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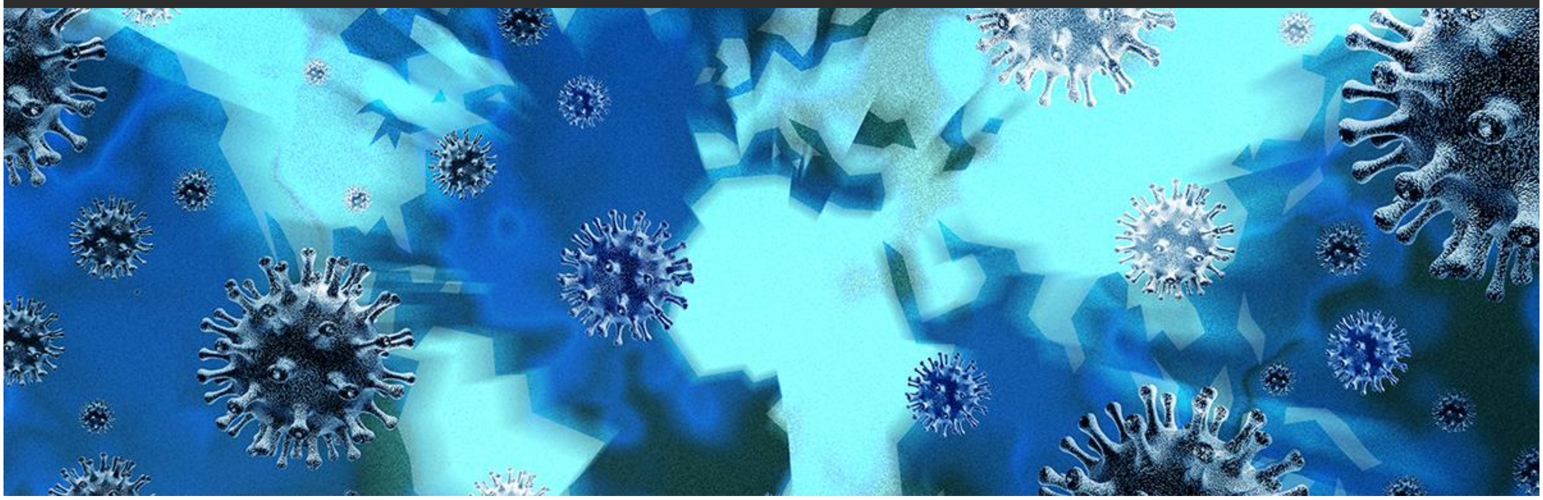
Alert | Health Emergency Preparedness Task Force: COVID-19 Economic Stimulus



May 2, 2020 (Updated May 6, 2020)

Update: PPP Loans - Safe Harbor Deadline Extended

A Warning

Those who have obtained Paycheck Protection Program (PPP) loans (or have applied or been approved for such loans but not yet received the loan proceeds) have been warned by the U.S. federal government to make sure that they, in fact, qualify for the loans. Secretary Mnuchin exonerated lenders who processed the loans and warned that it is the borrowers themselves who sign the application and make the relevant certifications who face potential criminal action for false certifications. Borrowers have now been given a grace period until May 14, 2020 (extended from May 7 pursuant to SBA PPP Loans FAQ No. 43 released May 5), to repay loans they may have obtained "based on a misunderstanding or misapplication of the required certification standard." This short period gives PPP loan borrowers very little time to act, and is aggravated by the ambiguity of applicable regulatory and other guidance as discussed below.

Thinking About What to Do

Borrowers are, and should be, asking, "what do we do about our PPP loan?" They are doing so in a unique moment. Indeed, a former member of a Congressional oversight board following the last financial crisis opined in the *Wall Street Journal*: "[B]orrower beware! Businesses with flexibility should seriously consider to what extent accepting the terms of federal loans or other support may be a Faustian bargain. The ultimate cost may dramatically outweigh the temporary gain." Understanding the issues that inform the answer to this question unfortunately involves some detailed analysis as discussed below.

