“Need” Requirement for Paycheck Protection Program Loan

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Within the past two weeks, legislators, regulators, the media and the public have questioned the need for public companies and other larger companies to participate in the PPP. In particular, stakeholders have focused on the certification in the PPP application that “[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the [a]pplicant.”

In response to the scrutiny of Phase 1 loan recipients, on April 23, 2020, the SBA added Question 31 to its PPP Frequently Asked Questions (FAQ #31). FAQ #31 provides that “borrowers must assess their economic need for a PPP loan under the standard established by the CARES Act and the PPP regulations at the time of the loan application.” This guidance further states that when making this certification, borrowers should consider “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.” FAQ #31 then states that “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 the certification.” Finally, this guidance states that “[a]ny borrower that applied for a PPP loan prior to April 23, 2020 and repays the loan in full by May 7, 2020 will be deemed by SBA to have made the required certification in good faith.” However, revised guidance was provided by the SBA stating that the May 7th safe harbor date has been extended to May 14th.

On April 24, 2020, President Trump signed the Paycheck Protection Program and Health Care Enhancement Act, which provided $310 billion in additional funding for the PPP.

On April 28, 2020, the SBA added Question 37 to its PPP Frequently Asked Questions (FAQ #37). FAQ #37 builds on FAQ #31 (referenced above) by providing that “businesses owned by private companies with adequate sources of liquidity to support the business’s ongoing operations … [should] see response to FAQ #31.”

Additionally, on April 29, 2020, the SBA added Question 39 to its PPP Frequently Asked Questions (FAQ #39). FAQ 39 provides that “[t]o further ensure PPP loans are limited to eligible borrowers in need, the SBA has decided … that it will review all loans in excess of $2,000,000, in addition to other loans as appropriate, following the lender’s submission of the borrower’s loan forgiveness application. Additional guidance implementing this procedure will be forthcoming.”

The PPP Frequently Asked Questions do not define what level of market value would be considered “substantial.” Furthermore, they provide little guidance on what constitutes “access to capital markets." Nevertheless, the threat of a federal investigation should be taken seriously, given the expense, management distraction, and reputational harm that could result, even if the company's PPP application complied with all applicable requirements.

Approach to PPP Participation by Public, Large Companies and Private Companies

In light of the updated SBA guidance and increased scrutiny of PPP loan recipients, we believe that public, large companies and private companies should implement certain "best practices" in determining whether to apply for a loan under Phase 2 of the PPP, or in determining whether to repay a PPP loan funded in Phase 1:

1. **<u>Determine Need</u>**

   First, borrowers and prospective borrowers should consider FAQ #31 and analyze their ability to provide the need certification. In order to do so, borrowers and prospective borrowers should gather their accounting, finance, legal and operational teams and analyze the business activity and sources of liquidity at the time of the application.

   > *Current Business Activity*. The working group should discuss in detail the impact of the COVID-19 pandemic on the company's operations, including customer demand, supply constraints, required or recommended restrictions on operations and employee dislocation.
   >
   > *Sources of Liquidity*. Next, the working group should examine the company's sources of liquidity. The finance and legal teams should describe the company's ability to obtain equity financing. For a private company, the working group should examine the company's LLC Operating Agreement to determine whether members are required to contribute additional capital. For a public company, the working group should consider whether the company has effectively accessed equity markets in the last two to three years and whether there is a realistic ability to access the equity markets on commercially reasonable terms given the current state of the markets.

   Also, the working group should examine the company's access to debt financing on commercially reasonable terms given the current state of the markets. The finance team should report to the working group on the company's ability to access lines of credit or other debt financing, including whether the COVID-19 pandemic has caused the company to breach any of its loan covenants.

   After examining the availability of sources of liquidity, the working group should consider the potential terms of such financing sources. FAQ #31 indicates that borrowers should focus their review on "sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business." We believe this means that applicants need only consider reasonable sources of liquidity. Therefore, if available liquidity would require the company to issue significant amounts of equity at unfavorable valuations, accept lending arrangements with high interest rates or other unfavorable and potentially severely restrictive terms, or sell off a portion of the company's assets to raise sufficient liquidity, the applicant should still be able to satisfy the need requirement for participating in the PPP.

