REID & RIEGE ATTORNEYS

COVID-19 Alert

CARES ACT PAYCHECK PROTECTION PROGRAM LOANS MAY 1, 2020 UPDATE

MAY 2020

This continues our effort to provide up-to-date information on the Paycheck Protection Program (PPP) loan offerings created by the CARES Act and overseen by the Small Business Administration (SBA) in consultation with the Department of the Treasury. Our prior pieces can be found on our website April 1, 2020, April 3, 2020, April 9, 2020, April 16, 2020, and April 24, 2020.

WHAT HAS CHANGED?

A lot.

As discussed in our last update, at the end of last week $310 billion was added to the quickly exhausted $349 billion originally authorized by the CARES Act for the PPP. The SBA began processing applications for the second tranche of funding earlier this week.

Meanwhile, extensive public criticism has developed with respect to the awarding of PPP loans to certain borrowers. The criticism is multi-faceted, but the two main currents pertain to applicants "who didn't really need it" obtaining loans, and large lenders prioritizing their large customers in application processing.

Starting April 23, 2020 a flurry of guidance from SBA in consultation with the Department of Treasury has spoken to the "necessary" component of PPP loans. It is unclear whether this is in reaction to the criticism, or simply coincidental and a result of the guidance moving more slowly than the flow of funds.

In addition, the Internal Revenue Service (IRS) has weighed in with new guidance implicating the tax effects of PPP loans, at least to the extent they are ultimately forgiven.

The interplay of all of this guidance is to substantially change common understanding of the PPP as originally created, and as in effect when most applications for loans were originally filed.

WHERE DID WE BEGIN?

The CARES Act was a federal response to the COVID-19 pandemic and related economic disruption. Among many other things, it created the PPP as a graft on to the SBA Section 7(a) loan program. The policy objective was to provide

OUR COVID-19 TEAM

Business & Contracts

Kathleen M. Coss
(860) 240-1035 • kcoss@rrlawpc.com

Thomas R. Kasper
(860) 240-1084 • tkasper@rrlawpc.com

Cathryn A. Reynolds
(860) 240-1019 • creynolds@rrlawpc.com

Commercial Real Estate

Louis J. Donofrio
(860) 240-1042 • ldonofrio@rrlawpc.com

Thomas R. Kasper
(860) 240-1084 • tkasper@rrlawpc.com

Employee Benefits & Compensation

Douglas K. Knight
(860) 240-1028 • dknight@rrlawpc.com

Estate Planning & Trust Matters

John R. Ivimey
(860) 240-1062 • jivimey@rrlawpc.com

Barbara A. Taylor
(860) 240-1033 • btaylor@rrlawpc.com

a mechanism, through federal government loan guaranties and ultimately loan forgiveness, for small businesses to maintain their work forces in place at pre-emergency compensation levels despite economic uncertainty.

Our original piece discussed the mechanics of the PPP, at least as we originally understood it. Eligible small businesses could obtain low interest SBA guaranteed loans from eligible lenders. The amount of each loan would be tied to the prior Payroll Cost history of the borrower. To the extent the borrower used the loan proceeds to fund Payroll Costs and related rent, mortgage interest and utility expense during the eight weeks following loan funding, the loan would be forgiven (with the lender reimbursed pursuant to the SBA loan guaranty). The borrower would not have taxable income on account of the forgiveness. And, as a cherry on top, the borrower would have a tax deduction for the expenses giving rise to the amount forgiven.

To obtain these benefits, a borrower had to apply for its loan with an eligible lender. In applying, the borrower needed to certify that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant," as contemplated by SBA's model loan application. Given the economic disruption of the pandemic, this seemed an easy certification for the vast majority of otherwise eligible borrowers. And so many applied – and with the expectation of the loan availability and ultimate forgiveness, many continued to employ substantially their entire workforce without pay reduction.

WHAT DID SBA DO?

Since the PPP commenced, SBA has been issuing guidance in the form of FAQs (which do not have the force of law) and Interim Final Rules (which do). In the past week, a series of new SBA guidance has been released to spell out SBA's interpretation of the "necessary" certification, and also its enforcement intent for those who improperly make the certification.

We will begin with the FAQs. Here is the full text of the now infamous FAQ 31, put out April 23, 2020, and related FAQs 37 and 39 which have followed:

31. 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

OUR COVID-19 TEAM (CONT.)

