<u>PPP Loans: Use of Proceeds and Forgiveness</u>
NADA Preliminary Guidance

Dealers are now obtaining loans under the Paycheck Protection Program (PPP) and having those loans funded. The next set of questions confronting dealers involve what those loan proceeds can be used for and whether and to what extent the loan, if used properly, can be forgiven. The following analysis seeks to provide direction on some of the central questions raised in this context.

<u>It is recognized that this analysis raises additional questions; indeed, as noted in several places below, there remain a number of open issues. Nonetheless, it is hoped that this will assist dealers in framing the questions and issues they must confront</u>.

Disclaimer

NADA believes that the analysis that follows will be correct. However, as with all of the guidance NADA has been issuing in connection with the CARES Act and other responses to the COVID-19 pandemic, implementing guidance has not yet been issued by the Small Business Administration (SBA) on many of the questions raised. Accordingly, this analysis may change over time with new information and developments. Until guidance confirming this analysis is forthcoming from the SBA, no definitive conclusions may be drawn.

Furthermore, this analysis does not provide, and is not intended to constitute, legal advice. All content is for general informational purposes only. As necessary and appropriate, dealers should consult an attorney familiar with the federal, state and/or local laws at issue and with dealership operations to obtain specific advice with respect to any specific legal matters.

- *<u>Use of Loan Proceeds: For what expenses may the proceeds of PPP loans be used?</u>*
    - *<u>Expenses that are allowable uses</u>*. The CARES Act states that PPP loan proceeds may be used to pay for the following expenses:
        - Payroll Costs (which includes salaries, wages and commissions below $100,000; leave benefits; health care benefits; retirement benefits; and state and local payroll taxes);
        - Salaries and commissions that are excluded from Payroll Costs (e.g., compensation in excess of $100,000);
        - Rent (including rent under a lease agreement);
            - <u>Unresolved issue</u>: Whether "rent" includes amounts due on equipment and other non-real estate leases is an unresolved issue. NADA is seeking clarification.
        - Utilities;
        - Interest (but only interest) on any "mortgage" obligation; and
        - Interest (but only interest) on any "other debt" obligations that were incurred before 2/15/20.

        - "Other debt" likely includes floor plan interest (but not curtailment) for inventory acquired before 2/15/20.
        - Unresolved issue: Whether "other debt" applies to floorplan interest on inventory acquired on or after 2/15/20 is an unresolved question. NADA has asked for guidance.

  - *Time period for allowed use*.

    - The CARES Act suggests that the proceeds of a PPP loan are only to be used for the allowed expenses incurred from 2/15/20 through 6/30/20. However, the law also suggests that PPP loans may be originated until 6/30/20. Finally, the loan forgiveness provisions contemplate application during the period prior to 6/30/20 but do not contain a specific availability cutoff.

    - Unresolved issue: As a consequence, it is unclear whether there is a 6/30/20 cutoff limitation on either the use of PPP loan proceeds or the availability of loan forgiveness. NADA has requested guidance.

- *Loan Forgiveness: What allowable uses are forgivable*?

  - *In general*. The loan proceed uses that qualify for loan forgiveness are a subset of the universe of allowable uses listed above, and a different time period is involved.

  - *Expenses eligible for forgiveness*. Under the CARES Act, PPP loan proceeds may be forgivable only to the extent they are used to pay for the following expenses within the relevant time period of use. As noted, these categories are subject to more restrictions, and therefore are (or may be) generally narrower, than the allowable uses listed above.

    - Payroll Costs (but not including other salaries and commissions above $100,000)
    - Rent (on a leasing agreement in force before 2/15/2020)
      - Unresolved issue: Whether "rent" includes amounts due on equipment and other non-real estate leases is an unresolved issue. NADA is seeking clarification.
    - Utilities (for which service began before 2/15/2020)
    - Interest (but only interest) on mortgages (originated before 2/15/2020) on
      - Real estate; or
      - Personal property
        - Unresolved issue: Whether a floorplan line of credit qualifies as a "mortgage on . . . personal property" is an open and unresolved question for which guidance is being sought.

  - *Time period for forgivable use*.

    - To qualify for forgiveness, PPP loan proceeds must be used for the foregoing expenses incurred and payments made during the 8 weeks immediately following initial disbursement of the funding of the loan.

- *Loan Forgiveness: What Triggers a Reduction in Loan Forgiveness?*

  - *Why has Congress set limits on the forgivable amounts to begin with*?

    - Congress created the PPP to put people back on the payroll, even if there is no work for those employees. Congress intended for people to get paid, even if hotel rooms are not occupied, if meals are not served, if cars are not sold or repairs are not made.