Broad Loan Availability Initially Heralded and Broad CARES Act Approach

The signing into law of the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) on March 27, 2020, was heralded as a critical response to the COVID-19 economic crisis. The PPP loan program was enacted to make $349 billion of loan funds broadly available to qualifying businesses so that those businesses could keep their employees employed. In fact, following enactment, the federal government repeatedly encouraged businesses to apply for (and lenders to quickly process) PPP loans. Even as late as April 15, 2020, Secretary Mnuchin announced that “[w]e want every eligible small business to participate and get the resources they need.” In order to broaden its reach, the CARES Act affirmatively took action to cut back eligibility restrictions in the existing Small Business Administration (SBA) loan program through which PPP loans are administered, including:

- suspending the requirement that borrowers must not be able to obtain credit elsewhere;
- repealing the requirement that liquid owners contribute capital alongside an SBA loan;
- creating a presumption that loan applicants were adversely impacted by COVID-19; and
- reducing the breadth of the complex affiliation rules.

The SBA itself even published guidance allowing borrowers to restructure their governance arrangements to qualify for a loan.

A Continuing Changing Landscape; Making a Decision to Keep a PPP Loan

Since the passage of the CARES Act, the landscape has continued to evolve — sometimes daily — with ongoing guidance from the SBA and Treasury, whether in the form of Interim Final Rules (immediately effective upon publication in the *Federal Register* without first soliciting public comment due to the emergency nature of the situation), FAQ guidance from the SBA with new questions and answers added frequently over the past month, or mere public statements by public officials. Through the beginning of May — just over a month into the CARES Act — eight formal Interim Final Rules for the CARES Act have been issued and 14 updates to the SBA’s FAQs on the PPP have been published. It has been difficult to find clear guidance and sure footing, even before the most recent government warnings.

A Sudden Shift in Approach

On April 23, 2020, after significant press reporting and commentary on those participating in the PPP loans, the SBA and Treasury Secretary abruptly shifted course with the publication of a new FAQ (Question 31) stating that the certification each borrower makes in its application that “[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant” must be made “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” (emphasis supplied). As to specific examples where certification might raise questions or get a closer look, an April 23 FAQ highlighted large public companies and an April 24 Interim Final Rule highlighted Private Equity (PE) portfolio companies. On April 28, Secretary Mnuchin made public comments promising audits of all loan amounts over $2 million, and then — also on April 28 — the SBA updated its FAQs twice to highlight this new certification interpretation as also applicable to private companies and to formalize the $2 million audit threshold requirement. In other words, virtually all borrowers must be cognizant of the certification that they made in their loan application.

What Does the Certification Mean?

Unfortunately, there is no real guidance as to what this certification means. However, one thing is certain — this certification and the question of access to "other sources of liquidity" will be judged in retrospect. It is anyone's guess how long the "look back" risk will exist. Our experience is that these kinds of after-the-fact examinations have a long life. In this respect, a borrower may legitimately ask how it knows if it has access to liquidity — must a public company try to test the capital markets; must a PE fund owner consider drawing down on undrawn commitments or fund level credit agreements to fund a highly distressed portfolio company; will VC-backed companies be judged poorly in this context if their investors have large amounts of so-called "dry powder" to invest; and will private business owners have to evaluate their own wealth, liquidity positions, and borrowing capacity? These are all questions that have no ready answer through current SBA rules or guidance. The fact that the CARES Act "suspended" the normal requirement that a borrower be unable to obtain credit elsewhere and repealed the requirement of liquid owners to contribute capital has simply not been reconciled with the SBA's new scrutiny on available liquidity, as the Treasury and SBA have leaned hard into the statutory certification requirement that any loan request must be "necessary." Borrowers and applicants would be excused from asking what it means for the SBA to require liquidity that is not "significantly detrimental to the business." Does that mean "significantly detrimental" to the current business owners (whether public company stockholders, PE or VC fund investors, or the owners of private businesses themselves) in terms of dilution or the like, or does this important phrase instead mean just what it says — such alternative available liquidity is not "significantly detrimental to the business" itself (e.g., financing that the business cannot make "work" for any real period of time and which damages the business as a going concern)? Again, the SBA and Treasury have provided no clear answers. The SBA indicated on May 5 in FAQ No. 43 its intention to provide prior to May 14, 2020 additional guidance on how it will review the certification.