Finance & Business Insolvency

Jon P. Newton
(860) 240-1090 • jnewton@rrlawpc.com

Government & Regulatory Investigations

Thomas V. Daily
(860) 240-1067 • tdaily@rrlawpc.com

Health Care Providers & Privacy

Adam Carter Rose
(860) 240-1065 • arose@rrlawpc.com

HR & Employee Issues

Adam T. Boston
(860) 240-1023 • aboston@rrlawpc.com

Brian O'Donnell
(860) 240-1012 • bodonnell@rrlawpc.com

Trust & Wealth Management

*David L. Sullivan, CTFA**
(860) 240-1022 • dsullivan@rrlawpc.com

**Mr. Sullivan is a Certified Trust Financial Advisor; he is not an attorney.*

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.

37. 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.

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. Additional guidance implementing this procedure will be forthcoming.

    The outcome of SBA's review of loan files will not affect SBA's guarantee of any loan for which the lender complied with the lender obligations set forth in paragraphs III.3.b(i)-(iii) of the Paycheck Protection Program Rule (April 2, 2020) and further explained in FAQ #1.

In addition, a new Interim Final Rule (the New IFR) was published on April 28, 2020. Part III of the New IFR sets out certain rules applicable to the PPP, including Section 5 of it formalizing the safe-harbor for loans repaid by May 7, 2020 first announced at the end of FAQ 31. Notably, it does not formalize any other guidance set forth in FAQ 31, although it does mention in multiple places the "necessary" certification, which now needs to be construed in light of FAQ 31.

WHAT DOES THAT GUIDANCE MEAN?

Like everyone else, we are not entirely sure. Here is our crack at decoding it.

The CARES Act grafted the PPP onto the SBA Section 7(a) loan program. They do not comfortably tie together. The PPP vastly expands the universe of potential

SBA borrowers, both by adding a new size requirement and enabling non-profit organizations to apply. The new size category of up to 500 employees (taking into account affiliation rules) enables access to some businesses that are not commonly perceived to be small. Add to that the special treatment of NAICS Code 72 businesses, where the 500 limit is applied on a per location basis and not to the business as a whole, and some very large entities might for the first time be eligible for SBA assistance.

In addition, the CARES Act did away with the typical SBA loan requirement that a borrower provide evidence that it is unable to obtain credit elsewhere. It did however add the "necessary" certification requirement. It is unclear whether the certification was always intended to be in lieu of proving a lack of credit. One can view it that way: "given the borrower's need for immediate cash, we will skip the time consuming need to prove it and just take the borrower's word." But that is not explicit in the CARES Act or any prior guidance.

Be that as it may, public attention focused on how high-profile, and seemingly very well capitalized, businesses that were able to obtain loans, including well known restaurant chains, educational institutions, and professional sports teams. Even assuming they satisfied all other eligibility criteria (e.g., as to employee count in light of affiliation rules), how could they possibly need money intended for truly small businesses?

And so SBA acted to address the situation and create a standard as to what "necessary" means. FAQ 31 in its question speaks to "businesses owned by large companies with adequate sources of liquidity" and in its answer illustrates its point by way of discussing "a public company with substantial market value and access to capital markets." FAQ 37 in its question addresses "businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations." Public companies and private equity portfolio companies are on clear notice to be very careful.

The problem lies in the answer to FAQ 31. Before getting to its public company example, the answer begins by saying "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." So ALL BORROWERS are on notice. And nothing in the CARES Act itself provides any "standard" as to what "economic need for a PPP loan" consists of, nor, to our knowledge, are there any "regulations" on the point even as of this date. Essentially, all we have is FAQ 31 itself, and its key sentence seeking to establish a standard:

> 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.

What exactly are "other sources of liquidity?" Clearly cash on hand fits the description. Perhaps so does existing borrowing capacity. Does it include obtaining new loan facilities? Obtaining new equity investment or capital

For information regarding Reid and Riege, P.C., please visit our website at www.rrlawpc.com or contact us at:

Reid and Riege, P.C.
One Financial Plaza
Hartford, CT 06103

or

Reid and Riege, P.C.
234 Church Street
New Haven, CT 06510

contributions by existing owners? Up to here, it would seem from FAQ 31 that the answer is clearly yes, at least for public companies and private equity portfolio companies, but what about other businesses? And what about compensation cuts for employees, or at least those making more than $100,000 per year?