If a public, large company, or private company believes that it can demonstrate the requisite need, it should memorialize all relevant facts so that it has a record of its current situation that can be used to defend itself against future scrutiny. If a public, large company, or private company does not believe that it can demonstrate the requisite "need," or concludes that the benefit of receiving a PPP loan would be outweighed by the potential reputational harm that may result from adverse political, media and public reaction, it should consider returning Phase 1 funds or not applying for Phase 2 funds.

2. Consider the Political, Media and Public Reaction

Once a public, large company or private company has determined that it can properly provide the "need" certification and otherwise qualifies for a PPP loan, it should weigh the benefit of PPP funds against the political, media and public reaction to participating in the program. In particular, public and large companies should consider whether they have or plan to furlough employees, terminate employees or reduce employee compensation. The primary legislative purpose of the PPP was to provide funds to small businesses so that they would forego or limit employee terminations and furloughs during the COVID-19 pandemic. If a borrower plans to use the funds for authorized purposes under the PPP (e.g., payments of interest on mortgage obligations, rent, utilities and interest on any other debt obligations that were incurred before February 15, 2020), but terminates or furloughs large portions of its employee base, it will be subject to increased scrutiny even though there is no requirement in the PPP to use the proceeds primarily for payroll expenses, unless the company expects to seek forgiveness of the loan.

Public and large companies also should consider other factors that would increase scrutiny of their participation in the program. For instance, even though participation in the PPP does not impose explicit limitations on executive compensation or stock buybacks (unlike other loan assistance programs under the CARES Act such as the Main Street Lending Program), large executive compensation and stock buybacks would be fertile ground for criticism of PPP participants. Therefore, borrowers should consider their history and future plans for executive compensation payments and stock buybacks before retaining Phase 1 funds or borrowing funds under Phase 2.

In addition, a company borrower should consider its financial results for the first quarter of 2020 and expected financial results for the remainder of the year. If a company expects to experience strong results for the first quarter 2020, it should be ready to explain such achievement in its earnings release (if applicable) and Form 10-Q (again, if applicable), and it should highlight that the impact of COVID-19 was not fully realized in the first quarter, but that it expects to feel an impact in the second quarter and in future quarters.

3. **Communicate with Your Board**

Depending on the size of the loan and other factors, some borrowers may need approval of their Board of Directors or other governing body. In connection with such approval, we believe the determination of need should be presented to, and considered by, the Board or governing body. Even if a business is not required to seek the approval of its Board or governing body, the officers or managers of the business should communicate their intention to participate in the program and should strongly consider securing board approval in any event given the possibility of regulatory and media scrutiny.

4. **Develop an Effective Communication Strategy**

The PPP application states that information about PPP loans, including borrower name and loan amount, is subject to public disclosure under the Freedom of Information Act. In furtherance thereof, on April 23, 2020, the Federal Reserve announced that it will report substantial amounts of information on a monthly basis for the liquidity and lending facilities using CARES Act funding, including the:

- Names and details of participants in each facility;
- Amounts borrowed and interest rate charged; and
- Overall costs, revenues, and fees for each facility.

Therefore, borrowers should develop a communication strategy to prepare for the eventual public disclosure of their participation in the PPP. In particular, borrowers should be able to: (i) describe how COVID-19 has impacted, and is reasonably expected to impact, their business; (ii) communicate the need for the PPP loan; and (iii) indicate the uses of the PPP proceeds, particularly as they relate to employee retention and remuneration.

Summary

The foregoing is not meant to discourage any eligible business from participating in the PPP. However, eligibility in the program and the potential related scrutiny and institutional reputational harm should be carefully considered. Public, large companies and private companies should carefully document their need for participation in the program. In addition, public, large companies, and private companies should communicate with their Boards or governing bodies, consider public reaction to their participation and develop a strategy to communicate effectively with their stakeholders.

Market Reach

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