

Clients & Friends Memo

COVID-19 Update: These Are Not the Droids You're Looking For: The "Wrong" Type of PPP Borrowers May Need to Repay Their Loans or Prepare for an Audit

May 4, 2020

On this May the Fourth (Be With You), many Paycheck Protection Program ("PPP") borrowers may be grappling with a difficult question: At the time of loan application, was the company the type of borrower the Small Business Administration ("SBA") was looking for? Specifically, given that the Treasury Department's prior guidance on the standards for obtaining a PPP loan were at best vague and at worst inconsistent with current guidance,¹ was the borrower's certification that the PPP loan was "necessary" made in good faith? If not, a borrower has until May 7, 2020 to repay the loan and be deemed to have made the required "necessity" certification in good faith.² If the answer is yes, some borrowers should nonetheless prepare to be audited, as the SBA has announced plans to review "all loans in excess of \$2 million, in addition to other loans as appropriate."³ Borrowers seeking to navigate a middle way by keeping the loan proceeds but foregoing a request for forgiveness are unlikely to emerge unscathed if they do not meet the "necessity" requirements. Underlying the Trump Administration's guidance on "necessity" is a requirement that PPP borrowers consider whether, at the time of application, they were able to access non-PPP funds "in a manner that is not significantly detrimental to the business."⁴ As a follow-up to Cadwalader's recent Clients & Friends Memo, [The Paycheck Protection Program and the Concept of "Necessity"](#),⁵ this article provides questions to consider when evaluating whether a PPP borrower's loan was "necessary."

¹ See Cadwalader, Wickersham & Taft, *COVID-19 Update: The Paycheck Protection Program and the Concept of "Necessity"* (Apr. 30, 2020), available at <https://www.cadwalader.com/resources/clients-friends-memos/covid-19-update-the-paycheck-protection-program-and-the-concept-of-necessity>.

² Paycheck Protection Program Loans: Frequently Asked Questions, FAQ #31 (Apr. 23, 2020).

³ Paycheck Protection Program Loans: Frequently Asked Questions, FAQ #39 (Apr. 29, 2020).

⁴ FAQ #31, *supra* note 2.

⁵ *The Paycheck Protection Program and the Concept of "Necessity"*, *supra* note 1.

Forecasting and Modeling

As a necessary first step, a borrower should enlist either its outside accounting firm or professionals in a finance role to create a cash forecast for how COVID-19 will affect short-term cash inflows and outflows. In senior-level discussions, the company should then develop best- and worst-case scenarios to evaluate whether the company had, at the time of its loan application, access to non-PPP-funds in a manner that was “not significantly detrimental to the business.”⁶ The senior-level considerations should be clearly documented and justified, taking into account a variety of quantitative and qualitative factors, including, but not limited to:

- Cash and cash equivalents

A company, whether public or private, with sizeable and relatively liquid assets may not be able to make the necessity certification. On the other hand, if cash-on-hand is earmarked for a non-payroll critical use, the use of that cash to pay employees could be “significantly detrimental” to the business.

- Existing Sources of Funds

While the SBA Interim Final Regulations make clear that borrowers need not first seek credit elsewhere,⁷ borrowers should evaluate their existing sources of funds. Existing lines of credit that were near exhaustion or unlikely to be renewed may support a necessity certification, but largely untapped lines of credit, even where the cost of borrowing is higher, may not. Similarly, businesses owned by companies with adequate sources of liquidity should carefully consider whether they had ready access to funds, through debt or even equity, that could support the business’s ongoing operations.⁸

- Industry Projections and Regional Differences

Borrowers should consider their specific needs in the context of their industry and the location of their operations, suppliers, and customers. Borrowers in industries hard-hit by COVID-19 are more likely to be able to certify necessity than borrowers experiencing increased demand. Likewise, borrowers with operations, suppliers, or customers in hard-hit regions may face operational and financial challenges that borrowers in other locations do not. Each business should evaluate the extent to which it is able to (1) procure the supplies, equipment, and labor it requires, and (2) sell goods or services to its particular customers. In particular, businesses should consider the impact

⁶ FAQ #31, *supra* note 2.

⁷ Small Business Administration, Interim Final Regulation, *Business Loan Program Temporary Changes; Paycheck Protection Program* § 3(c), 85 Fed. Reg. 20811, 20815-16 (Apr. 15, 2020).

⁸ Paycheck Protection Program Loans: Frequently Asked Questions, FAQ #37 (Apr. 28, 2020).

of COVID-19 on the volume and timing of customer receipts, especially over the period between now and June 30, and whether any reduction in receipts will strain existing cash resources.

Are You a Public Company?

Public companies certainly have access to the capital markets, but in many instances that capital may not be available readily enough to provide the needed cash infusion to sustain operations. Accordingly, public companies should consider documenting its consideration of the feasibility of securities offerings, including debt and equity, to fund ongoing operations without resort to the PPP program. Included in this calculus should be a review of the financial strength of the company, current analyst recommendations, the current stock price and outlook, and the time horizon for realizing cash through a debt or equity offering. In particular, the company should consider the costs and practicality of raising cash in the debt markets if the company does not currently have a shelf registration. More likely than not, a company facing a short-term liquidity need may be unable to generate cash through a new offering. Even though it is unlikely that fundraising through the capital markets would swiftly provide funds to support ongoing operations, the company should document a board-level discussion of that option.

Public Scrutiny

Public companies in particular should also consider the risk of public scrutiny of any PPP borrowing. Generally, SBA loans are intended to benefit small businesses, and the intent of the PPP was no different. However, due to the CARES Act's easing of SBA eligibility criteria—particularly with respect to companies in the food service and accommodation industries that were partially exempted from the 500-employee limit—companies the public may perceive as “large” (and thus not the droids the SBA was looking for) were able to access the PPP funds.⁹ Some of these companies have been criticized and several have voluntarily returned PPP loan proceeds in response to the public outcry. Given that the Pandemic Response Accountability Committee website (<https://pandemic.oversight.gov>) will soon publicly report details about PPP borrowers, loan recipients should consider whether they are willing and prepared to withstand the reputational hit of a Wall Street versus Main Street accusation. This is especially true given the SBA's plans to audit all PPP loans over \$2 million and the regulatory scrutiny – and plaintiffs' attorney trolling – that will likely follow.

Preparing for Audits and Investigations

The analysis of whether a PPP loan was “necessary” under the Trump Administration's retroactive guidance in FAQ #31 and whether a company should take advantage of the limited safe harbor the FAQ offers to borrowers who repay their loans is highly fact-dependent. A company that carefully considers and thoroughly documents its analysis will be well-positioned to respond to the audits and investigations of borrowers that are certain to come. Attorneys across Cadwalader's finance,

⁹ See e.g., *The Paycheck Protection Program and the Concept of “Necessity”*, *supra* note 1.

regulatory and investigations teams have combined together to assist borrowers in conducting the necessity analysis, either to assess potential returning PPP loan proceeds, or to prepare for audits, or worse, down the road.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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