COVID-19 Borrowing Options: A Primer for Franchisees and Other Small and Medium-Size Businesses

(Updated as of June 16, 2020)

Amid unprecedented economic disruption caused by COVID-19, small and medium-size businesses (SMBs) that are the backbone of the U.S. economy face intertwining choices and challenges in determining the best courses of action to preserve their operations and protect the financial well-being of their employees.

While direct bank and market financing remain an option for some, most small and medium-size businesses are at least considering government-sponsored borrowing options, including the Paycheck Protection Program (PPP) and the Main Street Lending Program (MSLP). Both of these programs were designed to provide liquidity to businesses that have been adversely affected by COVID-19, but there are differences between the programs:

- The PPP was established by the CARES Act and implemented by the Small Business Administration (SBA) to support the payroll and operations of small businesses through the issuance of government-guaranteed loans that include a forgiveness feature for borrowers that satisfy the requirements of the PPP.
- The Federal Reserve Board (FRB) designed the MSLP to support small and medium-sized businesses that were unable to access the PPP or that require additional financial support after receiving a PPP loan. Main Street loans are not forgivable.

Among the questions that SMBs need to consider are:[1]

- For which program(s) is the SMB eligible, and are any of the programs mutually exclusive or otherwise independent?
- How do any of these loans fit into the SMB's overall COVID-19-related planning?
- Will the available funds be enough? If not, what are the next steps?
- Are the conditions tied to the loan acceptable?
- Where loan proceeds can only be applied to certain categories of expenses, are those expense categories sufficiently large to improve the business's financial condition materially?
- How easy or difficult will it be to comply with the loan terms, such as those related to executive compensation, share repurchases, and restrictions on the paydown of other debt?
- Are mandated reporting and record retention requirements manageable?
- What does receiving the loan mean for the business owner? For the employees?
- What is the likelihood that an SMB's loan application will be approved? And will it be approved in a timely manner relative to the business's cash flow needs?
- Is there any reputation risk in applying for and receiving a loan or grant?

[1] The information in this paper is provided for general information only. The responses and points of view included herein are intended to assist companies with understanding the current loan programs for small and medium-size businesses. However, the information provided is not intended to be legal analysis or advice. Companies should seek the advice of legal counsel or other appropriate advisers on specific questions as they relate to their unique circumstances.

Three Stages of COVID-19 Planning

For most companies, COVID-19 planning will need to address at least three time phases of activity, and many steps within these phases are likely to be iterative:

1. **Immediate**: React	• Assemble COVID-19 task force of senior leaders to manage challenges. • Keep employees safe. • Maintain/restore services. • Focus on immediate steps to shore up financial position and operations.
2. **Soon Thereafter**: Plan and Control	• Formalize and build out response functions (e.g., COVID-19 command center). • Conduct scenario analysis and develop response plans that include triggers and accompanying actions. • Design and implement controls over new processes/ways of conducting business.
3. **Next:** Build for the "New Normal"	• Forecast future demand. • Confirm or adjust business strategy. • Determine financial outlook/needs. • Retool people, processes, workspaces and locations, as necessary. • Focus on sustainability but continue to prepare for the unknown and pivot as necessary.

Comparison of Two Lending Programs

The following chart provides a high-level summary of two major lending programs from the perspective of the borrower. It is not intended to be all-inclusive and does not include some program features, such as availability of a secondary market, that may influence lender decisions. It is important to note that program terms continue to evolve and are subject to change and that funding amounts may be increased.

Summary of Two Major Lending Programs[2]

Paycheck Protection Program[3]	Main Street Lending Program[4]	
	New Loan Facility	Priority Loan Facility
PROGRAM ADMINISTRATOR		
SBA	Federal Reserve	Federal Reserve
SIZE OF PROGRAM		
$660 billion	$600 billion	$600 billion
PERIOD EFFECTIVE		
April 3, 2020, to the earlier of June 30, 2020, or when funding is exhausted	Loans made on or after April 8, 2020, until September 30, 2020, unless extended by the FRB and the Treasury Department[5]	Loans made on or after April 8, 2020, until September 30, 2020, unless extended by the FRB and the Treasury Department[6]
PURPOSE		
Primarily payroll, plus some operating costs for small businesses affected by COVID-19	Assistance to small and medium-size businesses that were in good financial standing prior to COVID-19	Assistance to small and medium-size businesses that were in good financial standing prior to COVID-19

[2] In a prior version of this paper, we included information on the SBA's Economic Injury Disaster Loan (EIDL) program. However, on May 7, the SBA announced it was capping loan amounts under this program at $150,000 and limiting eligible borrowers to U.S. agricultural businesses. As this disqualifies most small and medium-size businesses, we have removed information on the EIDL from our paper.

