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Should BDCs be part of the "Main Street Lending Program"?

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On March 27, 2020, the President signed into law the Coronavirus Aid, Relief, and Economic Security (CARES) Act in response to the COVID-19 emergency. Title IV of the CARES Act directs the Federal Reserve to establish programs and facilities to support impacted small and mid-size businesses, consistent with its emergency lending authority under Section 13(3) of the Federal Reserve Act.

On April 9, 2020, the Federal Reserve unveiled several programs that aim to provide up to $2.3 trillion in loans to bolster the economy using funds appropriated under the CARES Act.[1] Among the announced programs is the Main Street Lending Program, which will make loans available for U.S.-based borrowers that have 10,000 or fewer employees or earned no more than $2.5 billion in annual revenue in 2019. The program includes the Main Street New Loan Facility (New Loan Facility) and the Main Street Expanded Loan Facility (Expanded Loan Facility), which will fund new term loans and expand existing term loans, respectively. Term sheets published by the Federal Reserve for the New Loan Facility and the Expanded Loan Facility are available here and here. We refer to these term sheets as the "Term Sheets" and these facilities together as the "Program."

As key details continue to emerge, we expect the Federal Reserve to issue additional guidance on the requirements for the Program. The Federal Reserve has stated that it will accept comments on the terms and conditions of the Program until April 16, 2020, and may make adjustments.

Are BDCs currently able to lend under the Program?

The current Program does not permit business development companies (BDCs) or other non-bank lenders to serve as eligible lenders. Only banks are permitted to make loans under the Program. In prohibiting BDCs and other non-bank lenders from lending under the Program, the Federal Reserve disregards the fact that, since the 2008 financial crisis, traditional banks have significantly reduced or ceased lending to U.S. middle-market companies.

The decision to sideline BDCs from the Program is particularly baffling given that the stated mission of BDCs is to support U.S. middle-market businesses. A perceived crisis in the capital markets in 1980 sparked a congressional effort to jumpstart investment in small and mid-sized U.S. businesses, which culminated in the enactment of the Small Business Investment Incentive Act of 1980 (the 1980 Amendments). The 1980 Amendments created BDCs to address the slowing of capital flow to small and middle-market companies, such companies which have proven important to innovation, productivity, and job creation in the U.S. economy. BDCs primarily focus on making loans to middle-market companies. When banks significantly curtailed lending to middle-market businesses after the 2008 financial crisis, BDCs filled this vacuum by providing

Contacts

If you have any questions about this Legal Alert, please feel free to contact any of the attorneys listed or the Eversheds Sutherland attorney with whom you regularly work.

Cynthia M. Krus
Partner
cynthiakrus@eversheds-sutherland.com
+1.202.383.0218

Jeremy P. Entwistle
Associate
jeremyentwistle@eversheds-sutherland.com
+1.202.383.0151

Jeanne M. Waters
Associate
jeannewaters@eversheds-sutherland.com
+1.212.389.5009

Related People/Contributors

- Cynthia M. Krus
- Jeanne M. Waters
- Jeremy P. Entwistle
- Steven B. Boehm
- Cynthia R. Beyea
- Vlad M. Bulkin
- Kristin Hespos Burns
- Stephani M. Hildebrandt
- Payam Siadatpour

financing to these businesses at attractive interest rates.

Almost all of the portfolio companies financed by BDCs would be able to receive funding under the Program. It would be more efficient to run the Program through the financial institutions that have the knowledge, experience, and expertise that derives from years of working with these types of middle-market borrowers. BDCs originate loans to these businesses on a day-to-day basis and they have the resources necessary to provide valued intellectual, as well as financial, capital to middle market borrowers. BDCs have established due diligence and underwriting practices that are specifically tailored to middle-market lending, and understand the extensive ongoing monitoring required by the lender. Because BDCs are currently in the business of lending to middle-market companies, they are ideally positioned to lend to their portfolio companies through the Program, if given the opportunity.

The Program would have a greater likelihood of success if BDCs, a significant funding source for many U.S. middle-market companies, were allowed to serve as eligible lenders and, consequently, assist their portfolio companies during these challenging times.

How is the Program structured?

