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PPP Loan Standard Of Necessity Hinges On Documentation

By **Adrianne Goins, Caroline Phillips, Brittany Sakowitz and Daniel Graham**
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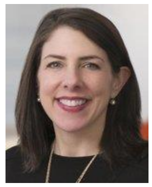

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On April 28, U.S. Treasury Secretary Steven Mnuchin told large companies they should apologize for taking Paycheck Protection Program loans. This loan program was established by the Coronavirus Aid, Relief and Economic Security, or CARES, Act, enacted March 27, and it is administered by the Small Business Administration.

While the PPP was designed primarily to help small businesses retain employees on their payrolls during the coronavirus outbreak, the CARES Act provides several exceptions allowing additional businesses to participate. Applicants for PPP loans are required to make several certifications including: "Current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant."

In his comments on April 28, Mnuchin promised audits of PPP loans over $2 million, and he threatened criminal liability for false certifications of eligibility.

Mnuchin was reacting to a growing public concern that large and well capitalized companies have taken advantage of the PPP, leaving smaller business in relatively worse positions without available PPP funding when the funds are depleted. Amid the uproar, the U.S. Department of the Treasury and the SBA published additional guidance on PPP eligibility in the form of frequently asked questions on April 23, and these FAQs continue to be updated.[1]

In light of this additional guidance and Mnuchin's statements, PPP loan applicants should review and document their evaluation of their eligibility for the PPP, including their qualification under the relevant size limit and their determination that the PPP loan is necessary to support ongoing operations given current economic uncertainty.

If, after further review, an applicant is concerned that it may not be eligible under the PPP, the applicant should consult with experienced counsel and consider the risks of retaining PPP loan proceeds.

The FAQ guidance explains that when making the necessity certification for the PPP, both public and private companies must consider whether they have access to sources of liquidity "sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business."

As an example, the guidance notes that "it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith."

The FAQ guidance and an SBA rule released on April 24 offer a safe harbor for borrowers who repay their PPP loans by May 7.[2] Borrowers who repay by this date will be deemed to have made the required certification in good faith, presumably avoiding any civil or criminal liability.

The SBA rule also makes clear that private equity funds and hedge funds are not eligible for PPP loans. Portfolio companies of private equity funds may nevertheless be eligible borrowers if they satisfy the eligibility requirements, including the certification of necessity as explained in the new guidance.

Mnuchin's statements and the FAQ guidance have understandably raised concerns among PPP loan applicants and PPP loan recipients that have some access to capital. Adding to these concerns is the clear pressure for borrowers to repay the loans in full or risk liability.

The Standard for Necessity Under the CARES Act

There is no bright-line test for determining the necessity of a PPP loan. While it is challenging to determine the precise standard, the CARES Act includes three provisions relevant to the assessment.

First, the act expressly removed the SBA's "credit elsewhere" test: "During the covered period, the requirement that a small business concern is unable to obtain credit elsewhere... shall not apply to a covered loan."

The SBA has provided guidance on its long-standing credit elsewhere test. In general, an applicant is eligible for SBA assistance if it is unable to obtain credit on reasonable terms from nonfederal, nonstate and nonlocal government sources. The test takes into account both the liquid assets of the business, its owners and guarantors, and whether credit could be obtained elsewhere on reasonable terms and conditions.

Given the removal of this requirement in the CARES Act, the credit elsewhere test is not the standard for PPP eligibility.

Second, the CARES Act provides that "an impacted borrower is presumed to have been adversely impacted by COVID-19."

Third, the CARES Act requires that PPP borrowers certify in good faith "that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient."

The SBA's FAQ guidance appears to offer the only interpretation of this certification: applicants making the PPP loan certification should "tak[e] 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."

These provisions provide the conceptual guardrails of the necessity analysis. To certify that a PPP loan is necessary to support ongoing operations, an applicant should have a financial position worse than merely adversely impacted by COVID-19 (since that condition is presumed), but an applicant could have a financial condition better than a company unable to obtain credit elsewhere under the ordinary SBA test.

