THE SMALL BUSINESS LEGISLATIVE COUNCIL ALERT

JUNE 5, 2020

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- **THE PAYCHECK PROTECTION PROGRAM FLEXIBILITY ACT**

THE PAYCHECK PROTECTION PROGRAM FLEXIBILITY ACT

Overview

Today the President signed into law the Paycheck Protection Program Flexibility Act of 2020 (HR 7010) which was passed by unanimous consent in the Senate on June 3rd and by the House last week.

The big push behind the Flexibility Act was to help businesses, like restaurants and retailers, which were fully or partially closed due to government shutdown orders, by providing a greater opportunity for them to use, and seek forgiveness of, their PPP loan proceeds. Specifically, the CARES Act, which established the PPP loan program, gave businesses 8 weeks (after receipt of the loan) to use the proceeds of the PPP loans and have those loans forgiven. Many businesses found this impossible to do without simply paying employees while the businesses remained closed (which many businesses did to ensure compliance with the CARES Act).

The changes that will be ushered in by the Flexibility Act will be helpful for many businesses. However, as described below, now that there are more roads to reach the ultimate goal of loan forgiveness, businesses will need to be careful to understand their options and select the route that is best for them. This will be particularly true with respect to how the longer loan period made available by Flexibility Act will impact a business' ability to make changes to employee compensation without impacting the business' loan forgiveness amount (this issue is described in the yellow highlighted section below).

The Flexibility Act:

- Expands the covered period during which businesses can make forgivable use of their loan to 24 weeks or the end of the year, whichever comes sooner (more on this below).

- Extends, from June 30, 2020 to December 31, 2020, the deadline by which a business can eliminate a reduction in employee headcount or compensation levels that occurred between Feb. 15 and April 16 and thereby avoid a reduction in forgiveness (more on this below).

- Adds additional safe harbors for businesses that eliminated workers and have been unable to rehire (more on this below).

- Preempts the SBA's rule requiring businesses to spend 75% of their forgivable PPP loan funds on payroll costs and requires, instead, that only 60% of the PPP loan be spent on payroll costs. Some Senators raised concerns that, as phrased, the Flexibility Act could be read to say that any business that spends more than 40% of its PPP loan on eligible non-payroll costs would not be eligible for any loan forgiveness. This was clearly not the legislative intent, and we expect that the SBA regulations will clarify that a business in such a situation will still be eligible for partial loan forgiveness, it just will not be able to have any non-payroll expenses that exceed 40% forgiven.

- Allows businesses that receive a PPP loan to take advantage of the provisions in the CARES Act permitting businesses to defer payment of 2020 payroll taxes (under the CARES Act businesses receiving a PPP loan were not eligible for the tax deferral). This is a major positive change.

- Gives borrowers that don't apply, or qualify, for full loan forgiveness, at least 10 months after the PPP loan program ends to begin making payments on the loan and adds additional payment deferral options in the event that the SBA has not yet refunded the lender for the loan funds.

- Extends the minimum PPP loan maturity from two to five years for PPP loans, but only for those made after the enactment of the Flexibility Act, and allows borrowers and lenders to negotiate an extension of the maturity date on existing PPP loans.

The following sections will discuss the above bulleted changes in greater detail.

Redefining the "Covered Period"

The biggest change that the Flexibility Act makes is that it changes the CARES Act's definition of the "covered period" for the purposes of the PPP loan forgiveness provisions. The CARES Act defined the covered period as the 8 weeks following the origination of the PPP loan. The Flexibility Act expands the covered period and redefines it as starting when the PPP loan originates and ending either 24 weeks later or on December 31, 2020, whichever comes first. For most businesses, however, the SBA in its guidance has made it clear that the origination date is the date on which the business receives the loan funds.

Before we dive into what this change will mean, it is important to note that the Flexibility Act gives businesses that have already received a PPP loan (as of the date of the Flexibility Acts enactment) the option to stick with an 8 week covered period. Thus, such businesses are not required to use the longer covered period if it is not advantageous for them to do so.

Based on the way the PPP loan program was structured under the CARES Act, the "covered period" is relevant at two key junctures - first when it comes to calculating how long the business has to make forgivable use of the loan and then when it comes to determining whether the business will be subject to any reductions in its forgiveness amount. The Flexibility Act doesn't change this, it just changes how the "covered period" is defined.