The Other Key Certification Issue

As borrowers evaluate their options to return loans before expiration of the safe harbor on May 14, 2020 (*extended from May 7*), they must also focus on compliance with the SBA "affiliation" rules. The affiliation rules are complex and directly impact the question of who may apply for a PPP loan. This is because the way in which the CARES Act defines eligible borrowers largely turns on the number of employees involved, and an applicant must generally (under applicable regulatory guidance and rules, but subject to certain waivers set forth in the CARES Act itself) apply the SBA's affiliation rules to aggregate its own number of employees with that of all of its affiliates. Thus, the application of the SBA's affiliation rules is critically important to an applicant's ability to make another certification in each PPP loan application: that "the Applicant is eligible to receive a loan under the rules in effect at the time this application is submitted that have been issued by the Small Business Administration (SBA) implementing the Paycheck Protection Program …." So, in addition to the question of necessity for the PPP loan and alternate sources of liquidity, borrowers must ensure that they have considered the application of the affiliation rules (unless otherwise waived) in deciding whether to keep SBA loans.

Who Is an Affiliate Under the CARES Act?

According to the SBA, affiliate status for purposes of determining the number of employees of a business concern for PPP loans works as follows:

- "Concerns and entities are affiliates of each other when one controls or has the power to control the other, or a third party or parties controls or has the power to control both";
- "It does not matter whether control is exercised, so long as the power to control exists. Affiliation under any of the circumstances described [in 13 C.F.R. § 121.301(f)] is sufficient to establish affiliation" for applicants for the PPP; and
- There are four general bases of affiliation that the SBA will consider when determining the size of an applicant: (1) affiliation based on ownership; (2) affiliation arising under stock options, convertible securities, and agreements to merge; (3) affiliation based on management; and (4) affiliation based on identity of interest.

As noted, these affiliation rules are both subtle and complex. Interestingly, even Congress did not seem to get the affiliation rules quite right in the CARES Act. In this regard, there are two SBA-related affiliation rules — rules set forth in 13 C.F.R. § 121.103 (Section 103) and rules set forth in 13 C.F.R. § 121.301 (Section 301). When Congress exempted certain business concerns from the affiliation rules for the PPP, it did so under the Section 103 rules. Yet, according to the SBA April 3 Interim Final Rule, it is, in fact, the Section 301 rules that govern affiliation for the PPP loan program (though the SBA explained that it would, consistent with the Congressional Section 103 waiver, also make that waiver applicable for Section 301).

Uncertainty in Application

As questions have arisen under these affiliation tests, borrowers who relied on them in submitting their application would be well advised to "double check" their analysis with appropriate counsel given the heightened scrutiny that will most certainly be applied in retrospective audits of PPP loan recipients. And, it is not just the application of the four bases of control that have given rise to questions of how the affiliation rules work, but the actual language of the CARES Act itself. In this regard, while the CARES Act clearly waives affiliation rules for "any business concern with not more than 500 employees that, as of the date on which the loan is disbursed, is assigned a North American Industry Classification System [(NAICS)] code beginning with 72," the CARES Act itself has a separate and more expansive provision for NAICS code 72 companies allowing for more than 500 aggregate employees and which provides: "During the covered period, any business concern that employs not more than 500 employees per physical location of the business concern and that is assigned a North American Industry Classification System code beginning with 72 at the time of disbursal shall be eligible to receive a covered loan." This seems to be clear and self-executing language. Indeed, both applicable House and Senate publicly available explanations of the CARES Act suggest as much, explaining that a qualifying borrower is "Any business concern that employs not more than 500 employees per physical location of the business concern and that is assigned a North American Industry Classification System code beginning with 72, *for which the affiliation rules are waived*" (emphasis supplied). But, nowhere has the SBA specifically addressed the question of how these two specific NAICS code 72 provisions of the CARES Act are to be applied in conjunction with one another. Even the SBA FAQs seem to intentionally avoid addressing this issue head-on, leaving borrowers at risk for after-the-fact second guessing.

The Criminal Issue

Secretary Mnuchin referenced criminal liability for a reason. During the past two decades, for every major crisis this country has witnessed, from the Financial Crisis to Hurricane Katrina, high levels of fraud were identified and addressed post-crisis. From the experience gained in prior disasters, the Department of Justice and other enforcers are well aware that fraud may occur under the CARES Act as well. They almost certainly realize that a strong way to prevent such fraud is to take an early, aggressive stance against misconduct. We would predict that U.S. law enforcement will seek to make extreme examples of the individuals who exploited COVID-19-related government assistance improperly and precluded the assistance from helping those actually in need.