Assuming all of those potential sources of liquidity must be considered by all borrowers, how does an individual borrower then perform the balancing required to determine that applying or obtaining them is "not significantly detrimental to the business"?

The questions are many, and the answers are few. Each potential borrower has to struggle with the analysis in light of its own unique circumstances and very cloudy crystal ball as to how long the current economic disruption will last and what its ultimate effects will actually be. It seems that borrowers are being asked to forecast with precision the ultimate outcome of the very "[c]urrent economic uncertainty" that makes them feel the loans are necessary to determine whether they are in fact necessary, with judgment to be made in hindsight by way of SBA audit or even more unpleasant enforcement action.

WHAT ARE THE RISKS?

First, we continue to operate in a world of incomplete guidance. For example, at the moment we know what types of expenses can give rise to loan forgiveness, and we know that lenders will be required to process applications for forgiveness within 60 days of receipt. However, as yet we have no guidance on how exactly the forgiveness will work, or on the detail and certifications that will need to be provided to obtain it. This includes any detail and certification that may ultimately be required at the time of requesting forgiveness to prove there was necessity at the time of application.

Second, as indicated by FAQ 39, there will be an SBA audit process. And it will apply at a minimum to all loans in excess of $2,000,000, following application for forgiveness. This is in addition to smaller loans "as appropriate." One cannot presume from FAQ 39 that the audit process will be limited to loans for which forgiveness is sought. It must be read to simply say that a business that received a more than $2,000,000 loan and asked for forgiveness will be audited. Of course, "[a]dditional guidance implementing this procedure will be forthcoming."

Third, this is a government-sponsored loan program. If a loan is forgiven, the government will write a check to the lender by way of the SBA guaranty. The same is true in the case of a borrower that does not seek forgiveness but does default on the loan. And, regardless of forgiveness or default, the government is already out-of-pocket, since under the PPP it has already paid processing fees to the lenders for each approved loan.

Accordingly, the federal False Claims Act (FCA) is fully applicable to borrowers under the PPP. Under the FCA, civil liability exists for anyone who knowingly presents or causes to be a presented a false claim for payment to the federal government, or who knowingly makes, uses or causes to be made a false

record or statement material to a false or fraudulent claim. For FCA purposes, "knowingly" can mean having actual knowledge, or acting in deliberate ignorance or reckless disregard of the truth or falsity of the information. Every statement made in connection with a PPP loan, whether a certification in or documentation provided with the initial application or a subsequent request for forgiveness is a potential source of liability under FCA, most particularly including the "necessary" certification. FCA exposure can be extreme, with up to treble damage recovery plus penalties. And it is not limited to government initiated claims – whistleblower provisions enable private individuals to initiate suits and ultimately share in the recovery. Whistleblowers may include company employees, competitors and public interest motivated individuals. The list of those who received PPP loans likely will ultimately be made public. Finally, potential targets of an FCA claim are not limited to the borrower entity itself, and can include the authorized representative who signed PPP paperwork on behalf of the entity as well as other executives, board members and owners who participated in the decision making process to obtain the loan.

In addition, criminal sanctions are possible for the most egregious situations. Federal criminal law includes strict prohibitions on making false statements in connection with loan applications, making false statements to the government, wire fraud, and the like.

Finally, there are the twin demons of public shaming. Undoubtedly there will be Congressional investigations into "what went wrong" with the PPP. And the media will look for examples of impropriety, likely with a list of borrowers in hand.

WHAT TO DO?

All borrowers who have received PPP loans, all applicants hoping to receive them, and all considering becoming applicants in "round two" or any "round three" to come need to re-evaluate their thought process in light of FAQs 31, 37 and 39, as well as the new IRS guidance discussed below.

The central points to consider are whether the loan is "necessary" and why, which in turn entail a consideration of where the borrower is likely to be with and without the loan. The subsidiary questions are what other sources of liquidity are available, at what cost, and with what effect on the business.

The first decision point for those who have a loan in hand is whether to repay it by May 7 and obtain the safe harbor benefit of FAQ 37 and the New IFR. For those who do not yet have loans, the question is whether to withdraw (or not submit) an application.

