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Client Alert

April 2020

Introduction

This alert discusses the federal loan components of the recent coronavirus stimulus package signed into law on Friday March 27, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The alert focuses on the applicable rules and provisions for businesses seeking loans under Title IV of the CARES Act, also cited as the Coronavirus Economic Stabilization Act of 2020.

For additional information please contact any member of Baker McKenzie's North America Transactional Groups.

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CARES Act provisions dealing with financing programs to be provided by the Treasury Department and the Federal Reserve; Federal Reserve measures in response to Coronavirus Pandemic

The Coronavirus Aid, Relief, and Economic Security Act (CARES Act) contains several provisions that contemplate financing programs to be administered by the Treasury Department or the Federal Reserve.

Prior to the enactment of the CARES Act, in response to market dislocations caused by the coronavirus pandemic, the Federal Reserve had announced that it is taking extensive measures to support the US economy, including setting up extraordinary programs to provide credit to non-banks such as corporate borrowers. The Federal Reserve also announced measures to support liquidity and market functioning. Some of these measures revive programs put in place by the Federal Reserve in response to the 2008 financial crisis, while others are new programs.

Certain of the programs announced by the Federal Reserve are funded by appropriations made in, and subject to requirements imposed by, the CARES Act.

Section 4003(b)(4) of the CARES Act appropriates $454 billion to make loans and loan guarantees to, and other investments in, programs or facilities established by the Federal Reserve for the purpose of providing liquidity to the financial system that supports lending to eligible businesses, states and municipalities. The CARES Act also contemplates direct loans to eligible businesses as borrowers. "Eligible business" is defined to mean "(A) an air carrier; or (B) a United States business that has not otherwise received adequate economic relief in the form of loans or loan guarantees provided under" the CARES Act.[1] (CARES Act, Section 4002(4).)

Section 4003(b) of the CARES Act also provides liquidity in the form of loans and loan guarantees as follows:

1. $25 billion for passenger air carriers[2], ("Air carrier" has the meaning given in 49 USC §40101.) eligible businesses that are certified under part 145, of title 14, Code of Federal Regulations, and approved to perform inspection, repair, replace, or overhaul services, and ticket agents[3] (As defined in 49 USC §40101.) (Section 4003(b)(1));

2. $4 billion for cargo air carriers (Section 4003(b)(2)); and

3. $17 billion for businesses critical to maintaining national security (Section 4003(b)(3)).

Any amounts not used under Sections 4003(b)(1)-(3) may be made available, in addition to the $454 billion otherwise appropriated, to make loans and loan guarantees to, and other investments in, programs or facilities established by the Federal Reserve under Section 4003(b)(4).

The Federal Reserve programs or facilities established under Section 4003(b)(4) must comply with Section 13(3) of the Federal Reserve Act.[4] (CARES Act, Section 4003(c)(3)(B). These requirements are discussed below.

Section 4003(c)(1)(A) of the CARES Act provides that any loans under Section 4003 shall be at a rate determined by the Secretary of the Treasury "based on the risk and the current average yield on outstanding marketable obligations of the United States of comparable maturity."

Further, Section 4003(c)(3)(A)(ii) of the CARES Act requires that in connection with any direct loan[5] ("Direct loan" is defined as "a loan under a bilateral loan agreement that is (I) entered into directly with an eligible business as borrower; and (II) not part of a syndicated loan, a loan originated by a financial institution in the ordinary course of business, or a securities or capital markets transaction." CARES Act, Section 4003(c)(3)(A)(i).) under any program or facility pursuant to Section 4003(b)(4), the borrower must agree (a) for a period of 12 months from the date such loan is no longer outstanding, (i) not to buy back any equity securities of the borrower or any parent company that are listed on any national securities exchange (other than to the extent required under a contractual obligation in effect prior to the enactment of the CARES Act) or (ii) pay any dividend or make other capital distribution, and (b) comply with certain limitations regarding employee compensation set forth by the CARES Act in Section 4004 (essentially, total compensation to officers or employees exceeding $425,000 in 2019 is frozen and total compensation to officers or employees exceeding $3 million is limited to the sum of (i) $3 million and (ii) 50% of the excess over $3 million received by the officer or employee in 2019). These requirements may be waived by the Secretary of the Treasury only if such waiver is deemed necessary to protect the interests of the Federal Government.

