Client Alert

April 2020

Odds and Ends Regarding the Paycheck Protection Program

The stresses of the Paycheck Protection Program (the "Triple P") cannot be understated or, frankly, contemplated by those who are operating outside the trenches. In light of the challenges for a lender to just obtain the required documentation and work applications through the system amid the constant rule changes, it is easy to lose track of some important issues that have not made headline news for the Triple P. The purpose of this client alert is to percolate some of those matters to the surface to ensure bankers do not lose sight of them.

1. When is Nonrecourse Potentially Recourse? The Federal Reserve's Triple P Liquidity Facility ("PPPLF") has been billed as a nonrecourse arrangement. After all, in the Federal Reserve's FAQs and in interim final rules, it says that it is nonrecourse. For the most case, it is expected to be.

The agreement with the Reserve Banks, however, states that the loan will be on a recourse basis if the borrower "has breached any of the representations, warranties, or covenants made under the PPPLF agreement." In essence, the Federal Reserve Board is reading into the PPPLF a "side door" with regard to loans that lose their Small Business Administration ("SBA") guarantee. When this issue was raised with one of the Reserve Banks, the response received was as follows:

> Failure by the Borrower to meet any of the requirements of the PPPLF Agreement (including if any PPPLF Collateral fails to satisfy the requirements of the PPP) may, at the *sole discretion* of the Reserve Bank, void the nonrecourse provisions and any related provisions, i.e., the Reserve Bank's rights shall be full recourse with respect to *that portion of any Advance* equal to the amount of the PPPLF Collateral Valuation (on the date of the Advance) of any non-conforming PPPLF Collateral, and may, at the sole discretion of the Reserve Bank, result in the Borrower's disqualification from participating in the PPPLF. For the avoidance of doubt, the Reserve Bank's exercise of any of the foregoing rights and discretion will not be deemed exclusive of any other rights or remedies to which the Reserve Bank may be entitled under the PPPLF Agreement or any other Lending Agreement or applicable law. The *Reserve Bank's determination* that any PPPLF Collateral fails to conform to the requirements of [the] PPPLF Letter of Agreement or the Circular *shall be conclusive absent manifest error*.
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> The Federal Reserve System announced the Paycheck Protection Program Liquidity Facility ("PPPLF") in an effort to bolster the SBA's Paycheck Protection Program ("PPP"), which had faced some challenges since rollout. The nonrecourse provisions of the loans made to financial institutions ("PPPLF Advances") are a key feature in ameliorating the initial difficulties of the PPP. The nonrecourse provisions of PPPLF Advances are not automatically voided if the collateral is ultimately determined to be non-conforming; however, the nonrecourse feature may be modified at the Reserve Bank's discretion. It is our expectation that an overwhelming majority of the loans pledged under the PPPLF will be acceptable to the SBA and will enter/exit the PPPLF with no issue. Any decision by the Reserve Banks in this area will be a facts and circumstances inquiry that will include *a review of the pledging institution's processes and procedures for complying with the*

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> *SBA guidelines, and, if applicable, the dates that such guidance may have been amended by the SBA*.
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> The Federal Reserve launched the PPPLF using its 13(3) emergency lending powers. Its stated goal is to supply liquidity to financial institutions so that those institutions could in turn provide relief to American workers and businesses. The discretion to revise the nonrecourse provision, while essential to prevent fraud and abuse of the program, is not meant to be used as a method to arbitrarily disqualify PPP loans as collateral (emphasis added).

The response to the inquiry, obviously written by counsel, is illuminating in a number of important respects. We expect most bankers will not give much credence to the Federal Reserve's protestations that it will only use its "super powers for good," and only remove nonrecourse status in limited circumstances. Accordingly, bankers might focus on the basis stated for how a Reserve Bank may make the determination to disqualify a lender from the PPPLF or to void the nonrecourse nature of the PPPLF with regard to one or more loans.

The Reserve Bank focuses on the policies and procedures that banks put in place in a manner designed to ensure compliance with the SBA rules. Accordingly, the PPPLF implicitly encourages that lenders pledging Triple P loans as collateral should be able to support the reasonableness of their processes. The Reserve Bank also acknowledges that a bank's policies and procedures will be based upon the rules then in effect.

2. OCC Update Regarding Documentation of Triple P Loans. The Office of the Comptroller of the Currency ("OCC") has updated its view of national bank processes for Triple P loans, specifically with respect to documentation. Some of the highlights are as follows:

- National banks are encouraged to identify and track the Triple P loans made to small business borrowers that have annual revenues of $1 million or fewer and are in low- to moderate-income ("LMI") areas. Such information may be used to track loan volumes for CRA purposes.