Breaking things down further:

- Forgivable Use Window - The defined covered period sets the window of time during which the business can use the PPP loan on eligible expenses and then apply to have those amounts forgiven. Under the CARES Act, businesses only had 8 weeks after receiving their loan to use up the loan and seek forgiveness. Now, under the Flexibility Act, businesses will be able to take up to 24 weeks after they receive the loan, or through the end of the year, whichever is earlier, to make forgivable use of their PPP loan proceeds.

- Forgiveness Reduction Window - The defined covered period also sets the relevant window of time for the purposes of determining whether the business has made any changes that will impact the business' loan forgiveness eligibility. As discussed in our prior alerts, a business' eligible loan forgiveness amount may be reduced if, during the covered period, the business reduced its average number of full-time equivalent (FTE) employees or reduced the average salary or hourly rate of any individual employee making $100k or less per year. Accordingly, the Flexibility Act will expand not only the time to use the PPP loan but also the period that will be looked at for the purpose of determining any reductions to loan forgiveness. **It is because of this that businesses that have already received a PPP loan will need to carefully consider whether to elect to use the original 8 week covered period or the new expanded covered period for all loan forgiveness purposes**.

- ***Reduction in Full-Time Equivalent Employees*** – As the PPP loan program is structured, unless a safe harbor applies, a business' loan forgiveness amount will be reduced if the business' average number of FTE employees during the defined cover period is less than its average number of FTE employees during the business' selected comparison period. The business may choose between two comparison periods, either (1) January 1 through February 29, 2020 or (2) February 15 through June 30, 2019.

  Accordingly, applying the new definition of "covered period" established by the Flexibility Act, a business will need to calculate the average number of FTE employees that it had in the 24 week period following the receipt of the loan or the period through Dec. 31, if that is shorter. (Please see our May 19 Alert for a detailed explanation on how the average number of FTE employees is calculated on the Loan Forgiveness Application). Then the business will need to calculate the average number of FTE employees that it had either between Jan. 1 and Feb. 29, 2020 or between Feb. 15 and June 30, 2019 (businesses should run both calculations and use the lower of the two). If the average number of FTE employees during the covered period (24 weeks/yearend) is less than the average number of FTE employees during the comparison period (Jan 1-Feb. 29, 2020 or Feb. 15-June 30, 2019), the loan forgiveness amount will be proportionately reduced unless a safe harbor applies.

  The headcount related safe harbors will be of particular importance for many businesses navigating the reductions. These safe harbor can be broken into three categories (1) the original safe harbor from the CARES Act, as modified by the Flexibility Act, (2) the additional safe harbors set forth by the SBA in its regulations and on loan forgiveness application, and (3) the new safe harbors introduced by the Flexibility Act.

  - *Original Cares Act Safe Harbor* –

    From the outset, the CARES Act provided a safe harbor for businesses that "eliminate" headcount reductions made between February 15 and April 26 by a specific date. The original restoration date provided by the CARES Act was June 30, 2020. The Flexibility Act amends the original safe harbor solely for the purpose of bumping the restoration date back from June 30, 2020 to December 31, 2020. With the enactment of the Flexibility Act, for a business to qualify for the original safe harbor (1) the reduction in FTE employees must have occurred between February 15 and April 26, 2020 and (2) by December 31, 2020, the business must be back to having the same number of FTE employees as it did during the pay period that included February 15, 2020. For the purposes of considering the employee headcount, the focus is simply on the number of FTE employees that the business has at the relevant dates. So a business that reduced its workforce between February 15 and April 26, need only have the same number of FTE employees as of December 31 that it had as of February 15 - it does not need to rehire the same individual employees or have the same breakdown between full-time and part-time employees.

