

BORROWER BEWARE IV: COLLECT AND PRESERVE YOUR “NECESSITY CERTIFICATION” EVIDENCE BEFORE SUBMITTING A FORGIVENESS APPLICATION

Hodgson Russ COVID-19 Litigation & Employment Action Team Alert
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A Paycheck Protection Program (PPP) borrower’s forgiveness application must be submitted to the servicing lender in the first instance, and it must include all the documentation specified in 15 U.S.C. § 9005(e). The content of the submission must include documentation verifying full-time equivalent employees and pay rates, documentary proof of the existence and payment of forgivable expenses in the covered period, and borrower certifications affirming that the forgiveness amount requested was used to retain employees or to satisfy a covered mortgage obligation, rent obligation, or utility payment.

An SBA review, however, may also include an audit of initial borrower eligibility. That could involve any number of sub-issues or disqualifying factors going back to the time of the loan application, including the nebulous “necessity certification.” But Section 9005(e) does not expressly require borrowers to submit documentation to the lender with the forgiveness application that proves their eligibility, and borrowers may not be thinking about eligibility issues or reevaluating their loan application certifications. If a lender flags an eligibility issue to the SBA, or an eligibility issue arises at the SBA level, borrowers who contemplated the risks and prepared in advance by gathering and preserving supporting records may fare better than those who did not.

SBA Review of the “Necessity Certification”

When Congress incorporated the PPP into the SBA’s existing Section 7(a) small business loan program, it expanded the availability of PPP loans by temporarily suspending the “credit elsewhere” restriction. That limitation ordinarily renders businesses ineligible for SBA Section 7(a) loans if they had access to other available credit from non-governmental sources. In submitting loan applications, however, the CARES Act required all borrowers to certify in good faith that “the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations” of the borrower. SBA FAQ #31 attempts to give this vague necessity certification some practical meaning, stating that:

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[b]orrowers must make this certification in good faith, taking into account their current business activity and their ongoing ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to their 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. . . .

SBA FAQ #37 extended FAQ #31 to private companies. The SBA’s FAQ responses and Interim Final Rules (IFRs) attempt to introduce an ill-defined liquidity and capital access test for making a determination—in hindsight—of borrower eligibility. While this has been widely criticized as a reincarnation of the “credit elsewhere” requirement, and may be the subject of future litigation, borrowers should take heed of the risks. FAQ # 46 states that “If SBA determines in the course of its review that a borrower lacked an adequate basis for the required certification concerning the necessity of the loan request, SBA will seek repayment of the outstanding PPP loan balance and will inform the lender that the borrower is not eligible for loan forgiveness.”

FAQ #39 made clear to borrowers that the SBA intends to review/audit every loan in excess of \$2 million. By contrast, FAQ #46 offers a safe harbor for borrowers with sub-\$2 million loans, deeming the required necessity certification to have been presumptively made in good faith (although this “safe harbor” does not protect a borrower from investigation by other federal agencies). FAQ #46 recognizes, however, that “borrowers with loans greater than \$2 million that do not satisfy this safe harbor may still have an adequate basis for making the required good-faith certification, based on their individual circumstances in light of the language of the certification and SBA guidance.” But how and when are borrowers to do this?

Collect and Preserve Supporting Records Now

The statute and existing IFRs contain no express requirement to submit information supportive of the necessity certification with the forgiveness application. At best, 15 U.S.C. § 9005(e)(4) requires borrowers to submit to the lender “[a]ny other documentation the Administrator deems necessary.” The SBA’s loan review procedures are set forth in an IFR (see, 85 Fed. Reg. 33010). The IFR explains that if the SBA receives information from a lender, or otherwise, indicating that a borrower may have been ineligible, the SBA will require the lender to request additional information. The SBA may also make a direct inquiry to a borrower. The SBA will then consider whatever information the borrower supplies. If the borrower does not respond to an inquiry, a determination of ineligibility may result. The SBA, however, has not explained what kind of evidence would support a borrower’s necessity certification or how a borrower is to demonstrate the basis for the certification to the SBA. All borrowers—particularly those with loans of \$2 million and above—should think critically and creatively now about how they would respond to such an inquiry. Gather the supporting records and preserve them.

