

May 6, 2020

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FEDERAL EMERGENCY RELIEF RISK MITIGATION: THE PAYCHECK PROTECTION PROGRAM

I. INTRODUCTION

On April 28, 2020, Treasury Secretary Mnuchin announced that the Small Business Association would be conducting a "full audit" of any loans over \$2 million made pursuant to the Paycheck Protection Program ("PPP") before those loans can be forgiven. The PPP was created as part of the CARES Act in response to the COVID-19 crisis. It was designed to help small U.S. companies retain their employees and offset certain operating costs through potentially forgivable loans. The PPP was developed and implemented in a matter of weeks and the funds set aside for the program were expended in a matter of days, with Congress appropriating additional funds approximately two weeks after the first tranche was exhausted.

History shows that each financial crisis spawns post-crisis law enforcement action. One example is the Special Inspector General for the Troubled Asset Relief Program (SIGTARP), designed to address fraud in connection with the 2008 TARP program, which sought to address the subprime mortgage crisis. SIGTARP has brought criminal charges against 438 individuals and entities

leading to 300 prison sentences and massive forfeiture orders. Twelve years later, SIGTARP is still in business.

The PPP will be no different. The PPP has already been the subject of substantial scrutiny amid allegations that funds were disbursed improperly or inequitably. Indeed, major institutions, like Harvard and the Los Angeles Lakers, and large or publicly traded companies, like Shake Shack, have even returned loans they received in response to public backlash. In response, Treasury issued new guidance—including a FAQ^[1] specifically addressing these concerns—reaffirming that an applicant's certifications as to qualification and necessity of any PPP loan are not to be taken lightly. Because of public pressure and the underlying interest in ensuring that public funds are administered properly, regulators and law enforcement, including the Special Inspector tasked with overseeing the administration of these funds, are likely to be especially committed to investigating and prosecuting potential fraud or misuse of funds disbursed through the PPP.

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¹ The FAQ is available [here](#). Of particular note are the following questions and responses: #31 ("Do businesses owned by large companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan? [Answer:] borrowers still must certify in good faith that their PPP loan request is necessary...Borrowers 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. 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.") (emphasis added), #37 ("Do businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan? Answer: See response to FAQ #31.") and #39 ("Will SBA review individual PPP loan files? Answer: Yes.")

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Indeed, the first charges have already been filed. On May 5th, the U.S. Attorney's Office for the District of Rhode Island unsealed criminal charges arising out of fraudulent applications to the PPP. The two defendants were charged with conspiracy to make false statements to influence the SBA, conspiracy to commit bank fraud, bank fraud and aggravated identity theft. In a statement announcing these charges, Aaron L. Weisman, the U.S. Attorney for the District of Rhode Island, stated that: "Attorney General Barr has directed all U.S. Attorneys to prioritize the investigation and prosecution of crimes related to coronavirus and COVID-19, and we are doing just that."^[2]

The recent Treasury guidance, Secretary Mnuchin's comments and the federal law enforcement's stated interest in protecting the integrity of the program are a clear warning to recipients of PPP loans that they should be prepared to prove their compliance with the PPP's requirements.

II. POTENTIAL BASES FOR ENFORCEMENT ACTIONS

An investigation or enforcement action centered on an application to the PPP is likely to focus on potentially false claims made in connection with: (1) eligibility (including the necessity of the loan); (2) the amount of the loan; and (3) the use of the loan proceeds.

Eligibility: PPP Loans are only available to companies which meet certain qualifications, including having fewer than 500 employees (taking into account

the applicable affiliation rules) or other applicable size standards and require the loan to support the ongoing operations of their business due to economic uncertainty caused by the coronavirus. An applicant-company must also be a U.S. company not owned by a person subject to indictment for a felony or convicted of a felony in the last five years.

The PPP application requires that an applicant self-certify its eligibility for the program, including the necessity of the PPP loan in light of economic uncertainty. Self-certifications, even those only held to a "good faith" standard, are inherently susceptible to fraud and that risk is compounded where, as here, the program was created and implemented at a rapid pace and faced with a huge volume of applications in a short period of time. Thus, applicants should be sure that they retain records used in preparing the application, including corporate governance records of correspondence confirming the accuracy of the certifications, payroll records, ownership records, and financial records justifying the need for the loan. Indeed, the issue of "need" has become a hot button subject for loans issued to publicly traded companies who may have been seen in perfect after-the-fact hindsight as having had other ways to raise capital or access liquidity in a manner that was not significantly detrimental to their on-going business prospects, and will, therefore, be a likely focus of future investigation and enforcement efforts.