    This safe harbor applies ONLY to reductions (i.e. layoffs, furloughs, or reductions in hours) that occurred between February 15 and April 26, 2020. The Flexibility Act just changed the restoration date not the window for when the reductions being corrected were made. Thus, <u>any FTE employee reductions made after April 26 will not be able</u>

to be corrected using this safe harbor. In other words, a business that maintained its average number of FTE employees through April 26, but then reduced its average number of FTE employees during the remainder of its 24 week covered loan period, could still be subject to a reduction in forgiveness even if the business restores employees so that it has the same number of FTE employees on December 31 as it did on February 15. **Many small businesses that needed to make headcount or hours reductions due to COVID-19 did so before April 26 (and thus could qualify for this safe harbor). However, any businesses that did not make any pre-April 26 headcount reductions, and that have the choice, should be careful about selecting the longer 24 week covered period, as, with the exceptions of individual reductions that would qualify for one of the other safe harbors described below, they will not be able to make any reductions to their average number of FTE employees during the longer 24 week period without suffering a reduction in the loan forgiveness.**

- *SBA Developed Safe Harbor*s

The SBA Loan Forgiveness Application provides that, in making the reduction calculation, businesses can exclude and will not be penalized for, employees that leave during the covered period and are not replaced if: (1) the employer made a written offer to rehire the employee during the covered period which was rejected by the employee, (2) the employee was terminated for cause during the covered period, or (3) the employee voluntarily resigned during the covered period. The application further provides that the forgiveness will not be reduced if an employee voluntarily requested, and received, a reduction in his/her regular scheduled hours during the covered period. As these safe harbors were created by regulation, rather than by Congressional enacted statue, there is a chance that they may change or be integrated into the SBA regulations that will flesh out the legislative safe harbors set forth by the Flexibility Act, described below.

- *New Flexibility Act Safe Harbors*

The Flexibility Act provides two new safe harbors that will allow businesses to avoid a reduction in their forgiveness amount.

First, the Flexibility Act provides that, in making the reduction calculation, a business can exclude, and will not be penalized for a reduction in the business' average number of FTE employee that is the result of the business being (1) unable to rehire someone who was an employee as of February 15, 2020 and (2) unable to hire someone similarly qualified to fill that employee's position by December 31, 2020. It will be up to the SBA to flesh out how a business will be required to show that it is unable to hire a qualified replacement so as to qualify for the safe harbor.

Additionally, the Flexibility Act provides that, in making the reduction calculation, a business can exclude, and will not be penalized for a reduction in the business' average number of FTE employee that is the result of the business being unable to "return to the same level of business activity as such business was operating at or before February 15, 2020" because of COVID-19 related requirements or guidance that was established by the Departments of Health and Human Services (HHS), the Centers for Disease Control (CDC) or the Occupational Safety and Health Administration (OSHA) between March 1, 2020 and December 31, 2020. Thus, for example, if because of social distancing guidance, a business is unable to bring back its full workforce, this will not be counted against its loan forgiveness. Again, this new safe harbor and what employers will be required to show to qualify for it, will be fleshed out by the SBA.

- ***Reduction in Employee Compensation*** – In addition to any reduction resulting from a business' reduction in the number of FTE employees that it has during the covered period, the loan forgiveness amount may also be reduced if the business reduces the salaries or hourly rates of employees making equal to or less than $100k annually by more than 25% during the covered period. This analysis is conducted as to each employee making $100k or less.

  The way that compensation reductions are to be calculated was explained for the first time in the Loan Forgiveness Application and accompanying Interim Final Rule that were recently issued by the SBA. (Please see our May 19 Alert for a detailed explanation of these calculations). **In particular, the SBA made it clear that reductions will not be double counted and that "the salary/wage reduction applies only to the portion of the decline in employee salary or wages that is not attributable to the FTE reduction."** In other words, if the business reduces the number of hours that the employee is working or being paid for, that will be accounted for in the FTE reduction (and may be subject to one of the safe harbors described above) and the fact that reduction in hours means that the total amount that the employee is earning is less will not result in a second reduction as long as the employee's average rate of compensation over those hours worked is not reduced (as compared to the average during the most recent full quarter before the covered period started).

  For example, if an hourly employee was working 40 hours per week at $20 per hour before COVID-19, but is reduced during the covered period to only working 20 hours per week at $20 per hour, this change may reduce the business' average number of FTE employees (and may or may not result in a forgiveness reduction as described above), but it will not be counted as a reduction in compensation because the employee's hourly rate has remained the same. However, if the employee who was working 40 hours per week at $20 per hour before COVID-19 is reduced during the covered period to working 40 hours per week but at $15 per hour, this change will result in a reduction to the forgiveness amount based on reduction in compensation (the hourly rate being reduced from $20 to $15), unless a safe harbor applies.