[3] The SBA has published and continues to update PPP Loans Frequently Asked Questions.

[4] The Main Street Lending Program is comprised of three facilities: the Main Street New Loan Facility, the Main Street Priority Facility and the Main Street Expanded Facility. The descriptions included herein relate specifically to the first two programs which are new money programs. The Main Street Expanded Facility provides for upsizing of existing loans with a maturity of at least 18 months (taking into account any adjustments made to the maturity of the loan after April 24, 2020, including at the time of upsizing). Terms are similar, but not identical to the Main Street New Loan Facility. Current terms for all three of the facilities are available in the sheets titled "Main Street New Loan Facility," "Main Street Priority Loan Facility," and "Main Street Expanded Loan Facility." The Federal Reserve has also published "Main Street Lending Program: Frequently Asked Questions."

[5] On June 15, 2020, the Federal Reserve Bank of Boston announced that the Main Street Lending program was open for Lender registration. Lender Registration Forms and Agreements are available on the Boston Federal Reserve's website.

[6] Ibid.

Paycheck Protection Program[3]	Main Street Lending Program[4] — New Loan Facility	Main Street Lending Program[4] — Priority Loan Facility
ELIGIBLE LENDERS		
All federally insured depository institutions, federally insured credit unions and Farm Credit System institutions, as well as a broad range of nonbanks	U.S. federally insured depository institution (including a bank, savings association, or credit union), a U.S. branch or agency of a foreign bank, a U.S. bank holding company, a U.S. savings and loan holding company, a U.S. intermediate holding company of a foreign banking organization, or a U.S. subsidiary of any of the foregoing	U.S. federally insured depository institution (including a bank, savings association, or credit union), a U.S. branch or agency of a foreign bank, a U.S. bank holding company, a U.S. savings and loan holding company, a U.S. intermediate holding company of a foreign banking organization, or a U.S. subsidiary of any of the foregoing
ELIGIBLE BORROWERS		
With some exceptions, small businesses with 500 or fewer employees that were in business as of February 15, 2020. Companies must, however, certify that the loans are necessary and that they cannot tap other sources of funding, which may effectively preclude public companies with market access from applying. Ineligible businesses include the list of ineligible businesses in SBA's Standard Operating Procedure (SOP) 10 5.	Small and medium-size businesses – i.e., companies employing up to 15,000 workers or with revenues of less than $5 billion that were in operation as of March 30, 2020, and are organized in the U.S. with significant operations and a majority of employees in the United States; that were in good financial standing before the crisis; and that have not received support pursuant to the CARES Act, except for a PPP loan. Ineligible businesses are consistent with those deemed ineligible under PPP. On June 15, the Federal Reserve Board announced that it was seeking comments until June 22 on a proposal to extend MSLP eligibility to nonprofit organizations. The proposed standards and terms for nonprofit lending are available here.	Small and medium-size businesses – i.e., companies employing up to 15,000 workers or with revenues of less than $5 billion that were in operation as of March 30, 2020, and are organized in the U.S. with significant operations and a majority of employees in the United States; that were in good financial standing before the crisis (including having a "pass" rating on any existing loans with the Eligible Borrower); and that have not received support pursuant to the CARES Act, except for a PPP loan. Ineligible businesses are consistent with those deemed ineligible under PPP. On June 15, the Federal Reserve Board announced that it was seeking comments until June 22 on a proposal to extend MSLP eligibility to nonprofit organizations. The proposed standards and terms for nonprofit lending are available here.
MINIMUM LOAN		
N/A	$250,000	$250,000
MAXIMUM LOAN		
Lesser of $10 million or 2.5 times average monthly payroll	Lesser of $35 million, or an amount that, when added to outstanding and undrawn available debt, does not exceed 4.0x adjusted EBITDA *(previously $25 million)*	Lesser of $50 million, or an amount that, when added to outstanding or undrawn available debt, does not exceed 6.0x adjusted EBITDA *(previously $25 million)*

