

## Preparing for SBA Questions in the Loan Forgiveness Review Process

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As many commercial businesses and nonprofit organizations are submitting their Paycheck Protection Program (“PPP”) loan forgiveness applications, considering the possibility of “second draw” loans, and looking back over 2020, it is a good time to discuss preparation for potential Small Business Administration (“SBA”) scrutiny. With potentially short timelines to respond to reviewer questions or an adverse decision, adequate preparation is essential.

### How We Got Here

When the PPP Loan Program was first implemented in the spring of 2020, we had little knowledge of how the coronavirus pandemic would affect the national economy and individual businesses. PPP loans were of great interest to both commercial businesses and nonprofits as a tool to weather the unknown. Borrowers approached their lenders in large numbers to submit applications for funds that were widely reported to quickly be running out.<sup>[1]</sup>

In the initial loan application rush, borrowers faced the challenge of complex federal rules. First, as eligibility was generally limited to small business concerns and certain nonprofit organizations with fewer than 500 employees,<sup>[2]</sup> taking into account complex SBA affiliation rules,<sup>[3]</sup> baseline eligibility was complicated for larger borrowers. In addition, loan calculations were complicated by the fact that maximum loan amounts were set at 2.5 times average monthly payroll costs under a very specific definition of what constituted “payroll costs.”<sup>[4]</sup>

A third challenge quickly arose out of the sheer popularity of the program. National media attention focused early on certain borrowers that seemed unlikely to need PPP loan support to maintain operations.<sup>[5]</sup> Under heightened public scrutiny, the SBA issued new guidance “clarifying,” a certification that every borrow was required to make in its loan application, namely that: “current economic uncertainty makes

this loan request necessary to support the ongoing operations of the Applicant.”<sup>[6]</sup> The new SBA guidance, issued on April 23, 2020, explained that, in making the certification, the borrower was “taking into account [its] current business activity and [its] access to other sources of liquidity sufficient to support [its] ongoing operations in a manner that [would] not [be] significantly detrimental to business.”<sup>[7]</sup>

The SBA’s clarification caused considerable concern to borrowers. In an apparent response to these concerns, by May 13, 2020, the pendulum swung back toward a middle ground in which the SBA announced that borrowers of amounts under \$2 million would be “deemed” to have made their economic uncertainty certifications in good faith.<sup>[8]</sup>

With loan proceeds being disbursed by lenders, attention shifted for many borrowers to proper use of the funds on forgiveness-eligible costs. As originally implemented, (i) only certain costs incurred or paid in a brief 8-week “covered period” would be eligible for forgiveness,<sup>[9]</sup> and (ii) a substantial portion of the funds had to be expended on “payroll costs.” Borrowers were again given some relief by yet another program change, this time by Congress. On June 5, 2020, the PPP Flexibility Act<sup>[10]</sup> established an option for borrowers to elect a 24-week covered period, rather than 8-week covered period;<sup>[11]</sup> making it, as a practical matter, fairly easy for most borrowers to expend all loan funds on eligible payroll costs and other costs unambiguously eligible for forgiveness.

The PPP Loan Program largely left the spotlight through the fall as borrowers expended their loan proceeds on “safe” costs, such as payroll and rent, and began to submit their loan forgiveness applications. In preparing forgiveness applications, the most complicated issue is determining whether overall expenses eligible to support loan forgiveness must be reduced due to certain workforce (full time employee (“FTE”)) or salary/wage reductions. Though on the one-hand helpful, Congress and the SBA have promulgated a complex web of exceptions and safe harbors with respect to these reductions. As of the SBA’s February 5, 2021, Federal Register recap of program rules, the rules, exceptions, and safe harbors in this area comprise three full pages of detailed discussion,<sup>[12]</sup> ranging from exceptions for employees who were terminated for cause or refused offers of rehire, to safe harbors where an organization’s compliance with Department of Health and Human Services (“HHS”), Centers for Disease Control (“CDC”), or Occupational Safety and Health Administration (“OSHA”) guidelines made a return to pre-coronavirus workforce levels impossible.<sup>[13]</sup>

Remaining a popular stimulus measure, on December 27, 2020, the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act,<sup>[14]</sup> created the possibility of “second draw” PPP loans for businesses and nonprofits with fewer than 300 employees that already had received a PPP loan, but that could demonstrate reductions in gross receipts of twenty-five percent (25%) for 2020 or any quarter therein, as compared to the same time period in 2019.<sup>[15]</sup>

Against this backdrop, we are left to question where the SBA will land on some of the more complicated issues that borrowers faced in submitting their loan applications and loan forgiveness applications. Since that is something we can speculate about but not truly know, now is a good time to become familiar with the SBA loan forgiveness review process, including borrower rights to appeal unfavorable decisions.