Section 4003(c)(3)(C) requires that facilities and programs established under Section 4003(b)(4) may only purchase obligations or other interests (other than securities that are based on an index or that are based on a diversified pool of securities) from, or make loans or other advances to, businesses that are created or organized in the United States or under the laws of the United States and that have significant operations in, and a majority of its employees based in, the United States.

A. Federal Reserve programs

1. Primary Market Corporate Credit Facility

The Federal Reserve will make available to large employers a Primary Market Corporate Credit Facility (PMCCF) for new bond and loan issuance. The PMCCF is open to investment grade companies and will provide bridge financing for up to four years[6]. (Federal Reserve, press release, Federal Reserve announces extensive new measures to support the economy, March 23, 2020. See also Federal Reserve Bank of New York, Primary Market Corporate Credit Facility.)

Under the PMCCF, the Federal Reserve Bank of New York (FRBNY) will lend to a special purpose vehicle on a recourse basis. The SPV will (i) purchase qualifying bonds directly from eligible issuers and (ii) provide loans to eligible issuers. The FRBNY will be secured by all the assets of the SPV. The US Treasury Department will make an initial $10 billion equity investment[7] (The Treasury Department investments in the PMCCF, the SMCCF and the TALF are funded from the Treasury's Exchange Stabilization Fund.) in the SPV.[8] (Federal Reserve, Primary Market Corporate Credit Facility Term Sheet.)

In order to be an eligible issuer, a company must (i) be "rated at least BBB-/Baa3 by a major nationally recognized statistical rating organization ('NRSRO') and, if rated by multiple major NRSROs, rated at least BBB-/Baa3 by two or more NRSROs," (ii) a "U.S. compan[y] headquartered in the United States and with material operations in the United States" and (iii) not receive direct financial assistance under the CARES Act (e.g., air carriers). The Fed's term sheet for the PMCCF says that the "scope of eligible issuers may be expanded in the future."

Under the PMCCF, the SPV will purchase eligible corporate bonds directly from eligible issuers and will make eligible loans to eligible issuers. Eligible corporate bonds and loans must meet the following criteria at the time of bond purchase or loan origination: (a) issued by an eligible issuer; and (b) have a maturity of four years or less.

The maximum amount of loans made to or bonds purchased from any eligible issuer under the PMCCF is tied to maximum amount of outstanding bonds and loans of such issuer on any day between March 22, 2019 and March 22, 2020 (without giving effect to undrawn commitments) (such issuer's Historic Maximum). The maximum amount to be extended to any issuer under the PMCCF will not exceed the percentage set forth below multiplied by such issuer's Historic Maximum:

- 140 percent for eligible assets/eligible issuers with an AAA/Aaa rating from a major NRSRO;
- 130 percent for eligible assets/eligible issuers with an AA/Aa rating from a major NRSRO;
- 120 percent for eligible assets/eligible issuers with an A/A rating from a major NRSRO; or

- 110 percent for eligible assets/eligible issuers with a BBB/Baa rating from a major NRSRO.

With respect to interest applicable to the PMCCF, the Fed's term sheet says only that the PMCCF will "have interest rates informed by market conditions." The term sheet goes on to say that a borrower may elect to PIK interest for six months, extendable at the discretion of the Board of Governors of the Federal Reserve System. A borrower that makes this election may not pay dividends or make stock buybacks during the period it is not paying interest in cash. There will be a 100 bps commitment fee.

Bonds and loans under the Facility are callable by the issuer at any time at par.

The SPV will cease purchasing eligible corporate bonds and extending loans under the PMCCF on September 30, 2020, unless such date is extended by the Board of Governors of the Federal Reserve System.

The FRBNY announced that it had retained BlackRock Financial Markets Advisory as a third-party vendor to serve as the investment manager for the PMCCF.

Many details about the PMCCF await further clarification, not least the interest rate. Also, it is unclear what would constitute "material operations in the US" and what the term sheet means when it refers to a "major" NRSRO, which may imply that certain rating agencies currently registered with the SEC as an NRSRO would be excluded.[9] The FRBNY stated that additional information, including more detailed program terms and conditions, would be published when the PMCCF is launched.