    - The extraordinary nature of this program is that the federal government is using private sector payroll departments to deliver a government benefit to employees. As a result, the level of loan forgiveness (in essence, the extent of the government grant) is heavily tied to payroll costs incurred over an 8 week period and is reduced based on certain payroll-related calculations.

  - *How are loan forgiveness reductions calculated?*

    - Unresolved Issues: This area is fraught with questions and, to date, there is very little guidance available from the SBA. For example, although there are three bases for imposing forgiveness reductions, there is no indication of in what order these bases should be applied, and the order of application will affect the outcome. NADA is seeking clarification.

    - Types of loan forgiveness reduction. Three types of events can trigger a reduction in the amount of loan forgiveness: 1) a reduction in employee headcount, 2) a reduction in employee pay level, and 3) the use of more than 25% of loan proceeds for non-Payroll Cost expenses. These three reduction types are described below along with some of the unresolved questions applicable to each. For purposes of this analysis, it is assumed that the three reduction types are applied in the order presented.

      - Reduction Basis 1 – reductions based on headcount levels

        - Generally, if a dealer's employee headcount is lower during the 8 week forgiveness period relative to an earlier measuring period, the dealer will receive a pro rata reduction in the overall amount of forgiveness.

          - This reduction basis involves relatively straight-forward math.

        - Key terms for the determining headcount-based reduction (positions, not specific people):

    - 8 Weeks = the 8 weeks immediately following the initial disbursement of the loan (SBA has determined this).

    - Average Fulltime Equivalents (AFTEs) = the average number of FTEs for each pay period falling within a month. (Not specific employees). Typically, an FTE involves at least 30 hours per week of work.

    - Total Expenses = Loan proceeds used to pay Payroll Costs and other forgivable costs incurred and payments made during the 8 Weeks.

  - Calculation of the headcount-based forgiveness reduction:

    - Compute both Options 1 and 2 and, to minimize the reduction amount, dealers will likely want to choose the higher of the two percentages:

Option 1 AFTEs during 8 Weeks ÷ AFTEs during 2/15/19 to 6/30/19 = ____%

OR, at the borrower's option,

Option 2 AFTEs during 8 Weeks ÷ AFTEs during 1/1/20 to 2/29/20 = ____%

    - Then apply the percentage chosen to the Total Expenses incurred as follows:

      - Total Expenses X _% from Option 1 or 2 = $ ___

    - The resulting dollar amount is the most that a dealer would be able to have forgiven.

    - Practical tip: To the extent possible, dealers should attempt to have on their payrolls during the 8 Weeks the same number of AFTEs as they did during whichever measuring period they choose. This could involve re-hiring employees previously terminated. Dealers should also keep this objective in mind in considering personnel reductions (layoffs, furloughs, etc.) in the period leading up to the 8 Weeks.

- Reduction Basis 2 – reductions based on level of pay

    - Generally, if employee pay levels go down during the 8 Weeks relative to an earlier measuring period, the dealer will have to reduce the level of forgiveness by a specific dollar amount.

        - Unresolved issues: This reduction basis is highly confusing and contains internally inconsistent directives. Additional guidance from SBA will be needed for dealers to correctly navigate this portion of the PPP rules.

    - Calculation of the level of pay-based forgiveness reduction (**Important – the following calculations are specific to individual employees**):

        - For each employee, determine total salary and wages for Q-1 of 2020.[1] (This is the base level of salary and wages used to assess reductions based on pay level in comparison to the levels paid during the 8 Weeks.)

        - But, exclude any employee who earned an annualized pay rate of more than $100,000 in any single pay period in 2019.

        - For each employee not excluded, determine total salary and wages for the 8 Weeks.

        - Determine if the amount of any employee's salary and wages deceased by more than 25% during the 8 Weeks in comparison to Q-1.

        - Add up the total of any amounts in excess of 25%.

        - Reduce the amount eligible for forgiveness by the total amount of the excess.

        - **Unresolved Issues: Additional regulatory guidance is essential to make these computations. Clearly, the CARES Act drafters did not intend to compare a 13-week period (Q-1) to an 8-week period without a pro rata adjustment, but the statute suggests otherwise**.

[1] If, for some unusual circumstance, Q1 2020 was not the most recent full quarter during which the employee was employed before the 8 Weeks, you may need to amend this calculation to any such full quarter.

- Reduction Basis 3 – reductions based on a requirement that at least 75% of a PPP loan forgiveness must be for loan proceeds used to pay Payroll Cost expenses

    - Generally speaking, at least 75% of the PPP loan forgiveness must be for proceeds applied to Payroll Costs. In other words, Payroll Costs must account for at least 75% of the loan forgiveness.

        - While not in the CARES Act, the SBA has issued this regulatory requirement to incentivize putting people back on the payroll.