A PPP applicant could have other sources of liquidity but be unable to access those sources without significantly damaging the business.

Documenting the Good Faith Determination of Necessity

In light of the potential for future investigations and enforcement actions, as well as public relations or political challenges, it is important that the use of PPP loan proceeds be carefully documented. The FAQ guidance states that "a company should be prepared to demonstrate ... the basis for its certification" of necessity.

A company certifying necessity under the guidance — including impliedly, by retaining PPP loan funds after the guidance was released — is best advised to document its good faith determination of necessity in light of other access to capital.

This documentation can take the form of an extensive memorandum to the file describing:

- The company's perspective on "the uncertainty of current economic conditions";
- How the company's ongoing operations have been impacted by the economic uncertainty. Has the company been required to close or limit operations? Does the company expect a significant reduction in its business or work?;
- Likely business risks and effects expected to occur in the near term assuming the economic uncertainty persists. Is the company unable to retain, recruit or train employees?;
- Any other sources of liquidity and planned uses for those sources, with an explanation why additional financial support is necessary to avoid significant damage to the business. For instance, does the company have availability under a revolver, cash on hand, remaining capital commitments, potential to cover budget shortfalls from an endowment or foundation, or access to public markets? If available capital would not be used to keep workers employed, it is important to document the basis for other priorities;
- The unavailability of other sources of liquidity on reasonable terms in light of market conditions. For example, would capital raises be on terms unfavorable to the company?; and
- The reasons that the loan is necessary to "support the ongoing operations" given the economic uncertainty, likely risks and effects, as well as the other sources of liquidity and planned uses. Consider whether the company would have to lay off employees or reduce compensation without a PPP loan.

Such a memorandum, with supporting documentation, should assist companies in demonstrating that their PPP certification was made in good faith. The memorandum should thoroughly address each aspect of the required certification.

Extreme hygiene should be used in all emails regarding the loan proceeds and reasons for applying. Emails or other written communications contradicting or compromising the need for the funds are not advised.

Discretionary spending during the loan period should be very limited: company retreats, charity golf sponsorships, retention bonuses, unplanned or increased distributions or dividends, and other discretionary spending could be interpreted to show that the PPP funds were not necessary.

If a company has the financial strength to execute near-term acquisitions or spend growth capital expenditures, the PPP funds may not have been necessary.

The principal civil enforcement mechanism for false claims submitted to the government is the False Claims Act, which prohibits knowingly submitting false statements to the government, including false certifications. The SBA rule and FAQ guidance on the necessity certification provide a safe harbor if PPP loan funds are repaid by May 7. A borrower returning the funds within this period is presumed to have obtained the loan "based on a misunderstanding or misapplication of the required certification standard," likely precluding a False Claims Act case.

If the PPP funds are not repaid within the safe harbor, however, the government or a private relator may bring a False Claims Act case against the borrower. The False Claims Act provides for treble damages — three times the loss to the government. While there are various ways to measure damages under the act, one possible measure would be the loan amount, even if ultimately repaid.

The act also provides for a minimum penalty, per violation, of over $11,000. Additionally, the government's litigation costs are recoverable from the defendant.

It is critically important for PPP applicants and recipients to evaluate the standard for necessity established by the CARES Act, as explained in the recent guidance, and to apply this standard to assess their eligibility for the loans.

Documenting the basis for concluding that a PPP loan is necessary to support ongoing operations will provide a company retaining loan funds with the ability to demonstrate necessity; and, if a company is uncertain about that conclusion, the exercise may lead to a decision to return the funds before the safe harbor expires on May 7.

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[1] U.S. Dep't of the Treasury, Paycheck Protection Program Loans: Frequently Asked Questions (FAQs) (updated April 28, 2020) https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf.

[2] Business Loan Program Temporary Changes, 85 Fed. Reg. 23,450 (Apr. 28, 2020) (interim final rule).