SQUIRE PATTON BOGGS

Main Street Lending Program: Considerations for Private Equity Sponsors

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Background on the Main Street Lending Program

As a result of the coronavirus disease 2019 (COVID-19) pandemic, more so now than ever, private equity sponsors and their portfolio companies are regularly monitoring their cash flows and cash reserves, sometimes on a daily or weekly basis.

By and large, many private equity sponsors have encouraged their portfolio companies to draw down on credit lines and implement significant cost-cutting measures. Given the uncertainty of when the crisis will ease and the economy will begin to recover, private equity sponsors and their portfolio companies are evaluating options for obtaining additional liquidity.

To support the US financial system that facilitates lending to eligible businesses, the Federal Reserve has established programs providing up to US $2.3 trillion in credit. One recently established program, the Main Street Lending Program (Main Street Program), will provide up to US $600 billion in new financing in the form of four-year term loans available to US businesses employing up to 10,000 employees, or with less than US $2.5 billion in 2019 annual revenues, that were in good financial standing before the crisis and plan to take reasonable efforts to maintain payroll and retain employees during the term of the loan.[1] These businesses may have been too small to access broader capital markets or the Federal Reserve's facilities supporting larger companies or may have not qualified under the Paycheck Protection Program. Unlike loans under the Paycheck Protection Program, loans under the Main Street Program (Main Street Loans) are not eligible for forgiveness and come with additional strings attached, including restrictions related to use of proceeds, employee compensation, stock repurchase and capital distribution.

In this alert, we summarize the key terms of the Main Street Program, discuss considerations for private equity sponsors whose portfolio companies are contemplating applying for a Main Street Loan and identify additional guidance that is required from the Federal Reserve. We plan to update this alert as the Federal Reserve issues additional guidance. The Federal Reserve is accepting comments on the Main Street Program until April 16, 2020, following which we expect to receive further details and clarifications on qualifying for and submitting applications for Main Street Loans. In our separate alert, we provide detailed summaries of all of the available federal assistance programs, including the Main Street Program.

Key Terms and Considerations for Private Equity Sponsors

Eligibility

To be eligible, a borrower must be a business that:

1. Has no more than 10,000 employees or no more than US $2.5 billion in 2019 annual revenues
2. Was created or organized in or under the laws of the US with significant operations in and a majority of its employees based in the US, and
3. Is able to make certain certifications, including that the financing is required because of the COVID-19 pandemic and that it is not insolvent

Required Guidance:

- Which employees have to be counted to determine eligibility (e.g., full-time equivalents or full-time, part-time and other-basis employees)?
- What constitutes annual revenues, what constitutes "significant" operations, and whether businesses must aggregate their employees or annual revenues with their affiliates?

1 The Federal Reserve announced the establishment of the Main Street Program on April 9, 2020, pursuant to its emergency lending authority under Section 13(3) of the Federal Reserve Act and using funds appropriated to the Treasury Department under the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The Main Street Program will be funded by a special purpose vehicle (SPV) established by the Federal Reserve and capitalized with an equity investment of US$75 billion by the Treasury Department and up to an additional US$525 billion in loans from the Federal Reserve. After a lender extends a Main Street Loan to a business, the SPV will purchase from the lender a 95% participation (or economic interest) in the loan and the lender will keep the remaining 5% and service the loan.

Loan Structure

The Main Street Program will have two facilities: the New Loan Facility and the Extended Loan Facility, with aggregate available funding of up to US$600 billion that US insured depository institutions[2] can use to extend credit. Businesses may borrow under either facility, but not both.[3]

- Loans issued pursuant to the New Loan Facility will be structured as new unsecured term loans. This loan will be suitable for a borrower that either does not have an existing term loan or, if it does, its existing lender is not willing to upsize the amount (in which case an amendment to the existing agreement may be required).
- Loans issued pursuant to the Expanded Loan Facility will be structured as an incremental increase (or upsized tranche) to the amount under term loans made prior to April 8, 2020. Unless a borrower's existing term loan has "incremental loan" or "accordion" provisions, which provide a framework for increasing the aggregate amount of financing available under an existing agreement, an incremental loan would require an amendment to its existing agreement in order to add these provisions. An incremental loan must be secured if the existing term loan is secured (whether the collateral was pledged prior to or at the time of the upsizing), and collateral securing these loans will secure the loan participation on a pro rata basis.