The underlying criminal issues relating to PPP loans are relatively straightforward. The loan application itself makes clear that applicants are required to state they qualify, and advises that there are criminal penalties for knowingly making false certifications. Each applicant, by signing the loan application, makes the following statements:

> I further certify that the information provided in this application and the information provided in all supporting documents and forms is true and accurate in all material respects. I understand that knowingly making a false statement to obtain a guaranteed loan from SBA is punishable under the law, including under 18 USC 1001 and 3571 by imprisonment of not more than five years and/or a fine of up to $250,000; under 15 USC 645 by imprisonment of not more than two years and/or a fine of not more than $5,000; and, if submitted to a federally insured institution, under 18 USC 1014 by imprisonment of not more than thirty years and/or a fine of not more than $1,000,000.

This certification is essentially the same certification generally applicable to forms and information required by a bank or the government that involve applications for loans, grants or other financial assistance. The certification provides that if you knowingly mislead or lie on the application, you have committed a felony. However, the one completing such an application should endeavor in good faith to provide correct information. This means not simply guessing or blindly answering to expedite processing of the loan application or superficially making the certifications in question. In short, if you mislead in order to receive a PPP loan or lie to receive forgiveness, there is a material risk that the government will believe a felony has been committed.

As stated above, because of the intense pressure to protect the integrity of the PPP loan program and to deter widespread fraud, government enforcers may well use additional criminal statutes to prevent fraud on the United States and the banks. PPP-related prosecutions may involve the usual bank fraud, wire fraud and other common financial fraud statutes. These specific laws all have the common requisite element of deceit. Further, the government will clearly feel free to use whatever remedies possible to recover ill-gotten PPP money and assess related fines to make the U.S. taxpayers whole through various civil enforcement remedies. To avoid such criminal consequences, borrowers need to exercise their best efforts to provide the government with accurate information. There is no criminal liability for mistakes or inadvertent omissions, but when actions are judged retrospectively, trying to prove a lack of intent is not a situation any borrower would want to face. Of course, possible criminal prosecution is not the only redress or negative consequence that wrongful borrowers may face. There are, for example, civil penalties and actions that can be pursued by regulatory or government authorities, qui tam actions, and possible stockholder or equityholder claims against boards or managers, not to mention potential negative press.

In Sum – This Much is Clear – Double Check, Document and Be Careful Either Way

It would not be surprising or unreasonable for business owners to ask how they are supposed to act with any comfort as to PPP loans given all the uncertainty noted above, with the Treasury Secretary highlighting criminal penalties in relation to improper applications, and with a new safe harbor loan give back period running only until May 14 (*extended from May 7*). It also would not be surprising to see those borrowers who can find a way to make it without the PPP loan decide to return PPP loan proceeds (or not accept funds that have been approved but not yet been received) — even when they have been truly harmed by the COVID-19 pandemic, even when they have always intended to use the loan to keep employees paid exactly as intended by the CARES Act, and even when they believe they qualify for the PPP loan. What is clear from all of the above is that not much is truly clear with respect to the eligibility criteria and certification requirements for PPP loans. What also seems clear — including from the SBA rules issued April 30 stating that the maximum loan amount for a related corporate group will be limited to $20 million — is that loans (even big loans) for qualifying firms are legitimate.

Some Practical Points

Finally, those borrowers who ultimately elect to keep their loans should strongly consider working with counsel to create a contemporaneous, written record to support their certifications or their current decisions to keep those loans based on the certifications that were made at the time of the loan application. There are two key inquiries. First, the borrower should review compliance with the affiliation rules to support the eligibility certification. Second, the borrower should review support for its "necessity" certification, considering (for example) the following questions:

- What were the specific facts and circumstances showing that the applicant bore financial hardship and faced material economic uncertainty?
- Did the applicant consider its ability to access capital, including conducting discussions with those who were in a position to provide capital such as the applicant's current lender(s) and equityholders?
- Did the applicant prepare a forecast projecting its liquidity position and effect on the operations of not obtaining a PPP loan and that would demonstrate that the loan was necessary to support the ongoing operations of the borrower? Alternatively, did the borrower conduct any other financial review in connection with such certification?

Best practices would then have the foregoing crisply documented and reviewed and approved by the borrower's board or other governing body. The written record should demonstrate that a bona fide, good faith effort was undertaken to support the certifications truthfully. If this exercise cannot produce a defensible written record, then the prudent decision may be to return the loan proceeds, ideally before elapse of the grace period for doing so.

For more information and updates on the developing situation, visit GT's Health Emergency Preparedness Task Force: Coronavirus Disease 2019 or GT's COVID-19 Economic Stimulus Team.

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