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Restrictions on Stock Repurchases, Dividends, Capital Distributions and Compensation

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Under Section 4003(c)(3)(A)(ii) of the CARES Act (the Act), an eligible business obtaining a Main Street Facility must agree to certain restrictions on 1) repurchases of equity interests, 2) dividends and capital distributions, and 3) compensation for officers and employees. These provisions have been further supplemented by the frequently asked questions (the FAQs) and by the form of Borrower Certification and Covenants issued in connection with the Main Street Facilities (the Certification).

Restrictions on Repurchases

Section 4003(c)(3)(A)(ii)(I) of the Act requires an agreement from the business that:

» until the date 12 months after the date on which the direct loan is no longer outstanding, not to repurchase an equity security that is listed on a national securities exchange of the eligible business or any parent company of the eligible business 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 this Act.

This specific restriction applies with regard to the repurchase[1] of any equity security that is listed on a national security exchange, except to the extent that there was a contractual obligation of the business to purchase such equity in place on March 27, 2020, the date of enactment of the Act. The restriction applies whether the equity that the business is required to purchase is in the business itself or in any (direct or indirect) parent[2] of the business and continues for 12 months after the direct loan is repaid. Because this restriction is limited to publically listed equity securities, there have been questions raised regarding whether privately held companies will be permitted to repurchase equity securities while a direct loan is in place, questions that intersect with the next provision of the Act.

Restriction on Dividends and Capital Distributions

Section 4003(c)(3)(A)(ii)(II) of the Act requires an agreement from the business that:

» until the date 12 months after the date on which the direct loan is no longer outstanding, not to pay dividends or make other capital distributions with respect to the common stock of the eligible business.

Unlike the restriction on repurchases, this restriction is without limitations or exclusions. This restriction also continues to apply for the 12 months after the direct loan is repaid. While the reference here is only to the corporate concept of "common stock" and not the broader concept of "equity securities" (as used in the repurchase restriction), or even stock generally (which would include other classes of stock). FAQ H.2. following up on this provision implied that the U.S. Department of the Treasury views the use of "common stock" here as including other categories of equity interests as well (i.e., the equivalent of "dividends" for noncorporate entities are typically referred to as "distributions"). The FAQ allowance (set forth below) has been expanded on by the

Certification which further expands "common stock" to mean "common stock equivalents" – i.e., interests in any partnership, limited liability company, trust or other legal entity and treats preferred stock in a similar manner (but subject to any existing contractual obligations).[3] Absence from the guidance is whether this broader category of "common stock equivalents" could be stretched to options, warrants or other similar equity interests.

- The compensation, stock repurchase, and capital distribution restrictions that apply to direct loan programs under section 4003(c)(3)(A)(ii) of the CARES Act apply under each of the MSELF, MSNLF and MSPLF, except that, in each case, restrictions on dividends and other capital distributions will not apply to distributions made by an S corporation or other tax pass-through entity to the extent reasonably required to cover its owners' tax obligations in respect of the entity's earnings.

Further clarity would be helpful regarding what is intended by "reasonably required." It will be helpful if this is intended to allow distributions to all owners based on a single highest marginal tax rate, consistent with how this issue is typically addressed in senior credit facilities. The Certification adds an addition requirement, that, "such distributions shall be subject to an annual reconciliation, with any surplus or deficiency to be deducted from or added to distributions, as applicable, in the following year."

Similar concerns arise regarding what types of transactions that the Treasury Department will view as "capital distributions." It remains unclear whether this is intended to more narrowly cover dividend-like payments or a broader scope of payments made with respect to equity interests in the business (i.e., a transaction that is in substance a distribution of capital to the owners of the business). However, the Certification provides that "dividends and other capital distributions do not include repurchases or redemptions."

Restriction on Compensation

Section 4003(c)(3)(A)(ii)(III) of the Act requires an agreement from the business:

- to comply with the limitations on compensation set forth in Section 4004.

Section 4004 provides certain restrictions on "total compensation," which the Act defines to include salary, bonuses, awards of stock and other financial benefits provided by an eligible business to an officer or employee of the eligible business.

- Section 4004 of the Act requires that, during the period beginning on the date on which the loan agreement is executed and ending on the date that is 1 year after the date on which the loan or loan guarantee is no longer outstanding:

(1) no officer or employee[4] of the eligible business whose total compensation exceeded $425,000 in calendar year 2019 (other than an employee whose compensation is determined through an existing collective bargaining agreement entered into prior to March 1, 2020):

(A) will receive from the eligible business total compensation which exceeds, during any 12 consecutive months of such period, the total compensation received by the officer or employee from the eligible business in calendar year 2019; or

(B) will receive from the eligible business severance pay or other benefits upon termination of employment with the eligible business which exceeds twice the maximum total compensation received by the officer or employee from the eligible business in calendar year 2019; and

(2) no officer or employee of the eligible business whose total compensation exceeded $3,000,000 in calendar year 2019 may receive during any 12 consecutive months of such period total compensation in excess of the sum of—

(A) $3,000,000; and

(B) 50 percent of the excess over $3,000,000 of the total compensation received by the officer or employee from the eligible business in calendar year 2019.

Although the Act refers to calendar year 2019, the Certification adds a new concept of a "Subsequent Reference Period," which means that these limits will start to apply for the earliest of any of the following 12-month periods during which the business provided the officer or employee total compensation in excess of $425,000 or $3 million, and continue thereafter:

(a) either (i) the calendar year 2020 (if the individual's start date was before 2019), or (ii) the twelve month period after the individual's initial twelve month period (if the individual's start date was in 2019 or thereafter); or

(b) the twelve month period after the individual's initial twelve month (see (a) above) period during which such level of total compensation was achieved (if the individual's total compensation was not above such level in any prior rolling twelve month period of employment).

The effect of the above is to cap an employee's salary at 1) the initial reference period salary if between $425,000 and $3 million (unless subject to an existing collective bargaining agreement entered into prior to March 1, 2020) and to reduce any such salary in excess of $3 million by 50 percent of the excess, while 2) limiting severance-related payment to twice the cap (again, unless subject to an existing collective bargaining agreement entered into prior to March 1, 2020).

Notes

[1] Per the Certification the term "repurchases" includes "redemptions."

[2] Per the Certification, a parent company is a company that consolidates with the business under Generally Accepted Accounting Principles (GAAP) or U.S. Securities and Exchange Commission (SEC) rules.

[3] The Certification provides that preferred stock or any other equity interest … that provides for mandatory or preferential payment of dividends or other distributions shall be subject to these restrictions unless both the equity interest and the obligation to pay dividends or distributions existed as of March 27, 2020.

[4] The Certification describes an "officer or employee" as an individual who performs compensated services for the business and would either receive a W-2 or is a partner or member (but is not an independent director or independent contractor); provided that in the parenthetical "employee" has the same meaning given the term in Section 2 of the National Labor Relations Act.