatever wage or salary rates it wants because the salary reduction restoration only applies if an individual remains employed and suffers a pay cut?
- If an employer restores the same number of FTEs, but reduces its headcount by combining part-time jobs into fewer full-time jobs, is the salary reduction portion of the savings provision satisfied because the employees who are still working earn at least as much on June 30, 2020, as they did on February 15, 2020, even though there are a number of employees who are no longer employed?
- If an employer does not layoff or furlough employees during the reduction window but nonetheless suffers a reduction in FTEs for unrelated business reasons (e.g., planned retirements, resignations, terminations based on misconduct or performance) during the eight-week loan period, will it still have its amount of forgiveness proportionally reduced?
- If an employer—such as a school or an employer that operates a school-year program—does not layoff or furlough employees during the reduction window, but loses a significant portion of its employees during the eight-week loan period based on the scheduled end of employment when the academic or program period ends, will it still have its amount of forgiveness proportionally reduced?
- If an employer does layoffs or furloughs or salary or wage reductions after the eight-week loan period ends, but before June 30, 2020, does it impact the amount of forgiveness for which the business is eligible?

With the eight-week loan period used to determine the amount of forgiveness beginning when the loan proceeds are received, most employers applying for PPP loans are making critical workforce decisions now. As a result, it already may be too late for any additional guidance to play a role in these decisions as they relate to loan forgiveness.

When Will We Know More?

SBA is required to issue regulations and guidance on loan forgiveness by April 26, 2020. When the SBA filed the Interim Final Rule it allowed for a 30-day comment window which lasts until May 2, 2020, meaning we could see changes to the existing Interim Final Rule in May, in addition to loan forgiveness guidance later in April.

Given how the guidance has been evolving in real-time since the CARES Act was passed, we could also see changes to the interim rules in the meantime, as well as any loan forgiveness guidance issued, as we have seen the Department of Labor do to correct concerns over interim rules issued under the FFCRA. In addition, updates to existing FAQs have been posted on the Treasury Department's website on an almost daily basis so additional guidance may come first in that form, although there is no way to predict when that will occur.

Given the program deadlines (i.e., statutory deadlines and existing funding limitations) of this program, definitive (final) guidance likely will not be available for borrowers before they apply or even before they start to use loan proceeds.

Ballard Spahr's Labor & Employment Group is well versed in the PPP and is available to assist you with compliance questions and practical advice in the tempestuous times of COVID-19.