## **Loan Forgiveness Review Process**

Borrowers request loan forgiveness by submitting a loan forgiveness application in a form prescribed by the SBA<sup>[16]</sup> with supporting documentation.

For each borrower that borrowed \$2 million or more, lenders have been instructed to require borrowers to submit, either before or with the loan forgiveness application, an SBA “Loan Necessity Questionnaire” (SBA Form 3509 for commercial businesses and Form 3510 for nonprofit organizations). This form calls for financial information comparing the borrower’s 2020 financial performance to its 2019 financial performance, to “inform SBA’s review of [the borrower’s] good-faith certification that economic uncertainty made [its] loan request necessary to support [its] ongoing operations.”<sup>[17]</sup> Though no specific element of these questionnaires will necessitate a particular determination, they appear calculated to hone the SBA’s focus on grantees for which 2020 activities and financial performance might indicate the loan was unnecessary.

Upon submission of loan forgiveness applications, lenders have sixty (60) days to reach preliminary decisions and forward them to the SBA.<sup>[18]</sup> The SBA will review the loan forgiveness applications and lenders’ decisions and, within ninety (90) days, notify the cognizant lender of whether a loan will be forgiven, *i.e.*, paid off by the SBA, in whole or in part.<sup>[19]</sup>

The SBA has stated that borrowers will have an opportunity to respond to SBA questions in the course of the review process, with SBA sending requests for additional information either directly to the borrower or via lenders.<sup>[20]</sup> As explained by the SBA in its February 5, 2021, Federal Register notice:

If SBA determines in the course of its review that the borrow was ineligible for the PPP loan under the statute, the SBA rules or guidance available at the time of the borrower's PPP loan application (for example, because the borrower lacked an adequate basis for the certifications it made in its PPP loan application), the loan will not be eligible for forgiveness. The lender must notify the borrower of the forgiveness amount. If only a portion of the loan is forgiven, or if the forgiveness request is denied, any remaining balance due on the loan must be repaid by the borrower on or before the maturity date of the loan.<sup>[21]</sup>

While the SBA's guidance does not describe all details of its internal review process, it does provide some useful insights from which we can surmise:

- + The SBA will likely review original loan applications as part of the loan forgiveness review process, focusing in particular on loans over \$2 million. For most borrowers, this review is likely to be the first time the SBA has looked directly at their loan documentation.
- + Given the flexibility created by the PPP Flexibility Act and subsequent SBA guidance on spending loan proceeds, the compliance areas most ripe for SBA scrutiny will be: (i) initial eligibility of borrowers (including interpretation of affiliation rules for larger borrowers); (ii) economic uncertainty certifications in loan applications, and; (iii) eligibility for workforce and salary reduction exemptions and safe harbors.
- + If the SBA has questions during the loan review process, it is likely to ask the lender to contact the borrower for more information before rendering a final decision. Adverse decisions by the SBA are likely to be initially communicated to borrowers via their lenders.

## **SBA Appeal Process**

A formal appeal process has been established for borrowers to challenge adverse SBA decisions.<sup>[22]</sup> This process has been codified in the Code of Federal Regulations

at 13 C.F.R. Part 134, Subpart L, employing SBA's Office of Hearings and Appeals ("OHA").

An administrative judge or administrative law judge from OHA will preside over each appeal, generally as a matter of paper record review and without any oral hearing.<sup>[23]</sup> Importantly, OHA's standard of review will be the very high bar of whether the SBA's "loan review decision was based on clear error of fact or law" with the borrower bearing the burden of proof.<sup>[24]</sup>

Though this article is not intended to convey all aspects of an appeal, key aspects with which borrowers should be familiar in advance are:

- + The appealable decision must be a "final written decision" of the SBA.<sup>[25]</sup> This means that a borrower should promptly obtain any underlying final SBA decision if it is not provided along with any adverse communication by their lender.
- + The borrower has only 30 days to file an appeal petition after receipt of a "final SBA loan review decision, or notification by the lender of the final SBA loan review decision, whichever is earlier."<sup>[26]</sup>
- + The appeal petition must, among other things, contain "[a] full and specific statement as to why the SBA loan review decision is alleged to be erroneous, together with all factual information and legal arguments supporting the allegations." Yet, it must not exceed 20 pages (not including attachments).<sup>[27]</sup>
- + The petition must be accompanied by signed tax returns relevant to the expenses and loan at issue if those returns were not already included in the relevant PPP loan application and/or PPP loan forgiveness application.<sup>[28]</sup>
- + Generally, within 20 days of commencement of the appeal, SBA will be required to provide to the borrower/appellant the "administrative record" upon which it made its determination.<sup>[29]</sup> The appellant will have only 10 days from receipt of a copy of the record to assert that the record contains errors or relevant documents are missing.<sup>[30]</sup>
- + The administrative judge will also set a date for "close of record," generally within 45 days of appeal commencement, by which date SBA officials will be required to respond to the borrower's petition.<sup>[31]</sup> Importantly, according to

the PPP loan appeal regulations, borrowers will generally not be permitted any reply to the SBA's response.<sup>[32]</sup>

