Holland & Knight

Ineligible PPP Borrowers Granted Safe Harbor Period to Return Money by May 7

April 24, 2020

Holland & Knight Alert

Megan Mocho Jeschke

Highlights

- Authorized by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the Paycheck Protection Program (PPP) was set up to provide small businesses access to emergency capital in the form of low-interest private loans guaranteed by the U.S. Small Business Administration (SBA).
- PPP loans are going to be audited and borrowers may face enforcement scrutiny. Main areas of risk include: 1) necessity for the loan, 2) size eligibility, 3) amount of loan requested and 4) use of loan proceeds.
- SBA wants borrowers to seriously consider their certification that the loan was "necessary" to support ongoing operations. Companies with alternative access to capital need to justify their determination that the loan was in fact necessary.
- Borrowers can return funds, which in retrospect may not have been "needed" per the PPP rules, by May 7, 2020, without penalty. Past and future borrowers must also consider the impending wave of potential criminal investigations and civil proceedings under the False Claims Act.

The U.S. Small Business Administration (SBA) has issued a supplemental interim final rule regarding the Paycheck Protection Program (PPP) to buttress its supplemental guidance issued on April 23, 2020. In these, SBA warned unqualified borrowers who do not "need" the loan: You get a pass if you return the funds by May 7, 2020.

Authorized by the Coronavirus Aid, Relief, and Economic Security (CARES) Act, the PPP was set up to provide small businesses access to emergency capital in the form of low-interest private loans guaranteed by SBA. The keystone feature of PPP is the ability to obtain repayment forgiveness of the amounts used by the recipient for qualifying expenses such as payroll costs to retain or rehire employees. The U.S. Department of the Treasury (Treasury) issued informal guidance and the SBA issued an interim final rule in early April.

The program, which authorized up to $349 billion in loans, ran out of funding a mere two weeks after initiation. While Congress just approved another $310 billion in funding for the program, SBA did not wait for the injection of new funding to amend its FAQs to address concerns that the original round of PPP funding went to large, financially secure businesses. This Holland & Knight alert addresses SBA's recent FAQs and enforcement considerations for PPP loans.

Key Takeaways

- PPP loans are going to be audited and borrowers may face enforcement scrutiny. Main areas of risk include: 1) necessity for the loan, 2) size eligibility, 3) amount of loan requested and 4) use of loan proceeds.
- SBA wants borrowers to seriously consider their certification that the loan was "necessary" to support ongoing operations. Companies with alternative access to capital need to justify their determination that the loan was in fact necessary.
- Borrowers can return funds, which in retrospect may not have been "needed" per the PPP rules, by May 7, 2020,

without penalty.

- Past and future borrowers must also consider the impending wave of potential criminal investigations and civil proceedings under the False Claims Act, which carries the potential for treble damages and per-claim penalties, and contains a "reverse" provision that requires the return of funds to which the holder is not entitled.

Areas of Enforcement

As intimated by the SBA in its supplemental guidance, PPP borrowers will undoubtedly be subject to audits and enforcement scrutiny. Aside from the obvious offenders who provided false or misleading information in the application itself, enforcement will also focus on the need for the loan, amount of loan requested and use of loan proceeds.

Does the business need the loan? Loans under the PPP program are intended to keep struggling businesses afloat during the COVID-19 crisis. The PPP application thus requires a certification that the "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant."

While the PPP interim rule did not define necessity, it is clear that Congress envisioned supporting companies that may not survive given their limited capital access. This does not mean that the business had to demonstrate likely foreclosure to qualify. Nor does the business need to demonstrate that the business had no other means of obtaining credit. Treasury expressly stated that it was waiving "the usual SBA requirement that [the applicant] try to obtain some or all of the loan funds from other sources."

Although applicants were not required to seek credit elsewhere or otherwise show likely closure before applying, SBA and enforcement agencies will be scrutinizing the perceived need for the funding. Post-issuance reviews seem likely to focus on whether the applicant had sufficient cash reserves, had access to capital from related sources, issued projections showing limited impact during the COVID-19 crisis, or was otherwise in a strong financial position prior to applying for the loan or loan forgiveness.