Paycheck Protection Program[3]	Main Street Lending Program[4]	
	New Loan Facility	Priority Loan Facility
SUBJECT TO CREDIT UNDERWRITING		
No	Yes	Yes
SUBJECT TO KNOW-YOUR-CUSTOMER STANDARDS		
Yes	Yes	Yes
TERM		
Up to 5 years, with all payments deferred for the first 6 months, although interest accrues	5 years, principal deferred for two years, years 3-5: 15%, 15%, 70%. Interest deferred for one year. Eligible Lenders will retain 5% of each Eligible Loan.	5 years, principal deferred for two years, years 3-5: 15%, 15%, 70%. Interest deferred for one year. Eligible Lenders will retain 5% of each Eligible Loan.
INTEREST RATE		
1%	1 or 3 month LIBOR + 300 basis points[7]	1 or 3 month LIBOR + 300 basis points[8]
FEES TO BORROWER		
None	100 basis points of the principal amount of the loan	100 basis points of the principal amount of the loan
STIPULATED USE OF FUNDS		
Payroll, benefits, mortgage interest, rent, utilities, other debt	Not, at the time of origination or at any time during the term of the Eligible Loan, contractually subordinated in terms of priority to any of the Eligible Borrower's other loans or debt instruments. Also, must verify compliance with the Required Certifications detailed below.	At the time of origination and at all times the Eligible Loan is outstanding, the Eligible Loan is senior to or pari passu with, in terms of priority and security, the Eligible Borrower's other loans or debt instruments, other than mortgage debt. Also, must verify compliance with the Required Certifications detailed below.
CAN BE USED TO REPAY OTHER DEBT		
No	See Required Certifications section below.	Proceeds can be used to refinance existing loans owed to other lenders only. See Required Certifications section below.
PERSONAL GUARANTY REQUIRED		
No	No	No

7 Consistent with the recommendations of the Alternative Reference Rates Committee, Eligible Lenders and Eligible Borrowers should include fallback contract language to be used should LIBOR become unavailable during the term of the loan.

8 Ibid.

Paycheck Protection Program[3]	Main Street Lending Program[4]	
	New Loan Facility	Priority Loan Facility
	COLLATERAL REQUIRED	
No	May be secured or unsecured.	Must be secured if, at the time of origination, the Eligible Borrower has any other secured loans or debt instruments, other than mortgage debt. If secured, then the Collateral Coverage Ratio for the loan at the time of its origination must be either (i) at least 200 percent, or (ii) not less than the aggregate Collateral Coverage Ratio for all of the Borrower's other secured loans or debt instruments (other than mortgage debt).
	REQUIRED CERTIFICATIONS	
A borrower must certify to (1) eligibility as a small business, and (2) need.[9]	Subject to Lender and Borrower Certifications and Covenants which address, inter alia, For Lenders: solvency eligibility as a lender, compliance with conflict of interest restrictions; Performance of reasonable due diligence. For Borrowers: eligibility under all terms of the MLP facility, identification of affiliates, identification of beneficial owners, acknowledgement of loan terms and restrictions.	Subject to Lender and Borrower Certifications and Covenants which address, inter alia, For Lenders: solvency eligibility as a lender, compliance with conflict of interest restrictions; Performance of reasonable due diligence. For Borrowers: eligibility under all terms of the MLP facility, identification of affiliates, identification of beneficial owners, acknowledgement of loan terms and restrictions.

[9] Initially and on its face, the certification of need was a limited and broad statement to the effect that COVID had created "economic uncertainty" for the small business. However, Treasury and the SBA have subsequently issued FAQ guidance indicating public companies that retain access to capital markets are unlikely to be able to make the certification of need in good faith.