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² The press release announcing the charges is available [here](#).

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Having these documents available will allow applicants to demonstrate their due diligence in completing the self-certification and verify their responses as truthful if their application becomes subject to later scrutiny.

Loan Amount: An applicant's maximum loan amount is determined by multiplying 2.5x the average historic payroll amounts (which have a number of components and exclusions dictated by the statute). This amount, like the eligibility criteria, is determined based on a self-reported and self-certified value for historical payroll. A bad actor seeking to exploit the program may attempt to inflate their historic payroll to increase the maximum amount of the loan, especially given that the loan does not require any personal guarantees and is potentially forgivable. Given that the loan amount would be a likely target for fraud, an applicant's representations affecting the size of the loan might be particularly subject to examination by regulators and law enforcement.

An inquiry into this element of a loan application might be conducted, at least initially, without alerting the subject of the investigation. For example, an investigator can review tax filings and other government records and seek the production of records from third parties such as banks and payroll processors, in order to compare that information against information on an application. As a result, it is possible that applicants may not know that they are being audited until an investigator has already determined that their application is sufficiently suspicious to merit a full-blown investigation. Given that Secretary

Mnuchin has indicated that there will be a blanket audit policy for loans above \$2 million, it is reasonably likely that at least some of this process will be automated or otherwise based on guidelines designed to facilitate rapid review. Thus, applicants cannot count on having an opportunity to engage in preliminary discussions to explain possible discrepancies and, instead, must have in place a plan to prove their compliance to an investigator whose suspicions might have been raised by a preliminary audit.

An applicant should ensure that the application is accurate and consistent with other government filings, such as tax returns, government contracts, and licensing forms. Applicants should also ensure that they maintain records justifying any variance in their applications from these existing filings.

The Use of Funds: PPP Loan funds may only be used to pay for certain limited operating expenses, including rent, utilities, mortgage interest and payroll. If employee headcount and related salary levels are maintained during the term of the loan and at least 75% of the loan proceeds are spent on permitted payroll costs, and the balance of the loan proceeds are otherwise spent on permitted uses, the loan may be eligible to be completely forgiven. A borrower will be required to substantiate the use of the funds when applying for loan forgiveness and, therefore, it will be important to maintain records tracking the receipt of the proceeds of a loan and the permissible use of those funds.

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Even if not seeking forgiveness, loan recipients should ensure they can prove they used the loan funds for permissible purposes. One of the easiest ways to do that is to segregate in a separate banking account the funds received pursuant to the PPP and avoid cash or other transactions that are difficult to verify. A borrower should also ensure that they have strict and well-communicated policies governing the use of these funds and tightly control access to the funds. This way, a borrower will be able to prevent the misuse of funds granted pursuant to the PPP and affirmatively demonstrate that they have complied with the requirements of the program.

Just as important as controlling the access to funds is employing good judgment and discretion in determining how to use those funds. A borrower must keep in mind the PPP's underlying purpose, which is to help a business keep its employees on the payroll and protect the business's viability as a going concern. Any use of loan funds that does not directly serve these goals should be avoided, even if that use "technically" fits within one of the program's enumerated permissible uses. For example, a business owner who uses the proceeds of a PPP loan to increase owner salary or distributions, hire family members, make irregular payments to other insiders, or purchase goods or service which are not immediately necessary for the business's operations will draw regulatory and/or law enforcement scrutiny. Borrowers should be sure that every use of their funds has a demonstrable good-faith

business justification.

III. POTENTIAL CONSEQUENCES

Ignoring the potential risks associated with applying for and seeking forgiveness of a PPP loan can have severe consequences. For one thing, inadequate record keeping might prevent companies that would otherwise be eligible for forgiveness from having their loans repaid. But compounding this negative impact on cashflows and balance sheets is the corresponding risk of a federal investigation into potentially false representations made during the application and forgiveness process. False claims investigations can drag on for years, resulting in substantial legal fees. The worst-case outcome of such an investigation is a criminal prosecution, exposing both the company and its officers to the possibility of incarceration, fines, and forfeiture. A better, but still negative outcome, would be a civil action under the False Claims Act exposing the company to treble damages. Even an investigation that leads to no further governmental action can be costly in terms of expense and reputational harm.

IV. RISK MITIGATION

The nature of the PPP, and the way it has been administered, expose applicants to regulatory and law enforcement scrutiny. With the Treasury Secretary's recent announcement, additional scrutiny for certain applicants has been guaranteed. indistinguishable from fraud.

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Thus, prudent applicants will make sure to retain and preserve all documents and information which justify and support their representations and certifications in their applications.

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