The Program includes the New Loan Facility and the Expanded Loan Facility, which will have a combined size of up to $600 billion. Under each facility, a special purpose vehicle (SPV) will purchase a 95% participation in loans made by eligible lenders, and the eligible lenders will retain a 5% participation in each loan. The Program will cease participations on September 30, 2020, unless extended by the Treasury and the Federal Reserve, but the SPV will continue to be funded until its assets mature or are sold.

Who is eligible to <u>borrow</u> under the Program?

Eligible borrowers are businesses that (i) have 10,000 or fewer employees or earned no more than $2.5 billion in annual revenue in 2019; (ii) are U.S. entities with significant operations in and a majority of their employees based in the United States; and (iii) were in good financial standing prior to the COVID-19 pandemic.

Borrowers may not participate in both the New Loan Facility and the Expanded Loan Facility, nor may they participate in the Primary Market Corporate Credit Facility, which is also part of the $2.3 trillion package announced by the Federal Reserve on April 9, 2020 to serve as a funding backstop for corporate debt issued by certain issuers. Notably, borrowers that have participated in the Small Business Administration's Paycheck Protection Program (PPP) <u>are also</u> eligible to participate in the Program.

The Federal Reserve has not yet provided certain specifics related to eligibility, including whether affiliation rules applicable to PPP loans may apply to these eligibility thresholds, how 2019 annual revenue and number of employees must be calculated, or what constitutes "significant operations" in the United States.

Who is eligible to lend under the Program?

Eligible lenders are restricted to U.S. insured depository institutions, U.S. bank holding companies, and U.S. savings and loan holding companies. As discussed above, non-bank lenders, such as BDCs and small business investment companies, are not currently eligible to serve as lenders.

Notably, loan agreements under the Program will be made directly between eligible borrowers and eligible lenders so that the loans will not be Federal Reserve "direct loans" under the CARES Act.

What are the terms and conditions of a Program loan?

The minimum loan amount will be $1 million. The maximum loan amount depends on whether the loan is issued under the New Loan Facility or the Expanded Loan facility:

- for borrowers under the New Loan Facility, the maximum loan amount is equal to the lesser of (i) $25 million; or (ii) an amount that, when added to the borrower's existing outstanding and committed but undrawn debt, does not exceed four times the borrower's 2019 earnings before interest, taxes, depreciation and amortization (EBITDA); or

- for borrowers under the Expanded Loan Facility, the maximum loan amount is equal to the lesser of (i) $150 million, (ii) 30% of the borrower's existing outstanding and committed but undrawn bank debt, or (iii) an amount that, when added to the borrower's existing outstanding and committed but undrawn debt, does not exceed six times the borrower's 2019 EBITDA.

Loans will have four-year terms, with principal and interest payments deferred for one year after the loan is disbursed; will be made at an adjustable interest rate of the Secured Overnight Financing Rate (SOFR) + 250-400 basis points; and may be prepaid without penalty. In addition, the loans will be unsecured, except that upsized loans under the Expanded Loan Facility may share in any collateral pledged for the rest of the facility on a pro rata basis.

With respect to fees:

- for loans under the New Loan Facility, lenders will be required to pay the Federal Reserve a facility fee of 100 basis points of the principal amount of the loan participation purchased by the Federal Reserve (which will be a 95% participation). The New Loan Facility Term Sheet provides that lenders may require borrowers to pay this fee to the Federal Reserve. In addition, borrowers will pay lenders an origination fee of 100 basis points of the principal amount of the loan;

- for loans under the Expanded Loan Facility, borrowers will pay lenders a fee of 100 basis points of the principal amount of the upsized tranche.

Are borrowers and lenders required to make attestations under the Program?

Yes, borrowers and lenders seeking to participate in the Program will be required to make certain attestations, including the following:

- borrower requires financing due to the exigent circumstances presented by the COVID-19 pandemic and, using the proceeds of the loan, it will make reasonable efforts to maintain its payroll and retain its employees during the term of the loan.