For those who determine to proceed, it is essential to document why the loan is "necessary." Immediately commit to writing the pertinent considerations and assemble evidence of them. Examples of relevant factors to take into account include:

- What governmental orders apply to the business? Are employees being forced to work from home (or not at all)?

- What impact has been felt on the business to date and is likely to be felt?
- Have supply chains been interrupted or are they likely to be?
- Has customer demand suffered or is it likely to?
- Are effects to your customers likely to substantially delay payment of, or lead to default on, receivable balances?
- What steps have been taken to date to minimize the damage?
- What steps remain available to minimize the damage?
- What is current working capital availability? How is that likely to change given observable trends in the business?
- What other sources of cash are available?
- What are the risks of furloughing or terminating employees or cutting their pay? Will they remain available when/if the business is prepared to recall them?
- Have previous plans to adjust payroll costs been conceived but tabled due to expectation a PPP loan will be received?

For those who elect to proceed, a second decision point will arise as a practical matter. The loan may have been sought in whole or part with the intention of obtaining forgiveness to the maximum extent possible, which clearly seemed to be a large point of the PPP in the first place. But forgiveness ultimately needs to be requested, and it cannot practically be requested until at least eight weeks after the loan is obtained. A decision can be delayed, at least until August given the 60 day period for lender evaluation and the forbearance of payment obligations with respect to the loan until six months following funding. Borrowers will have the opportunity to re-evaluate whether to seek forgiveness and re-evaluate whether the loan was "necessary" with more knowledge as to actual and likely economic effects and more guidance from SBA on the topic. A decision to forego forgiveness and repay the loan after May 7, 2020, does not have the benefit of the FAQ 31 safe harbor, but it may reduce the likelihood of SBA audit, SBA claims on audit, or the damages the government might seek in an FCA claim.

WHAT DID IRS DO?

The grand slam of PPP benefits was perceived to be (a) obtaining a very low interest loan, (b) that would be forgiven in whole or part, (c) without taxable income on account of the forgiveness, and (d) with the expenses giving rise to the forgiveness (Payroll Costs, rent, mortgage interest, and utility costs) also giving rise to income tax deduction for the business.

IRS has now taken one of those runs off the board, by way of Notice 2020-32. IRS has essentially said you cannot have your cake and eat it, too. The technical approach is to say that a taxpayer given a non-taxable benefit in the form of untaxed forgiveness of debt cannot claim deduction for the expenses incurred to obtain the exempt income. The detailed reasoning is in the Notice.

It is difficult to argue over the "fairness" of precluding a tax "double dip." As with the evolving SBA guidance, the frustration lies in the sense that the rules are being made up on the fly and without regard to the expectations that borrowers had in making difficult personnel decisions in order to obtain the benefits of the PPP and thereby maintain their work forces in place and fully compensated.

FINAL THOUGHTS

Borrowers must do some serious thinking about continued PPP participation. The benefits have been reduced, and the risks have substantially increased. Unfortunately, for many borrowers "[c]urrent economic uncertainty" offers no practical alternative. For those borrowers, the loans clearly are "necessary," but we have come a long way from the initial promise of keeping small business generally functioning as if we did not have the uncertainty.

We are interested to hear your experiences with the PPP.

Please contact the Reid and Riege attorney with whom you regularly work, or a member of our Business Services practice listed to the right, for more up to date information, or questions about your unique circumstances.

BUSINESS SERVICES

Karen L. Brand
(860) 240-1089 • kbrand@rrlawpc.com

Kathleen M. Coss
(860) 240-1035 • kcoss@rrlawpc.com

Louis J. Donofrio
(860) 240-1042 • ldonofrio@rrlawpc.com

Coleen Hurlie-Dunn
(860) 240-1085 • churlie-dunn@rrlawpc.com

Thomas R. Kasper
(860) 240-1084 • tkasper@rrlawpc.com

Earl F. McMahon
(860) 240-1016 • emcmahon@rrlawpc.com

Robert M. Mulé
(860) 240-1010 • rmule@rrlawpc.com

Cathryn A. Reynolds
(860) 240-1019 • creynolds@rrlawpc.com

Adam Carter Rose
(860) 240-1065 • arose@rrlawpc.com

Mark X. Ryan
(860) 240-1056 • mryan@rrlawpc.com