Required Guidance:

- Whether borrowers with existing syndicated term loans are eligible to apply under the Expanded Loan Facility, and if they are eligible, how extending an incremental loan will affect the various rights of co-lenders, such as voting rights and allocation of the incremental loan (and related fees).

Loan Amount

- **New Loan**: Minimum US $1 million and up to the **lesser** of (1) US $25 million and (2) an amount that, when added to the borrower's outstanding and committed (even if undrawn) debt, does not exceed four times (4x) the borrower's 2019 EBITDA.[4]
- **Incremental Loan**: Minimum US$1 million and up to the **lesser** of (1) US $150 million, (2) 30% of the borrower's outstanding and committed (even if undrawn) **bank** debt and (3) an amount that, when added to the borrower's outstanding and committed (even if undrawn) debt, does not exceed six times (6x) the borrower's 2019 EBITDA.

Required Guidance:

- What constitutes debt for purpose of calculating the applicable leverage test? For example, it is unclear if debt includes convertible debt securities, deferred obligations such as trade payables, guaranteed amounts by a borrower, accrued obligations not yet due or debt owed to affiliates.
- Whether a borrower can make adjustments to its EBITDA and whether values must be obtained from a borrower's audited 2019 financial statements if a borrower typically has its financial statements audited.

Maturity, Prepayment and Payment Deferment

Main Street Loans have a maturity period of four years, with prepayment permitted without penalty. A borrower with an existing term loan that is interested in obtaining an incremental loan should check its existing agreement for the maturity of the existing term loan because typically an incremental loan cannot mature before the existing term loan unless the existing agreement is amended to allow for this. Principal and interest payments will be deferred for Main Street Loans for one year.

Interest Rate

Main Street Loans have an adjustable interest rate equal to the Secured Overnight Financing Rate (SOFR) plus 2.5% to 4.0% (at the discretion of the lender).

Loan Fees

A borrower must pay its lender a fee equal to 1.0% of the principal amount of its Main Street Loan. The SPV will pay the lender an annual fee for loan servicing equal to 0.25% of the principal amount of its participation in the Main Street Loan. Under the New Loan Facility (but not the Expanded Loan Facility), a lender must pay the SPV a fee equal to 1.0% of the principal amount of the loan participation purchased by the SPV, which will be 95% of the loan participation, and the lender is authorized to charge this fee back to the borrower.

Restrictions on Share Repurchases

From the date a Main Street Loan is issued until one year after it is repaid, a borrower may not repurchase any of its (or its parent company's) equity securities that are listed on a national securities exchange, except to the extent required under a preexisting contractual obligation.

Restrictions Related to Existing Debt and Other Debt

A borrower may not use the proceeds of a Main Street Loan to repay or refinance pre-existing loans or lines of credit made by its lender. Moreover, until it has repaid its Main Street Loan, a borrower may not repay other debt of equal or lower priority (other than mandatory principal payments).

Required Guidance:

- What constitutes "other debt of equal or lower priority" (e.g., working capital liabilities, trade debt or advisory fees) and whether other debt has to be contractually subordinated.
- Given that money is fungible, how should a borrower keep track of its compliance with these restrictions?
- If a borrower obtained an incremental loan, would the borrower be restricted from repaying other debt of equal or lower priority until the borrower has repaid the incremental loan or both the incremental loan and the existing term loan?

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2 Eligible lenders under the Main Street Program include US insured depository institutions, US bank holding companies, and US savings and loan holding companies.

3 In addition, businesses cannot participate in both the Main Street Program and the Primary Market Corporate Credit Facility, which was established by the Federal Reserve on March 23, 2020, to serve as a funding backstop for corporate debt issued by investment grade companies.