SBA's most recent guidance specifically questioned loans going to large, public companies, indicating it would be "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[.]" Whether a company had sufficient capital to weather the COVID-19 crisis does not necessarily turn on whether it is public or private, as each case must be assessed individually. That said, SBA's non-binding comment does provide insight into the enforcement mindset that is forthcoming.

In its supplemental FAQs issued on April 23, SBA urged borrowers to "review carefully the required certification" regarding necessity of the loan. SBA's interim final rule gave borrowers a "limited safe harbor" window of opportunity, until May 7, 2020, to return funds that in retrospect they should not have received. SBA indicated it would deem the original certification as made in good faith – in other words, ignore the mistaken certification and forego civil, or even criminal, enforcement down the road – if the funds are returned within that time frame.

If, despite a hard retrospective view, borrowers elect to retain the funds, they should take affirmative steps now to document their need. Collecting and maintaining records of the company's employee count and hour requirements, pre-COVID-19 operations and subsequent decline, cost of and access to capital, cash on hand, budget forecasts and other metrics of financial performance will help to assuage the inevitable enforcement scrutiny down the road. It may make sense as a prudent practice to prepare an internal memorandum summarizing the nature of the current economic uncertainty – both current and foreseeable – that makes the PPP loan request necessary to support ongoing operations. Such an analysis might consider the consistency of current and future revenue from business activity, net assets of the business and the availability of cash reserves, access to alternative sources of financing and capital markets, and how detrimental it would be to the company to access these alternative resources. This contemporaneous documentation of the company's justification for seeking a PPP loan – if current, accurate and complete – could provide helpful support for the company's good faith basis for making the "necessity" certification, if this is questioned in the future.

Is the business qualified as a small business? In addition to revisiting their "necessity" for the loan, prior PPP borrowers, or potential new PPP borrowers, should also carefully assess whether they qualify as small under the PPP size standards.

The PPP defines eligible companies as those with a primary place of business within the United States that:

- have no more than 500 employees, including affiliates
- that are otherwise classified as small under the SBA employee-based or revenue-based size standards
- are a tax-exempt nonprofit organization described in Section 501(c)(3) of the Internal Revenue Code (IRC), a tax-exempt veterans organization described in Section 501(c)(19) of the IRC, a tribal business concern described in Section 31(b)(2)(C) of the Small Business Act , or
- that meet the alternative size standard requirement (i.e., less than $15 million in net worth and average net income after taxes of not more than $5 million).

Importantly, except for limited categories of businesses addressed below, the PPP and SBA's size standards require the entity to take into account employees of any "affiliates" when determining the entity's employee headcount. Affiliates are entities that control or have the power to control the other. Affiliates also includes entities that are controlled, or could be controlled, by a common third party. Parents and subsidiaries, brother-sister entities, and entities all owned by a common holding entity or person are obvious examples of affiliates.

Whether an entity controls or has the power to control another involves an assessment of the company's ownership and management structure. Control exists where there is a greater than 50 percent ownership of voting interests or the ability to control the board of directors or managing board. Minority owners can also be deemed to have control where, for example, they have the ability to block a quorum, can dictate operational aspects of the company, declare dividends or block certain non-extraordinary corporate events (e.g., bankruptcy). There is also a rebuttable presumption that entities owned by family members are affiliates where the entities operate in the same industry or geographic region. Other grounds for affiliation include common management and certain newly organized concerns spun off from an existing business.

The PPP exempted SBA-recognized franchises and businesses in the hospitality and food services industry from these affiliation regulations. Applicants, including large chain restaurants and hospitality companies, were eligible provided that the applying location had no more than 500 employees. The PPP did not exempt healthcare entities or other entities owed in whole or in part by private equity or venture capital companies; for them, the affiliation rules still apply and must be taken into consideration.

