The SBA’s Paycheck Protection Program: How to Prepare for a Potential Audit

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Today's Discussion

- Brief Overview of the Paycheck Protection Program (PPP)
- Focus on Risks of Audits and Scrutiny
  - Economic necessity of taking PPP loan in first place
  - Applications for loan forgiveness
  - Misuse of funds
- Practical Guidance for Minimizing Risks

Overview of the CARES Act and PPP

Massive "Rescue" Package

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What Relief Does the PPP Provide to Small Businesses?

- Coronavirus Aid, Relief, and Economic Security Act (CARES Act) appropriated $349 billion for small businesses through federally backed loans under a modified Small Business Administration (SBA) 7(a) loan guaranty program called the Paycheck Protection Program (PPP).
  - Qualifying businesses apply to SBA-approved lenders for loans up to 2.5 times their average monthly payroll costs (up to $10 million)
  - Loan proceeds may be used for qualified payroll costs, rent, utilities, and interest on mortgage and other debt obligations
  - Loan forgiveness is available for funds used to pay for payroll costs, rent, utilities, and interest on mortgage for the first 8 weeks after the loan originates
  - All payments (including interest) will be deferred for at least 6 months
  - No collateral or personal guarantee is required
- Congress subsequently approved an additional $310 billion for the PPP.

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What are the Qualification Criteria?

- The applicant employs fewer than 500 employees;
- The applicant employs more than 500 employees but fewer than the employee size standard for the applicant's respective NAICS code;
- If the applicant's respective NAICS code does not have an employee size standard, that applicant does not exceed the receipts-based size standard under that NAICS code; ***OR***
- The applicant satisfies the SBA's "alternative size standard" test as of March 27, 2020.
  - The maximum tangible net worth of the applicant is not more than $15 million; AND
  - The average net income after federal income taxes (excluding any carry-over losses) of the applicant for the 2 full fiscal years before the date of application is not more than $5 million.

Scrutiny of Economic Necessity for Taking a PPP Loan

What Does the CARES Act Say?

- CARES Act requires eligible borrowers to make certain certifications in connection with obtaining a loan, including "that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient."
- CARES Act ***does not include*** a "means" test or any liquidity test for obtaining a loan.
- In fact, the CARES Act ***expressly waives*** the SBA's standard "credit elsewhere test" in order to qualify for an SBA loan. Under normal circumstances, a borrower for an SBA loan must demonstrate that the borrower cannot obtain some or all of the requested loan funds from alternative sources without causing undue hardship (13 CFR 120.101).
  – Credit elsewhere test looks at the resources of the applicant business or those of its principals.

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Media Scrutiny of Borrowers of PPP Loans

- "Coronavirus Small-Business Loans Run Dry as Program Fails to Reach Hardest Hit," New York Times (April 15, 2020)
- "White House, GOP face heat after hotel and restaurant chains helped run small business program dry," Washington Post (April 20, 2020)
- "Public Companies Got $500 Million in Small Business Loans," Wall Street Journal (April 22, 2020)
- "Banks Gave Richest Clients 'Concierge Treatment' for Pandemic Aid," New York Times (April 22, 2020)
- "Large Troubled Companies Got Bailout Money in Small-Business Loan Program," New York Times (April 26, 2020)
- "Public companies received $1 billion in stimulus funds meant for small businesses," Washington Post (May 1, 2020)

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Administration Response to Concerns of Large Borrowers

- April 21, Secretary Mnuchin raises concern that large businesses that did not need the money were obtaining PPP loans.
- April 23, 2020, Treasury/SBA issue FAQ 31 concerning large companies with adequate sources of liquidity that take out PPP loans.
  - Borrowers must assess their economic need for a PPP loan under CARES Act and the PPP regulations at the time of the loan application.
  - Although the CARES Act suspends the credit elsewhere test, borrowers must certify in good faith that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." This requires taking into account current business activity and ability to access other sources of liquidity sufficient to support ongoing operations in a way that is not significantly detrimental to the business.
  - The government is skeptical 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.
  - May 14 Safe Harbor: Any borrower that repays a PPP loan in full by May 14, 2020 will be deemed by SBA to have made the required certification in good faith.
- On April 28, same guidance was issued in FAQ 37, specifically calling out private companies.

Administration Response to Concerns of Large Borrowers

- April 28, Secretary Mnuchin states that any borrower of a PPP loan of $2 million or more will be audited.
- April 29, Treasury/SBA issue FAQ 39 explaining that SBA will review individual PPP loan files.
  - References FAQ 31 (certification) and reminded all borrowers of the important certification required to obtain a PPP loan.
  - To further ensure PPP loans are limited to eligible borrowers in need, SBA/Treasury 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.
  - Additional guidance implementing this procedure will be forthcoming.

How to Assess Economic Necessity for a PPP Loan?

- Document in writing your financial and operational justifications for taking the PPP loan.
- Assess the totality of the circumstances.
- Factors to consider:
  - Liquidity
  - Access to capital
  - Operational revenue
  - Increase/decrease in recent business or expectation of business
  - Aging of accounts receivable
  - Prior or expected layoffs
  - Operational challenges (shutdown orders, sick employees, etc.)
  - Impacts on customers (e.g., is your target customer base significantly impacted by COVID-19?)
- Consider impact at time of application for PPP loan, but also any current new or different challenges or developments.

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Preparing for Loan Forgiveness

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How Must Relief be Used?