  When it comes to safe harbors to avoid a reduction in forgiveness based on changes to employee compensation rates – there is only one safe harbor which was established by the CARES Act and the Flexibly Act does not add any new safe harbors. The CARES Act safe harbor for compensation reductions is very similar to the CARES Act safe harbor described above for headcount reductions. Specifically, the CARES Act allows a business to avoid certain changes to employee compensation by "eliminating" the compensation reduction by a certain date. The original restoration date in the CARES Act was June 30, 2020. The Flexibility Act bumps the restoration date back to December 31, 2020. The safe harbor is only available for reductions in compensation that occurred between February 15 and April 26, 2020.

  To determine whether the safe harbor applies, the business must first compare the employee's average salary or hourly rate for the year as of February 15 against the employee's average salary or hourly rate from February 15 through April 26, 2020. If the average salary or hourly rate between February 15 and April 26 was less than the average as of February 15 (i.e. a reduction occurred during the Feb. 15-April 26 period), the business can move on to the next step in the safe harbor test. If, the reduction in compensation did not occur between February 15 and April 26 (i.e., the average from that period was the same or greater than the average as of February 15), the safe harbor will not apply and there will be a reduction in the loan forgiveness amount. Again, as with the CARES Act headcount safe harbor, the Flexibility Act simply moved back the restoration date, it did not expand the window for reductions, so any reductions being made after April 26 cannot be corrected using this safe harbor.

For the business that satisfies the first step of the safe harbor analysis, the next step will be to calculate the employee's average salary or hourly rate for the year as of December 31, 2020 (the new date set by the Flexibility Act). If, as of December 31, 2020, the average is at least equal to what it was as of February 15, the employer will be considered to have "restored" the employee's rate of pay and will not be subject to any reduction in forgiveness related to this employee. If the average as of December 31, 2020 is less than the average as of February 15, the safe harbor will not apply and there will be a reduction in the loan forgiveness amount. An important note – In calculating the CARES Act safe harbor for the headcount reductions (discussed in the prior section), the SBA has determined to just look at the employee headcount on two specific dates – Feb. 15 and Dec. 31, which allows for the businesses to make changes at the last minute to qualify for the safe harbor. However, for the CARES Act safe harbor for compensation reductions (as we are discussing here) the way the SBA has determined to calculate if the reduction in compensation has been eliminated is based on averages. So, for example, even if an employee's hourly rate was reduced during the Feb. 15-April 26 window, allowing the business to correct using the safe harbor, the business can't simply restore the employee to their prior hourly rate for one day of work on December 31. Rather, the focus will be on the average rate that the employee earned for all hours worked over the entire year as compared to the same average but as of February 15.

It is here in particular that the longer covered period (24 weeks/yearend versus the original 8 weeks) may turn out to not be advantageous for all businesses or, at very least, may restrain a business' decision during the covered period. Specifically, a business that elects or is required to use the longer loan period will have to maintain average compensation rates for three times as long as their counterparts that are able to use the original 8 week covered period.

For example –
Small Business A received its PPP loan on May 1 and elects the option to stick with the original 8 week covered period. Meaning Small Business A's covered period will run from May 1 through June 26. Small Business A will only have until June 26 to use its PPP loan and seek forgiveness for the use.

Small Business B also received its PPP loan on May 1 and elects the Flexibility Act's longer 24 week covered period. Meaning Small Business B's covered period will run from May 1 through October 16. Small Business B will have until October 16 to use its PPP loan and seek forgiveness for the use.

Because both businesses got their loans and had their respective covered periods start May 1, the period of time will be relevant for comparing compensation paid during he covered periods will be Q1 of 2020 – i.e. Jan. 1 - March 31, 2020 (the last full quarter before the covered period started)

Assume for the purposes of the example that neither business has reduced its average number of FTE employees and that neither business reduced employee compensation rates before receiving their loans (so the safe harbor described above would not apply and thus neither business will be trying to restore headcount ro compensation levels as of Dec. 31).

In order to avoid a reduction in their loan forgiveness based on reductions in compensation, both Small Business A and Small Business B will need to ensure that, during their respective covered periods, they do not overly reduce average employee compensation rates as compared to the average compensation rates paid in Q1.