- borrower will follow the executive compensation, stock repurchase and dividend and other capital distribution restrictions applicable to direct loans under the CARES Act. These restrictions require that for so long as the loan is outstanding and for one year after repayment, the borrower must agree to the following:

  - for any employee whose 2019 total compensation exceeded $425,000, total compensation for any 12-month period may not exceed 2019 total compensation levels, and severance will be capped at two times 2019 total compensation;

  - for any employee whose 2019 total compensation exceeded $3.0 million, total compensation for any 12-month period may not exceed the sum of (i) $3.0 million plus (ii) 50 percent of the excess over $3.0 million that the employee made in 2019;

  - borrower cannot repurchase equity securities; and

  - borrower cannot pay dividends or make other capital distributions.

- borrower will commit to refrain from (i) using the proceeds of the loan to repay other loan balances, and (ii) repaying any other debt of equal or lower priority (with the exception of mandatory principal payments) while the loan is outstanding;

- borrower will meet the applicable EBITDA leverage condition stated above under "What are the terms and conditions of a Program loan?";

- lender will not use the proceeds of the loan to repay or refinance pre-existing loans or lines of credit made by the lender to the borrower;

- lender will not cancel or reduce any existing lines of credit outstanding to the borrower, and borrower will not seek to cancel or reduce any of its outstanding lines of credit with the lender or any other lender; and

- borrower and lender will each certify to its eligibility to participate in the Program, including in light of the conflict of interest prohibition in Section 4019(b) of the CARES Act, which prohibits certain governmental officials from participating in various federal lending programs.

How do the Program's borrower restrictions generally compare to those of the mid-size "direct loan" program?

The Program generally subjects borrowers to less stringent conditions than those included in the mid-size "direct loan" program established by Title IV of the CARES Act, although it maintains the restrictions on dividends and other capital distributions, stock repurchases, and executive compensation. These restrictions require that for so long as the subject loan is outstanding and for one year after repayment, the borrower (i) cannot pay dividends or make other capital distributions; (ii) cannot repurchase equity securities; and (iii) is subject to employee compensation limits.

Under the CARES Act, Congress afforded the Treasury the right to waive the mid-size "direct loan" program's restrictions on dividends, stock repurchases and executive compensation. In contrast, the Program does not currently grant express waiver authority, although additional guidance is anticipated from the Federal Reserve after the comment period expires.

How is the Program different from the PPP?

The maximum loan sizes are different under the Program and the PPP (i.e., there is a $10 million cap under the PPP; a $25 million cap under the New Loan Facility; and a $150 million cap under the Expanded Loan Facility). Conditions for the Program also differ from those under the PPP (e.g., the restrictive affiliation rules for small businesses imposed by the Small Business Administration are not applicable here, and the use of funds is less restricted). Unlike PPP loans, loans provided under the Program will not be eligible for forgiveness (one-year deferral only), and the interest rate is higher for loans under the Program (the interest rate for PPP loans that are not forgiven is 1%).

Conclusion

Congress tasked BDCs with the mission of providing small and mid-size U.S. businesses with access to capital. After banks retreated from lending to these businesses following the 2008 financial crisis, BDCs filled this vacuum. The Federal Reserve should revise the Program to permit BDCs, a significant funding source for many U.S. middle-market companies, to serve as eligible lenders. If permitted to serve as lenders, BDCs could use their knowledge of, and experience with, these middle-market borrowers to assist in achieving the best possible outcomes during this crisis.

The Federal Reserve has cautioned that the Board of Governors of the Federal Reserve System (the Board) and the Secretary of the Treasury may make adjustments to the terms and conditions described in the Term Sheets, with any changes to be announced on the Board's website. As a result, this legal alert will be updated as additional information is provided.

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[1] Press Release, Board of Governors of the Federal Reserve System, Federal Reserve takes additional actions to provide up to $2.3 trillion in loans to support the economy (Apr. 9, 2020, 8:30 AM). Although the Program is the focus of this Legal Alert, the Federal Reserve simultaneously announced the creation or expansion of other facilities to strengthen the economy, including (i) the Paycheck Protection Program Liquidity Facility to extend credit to eligible financial institutions that originate PPP loans, (ii) the Primary and Secondary Market Corporate Credit Facilities, (iii) the Term Asset-Backed Securities Loan Facility, and (iv) the Municipal Liquidity Facility. See the Press Release for more information.

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