

Congratulations, You Got Your PPP Funds! Now What?

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Late last month, the federal government committed \$349 billion dollars in forgivable loans to small businesses under the Paycheck Protection Program (“PPP”), which was part of the Coronavirus Aid, Relief, and Economic Stability Act (the “CARES Act”). Under the PPP, eligible small businesses have been able to borrow two and one-half months of payroll costs, up to \$10 million, from banks and other financial institutions approved by the U.S. Small Business Administration (“SBA”) in order to fund payroll costs, rent, utilities, and certain other operating-related expenses (“Qualified Expenses”) incurred eight weeks after the loan is disbursed (“Covered Period”).

Many small businesses quickly saw the advantage of the generous terms of PPP capital not requiring collateral, personal guarantees, or SBA fees and providing a six-month deferment period at a fixed interest rate of 1%. **On Thursday, April 16, 2020, the SBA announced it is no longer accepting applications because it had already approved the \$349 billion allotted for the program (although it seems that Congress may add another \$300 billion to the PPP in coming weeks).** Approved borrowers have started to receive the proceeds of the loans, beginning the eight week Covered Period within which to spend the proceeds in order to qualify for loan forgiveness. As we enter the disbursement phase, borrowers need to focus on how to properly spend the money to maximize forgiveness and avoid potential problems in the future, when the government reviews the disbursements under the program. The SBA is required by the CARES Act to provide guidance on the implementation of the loan forgiveness feature by April 26, 2020.

Proper Use of PPP Funds

The PPP is a massive program that was very quickly rolled out with minimal supervision and review of the loan applications – a primary objective of the program was to inject a large amount of money into the economy quickly. There are undoubtedly some businesses that will take improper advantage of this loan program, and 2021 will likely see enforcement actions aimed at those engaged in fraud under the PPP. Given how quickly this was rolled out, there will also inevitably be those who inadvertently don't follow the rules and will find themselves trying not to be lumped in with those who committed actual fraud. Borrowers should protect themselves from liability by ensuring PPP funds are used only for authorized purposes.

The basic idea behind the use of the PPP proceeds is simple: **Borrowers should use the money quickly, mostly to pay employees, and should bring their workforce levels back to pre-pandemic levels, if possible.** That may be a challenge for many recipients given the rapidly changing COVID-19 environment, and the law anticipates that borrowers may not be able to spend all the money in the time frame indicated for the purposes indicated. As borrowers analyze the various options available, they should keep in mind that in applying for the PPP loan, the borrower needed to certify in good faith that “current economic uncertainty makes this loan request **necessary** to support the **ongoing operations** of the Applicant” and loan proceeds “will be used to retain workers and maintain payroll” (emphases added). Those responsible for enforcement and oversight will likely give a good deal of leeway to borrowers trying to navigate these very uncertain times, but will not look kindly on those who they determine did not obtain this money in good faith.

Under the CARES Act, PPP loan proceeds can lawfully be used for the various purposes of a normal SBA 7(a) loan, such as to provide working capital as well as to cover (1) payroll costs (as defined by the Act); (2) costs related to continuation of group health care benefits during periods of paid sick, medical, or family leave, as well as insurance premiums; (3) mortgage interest payments; (4) rent payments; (5) utility payments; (6) interest payments on other debt obligations incurred before February 15, 2020; and (7) refinancing an [SBA Economic Injury Disaster Loan](#) made between January 31, 2020, and April 3, 2020. CARES Act § 1102(f). The SBA has declared in its Interim Final Rule that 75% of the PPP loan proceeds must be spent on payroll costs.

If a borrower uses PPP funds for unauthorized purposes, the SBA will direct the borrower to repay those amounts. If a borrower knowingly uses the funds for unauthorized purposes, the borrower will be subject to additional liability charges for fraud. If a borrower uses funds for unauthorized purposes, the SBA will have recourse against the borrower's shareholders, members, or partner(s) for the unauthorized use.

Loan Forgiveness

Because the purpose of the program is to inject money quickly into the economy primarily by paying employees of small businesses, the PPP provides the opportunity for complete forgiveness of the PPP loan. **Those portions of the loan that are not spent quickly enough or for the right purposes must be repaid over two years**, but the idea is that these amounts should be small. Qualifying businesses will be eligible for loan forgiveness when PPP loan proceeds are spent on Qualified Expenses within the eight week Covered Period and at least 75% (the "75/25 Rule") of Qualified Expenses were payroll costs. The forgiven amount cannot exceed the principal amount of the PPP loan. CARES Act § 1106(d)(1).

