



COVID-19 RESPONSE TEAM

PAYCHECK PROTECTION PROGRAM: WHAT BORROWERS CAN DO NOW TO PREPARE FOR REVIEW

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On April 28, 2020 Treasury Secretary Mnuchin publicly stated that the Small Business Administration (“SBA”) would undertake a review of each loan under the Paycheck Protection Program (“PPP”) that exceeds \$2 million, as well as potential random audits of loans with proceeds below \$2 million.¹ This position was reiterated by the SBA in Q&A 39 of its Paycheck Protection Program Loans, Frequently Asked Questions (“FAQ”).² The purpose of the SBA’s review will be, among other things, to confirm a borrower’s eligibility for a PPP loan, including whether the borrower had an adequate basis for the required certification concerning the necessity of the loan.

In Q&A 46 of the FAQ, the SBA established a “safe harbor” for PPP loans with an original principal amount of less than \$2 million (inclusive of PPP loans obtained by affiliates of the borrower), under which the borrower will be “...deemed to have made the required certification concerning the necessity of the loan request in good faith.” In the case of PPP loans with an original principal amount of \$2 million or more, the borrower’s “...individual circumstances in light of the language of the certification and SBA guidance...” will determine whether the required certification was made in good faith.³

¹ Presumably for purposes of confirming that required borrower certifications were made in good faith, that loan proceeds were used for permissible purposes, and that loan forgiveness, if any, was justified.

² Small Bus. Admin., Paycheck Protection Program Loans, Frequently Asked Questions (May 13, 2020) [hereinafter Frequently Asked Questions] (Question 46).

³ *Id.*

The foregoing has caused PPP loan borrowers to consider how best to document, in anticipation of potential SBA review and/or audit, that their certifications were made in good faith and that their use of loan proceeds was appropriate.⁴ This Memorandum suggests documentation that borrowers can develop and retain in order to support their position that the certification was made in good faith, that the loan proceeds were used appropriately, and that the calculation of the loan proceeds was accurate.⁵

BACKGROUND:

As a general matter, all applicants for a PPP loan must certify, among other things, that “[c]urrent economic uncertainty makes [the PPP loan] request necessary to support the ongoing operations of the Applicant.”⁶

In making this certification, the SBA has stated that:

“Borrowers must make this certification in good faith, taking into account their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business.”⁷

The Coronavirus Aid, Relief and Economic Security Act (“CARES Act”)⁸ and the SBA’s subsequent guidance delineate the permissible purposes for which PPP loan proceeds can be used. In its initial Interim Final Rule 1, the SBA states that a PPP loan borrower will be directed to repay improperly used loan proceeds and will be subject to additional sanctions (including charges for fraud) if the borrower knowingly misuses the funds.

⁴ *Id.* Please note that if the original principal amount is less than \$2 million, inclusive of PPP loans obtained by affiliates of the borrower, then the certification is deemed to have been made in good faith. For this purpose, affiliation is determined pursuant to the same affiliation rules used to determine PPP loan eligibility.

⁵ This Memorandum is not intended to provide a detailed description of all PPP loans consideration. If additional questions arise, please contact an attorney at Shutts & Bowen and we will happy to provide assistance.

⁶ See Small Bus. Admin., Paycheck Protection Program Borrower application form (April 3, 2020).

⁷ See Frequently Asked Questions, *supra* note 2 (Question 31).

⁸ Coronavirus Aid, Relief and Economic Security Act, H.R. 748, 116th Cong. (2020).

GOOD FAITH CERTIFICATION THAT PPP LOAN IS NECESSARY:

As noted above, the certification of necessity must be in good faith.⁹ PPP loan borrowers are advised to document in writing (as contemporaneously as possible) their determination to apply for a PPP loan because the loan was necessary to support their ongoing operations. While the SBA has not offered any guidance for determining the circumstances under which a PPP loan is necessary, in Interim Final Rule 1, the SBA recognizes that the CARES Act's "...overarching focus [is] keeping workers paid and employed." Accordingly, the assessment of whether a PPP loan is necessary and that a borrower's alternative sources of liquidity are insufficient should be viewed in light of the core purpose of the CARES Act. The borrower should identify its alternative sources of liquidity and describe why those sources are not sufficient in light of circumstances and the intended purpose of PPP loans.

Management of the borrower should prepare an internal memorandum documenting need for the PPP loan at the time of the application. This memorandum should be approved by appropriate corporate (or limited liability company) action of the borrower – i.e., resolutions and/or consents.

The items that should be included in this memorandum include the following:

- Current and anticipated effect of COVID-19 emergency (and the attendant governmental restrictions) on the borrower's business and industry, including, but not limited to:
 - Current and anticipated labor needs, including any anticipated need to furlough employees;
 - The effect on revenues; and
 - Comparison of financial statements for periods prior to February 15, 2020 to projections for the 8 week period following loan disbursement.

⁹ As stated above, if the original principal amount is less than \$2 million, inclusive of PPP loans obtained by affiliates of the borrower determined using the same affiliation rules used to determine PPP loan eligibility), then the certification is deemed to have been made in good faith. See Frequently Asked Questions, *supra* note 2 (Question 46).