The latter must be particularly wary of SBA's present effect rule, which can create affiliation even before ownership is finalized or effectuated. Under this rule, SBA considers stock options, convertible securities and agreements to merge (including agreements in principle) to have a present effect on the power to control a concern. SBA treats such options, convertible securities and agreements as though the rights granted have been exercised, and has found agreements in principle to occur as early as the letter-of-intent stage in purchase or investment transactions. Companies seeking PPP loans or forgiveness who are in the process of being acquired or receiving investment must take this rule into consideration when determining size.

Enforcement entities will be scrutinizing whether the applicant appropriately classified itself as small. Although, as those in the government contracting community can attest, SBA's affiliation regulations are notoriously complex, the complexity will not absolve loan recipients from liability. The PPP application requires a certification 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)." SBA issued guidance regarding its affiliation regulations specific to the PPP on April 3, 2020, but it addresses only the more common bases for affiliation. Companies must look to the SBA business loan affiliation rules found at 13 C.F.R. § 121.301 for a full discussion of the affiliation rules.

What size loan does the business need? The amount of loan requested may also be an area of enforcement. The PPP authorizes loans up to $10 million. The amount of loan actually granted is based on the average monthly payroll costs for the prior 12 months multiplied by 2.5. Only salary, wages and tips up to $100,000 per employee are covered. Entities without a full year of payroll costs to draw from are permitted to use a different formula.

Providing misleading information about historical payroll costs, number of employees and total salary for those employees is an area of risk. Applicants must provide accurate information about the historical number of employees and the amount of payroll for those employees. In most cases, this can be done through the payroll records maintained by the employer or third-party vendors. Amendments to or deviations from any contemporaneous or independently prepared documents will be viewed suspiciously.

How did the company use the loan proceeds? Perhaps the most significant risk area for borrowers is how they use the proceeds. The CARES Act allows loan proceeds to be used for any allowable use identified in the SBA 7(a) loan program; however, borrowers who want to obtain loan forgiveness must use the loan proceeds for specific costs:

- payroll costs and benefits
- mortgage interest
- rent
- utilities

Forgiveness is available if the proceeds are 1) used primarily (75 percent or more) to cover payroll costs over the eight-week period following when the loan is made, with any remaining amounts used for the qualifying costs above, and 2) employee count and compensation levels are maintained for the eight-week period after funds are disbursed.

The PPP lays out specific costs that are legitimately considered payroll costs. Per-employee payroll costs may not exceed $100,000. Payroll costs can include costs for employee vacation, parental, family, medical and sick leave. There is a question as to whether bonuses qualify as payroll costs eligible for forgiveness. The payroll costs must relate to U.S.-based employees.

SBA plans to issue additional guidance regarding the loan forgiveness process and requirements.

Given that the loan in effect converts to a partial grant through forgiveness, this aspect of the PPP will be audited and strictly enforced. Treasury guidance notes with emphasis that "if the proceeds are used for fraudulent purposes, the U.S. government will pursue criminal charges …"

It is not just the recipient who may be subject of enforcement; all participants should be cautious. Loan recipients may not provide the money to non-applicants, shareholders, members or partners for unauthorized uses. SBA's final rule admonishes that "If one of [the borrower's] shareholders, members, or partners uses PPP funds for unauthorized purposes, SBA will have recourse against the shareholder, member, or partner for the unauthorized use" – and affiliates who participated in the loan transaction might also be implicated. This may come in the form of a direct charge for fraud or for conspiracy.

Oversight

As discussed more fully in another Holland & Knight alert (see "Oversight and Investigations Related to COVID-19 Pandemic Spending and Federal Programs," April 24, 2020), Congress recognized that fraud is an inexorable byproduct of rapidly deployed federal funding. It therefore included a prefabricated enforcement regime in the CARES

Act consisting of a tripartite of newly created entities: Office of the Special Inspector General for Pandemic Recovery; Pandemic Response Accountability Committee, which is a cross-agency committee of inspectors general; and a Congressional Oversight Commission. These entities will work in conjunction with the U.S. Department of Justice, agency inspector generals, audit entities such as the U.S. Government Accountability Office and even whistleblowers to identify fraudulently obtained PPP loans.