4 EBITDA is defined under the term sheets as earnings before interest, taxes, depreciation and amortization.

Restrictions on Dividends and Capital Distributions

From the date a Main Street Loan is issued until one year after it is repaid, a borrower may not pay dividends or make any other capital distributions with respect to its common stock. A portfolio company structured as a pass-through entity (S-corporation or limited liability company) that obtains a Main Street Loan may not be able to make tax distributions to its owners for purposes of paying income taxes on its earnings. In addition, a portfolio company that is part of a holding company structure may not be able to make distributions to its parent holding company for corporate overhead and expenses.

Unless the Federal Reserve issues guidance in the coming weeks that permits the payment of tax distributions, a private equity sponsor with a portfolio company structured as a pass-through entity and planning to apply for a Main Street Loan should consult with the private equity sponsor's tax advisors with respect to its potential tax exposure and any possible solutions.

Required Guidance:

- Whether tax distributions by a pass-through entity will be restricted payments.
- Whether the restrictions on paying dividends and making other capital distributions apply only to a borrower's common stock or all equity securities (e.g., preferred stock).

Restrictions on Employee Compensation[5]

From the date a Main Street Loan is issued until one year after it is repaid, the following restrictions apply:

- **Compensation Freeze**: Any non-union officer or employee of the borrower whose 2019 total compensation exceeded US$425,000 but was equal to or less than US$3 million will have their total compensation frozen at 2019 levels.
- **Compensation Reduction**: Any officer or employee of the borrower whose 2019 total compensation exceeded US$3 million will have their total compensation reduced by an amount equal to 50% of the excess of their 2019 total compensation over US$3 million and frozen at such level.[6]
- **Severance Limits**: Any non-union officer or employee of the borrower whose 2019 total compensation exceeded US$425,000 may not receive from the borrower more than two times (2x) their 2019 total compensation as severance or termination benefits.
- For purposes of these restrictions, "total compensation" includes salary, bonuses, awards of stock and other financial benefits.

A private equity sponsor whose portfolio company is contemplating applying for a Main Street Loan should consider the potential repercussions on the growth of its portfolio company and retention of key employees from having to comply with these restrictions, especially because these restrictions will last at least one year and potentially up to five years.

- First, even though the compensation freeze applies to officers and employees whose 2019 total compensation exceeded US$425,000, the effect of this restriction would be to freeze the compensation of certain employees whose 2019 compensation was less than but still close to US$425,000, such as the direct reports of officers and employees whose total compensation will be frozen. Depending on a company's enterprise value and the industry in which it operates, the compensation freeze could apply to its middle and senior management.[7]
- Second, these restrictions may affect a portfolio company's ability to retain key employees who may find better paying opportunities at other companies not subject to similar restrictions.
- Finally, the compensation freeze and the compensation reduction will likely misalign interests and eliminate incentives for the highest performing employees to pursue performance targets. Many private equity sponsors believe that bonuses and option awards align the interests of the employees of a portfolio company with the private equity sponsor's interests in growing and operating a successful company. A portfolio company that obtains a Main Street Loan will be restricted from paying bonuses or granting option awards to incentivize certain employees and align interests because of these restrictions, and this may result in the private equity sponsor having to hold on to its portfolio company for a longer period than planned in order for its portfolio company to achieve targeted growth metrics.

Required Guidance:

- How a borrower should value stock awards for purposes of calculating total compensation (e.g., grant date value vs. realized value during the applicable period), what is considered "other financial benefits" and how these would be valued, and how a borrower should treat compensation for 2019 that was deferred or that was subject to vesting over future periods for purpose of calculating total compensation.
- Whether after the restricted period expires, if a borrower that has a contractual obligation to its officer or employee to pay this officer or employee compensation in excess of US$425,000 or severance in excess of two times (2x) 2019 total compensation would then become obligated to pay its officer or employee what they would have been otherwise entitled to receive but for these restrictions.