- Identification of alternative sources of liquidity:
 - Revenue and earnings;
 - Balance sheet reserves;
 - Loans or credit from third party sources; and
 - Investor capital (capital markets).
- Description/explanation of why the above alternative sources of liquidity are not sufficient given the prevailing circumstances and the intended purpose of PPP loans. In documenting this aspect of the PPP loan's necessity, the following considerations may be appropriate (depending on the borrower and its industry):
 - Borrower's experiences and existing relationships with lenders and the capital markets (for example, borrowers without borrowing capacity or with little or no prior experience raising capital probably could not reasonably be expected to access these potential capital sources in a timely manner)
 - Analysis of why accessing capital or obtaining funds through traditional lending sources is not appropriate in this instance (e.g., the prohibitive cost of raising such capital, projected future revenues, the size of the loan compared to the amount of capital available, the willingness of lending institutions to provide capital in light of economic uncertainty, and the negative impact raising such capital may have on the borrower's balance sheets as compared to furloughing employees)
- Any correspondence, emails, or other documentation with or relating to customers or vendors indicating that such customer or vendor is or will be unable to perform its obligations due to COVID-19.

7

DOCUMENTING USE OF LOAN PROCEEDS

Under the CARES Act, PPP loan proceeds can be used for the following purposes: (i) payroll costs;¹⁰ (ii) costs related to the continuation of group health care benefits during periods of paid sick, medical, or family leave, and insurance premiums; (iii) mortgage interest payments; (iv) rent payments; (v) utility payments; (vi) interest payments on any other debt obligations that were entered into before February 15, 2020; and (vii) refinancing certain EIDL loans. In its guidance, the SBA requires that at least 75% of the PPP loan proceeds be used for payroll costs; although the CARES Act itself is silent on this point.¹¹ The CARES Act provides that loan proceeds used for certain permitted uses will be forgivable (described below), while those loan proceeds that are used for non-forgivable (but permissible) purposes are repaid in accordance with the PPP loan terms. A borrower may be required to immediately repay funds that are used for any impermissible purposes.

As important, repayment of all or a portion of the loan may be forgiven to the extent used, during the 8 week period following disbursement, to pay (i) payroll costs; (ii) rent under lease agreements dated prior to Feb 15, 2020; (iii) utilities provided under service agreements dated prior to Feb 15, 2020; or (iv) interest on mortgage obligations entered into before Feb 15, 2020. Moreover, the “forgiveness amount” is subject to potential reduction to the extent that the borrower decreases its number of full-time equivalent employees (“FTEE”) or to the extent that the borrower reduces an employee’s total salary during the 8 week period following loan disbursement by more than 25% of the total salary paid to that employee during the most recent quarter prior to loan disbursement. Note, however, that the SBA has not issued guidance on either of these potential reductions to the forgiveness amount.

Accordingly, upon receipt of the PPP loan proceeds, the borrower is advised to contemporaneously document its use of the proceeds, which can be used to substantiate the borrower’s use and support of its request for forgiveness. Some recommendations are:

If feasible, the borrower should establish a separate bank account for the PPP loan proceeds;

¹⁰ “Payroll costs” includes compensation to employees in the form of: (i) salaries, wages, commissions, and similar compensation; (ii) cash tips and equivalent compensation; (iii) paid vacation, family, medical, and sick leave; (iv) allowance for dismissal or separation; (v) payment for group healthcare benefits, including insurance premium; (vi) payment of retirement benefits, and (vi) payment of certain state and local taxes assessed on the compensation of employees.

¹¹ Note, the SBA’s guidance also appears to require that at least 75% of the portion of the PPP loan that can be forgiven (i.e., the forgiven amount) consist of payroll costs. This requirement is not contained in the Care Act itself.

- All payments for permissible purposes (and “forgivable purposes”) should come from that account or otherwise be documented;
- Retain records of all payroll costs, including those payroll costs incurred after the forgiveness period (8 weeks after receipt of the loan);
- Give priority to the payment of payroll costs from PPP loan proceeds;
- Collect detailed records (time cards) regarding the number of hours worked by all employees during the 8 week period following loan disbursement;
- Until 100% of the loan proceeds have been forgiven or repaid, track and record all expenses that have been paid for permissible purposes – the records of which should be retain in manner consistent with Borrower’s tax records retention policies (typically 7 years);
- Record and track the number of full time equivalent employees (i.e. FTEEs) employed by the business during the 8 week period following loan disbursement;
- Record and track any reduction in the compensation to any employee in excess of 25%;
- Record and track any reduction in the number of employees employed by the business, including without limitation, due to resignation, layoffs, or furloughs; and
- Documentation of any offer to re-hire any employee that was laid off after February 15, 2020, including each employee’s written acceptance or decline of such offer.

CONCLUSION

Collection and retention of these documents and records should assist a borrower in applying for forgiveness and in any review or audit conducted by the SBA. Where official reports and statements are not available, documentation evidencing the borrower considered any of the considerations above will help support the borrower’s claim to need the PPP loan. Ultimately, the purpose of PPP is to keep small businesses open and employees gainfully employed. Thus, while there is no formula or set of facts that clearly establish that a borrower needs a PPP loan, any evidence that indicates that the borrower would not have continued to operate in the same fashion and with the same number of employees had the borrower not received a PPP loan will likely support the claim that the borrower needed the loan.