    - Calculation of Reduction Basis 3 (the 75% Payroll Cost-based forgiveness reduction):

        - Unresolved issue: As indicated above, although the SBA has not confirmed that the Payroll Cost-based reduction will be applied last, it is presumed that such is the case. NADA has requested clarification because the CARES Act does not indicate in what order the Reduction Bases 1, 2, and 3 should be applied.

        - Unresolved issue: Assuming that the Reduction Basis 3 (the Payroll Cost-based reduction) is calculated last, the dealer would first apply Reduction Bases 1 and 2. However, the dealer would need to know whether, for purposes of calculating Reduction Basis 3, the other forgiveness reductions were applied only to the Payroll Cost forgiveness amount or ratably to the entire forgiveness amount. Guidance will be needed to answer this question. Only when the dealer knows that answer will it be able to determine how much of its forgiveness is for Payroll Costs.

        - When the dealer knows how much of its forgiveness is for Payroll Costs, it will need to assess what percentage of its overall forgiveness amount that portion represents. The following provides dealers with one method of doing so.

- Unresolved issue: Whether this will be the method approved by the SBA must await further guidance.

- To calculate this percentage, the dealer should simply divide the Payroll Cost portion of its forgiveness amount by the total forgiveness amount. This will result in a "Final Payroll Cost Percentage."

- If the Final Payroll Cost Percentage ≥ 75%, there will be NO further reductions in the total loan forgiveness amount.

- If Final Payroll Cost Percentage is less than 75%, then the dealer would need to lower the total forgiveness amount by reducing the non-Payroll Cost portion until the non-Payroll Cost portion was equal to 25% or less of the total.

- *Loan Forgiveness: If my anticipated loan forgiveness is subject to reduction, can I avoid any of those reductions in the amount forgivable*?

  - *In general*.

    - As described in detail above, three types of events can trigger a reduction in the amount of loan forgiveness: 1) a reduction in employee headcount, 2) a reduction in employee pay level, and 3) the use of more than 25% of loan proceeds for non-Payroll Cost expenses.

    - However, the CARES Act provides a means to avoid part of the loan forgiveness reductions that could result under Reduction Basis 1 and Reduction Basis 2.

    - In particular, the Act recognizes two "circumstances" in which otherwise mandated reductions in forgiveness will be avoided to the extent that those forgiveness reductions are based on either headcount reductions or reductions in pay levels made during the period beginning on 2/15/20 and ending on 4/26/20.

    - The provision laying out these circumstances is subject to at least two interpretations as to how it will be implemented. One of these interpretations is more favorable to borrowers and one is less favorable.

      - Unresolved issue: Until guidance is obtained from the SBA, it is not possible to know which interpretation is correct. Accordingly, this analysis sets out both interpretations, and dealers will need to consult with their individual counsel to determine which interpretation to follow in their own situations.

- *The "more favorable" interpretation*.

  - In general. Under the more favorable interpretation, some of both statutory categories of mandated forgiveness reduction is avoided if ***either*** of the two circumstances described below is present. (As described above, however, the Reduction Basis 3 – the one based on the Payroll Cost percentage – is not statutory. That reduction basis will need to be applied even if the statutory forgiveness reduction requirements are avoided as described below.)

  - Application of the two circumstances that avoid forgiveness reduction under the more favorable interpretation. A description of the two paths to avoiding forgiveness reduction follows. However, it is expected that more dealers will benefit from the first path because its elements are more likely to occur.

    - Path One – the "Easier" way. To use the first path, a dealer would need to go through the following three step evaluation:

      - Count the number of fulltime equivalent employees (FTEs) the dealer had on its payroll on 2/15/2020 (the "2/15 Number");

      - Ensure that, at some point during the period beginning on 2/15/20 and ending on 4/26/20, the number of FTEs employed by the dealer drops below the 2/15 Number; and

      - Ensure that the number of FTEs on the dealer's payroll on 6/30/20 is equal to or greater than the 2/15 Number.

      - If the number of FTEs on the dealer's payroll on 6/30/20 is equal to or greater than the 2/15 Number, then in calculating any loan forgiveness reduction, the dealer would be treated as if it had not reduced its headcount or its pay levels during the period beginning on 2/15/20 and ending on 4/26/20.

    - Path Two – the "Harder" way. To use the second path, a dealer would need to go through the following three step evaluation:

      - Determine what the level of pay was on 2/15/2020 for each employee of the dealership on that date;

      - Ensure that the level of pay of at least one of those employees was reduced at some point during the period beginning on 2/15/20 and ending on 4/26/20; and

- Ensure that the 6/30/20 compensation for each person who was on the dealer's payroll on 2/15/20 and who remains on the dealer's payroll on 6/30/20 is equal to or greater than the level of compensation that that person was paid on 2/15/20.[2]

- If the circumstance described in the preceding bullet is true, then in calculating any loan forgiveness reduction, the dealer would be treated as if it had not reduced its headcount or its pay levels during the period beginning on 2/15/20 and ending on 4/26/20.