The SBA’s IFR also states that it may undertake a review of any size loan, at any time. The IFR further emphasizes that the forgiveness application requires borrowers to retain “documentation supporting the Borrower’s certifications as to the necessity of the loan request and its eligibility for a PPP loan” for six years after forgiveness or repayment in full. These statements are important for at least three reasons.

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First, they suggest that an initial SBA determination to grant forgiveness and pay the lender isn’t necessarily final as regards the borrower. The SBA or other enforcement agencies could potentially open or reopen a PPP loan audit years after forgiveness or repayment occurred.

Second, they imply that the information supporting the certifications should be identified, collected, and preserved by the borrower by the time of the forgiveness application. Because borrowers are not expressly required to submit supporting documents for the necessity certification with the forgiveness application, borrowers may not appreciate the importance of collecting contemporaneous information while it is still fresh and readily available.

Third, it remains unclear how the SBA will test a borrower’s facts and circumstances against the necessity certification. Fundamental fairness and due process would seem to require that the SBA notify the borrower and give it an opportunity to submit and be heard on the issue. But how specific will the SBA be with its requests or setting a standard against which the additional information will be measured? Will it request specific documents, focus on particular financial information, or simply ask the borrower in a general way to substantiate its eligibility or necessity certification? The SBA’s approach could vary depending on the nature of the inquiry or the circumstances that prompted it. Notwithstanding how the SBA proceeds, the burden will be on the borrower to demonstrate the basis for the necessity certification.

Make Your Best Case and Build a Solid Record

There may be a myriad of facts or circumstances that led a particular borrower to make its necessity certification. Some may be obvious based on financial performance, loss of significant customers, supplier closures, or loss of distribution networks. Others may be equally or more impactful on the analysis, but less observable in straight financial data. Would tapping cash reserves or facial liquidity risk breaching loan covenants or trigger cross-default provisions? Was the business facing potential loss of key talent or personnel that would be significantly detrimental to the business if not retained? What were the warnings from experts or recognized trade groups about future business operations or recoveries for your market and industry? What kinds of calls and emails were you receiving from your customers and suppliers?

Borrowers also need to be careful relying solely on financial data, particularly annualized data, because it could mask the true depth of the realities and uncertainties facing the business when the borrower sought the loan. Weekly or monthly data may tell a very different story than the year-end numbers. Consider, for example, a manufacturing company that was facing potential ruin in April 2020 as order after order was canceled. But the year-end financials end up being consistent with prior years or perhaps even show improvement. How will the borrower explain its necessity certification if called upon by the SBA to do so? Perhaps the PPP loan not only enabled the company to survive, but the proceeds afforded the business the financial cushion it needed to retain its personnel, pay its mortgage, and keep the lights on. That loan may have allowed the company to use those personnel and its other limited resources to successfully rearrange its business operations to manufacture other products and restore the revenue stream. That may be the reality, and is very much within the purpose and intent of the CARES Act, but will the borrower be able to explain and demonstrate that reality with evidence if the SBA asks for it?

If the SBA concludes the borrower was ineligible for the loan or unable to demonstrate the basis for its necessity certification, forgiveness will be denied and the loan will need to be repaid in full. That could be millions of dollars for some borrowers. Borrowers facing a forgiveness denial of that magnitude will surely consider filing an administrative appeal. But

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as explained in our **Borrower Beware III Alert**, 30 days is a small window in which to frame an Appeal Petition detailing and supporting the reasons, and meeting the burden of proof on an appeal could prove challenging for borrowers who failed to build a strong Administrative Record and case before the SBA. The latter may prove particularly true for the amorphous necessity certification. Borrowers should therefore endeavor to make their best case to the SBA during the audit process, complete with supporting documentation that tells their individual stories.

For PPP borrowers in the \$2 million and up club, you know an audit is coming. That means investing time and effort now to prepare for the inevitable inquiry. Can you afford not to? Forgiveness may depend on it.

If you have questions about the PPP or how you can implement strategies to better protect your business from SBA review or other government scrutiny, please call Jason Markel (716.848.1395), Reetuparna Dutta (716.848.1626), or Benjamin Zuffranieri (716.848.1469).

Please check our Coronavirus Resource Center and our CARES Act page to access information related to both of these rapidly evolving topics.

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