Paycheck Protection Program[3]	Main Street Lending Program[4]	
	New Loan Facility	**Priority Loan Facility**
FORGIVABLE		
Yes, eligible for forgiveness up to the amount spent by the borrower in the 24-week period after the origination date of the loan on: • Payroll costs; • Interest payment on any mortgage obligation incurred before February 15, 2020; • Payment of rent on any lease in force before February 15, 2020; and • Payment of any utility for which services began before February 15, 2020. Forgiveness of nonpayroll costs is limited to 40% of the total forgiveness amount. The SBA has issued a PPP Forgiveness Application Form for both Borrowers and Lenders.	No[10]	No
PREPAYMENT PENALTY		
No	No	No
REQUIRED FINANCIAL REPORTING		
No financial reporting required of the Borrower while the loan is outstanding.	Lender must provide both quarterly and annual reports; quarterly reporting requirements vary depending on the specific MSL facility.[11]	Lender must provide both quarterly and annual reports; quarterly reporting requirements vary depending on the specific MSL facility.[12]
FAQs		
PPP FAQs	Main Street Lending FAQs	Main Street Lending FAQs

[10] On June 5. 2020, the Payment Protection Flexibility Act (PPFA) was signed into law. The PPFA extended the period for using PPP funds from 8 weeks to 24 weeks and increased allowable nonpayroll expenses to no more than 40%.

[11] Reporting requirements are detailed in the Main Street Lending FAQs.

[12] Ibid.

Franchisee Eligibility

In order for a franchisee to qualify as a small business under SBA guidelines, it must meet the Federal Trade Commission (FTC) definition of a franchisee and also be eligible under the SBA affiliation rules. Under the Franchise Rule, the FTC defines a “franchise” in Section 436.1(h) as follows:

> *Franchise means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:*
>
> > *(1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor's trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor's trademark;*
> >
> > *(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee's method of operation, or provide significant assistance in the franchisee's method of operation; and*
> >
> > *(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate.*

As a general rule, franchisees determined to be affiliated[13] under SBA guidelines would need to be aggregated to determine whether they still meet eligibility criteria. Indications of affiliation include the following:

- If a person (entity or individual) owns more than 50% of the voting stock of the applicant and other companies, then all of the companies are considered affiliates and will be aggregated in determining the size of any one of them.
- If a person owns and controls, or has the power to control, a block of voting stock of the applicant that is large when compared to all other outstanding blocks of stock (such as when the person owns 40% of the voting stock and the next largest share is at 2%), then the person and the applicant are affiliates and all other companies controlled by the person are considered affiliates of the applicant.
- If two or more persons each owns or controls, or has the power to control, less than 50% of the voting stock of the applicant and (i) the minority holdings are all approximately equal in size, and (ii) all of the minority holdings taken together are large compared to other

[13] The Cares Act: The Affiliation Rules and How They Impact Eligibility Under the Paycheck Protection Program; Frost Brown Todd LLC; March 31, 2020.

stock holdings, then each person will be considered an affiliate of the applicant and all companies controlled by each person.

- If one or more officers, directors, managing members or general partners who control the applicant also control the board of directors or the management of another company, the applicant and the company, plus all other companies controlled by such company, are affiliates. In its determination, the SBA considers negative control such as having veto power over certain decisions.
- Control over management includes management of the applicant's business concern through a management agreement, unless the applicant's business concern has "meaningful oversight" over the management company's activities under the management agreement. "Meaningful oversight" by the applicant business concern means involvement in the decisions made concerning the operation of the business. This includes a management agreement that provides for the applicant business concern to do all of the following: (i) approve the annual operating budget; (ii) approve any capital expenditures or operating expenses over a significant dollar threshold; (iii) have control over the bank accounts; and (iv) have oversight over the employees operating the business (who must be employees of the applicant business concern).

The CARES Act, which authorized the PPP, waives the affiliation rules with respect to eligibility for:

- Any business concern with no more than 500 employees at each physical location that is assigned a NAICS code beginning with 72 (this carve out generally applies to hotel and restaurant chains, although it has been heavily criticized as benefiting larger companies and several of the firms that initially received PPP loans under this provision have since announced their intent to return the funds);
- Any business concern operating as a franchise that is assigned a franchise identifier code by the SBA; and
- Any business concern that receives funding from a Small Business Investment Company (SBIC) licensed under Section 301 of the Small Business Investment Act of 1958.