- + OHA's initial decision is subject to further review by the Administrator of the SBA upon request by the borrower. The SBA regulations state that to exhaust one's administrative remedies, generally a prerequisite to judicial review, this additional request for Administrator review must be made.<sup>[33]</sup>
- + A challenge in federal court will likely be under the judicial review provisions of the Administrative Procedure Act ("APA"). The APA generally presents another high bar of proving, on the basis of the administrative record developed in the SBA appeal process, that the SBA's final decision was arbitrary, capricious, or contrary to law.<sup>[34]</sup>

As can be seen from the above, from the first moment any indication of an adverse decision is received, the borrower must be extraordinarily vigilant to avoid inadvertent waivers of rights. Moreover, the borrower must be prepared to rapidly prepare its arguments and gather evidence in support of those arguments.

This leads us to consider what a borrower can do now to be ready for any adverse decision that may be rendered later.

## How to Get Ready Now

As we advise our clients, every response to an audit or review really starts with what you did in the normal course of business that is now under audit or review – in this case submitting the loan application and expending the loan proceeds. To this end, documentation of eligibility, calculation of maximum loan amount, and the circumstances constituting economic uncertainty (*e.g.*, available liquid assets, cash flow projections, *etc.*) near in time to submission of the initial loan application will be the best possible evidence.

Understanding that, in the midst of the pandemic's early weeks, not every entity prepared such documentation (or at least did not do so in an organized manner) submitting its application, the following steps may now be helpful:

- + Create and maintain a single, clear file showing everything your organization submitted with its loan application and loan forgiveness application. If this information was submitted through an electronic portal controlled by your

lender, log in and print what you can. Consider requesting from your lender copies of everything submitted that cannot now be printed from your account.

- + Gather any written analysis of employee counts, affiliation determinations, and other key eligibility matters, generated internally or with the assistance of outside consultants or counsel in preparation for submission of the loan application.
- + To the extent possible, gather reliable financial-related information from the relevant time period and organize it in a comprehensive file. In particular, gather the following into a single orderly file:
  - Documentation of cash and non-cash assets reflecting your organization's degree of access to liquid assets as of the time of submission of the loan application (this may be as simple as generating reports as of the pertinent date from your financial management system);
  - Copies of any cash flow projections presented to senior management and/or your Board of Directors at, or near, the time of submission of the loan application;
  - Copies of any presentations or communications to employees about organizational expectations and workforce measures at the time of, and in the weeks after, submission of the loan application; and
  - Documentation of negotiations with landlords, creditors, and suppliers regarding economic uncertainty at the time of, and in the weeks after, submission of the loan application.
- + Gather documentation supporting any application of FTE and salary/wage reduction exemptions or safe harbors, including information from your organization's human resources department as necessary to support an exemption.
- + Take full advantage of any inquiry by the SBA during the loan forgiveness review process to prepare and provide robust support for your position. This opportunity will likely be your best opportunity to convince the SBA of your

position – especially considering the high bar embodied by the “clear error of fact or law” standard of review should your case have to be made through an OHA appeal.

- + If you have concerns that a particular aspect of your loan forgiveness application may be scrutinized, coordinate in advance with your legal counsel to facilitate the above-described file preparation and to avoid “getting up to speed” time when facing a 30-day filing deadline.

## Conclusion

Uncertainty has been a fact of life in the pandemic. Commercial businesses and nonprofit organizations alike have had to use all available tools, and a considerable degree of creativity, to ensure continuity of operations.

While federal programs such as the PPP have been extraordinarily helpful, they come with “strings attached” and the risk that what appeared a reasonable decision in March or April of 2020 will be second guessed as the emergency wanes. The best way to mitigate this inherent risk is to prepare your file demonstrating the circumstances faced at the time, and the reasonableness of the decisions made.

We recommend borrowers take the time now to gather and organize relevant records so that they are prepared to confidently answer any questions the SBA may pose in the loan forgiveness review process.

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[1] See Paycheck Protection Program Goes from Popular to Pariah, CBS News (May 11, 2020) *available at*: <https://www.cbsnews.com/news/paycheck-protection-program-ppp-loan-volume-demand/> (last visited Feb. 13, 2021).

[2] 15 U.S.C. § 636(a)(36)(D)(i) (setting forth eligible entities).