Payroll Costs. The CARES Act defines payroll costs as Qualified Expenses. CARES Act § 1106(b)(1). For a business (as opposed to an independent contractor or sole proprietor), payroll costs are payments to employees that are (i) salary, wages, commissions, or similar compensation (up to an annualized \$100,000); (ii) cash tips or equivalent; (iii) vacation, parental, family medical, or sick leave (excluding payments for emergency paid sick leave or expanded family and medical leaves); (iv) separation or dismissal pay; (v) for group health insurance; (vi) retirement benefits; or (vii) state or local payroll tax (but not federal payroll tax). This definition raises some issues for borrowers.

- **How Are Working Partners or Working Members of an LLC Treated?** Under most traditional definitions of "employee," owners of a business such as partners and members of an LLC are not considered "employees." Nor, if there are several owners, are they "sole proprietors" or "independent contractors," which are separately addressed under the program. The question arises, therefore, whether payments to such owners who perform work for a small business are payroll costs under the PPP for which the borrower may seek forgiveness. The Treasury Department, in consultation with the SBA, issued [guidance](#) on April 6, 2020, that indicated that payments to such individuals may be included in payroll costs. Pre-PPP

cases under the SBA have indicated that owners who work at least 40 hours per month on the business may be considered employees for SBA purposes. We expect further guidance this week that may address this question. Borrowers should work closely with their accountants and counsel to properly calculate which such payments may be included.

- **What About Employee Bonuses and Raises?** The CARES Act and current SBA guidance remain unclear regarding employee bonuses and raises that would increase payroll costs that are not in the ordinary course of the business. If any borrower wants to use PPP proceeds on such payments, it should have and document a sound reason as to why such expenditures are “necessary to support the ongoing operations” of the business. Borrowers should also remain aware of the rules concerning the \$100,000 annualized basis limiting payments.
- **What About Payments or Prepayments?** The CARES Act provides that “[a]n eligible recipient shall be eligible for forgiveness of indebtedness on a covered loan in equal to the sum of the following costs incurred and payments made during the covered period payroll costs.” There has been some suggestion that the word “and” means that any payment must be both incurred and paid during the eight week period. This creates a problem because most bills, including payroll costs, are paid after they are incurred. Payroll, for example, is usually a week or two in arrears. We do not expect this to be a problem, particularly for payroll, but will likely get more clarity when further guidance from the SBA is released this week. Until that guidance has been issued, we recommend that borrowers not use loan proceeds for Qualified Expenses other than payroll costs incurred for periods that ended before the beginning of the month in which the loan was disbursed to the borrower.
- **Mortgage Interest.** The CARES Act defines any interest on indebtedness incurred in the ordinary course of business before February 15 that is a mortgage on real or personal property as a Qualified Expense. Principal payments or prepayments are excluded and therefore are not Qualified Expenses. CARES Act §§ 1106(a)(2) and (b)(2).
- **Rent Payments.** The CARES Act defines any payments of rent under a leasing agreement in force before February 15, 2020, as a Qualified Expense. CARES Act § 1106(b)(3). The CARES Act does not disqualify rent paid to family members or an insider relationship among parties so long as the lease for the property was in force before February 15, 2020. There is no current SBA guidance on late payments of past-due rent or prepayments of future rent. The requirement that the lease was in force as of February 15, 2020, could create problems for borrowers that have renegotiated their leases since that date, as, for example, in getting rent abatement from the

landlord due to the COVID-19 circumstances. Borrowers who have been approved for PPP loans should consider waiting until at least the expected SBA guidance comes out before entering into new lease arrangements. Businesses should maintain adequate records of rental payments.