Business concerns that satisfy these criteria must also meet other PPP requirements, described in the table above.

Borrowing Considerations

If a company is seeking additional funding, it will first need to determine its eligibility under the existing programs. Eligibility requirements are summarized in the chart above and generally are based on size and/or revenue, whether the business is U.S.-based and was in operation as of a specified date, whether there is a demonstrated need for financing, and whether the company was in good standing prior to the impact of COVID-19 (i.e., not in bankruptcy, not owned by someone who has been convicted of a recent felony, etc.). It is important to note, however, that program requirements continue to evolve and eligibility standards are subject to change.

The decision to participate in either of the two programs may depend on where a company is in its COVID-19 planning. As examples:

- A determination to participate in PPP may be a stop gap strategy intended to give the company some breathing room while it considers the longer-term impact of COVID-19 on its business and that there is limited downside risk of not qualifying for debt forgiveness considering the lenient five-year loan repayment terms at 1% with payments deferred for the first six months.
- The decision to participate in the MSLP needs to be more deliberate because both have higher interest rates and longer terms; companies that choose to participate in these programs will likely want to have some degree of confidence that the amount of the loans, along with any existing credit facilities, will be sufficient to support their needs prospectively. In addition, the MSLP, among other stipulations, requires that unless waived by the Secretary of Treasury:

    1. Until 12 months after the direct loan is no longer outstanding, such eligible business shall not repurchase an equity security that is listed on a national securities exchange of such eligible business or any parent company of such eligible business while the direct loan is outstanding (except to the extent required under a contractual obligation that is in effect as of the date of enactment of the CARES Act – i.e., March 27, 2020);
    2. Until 12 months after the direct loan is no longer outstanding, such eligible business shall not pay dividends or make other capital distributions with respect to the common stock of such eligible business; and
    3. Such eligible business shall comply with the compensation limits set out in the CARES Act, which sets total compensation (defined as salary, bonuses, awards of stock and other financial benefits provided by an eligible business to an officer or employee of the eligible business), and severance payment limitations for officers and employees.

    The first two restrictions affect public companies, but all companies considering a MSLP loan should be aware of the compensations and severance provisions, although these are likely to be most impactful for larger businesses.

For most companies, making decisions that impact the future of employees is gut-wrenching. Yet, the business imperative is to ensure that the company remains adequately resourced to deal with the “new normal” when conditions improve. Given the likelihood that future operating models for some companies may change dramatically based on a change in strategy or the lessons learned having employees working from home, with a greater reliance on technology, the number and skillsets of the future workforce may differ from those of the pre-COVID-19 workforce.

Continuing to carry payroll for employees who may not have a role prospectively could, in some instances, jeopardize the future of the company. This is the crossroads at which many businesses are likely to find themselves. It may inevitably influence their decisions to take loans predicated on their maintaining staffing levels, other than for the purpose of providing some additional time to determine what the future may look like.

Participation in government lending programs may carry reputation risk for some companies. Those that followed the first round of PPP lending, which ended on April 16, know that there has been a backlash against some large companies that received PPP funding, even though the loans were made consistent with the requirements in place at the time. Some of these companies have reportedly returned the funds and others are under pressure to do so, although their loans are permissible under the regulation in effect at the time the program launched. PPP rules were changed prior to the second round of funding to make clear that a company is required to certify that a PPP loan is necessary and that the company cannot tap other sources of funding.

The importance of "time is money" cannot be overemphasized for businesses on the brink of ultimate ruin. However, as we have learned through the PPP process (where significant round two funds remain as of this writing), just because funds are available does not guarantee that a borrower will be able to meet or will find the terms of the loans acceptable. Despite the exigency of the circumstances, borrowers do need to consider fully the potential consequences of failing to comply with stated terms.

In Closing

The circumstances are extraordinary. The future is uncertain. The mettle of most companies will be tested. Companies, large and small, must move decisively, based on the best available information, to secure the future of their businesses.

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