Companies that have obtained or that are considering a PPP loan or loan forgiveness should heed the forthcoming enforcement vanguard and carefully assess their eligibility. Companies that run afoul of the PPP rules when seeking the loan or forgiveness may find themselves facing civil, or even criminal, enforcement.

Criminal and Civil Liability

The PPP application identifies several criminal statutes that are violated by the provision of false information: 18 U.S.C. § 1001 (false statements to federal officials), 15 U.S.C. § 645 (misrepresentation of size status) and 18 U.S.C. § 1014 (false statements to a lending institution). This highlights some, but not all, of the statutes that could be used in a criminal action. Expect to also see cases brought under the more commonly used provisions: 18 U.S.C. § 287 (criminal false claims), 18 U.S.C. § 1344 (bank fraud), 18 U.S.C. § 1341 (mail fraud), 18 U.S.C. § 1343 (wire fraud) and 18 U.S.C. § 371 (criminal conspiracy). These provisions regularly appear in cases involving fraud under other SBA loan programs. In instances where a loan was obtained through bribes or kickbacks, expect to see cases brought under 18 U.S.C. § 215 (bank bribery).

Though not identified in the PPP application, enforcement will also occur through the civil False Claims Act, 31 U.S.C. § 3729 *et seq.* (FCA). The FCA is a venerable statute that serves as one of the government's primary methods to recover damages from fraud.

Violation of the FCA exposes offenders to treble damages and per-claim penalties in excess of $21,000. Last year, DOJ recovered over $3 billion from cases brought under the FCA.

The statute is unique in that it provides a right of action for not only the government but private whistleblowers (known as relators) as well. Relators are typically, but not always, insiders who witness fraudulent conduct. The relators can file, under seal, a case in the name of the government, known as a *qui tam* case. The relator is entitled to a significant portion of the recovery as a reward for bringing the case to the government's attention. Following the money, relators accounted for a significant number of cases brought in the wake of other recent financial crises and the attendant federally funded disaster and recovery operations.

Liability under the FCA stems from the submission of false claims, causing others to submit false claims (i.e., claims submitted through an intermediary) or submitting false statements material to false claims. The FCA also includes a "reverse false claims" provision that imposes liability for retaining overpayments or avoiding an obligation to repay money to the federal government. These provisions encompass the submission of fraudulent loan applications or requests for loan forgiveness. The statute also proscribes conspiracy to engage in conduct that would violate the FCA. This provision could be used to pursue affiliate companies, owners, loan brokers or other individuals who participated in the process.

Unlike most of the aforementioned criminal statutory provisions, the FCA does not require specific intent to defraud the government. Liability can attach for recklessly disregarding the rules. It is for this reason that the statute will be deployed widely during the fund and chase enforcement regime.

Return What Is Not Yours to Keep and Maintain Records of Unwavering Detail

Aside from cases of true criminal intent, most of the scrutiny on the PPP loans will be viewed through the lens of the FCA. The reverse false claims provision in particular will be used to pursue companies that improperly take advantage of loan forgiveness.. It will be applied towards companies that did not need the loan financially and failed to return the funds. It may also apply to companies that realized they were not in fact eligible size-wise or used the funds for unauthorized purposes without returning the money.

Borrowers will need to document the purposes for which the loan was spent and provide a detailed accounting in order to obtain loan forgiveness. Entities should scrupulously track where they directed the money to be spent, their employee counts and compensation levels. Maintain receipts and logs in the moment; again, posthumous records are viewed with scrutiny by enforcement entities. This not only makes good compliance sense, it also will help in any forthcoming audit or enforcement action. Companies must keep in mind that while money is fungible, enforcement audits follow the money, tracking a straight line of money in and money out.

Holland and Knight's White Collar Defense and Investigations Team is working closely with the firm's COVID-19 Response Team to keep clients apprised of developments in this rapidly changing program. If you are the subject of an audit or inquiry from any of the aforementioned entities, our team is here to assist you in responding and addressing any concerns.

Megan Jeschke is an attorney in Holland & Knight's Tysons office and a member of the Government Contracts Group and White Collar Defense and Investigations Team.

703.720.8028 | megan.jeschke@hklaw.com