2. Secondary Market Corporate Credit Facility

The Federal Reserve will also provide a Secondary Market Corporate Credit Facility (SMCCF). Under the SMCCF, the FRBNY will lend, on a recourse basis, to an SPV that will purchase corporate debt issued by eligible issuers in the secondary market. The SPV will purchase eligible corporate bonds as well as eligible corporate bond portfolios in the form of exchange traded funds ("ETFs"). The FRBNY's loans will be secured by all the assets of the SPV. The Department of the Treasury will make an initial $10 billion equity investment in the SPV in connection with the SMCCF.[10]

Eligible issuers under the SMCCF are defined similarly as in the PMCCF, and are limited to investment grade US companies with material operations in the US. Eligible issuers do not include companies that receive direct financial assistance under the CARES Act.

The SPV may purchase corporate bonds that meet the following criteria at the time of purchase: (a) issued by an eligible issuer; and (b) have a remaining maturity of five years or less.

The SMCCF also provides that the SPV may also may purchase US-listed ETFs "whose investment objective is to provide broad exposure to the market for U.S. investment grade corporate bonds."

Under the SMCCF, the maximum amount of bonds that the SPV will purchase from any eligible issuer will be capped at 10% of such issuer's maximum bonds outstanding on any day between March 22, 2019 and March 22, 2020. The SPV will not purchase more than 20% of the assets of any particular ETF as of March 22, 2020.

Under the SMCCF, the SPV will purchase eligible corporate bonds at fair market value in the secondary market. The SPV Facility will avoid purchasing shares of eligible ETFs when they trade at prices that materially exceed the estimated net asset value of the underlying portfolio.

The SPV will cease purchasing eligible corporate bonds and eligible ETFs under the SMCCF no later than September 30, 2020, unless the SMCCF is extended by the Board of Governors of the Federal Reserve System.

The FRBNY announced that it had retained BlackRock Financial Markets Advisory as a third-party vendor to serve as the investment manager for the SMCCF.

Many details about the SMCCF await further clarification. The FRBNY stated that additional information, including more detailed program terms and conditions, would be published when the SMCCF is launched.

3. Term Asset-Backed Securities Loan Facility

The Federal Reserve will also provide a Term Asset-Backed Securities Loan Facility (TALF). The TALF is intended to facilitate the issuance by private entities of asset-backed securities (ABS) backed by student loans, auto loans, credit card loans, loans guaranteed by the Small Business Administration and certain other assets. The TALF is a revival of a loan facility put in place in response to the 2008 financial crisis.

The Federal Reserve published a preliminary term sheet for the TALF. That term sheet states that a more detailed term sheet will be published later, and will be "primarily based off of the terms and conditions used for the 2008 TALF." The preliminary term sheet also states that "the Federal Reserve reserves the right to review and make adjustments to these terms and conditions – including size of program, pricing, loan maturity, collateral haircuts, and asset and borrower eligibility requirements – consistent with the policy objectives of the TALF."

Under the TALF, the FRBNY will lend to an SPV on a recourse basis. The US Treasury Department will make an equity investment of $10 billion in the SPV.[11]

The SPV will make up to $100 billion of loans available. The loans will have a term of three years, will be nonrecourse to the borrower, and will be fully secured by eligible ABS.

All US companies[12] that own eligible collateral and maintain an account relationship with a primary dealer[13] are eligible to borrow under the TALF.

Eligible collateral includes US Dollar denominated cash (not synthetic) ABS that have a credit rating in the highest long-term or the highest short-term investment-grade rating category from at least two eligible NRSROs and do not have a credit rating below the highest investment-grade rating category from an eligible NRSRO. All or substantially all of the credit exposures underlying eligible ABS must have been originated by a US company.

Eligible ABS must be issued on or after March 23, 2020. Eligible collateral must be ABS where the underlying credit exposures are one of the following:

- Auto loans and leases;
- Student loans;

- Credit card receivables (both consumer and corporate);
- Equipment loans;
- Floorplan loans;
- Insurance premium finance loans;
- Certain small business loans that are guaranteed by the Small Business Administration; or
- Eligible servicing advance receivables.[14]

Eligible collateral will not include ABS that bear interest payments that step up or step down to predetermined levels on specific dates. In addition, the underlying credit exposures of eligible collateral will not include exposures that are themselves cash ABS or synthetic ABS. Notably, the eligible collateral for the TALF does not include mortgage loans.

To be eligible collateral, all or substantially all of the underlying credit exposures must be newly issued.

