Be Prudent, but Don’t Panic! SBA Updates FAQs to Include Review of Borrowers

ARTICLE 05.01.20   DEAN DORTON

Late Wednesday night, April 29, 2020, the U.S. Department of the Treasury and Small Business Administration updated the Paycheck Protection Program’s Frequently Asked Questions to include Q&A #39.

Question: Will SBA review individual PPP loan files?

Answer: Yes. In FAQ #31, SBA reminded all borrowers of an important certification required to obtain a PPP loan. To further ensure PPP loans are limited to eligible borrowers in need, the SBA has decided, in consultation with the Department of the Treasury, that it will review all loans in excess of $2 million, in addition to other loans as appropriate, following the lender’s submission of the borrower’s loan forgiveness application.

The SBA’s answer heightened the tension about the entire loan Program.

In this article, we address:

1. The background for the proposed reviews.
2. The criteria the SBA could use in performing a review
3. What borrowers should do in the face of this news.

Background

Recall the week of April 20, 2020, it was disclosed that Ruth’s Chris Steak House and Shake Shack obtained millions of dollars of loans from the Program. Both companies, as well as others, have repaid the loans. This week revealed that the Los Angeles Lakers, a private corporation and the NBA’s second most-valuable team, had obtained a PPP loan for $4.6 million, which the Lakers repaid on Monday.

In response, the U.S. Department of the Treasury and the SBA issued the Fourth IFR, updating the Program’s FAQs by adding Q&A #31 and #37, and topped it all off with Q&A #39 about reviewing all loans over $2 million and others. The Interim Final Rules (IFRs) and FAQs for the Program are available here. The Fourth IFR and each Q&A are premised on the “necessity” certification made by every loan applicant: ***“current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.***”

The Fourth IFR

The Fourth IFR was published mid-day on Friday, April 24, 2020. The IFR addresses the eligibility of hedge funds and private equity firms and provides a limited safe harbor for borrowers that obtained a loan "*based on a misunderstanding or misapplication of the required certification standard*." The Fourth IFR states that neither hedge funds nor private equity firms are eligible for a loan because the organizations are "primarily engaged in investment or speculation." Treasury also makes clear that the affiliation rules may prohibit a portfolio company of a private equity fund from being eligible for a loan, and reiterates that, "all borrowers should carefully review the required certification on the PPP Borrower Application."

Under the safe-harbor provision of the Fourth IFR, borrowers that have been approved for or received a loan and determine that the loan is not "necessary to support the ongoing operations" as they originally thought, may repay the loan in full by May 7, 2020, and the SBA will deem the certification on the application to have been made in "good faith." Stated otherwise, no harm will come to those that decide to repay the loans by May 7, 2020.

Q&A #31 – *Large companies with adequate sources of liquidity*

Q&A #31 was added to the FAQs on April 21 and addresses "large companies with adequate sources of liquidity."

Question: Do businesses owned by large companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?

Answer: In addition to reviewing applicable affiliation rules to determine eligibility, all borrowers must assess their economic need for a PPP loan under the standard established by the CARES Act and the PPP regulations at the time of the loan application. Although the CARES Act suspends the ordinary requirement that borrowers must be unable to obtain credit elsewhere (as defined in section 3(h) of the Small Business Act), borrowers still must certify in good faith that their PPP loan request is necessary. Specifically, before submitting a PPP application, all borrowers should review carefully the required certification that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant."

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. For example, 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, and such a company should be prepared to demonstrate to SBA, upon request, the basis for its certification. Lenders may rely on a borrower's certification regarding the necessity of the loan request. Any borrower that applied for a PPP loan prior to the issuance of this guidance and repays the loan in full by May 7, 2020 will be deemed by SBA to have made the required certification in good faith.

Q&A #37 – *Private companies with adequate sources of liquidity*

On Tuesday, April 28, 2020, Q&A #37 was added.

Question: Do businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?

Answer: See response to FAQ #31.

All of this culminated in the late night addition of Q&A #39 on Wednesday, April 29, announcing the SBA would review all loans over $2 million and other loans as appropriate.

What criteria will the SBA use to conduct a review?

Generally, when someone "reviews" conduct, there is a standard or criteria against which that conduct is measured. Those standards may be set by different groups; for example, by a legislature through a statute, the judiciary through a court case, or an agency, such as the SBA, through a regulation. With regard to the Program, the "standards" are set forth in the CARES Act, the statute authorizing the Program, and the First IFR, and are couched in terms of the certifications an applicant must make at the time of applying for a loan. The certifications must be made in "good faith."

The four certifications relevant to this discussion are:

1. The necessity certification – the uncertainty of current economic conditions makes this loan request necessary to support the ongoing operations of the business.
2. Funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments, and not more than 25% of loan proceeds may be used for non-payroll costs.
3. The information provided to the lender is true and accurate in all material respects.
4. Tax documents submitted to the lender are identical to those submitted to the IRS.

The SBA can determine, through documentation and statements from borrowers, whether certifications (2) – (4) were accurate by examining how the funds are used and whether the information provided to the lender was true and the same as submissions to the IRS. This examination may be accomplished by reviewing objective, documented facts, such as payroll records, payroll tax returns, canceled checks, lease agreements, and utility bills.

The question then is what objective or verifiable facts will the SBA use to determine whether the PPP loan was "necessary to support ongoing operations" of the business. Businesses, their advisors, and commentators have lamented the vague nature of this standard since the beginning of the Program. In Q&A #31, it is stated that (1) borrowers should look at their current business activity and their "ability to access other sources of liquidity," and (2) "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." Thus, liquidity appears to be the key to proving the necessity for a loan.

How do I support the necessity of my loan?

If necessity for the loan is going to be evaluated based on liquidity, two questions immediately arise:

1. What is liquidity?
2. How does a business owner assess and document it?

Liquidity is generally understood as the ability of a business to meet its short-term financial obligations. Most business owners have a gut feeling about the liquidity of their business. Now is the time to put that feeling on paper in the form of cash flow projections.

Cash flow projections should be prepared *with and without* PPP financing. Basic considerations for projections include: cash on hand, sources of cash, and uses of cash. When considering "sources" of cash, a business owner assesses future sales or services to be performed, the ease or difficulty of converting accounts receivable to cash, and other potential sources of cash, such as contributions from owners*****, available credit lines and investments. Considerations for "uses" include payroll, accounts payable, payments, rent, utility costs, etc.

It is easier to predict uses of cash than sources of cash. When assessing sources, assumptions will have to be made about future sales or service volumes (versus budgeted or historical volumes), completing current work in process, and collecting receivables (in today's environment versus historical periods). Documents should be gathered or prepared to support the sources and uses of cash in the projections. Your Dean Dorton or other business advisor can assist you with the projections.

After completion of this analysis, business owners may be more confident in their initial decision to apply for and receive the loan. If the analysis varies from the owners' original thinking and causes doubt related to the initial good faith certification regarding the necessity of the loan, then the loan proceeds may be repaid by May 7 under the safe harbor. In either event, the analysis should bring more certainty in these uncertain times.

A note about other sources of cash. In addition to contributions from owners, other sources of cash may include lines of credit or other opportunities to borrow funds. However, it may be argued that it would be unfair for the SBA to consider the availability of "credit elsewhere" because the CARES Act says that "credit elsewhere" is *not* a consideration when determining whether a borrower qualifies for a PPP loan. This waiver of a standard SBA requirement is reiterated in the First IFR.

For more information on how the Coronavirus is impacting businesses across multiple industries, visit our COVID-19 resource page:

COVID-19 Resources