- **Utilities.** The CARES Act defines utilities as electricity, gas, water, transportation, telephone, or internet access for which service began before February 15, 2020, as expenses which qualify for loan forgiveness (CARES Act § 1106(b)(4)), but it uses only the word “utilities” without any definition when setting out the allowable uses of loan proceeds. CARES Act § 1102(a)(2)(F)(i)(VI). However, there is ambiguity arising from whether utilities were intended to cover transportation, telephone, and internet expenses because they are listed with utilities. It is our presumption that the intention is that these costs are permissible Qualified Expenses, but we believe it prudent to await further guidance from the SBA on this issue.
- **Reduction in Forgiveness.** PPP loan forgiveness will be reduced (a) in proportion to the decrease in the average monthly full-time-equivalent employees (“FTEE”) during the Covered Period as compared to a reference period and (b) dollar for dollar for the amount of reduction in excess of 25% of the total salary and wages of any employee during the Covered Period as compared to a reference period. CARES Act §§ 1106(d)(2) and (d)(3).
 - **Employee Reductions.** The biggest driver of forgiveness of PPP loans is maintaining or restoring the borrower’s workforce to pre-pandemic levels. The PPP compares the average number of FTEEs that the borrower has each month during the Covered Period to the average number of monthly FTEEs the borrower employed during one of two base periods. The borrower may choose either (i) the period from February 15, 2019, to June 30, 2019, or (ii) the period from January 1, 2020, until February 29, 2020. As a practical matter, the borrower should calculate the number of FTEEs it had during both these periods and choose the period with the lower number of FTEEs. Because the PPP deals with FTEEs rather than specific individuals, whether people are hired or fired or replaced is irrelevant to the calculation. The easiest way to satisfy the 75/25 Rule is to bring the workforce back to base period levels as quickly as possible.
 - **Rehiring Employees.** The CARES Act has a limited exception to the forgiveness reduction that accompanies a reduction in the workforce from pre-pandemic base levels. To the extent that all or part of the reduction in FTEEs occurred between February 15, 2020, and April 26, 2020, and the borrower “eliminates the reduction in the number of” FTEEs by June 30, then the amount of loan forgiveness shall be determined without regard to the reduction in FTEEs that occurred

between February 15, 2020, and April 26, 2020. This may end up being all or a substantial portion of the FTEE reduction, which would result in an increase in the forgiveness amount. Satisfying the 75/25 Rule, however, will require that a lot of the workforce be active during the eight week Covered Period. Even given this ability to “wipe away” certain FTEE reductions by June 30, 2020, so it is not a panacea. We expect that the SBA guidance due this week will address with more precision what it means to “eliminate” a reduction in FTEEs by June 30, 2020; however, we can be sure it is unlikely to mean that borrowers may rehire people on June 28, 2020, and lay them off again on July 2, 2020, for example.

- **Salary Reductions.** Forgiveness is reduced by the amount of any reduction in total salary or wages of any employee (except employees who made more than \$100,000 in 2019) during the Covered Period that is in excess of 25% of the total salary or wages of the employee during the most recent quarter that the employee was employed before the Covered Period. Unlike the total number of employees, which is based on FTEEs, this reduction looks at individual employees for whom the borrower has reduced pay. This section of the CARES Act makes it possible for businesses to reduce wages without having to report a salary reduction, but reducing salary wages would make it harder for businesses to meet the 75/25 Rule required for loan forgiveness. Salary reductions can also be eliminated by June 30, 2020, which then eliminates this reduction. Again, we expect more guidance on this issue this week.

Each borrower needs to weigh carefully its ongoing liquidity needs beyond the eight week Covered Period against the benefit of maximizing the loan forgiveness feature. It may often be prudent for a borrower to forgo loan forgiveness and preserve cash to fund its operations into the late summer and fall.

Mechanics. As soon as practical after the Covered Period, a borrower must submit to the lender that is servicing the PPP loan an application for loan forgiveness, which will include (a) documentation verifying the number of **FTEEs** on payroll and pay rates for the Covered Period and the applicable reference period, including (i) payroll tax filings reported to the IRS and (ii) state income, payroll, and unemployment insurance filings; (b) documentation, including canceled checks, payment receipts, transcripts of accounts, or other documents verifying payments on covered mortgage obligations, payments on covered lease obligations, and covered utility

payments; (c) a certification from the borrower that (i) the documentation presented is true and correct; and (ii) the amount for which forgiveness is requested was used to retain employees, make interest payments on a covered mortgage obligation, make payments on a covered rent obligation, or make covered utility payments; and (d) any other documentation the SBA determines necessary. The lender will have up to 60 days to issue a decision on the loan forgiveness application. We expect further guidance from the SBA on this process. CARES Act § 1106(e) and (g).