The Federal Reserve stated that it will consider the feasibility of adding other asset classes to the TALF in the future.

The pledged eligible collateral will be valued and assigned a haircut according to a schedule based on the collateral's sector, weighted average life, and historical volatility of the ABS. This haircut schedule will be published in the detailed term sheet, and the preliminary term sheet indicates this schedule "will be roughly in line with the haircut schedule used for the TALF facility established in 2008."

For eligible ABS with underlying credit exposures that do not have a government guarantee, the interest rate will be 100 basis points over the 2-year LIBOR swap rate for securities with a weighted average life less than two years, or 100 basis points over the 3-year LIBOR swap rate for securities with a weighted average life of two years or greater. The pricing for other eligible ABS will be set forth in the detailed term sheet.

The SPV will assess an administrative fee equal to 10 basis points of the loan amount on the settlement date for collateral.

Loans made under the TALF will be prepayable in whole or in part at the option of the borrower, but substitution of collateral during the term of the loan generally will not be allowed.

No new credit extensions will be made under the TALF after September 30, 2020, unless the TALF is extended by the Board of Governors of the Federal Reserve System.

4. Main Street Business Lending Program

The Federal Reserve stated that it expects to announce soon the establishment of a Main Street Business Lending Program to support lending to eligible small-and-medium sized businesses, which will complement efforts by the SBA to provide credit in those markets.

5. Other actions

The Federal Reserve has taken other steps to increase liquidity and address market dislocations that have resulted from the pandemic. The Fed reduced the target range for the federal funds rate to 0% to 0.25%. It reduced reserve requirements for banks to zero and has encouraged banks to borrow from its discount window to meet their liquidity needs.

The Federal Reserve has also revived two other programs that were put in place in response to the 2008 financial crisis (i) a commercial paper funding facility,[15] and (ii) a primary dealer credit facility,[16] which is analogous to a discount window for primary dealers.

In addition, the Federal Reserve will provide a Money Market Mutual Fund Liquidity Facility (MMLF), which is similar to a liquidity facility that was created in response to the 2008 financial crisis (the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility). The MMLF will make loans to financial institutions to purchase assets that money market funds are selling to meet redemption requests.[17]

The Fed has also announced increased purchases of Treasury securities and agency MBS, and the provision of term repos.[18]

6. Emergency actions under Section 13(3) of the Federal Reserve Act

The PMCCF, the SMCCF, the TALF, the commercial paper funding facility, the primary dealer credit facility and the MMLF are being provided under Section 13(3) of the Federal Reserve Act. That section allows Federal Reserve banks expanded lending and discounting powers to non-banks if authorized by the Board of Governors of the Federal Reserve and the US Treasury Department during "unusual and exigent circumstances."

Section 13(3) sets forth several requirements for financing programs undertaken thereunder. Among other things, the borrower cannot be insolvent, the program must have "broad-based eligibility,"[19] the Fed must have evidence that each "participant in any program or facility with broad-based eligibility is unable to secure adequate credit accommodations from other banking institutions," and that the Fed must ensure that "the security for emergency loans is sufficient to protect taxpayers from losses."

Section 13(3)(C) of the Federal Reserve Act provides that the Federal Reserve is to provide certain information to Congress relating to credit extended under Section 13(3) on a periodic basis. This information includes borrower identities and the material terms of the assistance provided to each borrower.[20]

B. Treasury program

Assistance for mid-sized business under the CARES Act (Section 4003(c)(D))
Section 4003(c)(D) of the CARES Act directs the Secretary of the Treasury to implement a program or facility to provide financing to banks and other lenders to make direct loans to eligible businesses including, to the extent practicable, nonprofit organizations, with between 500 and 10,000 employees.[21] Any direct loans to such businesses would be subject to a 2% interest rate per year and would have no payable principal or interest for the first 6 months (or such longer period as the Secretary determines).

