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PPP Loan Good Faith Certification: Now What?

By Ted R. Batson, Jr., Partner and Tax Counsel

As we previously reported, U.S. Treasury Secretary Steven Mnuchin has announced that the Small Business Administration (SBA) will perform a "full audit" of the loan applications of all recipients of Paycheck Protection Program (PPP) loans of more than $2 million. According to the *Wall Street Journal*, loans for smaller amounts will be subject to "spot checks."

These announcements were followed by the SBA's release of PPP loan FAQs 31 and 37,[1] which state that access to other sources of liquidity without significant detriment to an entity's operations is a factor in assessing whether it could, in good faith, make the required certification. These FAQs make it clear that this standard applies equally to public and private companies, including nonprofit organizations.

So what should nonprofits do now? This article provides a framework for analyzing the PPP loan good faith certification requirement and how your organization can assess and document your decision to sign off on the certification during the loan application process.

Background

Secretary Mnuchin's remarks were made in the wake of the disclosure that a number of publicly traded companies and private companies, including Shake Shack and the Los Angeles Lakers, had received PPP loans.

The certification in question reads as follows:

> Current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant.

This certification naturally breaks into two elements:

1. "Current economic uncertainty" (the uncertainty element); and
2. "Necessary to support the ongoing operations" (necessity element).

Among the challenges organizations have consistently faced in understanding their obligations under the PPP loan program is the pervasive lack of timely guidance. Early discussions around the certification focused on the uncertainty element. Now that the program has been in operation (with funding for phase 1 running out after only two weeks) and high-profile recipients have been unveiled, hindsight is generating new attention on the necessity element. However, prior to the SBA issuing FAQ 31 on April 23, 2020, there was no guidance on how to assess the elements of the certification. Furthermore, FAQ 31 continues to raise questions, as we'll discuss below.

FAQ 31

FAQ 31 introduced the first SBA guidance regarding the good faith certification, specifying that:

> [b]orrowers 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.

The specific new elements introduced by this standard are:

1. An organization's "current business activity" (currency element);
2. An organization's "ability to access other sources of liquidity sufficient to support... ongoing operations" (alternate sources of liquidity element); and
3. Access to alternate sources of liquidity "in a manner that is not significantly detrimental to the business" (significant detriment element).

All three of these new elements continue to suffer from a lack of definition. In assessing an organization's current business activity, the time period covered by the word

[1] FAQ 37 simply applies FAQ 31 to private companies.

"current" is undefined. There are several possible definitions for this time period. The common accounting definition of "current" is "within the next 12 months." The CARES Act defines the "covered period" for PPP loan funds usage as the eight-week period commencing on the date loan funds are disbursed. In addition, the CARES Act uses June 30, 2020 as the terminal date for defining the period in which headcount and/or wages and salaries must be restored to pre-COVID 19 levels. Without a definition of "current," it is difficult to assess the level of liquidity to be considered.

As to alternate sources of liquidity, in the context of publicly traded companies, FAQ 31 specifically alludes to access to capital markets, an option foreclosed to nonprofit organizations. However, nonprofit organizations may have unrestricted cash reserves and access to credit facilities, such as lines of credit. The currently available guidance does not tell us whether nonprofit organizations must consider these resources as alternate sources of liquidity when applying for a PPP loan.

Finally, organizations are instructed that alternate sources of liquidity must be available "in a manner that is not significantly detrimental to the business." There are two concerns with this. First, there is no definition of what is meant by the term "manner." Presumably, this alludes to the existence or nonexistence of barriers to obtaining an alternate source of funding. Such barriers might include a lengthy loan underwriting process, a requirement to pledge organization assets as collateral, a requirement for personal guarantees, or other similar requirements.

Second, the term "significantly detrimental" is undefined. What degree of detriment suffices to reach a "significant' degree? Without definition, organizations are left to speculate.

With this background, let's now turn to the context in which your organization should assess the validity of your certification.

Context Matters

Hindsight is said to be 20/20. But the relevant context for assessing the validity of your organization's certification is the facts and circumstances that existed on the date your organization's representative signed the certification. This includes your understanding of the requirements for eligibility for obtaining a PPP loan, supported by documentation of your due diligence on this point.

A Framework for Assessing Your Situation

As an initial point, make sure that when you're assessing the appropriateness of your organization's PPP loan application certification you do so holistically, considering not only the certification's necessity element but also the uncertainty element. With that background in mind, following these steps is a suggested approach:

1. Describe your organization's situation at the time of your loan application.
2. Identify all sources of available cash, including unrestricted reserves and untapped credit facilities.
3. Forecast your future operations, with and without the PPP loan, through June 30, 2020 and through December 31, 2020.
4. Compare current-year activity through the date of application with prior-year activity for the same period.
5. Identify other considerations, such as your ability to retain staff regardless of activity levels.

Let's look at each of these elements in further detail.

Describe your organization's situation

When preparing a narrative of your organization's situation at the time of your loan application, there are a number of factors to consider. First, document your understanding of the eligibility requirements and any due diligence you performed with respect to your eligibility to receive a PPP loan. Include any contemporaneous discussions you may have had regarding the certification.

Second, document your perception of the nature of the uncertainty COVID-19 would have on your organization's activities. Consider:

- The impact of social distancing measures and government stay-at-home orders on the delivery of your services;
- The impact of social distancing measures, government stay-at-home orders, and unemployment on giving; and
- How changes in the delivery of your services and giving would impact your staffing needs.

Identify all sources of available cash

The necessity element, as addressed by FAQ 31, appears to focus on available cash resources. Therefore, to assess your need for a PPP loan, you should understand your organization's access to cash. This will include unrestricted cash reserves, untapped lines of credit, friendly banking relationships, and other similar sources of assistance, all as they existed at the time of your organization's loan application.