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5 We note that unlike the Mid-Size Business Facility that is described in the CARES Act, but yet to be established, borrowers under the Main Street Program are not yet (i) required to use loan proceeds to retain at least 90% of workforce through September 30, 2020, or to restore 90% of workforce that existed on February 15, 2020, and (ii) restricted from outsourcing jobs offshore or abrogating existing collective bargaining agreements.

6 For example, an officer or employee whose 2019 total compensation was US$4 million would have their total compensation reduced to and capped at US$3.5 million (US$3 million plus 50% of the US$1 million in excess of US$3 million). For this restriction, the regulations do not distinguish between union and non-union officers or employees.

7 Here is an example: Assume a company paid an assistant manager an annual salary of US$400,000 and a manager an annual salary of US$450,000 in 2019. When this company obtains a Main Street Loan, from the date the loan is issued until one year after it is repaid (potentially a period of up to five years), the manager's annual salary would be frozen at US$450,000. Even though this company could increase the assistant manager's annual salary, it would likely not increase it because it would be unusual for an assistant manager to be paid more than his or her direct report.

- Whether these restrictions apply to an officer or employee hired after 2019 and whether these restrictions apply to the officers and employees of the borrower's subsidiaries and affiliates.[8]

Exit Considerations

A private equity sponsor should bear in mind that when it plans to sell a portfolio company that has a Main Street Loan, which is either repaid (1) on the date its portfolio company is sold or (2) prior to the date its portfolio company is sold but a year has not passed since the repayment date, the restrictions related to employee compensation, dividends and capital distributions and share repurchases will apply to its portfolio company for a year even after the Main Street Loan is repaid. The applicability of these restrictions for a year even after the Main Street Loan is repaid may affect how much a buyer may be willing to pay to acquire its portfolio company.

Moreover, many portfolio companies' equity incentive plans are structured so that when the portfolio company is sold and its private equity sponsor no longer owns a majority of its securities (i.e., it has a change of control), all issued equity incentive units would automatically vest and the holders would be entitled to receive a share of the purchase price. Given the employee compensation restrictions that would apply to a portfolio company that has a Main Street Loan, key employees who hold equity incentive units may not be able to receive payment for their equity incentive units if the payment would result in their total compensation exceeding their 2019 total compensation. If the Federal Reserve issues guidance in the coming weeks related to how awards of stock and other financial benefits are to be valued, a portfolio company contemplating applying for a Main Street Loan should consider whether an amendment to its equity incentive plans is necessary or whether it could establish a new type of incentive plan for its key employees.

Reporting of Information

A private equity sponsor whose portfolio company is contemplating applying for a Main Street Loan should be aware of the Federal Reserve's reporting obligations under Section 13(3) of the Federal Reserve Act. The Federal Reserve is required to provide reports to the Senate Banking Committee and the House Financial Services Committee within seven days after the authorization of a loan or other financial assistance detailing the program, including the amount and material terms, the identity of the recipients of the assistance, justification for the program, any requirements imposed on the recipients under the program, list and value of collateral pledged, and expected costs to taxpayers. The Federal Reserve is also required to provide monthly reports to these committees detailing the value of collateral, amount of interest and fees received, and expected or final cost to taxpayers.

If the Chairman of the Federal Reserve submits a written request to Congress, information in these reports related to (1) the identity of the borrowers under the Main Street Program, (2) the amounts borrowed by each participant and (3) identifying details concerning the assets or collateral held in connection with the Main Street Program will be kept confidential and available only to the chairpersons or ranking members of these committees. The Federal Reserve has not indicated whether it will submit a written request to maintain the confidentiality of this information.

If you have any questions regarding the matters covered in this alert, please contact one of the authors listed here.

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8 Unlike the share repurchase restrictions, which expressly impose buyback restrictions at the ultimate parent-company level and the borrower level, the employee compensation restrictions appear to apply only to the officers and employees of the borrower, and it is unclear if these restrictions would apply to the officers and employees of the borrower's subsidiaries and affiliates.

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