Eligible borrowers will need to make a good-faith certification that:

- the uncertainty of economic conditions as of the date of the application makes necessary the loan request to support ongoing operations of the borrower;
- the funds will be used to retain at least 90% of the workforce (including full compensation and benefits until September 30, 2020);
- the borrower intends to restore not less than 90% of the workforce as of February 1, 2020 and to restore all applicable compensation and benefits within 4 months after the termination date of the public health emergency declared by the Secretary of Health and Human Services on January 31, 2020 related to Covid-19;
- the borrower is an entity or business that is domiciled in the United States with significant operations and employees located in the United States;
- the borrower is not a debtor in bankruptcy proceeding;
- the borrower is created or organized in the US (or under the laws of the US) and has significant operations in and a majority of its employees based in the US;
- the borrower will not pay dividends with respect to its common stock, or repurchase an equity security that is listed on a national securities exchange of the borrower or any parent company 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;
- the borrower will not outsource or offshore jobs for the term of the loan and 2 years after completing repayment of the loan;
- the borrower will not abrogate existing collective bargaining agreements for the term of the loan and 2 years after completing the repayment of the loan; and
- the borrower will remain neutral in any union organizing effort for the term of the loan.

The provisions under the CARES Act aimed at providing assistance to mid-sized businesses do not limit the ability of the Federal Reserve to establish a Main Street Lending Program or other similar program or facility that supports lending to small and mid-sized businesses.[22]

Further information on CARES Act and COVID-19

For additional information on the Small Business Loan components of the CARES Act, see the Baker McKenzie client alert. If you would like to draw from our other global resources developed by Baker McKenzie on the CARES Act and COVID-19, please visit our Coronavirus Resource Centre.

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[1] CARES Act, Section 4002(4).
[2] "Air carrier" has the meaning given in 49 USC §40101.
[3] As defined in 49 USC §40101.
[4] CARES Act, Section 4003(c)(3)(B).
[5] "Direct loan" is defined as "a loan under a bilateral loan agreement that is (I) entered into directly with an eligible business as borrower; and (II) not part of a syndicated loan, a loan originated by a financial institution in the ordinary course of business, or a securities or capital markets transaction." CARES Act, Section 4003(c)(3)(A)(i).
[6] Federal Reserve, press release, Federal Reserve announces extensive new measures to support the economy, March 23, 2020. See also Federal Reserve Bank of New York, Primary Market Corporate Credit Facility.
[7] The Treasury Department investments in the PMCCF, the SMCCF and the TALF are funded from the Treasury's Exchange Stabilization Fund.
[8] Federal Reserve, Primary Market Corporate Credit Facility Term Sheet.
[9] See list of current NRSROs on the SEC website.

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[10] Secondary Market Corporate Credit Facility Term Sheet. See also FRBNY, Secondary Market Corporate Credit Facility.
[11] Term Asset-Backed Securities Loan Facility Term Sheet.
[12] The TALF Term Sheet indicates that "A U.S. company would be defined as a U.S. business entity organized under the laws of the United States or a political subdivision or territory thereof (including such an entity that has a non-U.S. parent company), or a U.S. branch or agency of a foreign bank."
[13] "Primary dealers" refer to banks and broker-dealers that are trading counterparties of the FRBNY in its implementation of monetary policy. See, e.g., FRBNY, Primary dealers.
[14] The Fed stated that it expects the definitions to be broadly consistent with the defined terms used for purposes of the 2008 TALF.
[15] FRBNY, Commercial Paper Funding Facility: Program Terms and Conditions.
[16] Federal Reserve Board announces establishment of a Primary Dealer Credit Facility (PDCF) to support the credit needs of households and businesses.
[17] Federal Reserve Board broadens program of support for the flow of credit to households and businesses by establishing a Money Market Mutual Fund Liquidity Facility (MMLF).
[18] See Statement Regarding Treasury Securities, Agency Mortgage-Backed Securities, and Repurchase Agreement Operations March 15, 2020.
[19] Section 13(3)(B)(iii) of the Federal Reserve Act specifies that "a program or facility that is structured to remove assets from the balance sheet of a single and specific company, or that is established for the purpose of assisting a single and specific company avoid bankruptcy, resolution under title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act, or any other Federal or State insolvency proceeding, shall not be considered a program or facility with broad-based eligibility."
[20] Section 13(3)(D) provides that certain information to be provided to Congress, including borrower identity, may be kept confidential upon request upon the written request of the Chairman of the Board of Governors of the Federal Reserve , in which case such information shall be made available only to the chairpersons or ranking members of the relevant Congressional committees.
[21] We note that businesses with 500 or fewer employees may be eligible to take advantage of several programs authorized under the CARES Act to be administered by the Small Business Administration (SBA). Those programs are outside the scope of this client alert.
[22] CARES Act, Section 4003(c)(3)(D)(ii).