Note that legal restrictions imposed by the Uniform Prudent Management of Institutional Funds Act should make restricted cash reserves unavailable in this context. This rule includes both endowed funds as well as any other funds encumbered with a donor restriction that is not subject to a variance power vested in your organization, including building funds, funds received for short-term mission trips that have been canceled (they most likely must still be used for a future mission trip), and other similar donor restrictions. However, board-designated funds, rainy-day funds, and other similar organization set-asides should be included. It is likely that any donor-advised funds are also includable, as such funds are generally understood to be free of a donor restriction.

Finally, the mere existence of available cash is only half of the equation. Your need for these reserves for operations must also be considered. That is the next element in the analytical framework.

Forecast your future operations, with and without the PPP loan

Having identified your available cash resources, next forecast your organization's future operations with and without the PPP loan, based on what you knew at the time your organization applied for its PPP loan. This forecast should take into account estimates of future cash receipts from contributions and operations as well as expenses. It should also account for any expected furloughs or layoffs based on activity levels or other considerations. In addition, include the impact of any industry surveys or uncertainty (e.g., surveys showing declines in church offerings or press reports of uncertainty in fall college enrollment). Finally, identify any areas in the forecast that are particularly sensitive to COVID-19 uncertainty.

To the extent you prepared 2020 forecasts before COVID-19 to which you can compare these post-COVID-19 forecasts, you will be able to further identify and highlight the impact of COVID-19 on your activities, an exercise which may allow you to further highlight the necessity of the PPP loan funds. In addition, to the extent your aggregate cash reserves include funds reserved to fund strategic initiatives, planned capital projects, and other similar planning objectives, your forecast should consider the degree to which shifting these funds to cover current operating needs would constitute a significant detriment to your organization.

We recommend that this forecast cover the period through June 30, 2020 and December 31, 2020 to establish an adequate planning horizon. This also accounts for uncertainty surrounding the longer-term impact of COVID-19 on operations.

Compare current-year activity through the date of application with prior-year activity for the same period

A comparison of current-year activity through the date of application versus the same period in the prior year will set the context in which your organization's leadership is making decisions about the future of 2020. In this analysis, focus particularly on cash receipts and changes in your service levels.

Other considerations

Finally, document any additional considerations that may have caused you to find it necessary to apply for a PPP loan. For example, you can document factors such as:

- The fact that prudence would have argued for furloughs or layoffs in the absence of a PPP loan
- The fact that retaining skilled and trained employees is an overriding concern
- The fact that unemployment among your donor base is widespread
- The nature and impact of any substantial disruption your organization has experienced due to moving to delivering services online
- The fact that your organization is ramping up community engagement in light of COVID-19
- Any steps your organization took to reduce your loan amount
- Any contractual obligations that create a claim on your cash reserves (e.g., a future contract payment coming due later in 2020 or a loan covenant requiring certain levels of cash reserves)

Any contemporaneous documentation of plans or conversations surrounding any of the factors outlined above is valuable. For example, if your board discussed layoffs and perhaps had formulated a plan for layoffs prior to obtaining your PPP loan, this is more powerful support than an after-the-fact memorandum documenting prior conversations. (Although such an after-the-fact memorandum prepared now would be better than something prepared at the time of an audit.)

As a final thought, document your procedures for ensuring the PPP loan is used for permissible expenses (i.e., payroll costs, mortgage interest payments, rent, and utilities).

What to Do After Your Analysis Is Complete

Once your analysis is complete, your leadership should assess whether it believes the analysis supports the assertion that, given the uncertainty of current economic conditions, the loan request is necessary to support your organization's ongoing operations. If the answer to this is "Yes," file your documentation away so it's ready if you receive word that your loan application will be audited.

However, if your analysis does not support the assertion, you should evaluate whether your organization should return the loan funds. If you return the funds by May 18, 2020, the SBA has stated that it will deem your loan application to have been filed in good faith. (Note that the original date was May 7 and then May 14, but in FAQ 47, issued on May 13, the SBA stated that the date has been extended to May 18. You do not need to apply for this extension.)

If the results of your analysis are ambiguous, then your leadership will need to determine its tolerance for risk in consultation with your legal counsel.

What to Do if the SBA Finds You Did Not Meet the Necessity Element

Press reports have stated that organizations that cannot demonstrate they needed their PPP loan will not receive loan forgiveness. This would mean that they would simply have a 1% loan for two years.

Alternatively, the SBA could, in theory, conceivably demand immediate repayment if it determined a borrower was not eligible to receive a PPP loan in the first place. Finally, the first interim rule reminded loan applicants that "knowingly" making a false statement to obtain a PPP loan could result in criminal sanctions, including fines and imprisonment. Given the lack of authoritative guidance in this area, it is hard to imagine how anyone attempting to be compliant could meet the "knowing" standard for criminal sanctions to be realistically imposed.

You should consult your legal counsel regarding your risk that such sanctions could apply to your organization or its officers, or both.

The Burden of Compliance Is On the Borrower, Not the Lender

The PPP loan program is characterized by shifting the burden of compliance from the lender to the borrower. FAQ 31 specifically states that "[l]enders may rely on a borrower's certification regarding the necessity of the loan request." Thus, lender approval of the loan is not useful for the purpose of satisfying the good faith certification.

Please contact us online or at info@capincrouse.com with any questions.

This article was updated on May 6 and May 15, 2020, to reflect additional guidance provided by the SBA.

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Note: Although licensed to practice law in Indiana, Ted's services through CapinCrouse do not involve the practice of law and consequently do not result in the creation of an attorney-client relationship.

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