[3] *Id.* § 636(a)(36)(D)(vi) (applying SBA affiliation rules); see also SBA GUIDANCE DOCUMENT “APPLICABLE AFFILIATION RULES” (Apr. 3, 2020), *available at*: <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses> (last visited Feb. 13, 2021).

[4] *Id.* §§ 636(a)(36)(A) (defining payroll costs) and 636(a)(36)(A)(E) (setting maximum loan amount). See also SBA GUIDANCE DOCUMENT “HOW TO CALCULATE MAXIMUM LOAN AMOUNTS FOR FIRST DRAW PPP LOANS AND WHAT DOCUMENTS TO PROVIDE BY BUSINESS TYPE” (Revised Jan. 17, 2021), *available at*: <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses> (last visited Feb. 13, 2021).

[5] See Paycheck Protection Program Goes from Popular to Pariah, *supra* footnote 1.

[6] SBA FREQUENTLY ASKED QUESTIONS GUIDANCE DOCUMENT (“SBA FAQ”), FAQ No. 31, *available at*: <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses> (last visited Feb. 13, 2021).

[7] *Id.* Seemingly aware this was a new rule, SBA also implemented a safe harbor period during which borrowers could return their loans if they felt they did not meet the clarified standard.

[8] SBA FAQ No. 46. Complicating matters as the program rolled out rapidly in the midst of considerable uncertainty, lenders were largely absolved of liability for accuracy of the economic uncertainty certifications, reducing incentives for lenders to assist borrowers in gauging appropriateness of certifications. SBA FAQ No. 31 (“Lenders may rely on a borrower’s certification regarding the necessity of the loan request.”); Section 7A of the Small Business Act as re-designated by Section 304(b) of the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act, Pub. L. 116-260, Div. N, Title III, (Dec. 27, 2020).

[9] See 85 Fed. Reg. 20811, 20813-14 (Apr. 15, 2020).

[10] Pub. L. 116-142 (Jun. 5, 2020).

[11] *Id.* § 3 (amending § 1106 (now Section 7A of the Small Business Act) to define “covered period” as permitting 24-week covered periods).

[12] See 86 Fed. Reg. 8283, 8290-93 (Feb. 5, 2021); See also Loan Forgiveness Application (Form 3508) Instructions available at: <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses> (last visited Feb. 14, 2021).

[13] *Id.*

[14] Pub. L. 116-260, Div. N, Title III, (Dec. 27, 2020).

[15] 15 U.S.C. § 636(a)(37)(A)(iv); 86 Fed. Reg. 3712, 3713-14 (Jan. 14, 2021).

[16] The most formal form is SBA Form 3508. Simplified forms have been promulgated for small loans.

[17] SBA Form 3509 available at: <https://home.treasury.gov/policy-issues/cares/assistance-for-small-businesses> (last visited Feb. 15, 2021) and Form 3510 (Versions 1 and 2) available at: <https://www.sba.gov/document/sba-form-3510-paycheck-protection-program-loan-necessity-questionnaire-non-profit-borrowers> (last visited Feb. 12, 2021).

[18] 86 Fed. Reg. 8283, 8287-88 (Feb. 5, 2021).

[19] *Id.*

[20] *Id.* at 8285.

[21] *Id.* at 8288.

[22] 85 Fed. Reg. 52883, 52884 (Aug. 27, 2021). Note that lender decisions cannot be appealed through this process. However, SBA review of adverse lender decisions may be requested by borrowers as a first step in working toward this process. *Id.*

[23] 13 C.F.R. §§ 134.1206, 134.1207, and 134.1209.

[24] *Id.* § 134.1212.

[25] *Id.* § 134.1201.

[26] *Id.* § 134.1204 (emphasis added).

[27] *Id.* § 134.1202. Borrowers may identify confidential business information for protection from public disclosure under the Freedom of Information Act, 5 U.S.C. § 552, and to request its redaction in the final published OHA decision. *Id.* § 134.205(c) and (f).

[28] *Id.*

[29] *Id.* § 134.1206.

[30] *Id.* § 134.1207.

[31] *Id.* §§ 134.1206 and 134.1208.

[32] *Id.* § 134.1208.

[33] *Id.* §§ 134.1213 and 134.1216.

[34] 5 U.S.C. §§ 702 and 706.

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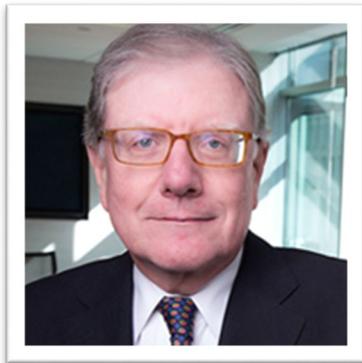
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