- Businesses can use funds from the Program loans to cover expenses including:
  - Payroll costs, including compensation to employees; payments for vacation, parental, family, medical or sick leave; severance payments; payments required for group healthcare benefits (including insurance premiums), retirement benefits, and state and local employment taxes
  - Interest payments on any mortgage obligations or other debt obligations incurred before February 15, 2020 (but not any payments or prepayments of principal)
  - Rent
  - Utilities
- The money cannot be used for:
  - compensation of individual employees, independent contractors, or sole proprietors in excess of an annualized salary of $100,000;
  - compensation of employees with a principal place of residence outside the United States; or
  - leave wages already covered by the Families First Coronavirus Response Act.

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What about Loan Forgiveness?

- Borrowers may apply for loan forgiveness for certain eligible expenses:
  - Payroll costs
  - Rent payments
  - Utility payments
  - Interest on mortgage payments
- Per recent Treasury/SBA guidance, 75% of the amount forgiven must be used to cover payroll costs
- The amount of loan forgiveness may be reduced if the employer reduces the number of employees as compared to the prior year, or if the employer reduces the pay of any employee by more than 25% as of the last calendar quarter. Employers who re-hire workers previously laid off as a result of the COVID-19 crisis will not be penalized for having a reduced payroll for the beginning of the relevant period. Forgiveness may also include additional wages paid to tipped workers.
- Borrowers must apply for loan forgiveness to their lenders by submitting required documentation and are expected to receive a decision within 60 days.

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Reductions to Loan Forgiveness

- **Reductions in FTE**: Reduction in number of full-time equivalent employees (FTEs) in 8-week period after origination of loan.
  - Period for calculating FTEs is average number from either (A) February 15, 2019 to June 30, 2019 or (B) January 1, 2020 to February 29, 2020.
  - Number of FTEs determined by calculating average number of FTEs for each pay period falling within a month.
- **Reductions in Payroll**: Reduction in pay of any employee making less than $100,000 by more than 25% - compared to last complete calendar quarter
  - No limit to amount of reduction in pay of employees who make over $100,000.

Benefits of Rehiring

- No penalty for lay-offs from February 15, 2020 to April 26, 2020 if employees are re-hired by June 30, 2020.
  - Employee count is based on number of FTEs as of June 30, 2020 being equal to number of FTEs as of February 15, 2020.
  - Example: Company A has 100 employees as of February 15, 2020, but it laid off 50 employees on April 1, 2020. If Company A has at least 100 employees as of June 30, 2020, there will be no penalty regarding the amount of loan forgiveness.

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Repairing Reductions in Payroll

- No penalty for salary reductions from February 15, 2020 to April 26, 2020 if salaries are restored to original amount by June 30, 2020.
  - Example: On February 15, 2020, Company A decreased the salaries of employees making $75,000 to $50,000. If Company A increases the salaries of those employees back to $75,000 by June 30, 2020, there will be no penalty regarding the amount of loan forgiveness.
- Keep in mind that this possible reduction in loan forgiveness applies only to employees who make less than $100,000 per year.

Preparing for Audits: Today & Tomorrow

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Preparing for the audit – Today

- Document consideration supporting conclusion the loan is necessary to support the ongoing operations of the Applicant
- Prepare models outlining alternatives
- Address access to other capital
- Capture relevant real-time data that supports models
  - Macro and Micro economic indicators
  - Point to competitors
- Track economic performance and model long-term implications
- Be specific about anticipated impact on staffing
- Prepare written report reflecting conclusion
- Discuss at Board level and have specific authorization to keep the money/maintain application
- Minutes of Board discussion should reflect thoughtful consideration

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Preparing for the audit – Tomorrow

- Have a clean file with all calculations and supporting material submitted as part of initial application
- Have a file, including Board resolution and material prepared to support Board decision to keep the money/maintain application. Presume this will be provided as part of the audit
- Segregate loan proceeds
- Prepare a forgiveness model to track forgivable expenditures. Have model reviewed and signed off on by counsel and accounting support
- Track expenditures from segregated funds
- Follow (and document) direction from lender
- Assemble documents relating to expenditures (i.e., leases for lease payments; utility bills; payroll records)
- Prepare backup package in real time

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What to Expect During the Audit Process & a Potential Investigation

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The Audit Process

– The SBA has stated it will provide additional guidance
– Audits likely conducted by SBA Inspector General
– Expectations that the following items will be evaluated during the audit:
  - Forgiveness documentation
  - Loan eligibility documentation
  - Good faith certification
  - Use of loan proceeds
– Audits could give rise to an investigation
– Fact-finding from an audit could be a predicate for pursuing a subpoena

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Potential Theories of Liability (Civil)

- False Claims Act
  - The FCA imposes liability for any person who knowingly submits a false claim to the government or causes another to submit a false claim to the government or knowingly makes a false record or statement to get a false claim paid by the government.
  - Civil penalties between $11,665 and $23,331 for each false claim and treble damages.
- FIRREA: Financial Institutions Reform Recovery and Enforcement Act of 1989
  - Prosecuted by the Department of Justice
  - Allows DOJ to obtain civil penalties; administrative subpoenas
  - Underlying causes of action are criminal fraud causes of action, relying on civil burden of proof standard
  - Conduct must affect a federally insured financial institution (bank)

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DOJ Makes Its First Move

- On May 5, DOJ announced it had filed its first criminal complaint against two individuals charged in Rhode Island for engaging in fraud in connection with PPP loans.
- Two businessmen allegedly filed bank loan applications seeking more than a half-million dollars in PPP loans while falsely representing that they had dozens of employees at multiple businesses.
- Both charged with conspiracy to make a false statement to influence SBA and conspiracy to commit bank fraud, among other charges.
- According to court documents the fraudulent loan requests were to pay employees of businesses that were not operating prior to the start of the COVID-19 pandemic and had no salaried employees, or, as in one instance, to pay employees at a business the loan applicant did not own.

QUESTIONS??

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