- **For hourly employees, this will mean that, to avoid a reduction in loan forgiveness, each hourly employee's average hourly rate of pay during the loan period must be at least 75% of his/her average hourly rate of pay between Jan. 1 and March 31.**

- **For salaried employees, this will mean that, to avoid a reduction in the loan forgiveness, each salaried employee's average annual salary paid during the loan period must be at least 75% of his/her average annual salary paid between Jan. 1 and March 31.**

The businesses must make this assessment as to each employee. However, they only need to worry about this as to employees who pre-COVID made $100k or less per year (for anyone making $100k or more per year, the business can make whatever changes to compensation it wants with no impact on loan forgiveness).

So for Small Business A, as long as it keeps its compensation rates stable through the end of its covered period (i.e. through June 26), it will not experience a reduction in loan forgiveness and will be free to do whatever it wants after its covered period is over on June 26. So, for example, if business continues to be slow, after June 26, Small Business A can reduce salaries and hourly rates however it much it needs to get by (subject to minimum wage requirements). Unless the business is trying to qualify for a CARES Act safe harbor by Dec. 31 (which as noted above, for the purposes of this example, these businesses are not) the only reductions that matter for the purposes of the loan forgiveness are reductions that occurred or continued during the covered period. So because it chose the shorter covered period, Small Business A gets to be free of the loan restrictions sooner.

Small Business B on the other hand will have longer to spend its loan but, in exchange, it will need to keep its compensation rates stable through October 16. So, if Small Business B had an employee who averaged $40 per hour from Jan. 1 – March 31, Small Business B would need to pay that employee at least $30 per hour (75%) for any hours she works until October 16 or Small Business B's loan forgiveness amount will be reduced. The same would be true with average annual salary for a salaried employee. If Small Business B starts struggling down the line (after the option to use all the loan money in 8 weeks is gone), Small Business B will be stuck until October 16 and until then will not be able to help make ends meet by reducing the employee's hourly rate to $20 per hour, and still get full loan forgiveness. Small Business B's options in this situation would be (1) to assess whether Small Business B could save money by reducing the number of hours that the employee works without resulting in a forgiveness reduction because of the business' FTE employee average or (2) to accept a reduction in the eligible forgiveness amount and pay that amount back as a loan in accordance with the PPP rules. The reduction to the forgiveness amount that would be caused by Small Business B reducing a single employee's compensation rate by just a bit more than 75% would generally be small. However, if Small Business B were to make more substantial reductions to the employee's compensation rate or reduced the compensation of multiple employees, this could substantially eat into the business' forgivable amount.

Key Takeaways

The Flexibility Act will, true to its name, provide more flexibility for many businesses in using their PPP loans. It is though very important that businesses understand the rules and options application to them. In other words, it should not be automatically assumed for those small businesses that have the option that going with the longer covered period will be the best choice. Businesses will also need to stay attuned to any changes to the existing processes that the SBA may make in implementing the Flexibility Act.

A business that (a) has already received a PPP loan (so has the option to choose between the original 8 week covered period and the new 24 week covered period) and (b) can effectively use up its PPP loan in the original 8 week covered period – will need to assess whether it is better off with a longer or shorter covered period with respect to assessing and avoiding reductions in headcounts or compensation. For some businesses, having a longer covered period may give them more time to adjust their headcount or compensation averages as things reopen and scale back up. For other businesses, particularly those that have already been fully or partially open, a longer covered period may simply result in a longer period during which the business is restrained from making certain business decisions with respect to staffing and compensation levels. This will be a case by case assessment for each business in this situation.

A business that either (a) has not yet received a PPP loan (so will be stuck with the longer covered period) or (b) already has a PPP loan but can't effectively use it up in the original 8 week covered period – will need to be careful over the longer covered period to make sure that they are mindful of any actions that might result in a reduction in their loan forgiveness amount. Based on the structure described above, a large part of this will be trying to make sure that any headcount reduction falls within a safe harbor and that the average rates for employees who are working and who made $100k or less continue to be at least 75% their pre-COVID 19 levels.

Upcoming Legislative Meetings

- **July 30, 2020**, 10:00 am – Noon, EST – By Video Conference
- **September 24, 2020**, 10:00 am – Noon, TBD [Hopefully at the Independent Community Bankers Association offices!]

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