

Impact of SBA PPP loans on loan covenants



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Loan agreements typically contain three types of covenants:

- 1. Negative loan covenants** - Borrower may not . . .
- 2. Affirmative loan covenants** - Borrower promises to . . .
- 3. Financial loan covenants** - Financial metrics tied to a borrower's revenue, expenses, and debt

Loan agreements usually provide that the occurrence of a breach of a covenant constitutes an event of default, triggering a lender's right to exercise remedies, increase interest rates, accelerate the due date of payments, and take other actions.

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security ("CARES") Act was signed into law, allocating billions of dollars in funds to certain qualifying businesses via the U.S. Small Business Administration ("SBA") issuing Paycheck Protection Program Loans ("PPP Loans," and each a "PPP Loan"). Between April and August 2020, the Paycheck Protection Program distributed \$523 billion in forgivable government-backed loans to 5.2 million small businesses to help them keep paying their workers through the pandemic's economic devastation.

On December 27, 2020, the Consolidated Appropriations Act of 2021 was signed into law, allocating \$284 billion in new PPP Loans for certain qualifying businesses. The SBA began accepting applications for second draw PPP Loans on January 13, 2021.

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Before taking advantage of a PPP Loan, borrowers and their counsel should pay careful attention to the covenants in such borrower's existing credit facility that potentially could be impacted by the PPP Loan.

Negative Covenants

The borrower must ensure that the PPP Loan is permitted under its existing credit facility. Most loan agreements contain a negative covenant that prohibits the borrower from incurring any additional indebtedness after the closing of the credit facility. The borrower should carefully review the indebtedness negative covenant contained in its loan agreement, along with the other negative covenants, to make sure the indebtedness from the PPP Loan is permitted. If it is not, the borrower will need to request an amendment or consent from its existing lender to allow for the incurrence of the PPP Loan.

Affirmative Covenants

While many lenders are willing to permit the PPP Loan in the negative covenants of a loan agreement, most lenders will require that certain affirmative covenants be added to the loan agreement regarding the PPP Loan as well. For example, lenders may require the borrower to agree to: (a) comply with the SBA's terms and conditions applicable to the PPP Loan, (b) use the proceeds of the PPP Loan only for "allowable uses" under the CARES Act, (c) use its best efforts to ensure that the entire PPP Loan is forgiven, (d) keep necessary and appropriate records relating to the use of the PPP Loan, or (e) promptly take all applicable action to apply for forgiveness of the SBA PPP Loan (and provide documentation, and status, of such forgiveness to the lender upon the lender's request). The borrower should pay close attention to these additions to the affirmative covenants section to make sure it stays in compliance with the loan agreement.

Financial Covenants

Lastly, the borrower should examine how the PPP Loan will impact the financial covenant calculations under the loan agreement. In a leverage ratio covenant (debt to EBITDA), the numerator may need to exclude the amount of the PPP Loan or else the calculation would be inflated. In a fixed charge coverage ratio covenant (EBITDA to fixed charges), the numerator may be increased from the proceeds of the PPP Loan being added back to EBITDA or the denominator might be increased due to the payments on the PPP Loan. The borrower should discuss the impact of the PPP Loan (and any later loan forgiveness) on its financial covenants with its lender to avoid unintended consequences of its receipt of the PPP Loan.

Conclusion

Understanding the scope of the covenants in a loan agreement and how they are impacted by a PPP Loan is essential to a company's ability to comply with each of their specific requirements. A borrower should take the time to assess its ability to comply with its loan covenants as part of the PPP Loan process.



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