- *<u>The "more conservative" interpretation</u>*.

  - <u>In general</u>. Under the "more conservative" interpretation, Path One only avoids forgiveness reductions based on headcount reductions and Path Two only avoids forgiveness reductions based on level of pay reductions. As a result, if a dealer is facing loan forgiveness reductions based on both headcount reductions and pay level reductions, both forgiveness reduction avoidance Paths will need to be present for the dealer to fully benefit.

  - <u>Application of the two circumstances that avoid forgiveness reduction under the more conservative interpretation</u>. A description of the two paths to avoiding forgiveness reduction follows.

    - <u>Path One – the "Easier" way</u>. To use the first path, a dealer would need to go through the following three step evaluation:

      - Count the number of fulltime equivalent employees (FTEs) the dealer had on its payroll on 2/15/2020 (the "2/15 Number");

      - Ensure that, at some point during the period beginning on 2/15/20 and ending on 4/26/20, the number of FTEs employed by the dealer drops below the 2/15 Number; and

      - Ensure that the number of FTEs on the dealer's payroll on 6/30/20 is equal to or greater than 2/15 Number.

      - If the number of FTEs on the dealer's payroll on 6/30/20 is equal to or greater than 2/15 Number, then in calculating any loan forgiveness reduction, the dealer would be treated as if it had

[2] There is a possible alternative interpretation of Path 2 that would require that this step include the additional underlined language in the following: "Ensure that all persons who were on the dealer's payroll on 2/15/20 <u>are also on the dealer's payroll on 6/30/20</u> and ensure that the compensation of each of those persons is equal to or greater than the level of compensation that that person was paid on 2/15/20." Of course, this additional language would reduce the value of this avoidance path significantly. That is why it is characterized as the "Harder Path." Until guidance is obtained from the SBA, it is not possible to know which interpretation is correct.

not reduced its headcount during the period beginning on 2/15/20 and ending on 4/26/20.

- Path Two – the "Harder" way. To use the second path, a dealer would need to go through the following three step evaluation:

  - Determine what the level of pay was on 2/15/2020 for each employee of the dealership on that date;

  - Ensure that the level of pay of at least one of those employees was reduced at some point during the period beginning on 2/15/20 and ending on 4/26/20; and

  - Ensure that the 6/30/20 compensation for each person who was on the dealer's payroll 2/15/20 and who remains on the dealer's payroll on 6/30/20 is equal to or greater than the level of compensation that that person was paid on 2/15/20.[3]

  - If the circumstance described in the preceding bullet is true, then in calculating any loan forgiveness reduction, the dealer would be treated as if it had not reduced its pay levels during the period beginning on 2/15/20 and ending on 4/26/20.

Practical Tips to Minimize Loan Forgiveness Reduction

Based on the foregoing analysis, a dealer seeking to maximize its loan forgiveness should, to the extent possible, consider the follow practical tips:

1. Other than as may be necessary for purposes of forgiveness avoidance (as described beginning on page 7 above), avoid reducing employee headcount or compensation during the 8 Weeks.

2. During the 8 Weeks, try to ensure that at least 75% of the loan proceeds used to pay permitted expenses are used for Payroll Costs and that no more than 25% are used for non-Payroll Costs.

[3] There is a possible alternative interpretation of Path 2 that would require that this step include the additional underlined language in the following: "Ensure that all persons who were on the dealer's payroll on 2/15/20 <u>are also on the dealer's payroll on 6/30/20</u> and ensure that the compensation of each of those persons is equal to or greater than the level of compensation that that person was paid on 2/15/20." Of course, this additional language would reduce the value of this avoidance path significantly. That is why it is characterized as the "Harder Path." Until guidance is obtained from the SBA, it is not possible to know which interpretation is correct.

3. Headcount: choose the Option that results in the lower number of AFTEs as the base number. If the average headcount at the end of the 8 Weeks is less than the base number, it may be possible to exclude reductions that occurred during the period beginning on 2/15/20 and ending on 4/26/20 if you restore those reductions by 6/30/20.

4. Compensation: during the 8 Weeks, avoid reducing the compensation of any employee who earned less than $100,000 (annualized in 2019) by more than 25% of what they received in compensation in the last full quarter before the 8 Weeks. A dealer may also exclude reductions in excess of the 25% figure that occurred during the period beginning on 2/15/20 and ending on 4/26/20 if it restores those reductions by 6/30/20.

April 16, 2020