- Prudent practices include documenting implementation decisions – such as the bank's business justifications and any alternatives considered – when setting eligibility criteria, establishing processes for considering applications, and approving or denying Triple P applications. We believe this addition is aimed at requiring lenders to follow the SBA's requirements, including that loans be processed in the order received, as well as to comply with fair lending laws.

- Relevant business decisions that should be documented may include estimates of resources needed to implement and support the Triple P, current available resources (including staff resources), and the ability to access needed information about an applicant in a timely way, among other factors. Additional factors that should be documented will vary by bank. It is ironic that round 2 of the Triple P was already underway before the OCC decided banks should be documenting these specific considerations.

- In addition to thorough documentation of program administration and loan decisions, national banks are encouraged to identify and track overall Triple P loan volumes.

The points raised in the OCC Bulletin further emphasize the need for banks to have, at least, procedures and quality control ("QC") around originations. We expect that policy, procedures and QC will be even more important regarding loan forgiveness.

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3. Customer Notice. There has been a media furor and political scrutiny involving public companies and other well-known organizations that have accessed the Triple P or other stimulus programs. Based on a tally the *Wall Street Journal* has been keeping, as of April 28, 2020, over 230 public companies have received Triple P funding. The antagonism seems to stem from the fact that while otherwise legally eligible for the stimulus loans, these enterprises should have accessed some, perhaps imaginary, alternate sources of liquidity instead – a contentious proposition during these uncertain times. Why the employees of these businesses are less worthy of support than others, or why a privately-held restaurant is more deserving than a publicly-held one, is a policy question for another forum.

As if the uncertainty created by the SBA and public uproar about public companies or "large companies with adequate sources of liquidity" obtaining Triple P loans were not bad enough, the SBA has now doubled down and issued a new FAQ purporting to relate to all "private companies with adequate sources of liquidity." The SBA has issued a new FAQ No. 37 pursuant to which the SBA seeks to apply the same standard as was previously cited as applicable to public companies in its Question and Answer No. 31 (which is quoted below). See new Question and Answer No. 37 below which we have pulled from the latest SBA FAQs:

> "**37. Question:** Do businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?
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> **Answer:** See response to FAQ #31."
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> **31. Question:** Do businesses owned by large companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?
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> **Answer:** In addition to reviewing applicable affiliation rules to determine eligibility, all 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. Although the CARES Act suspends the ordinary requirement that borrowers must be unable to obtain credit elsewhere (as defined in section 3(h) of the Small Business Act), borrowers still must certify in good faith that their PPP loan request is necessary. Specifically, before submitting a PPP application, all borrowers should review carefully the required certification that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." 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.
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> Lenders may rely on a borrower's certification regarding the necessity of the loan request. Any borrower that applied for a PPP loan prior to the issuance of this guidance and repays the loan in full by May 7, 2020 will be deemed by SBA to have made the required certification in good faith.

How then does this fit together with FAQ No. 17?

> **17. Question:** I filed or approved a loan application based on the version of the PPP Interim Final Rule published on April 2, 2020. Do I need to take any action based on the updated guidance in these FAQs?
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> **Answer:** No. Borrowers and lenders may rely on the laws, rules, and guidance available at the time of the relevant application. However, borrowers whose previously

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submitted loan applications have not yet been processed may revise their applications based on clarifications reflected in these FAQs.

They could not make this more challenging if they tried. Questions 17 and 31 are clearly at tension. The purpose of Question 31, and the recent interim final rule establishing the safe harbor, is to create amnesty for borrowers who have a loan and are no longer comfortable with having made the required certification based on new guidance. There is an argument that this new certification standard applies retroactively contrary to the explicit guidance provided in Question 17. The SBA may seek to harmonize this conflict by taking the position that considering other access to capital was always a requirement and that the safe harbor is an accommodation for borrowers to return funds who did not understand the SBA's position.

The ultimate resolution of any such controversy will likely play out another day. Regardless of such outcome, we believe a letter to borrowers, or at least borrowers with Triple P loans of at least $2 million[1], may be important to send to avoid borrower confusion. This issue is atop the news (there were three articles about it in the April 28, 2020 *Wall Street Journal* alone), so there is no ducking the questions. Lenders, whether or not they send a letter, should have talking points to respond to inevitable borrower inquiries.

4. Loan Disbursement. In yet another bi-weekly Interim Final Rule ("IFR") for the Triple P, the SBA advised that:

- Lenders must make a one-time, full disbursement within 10 calendar days of approval. A loan is considered approved when the loan is assigned a loan number by the SBA. For loans not fully disbursed prior to this IFR, the 10-day period begins on April 28, 2020 (and ends on May 8, 2020), and the 8-week period began on the date of first disbursement. As a result, lenders should track the date of disbursement. Then, lenders should reach out to borrowers who are slow to take the funds to advise them of this firm deadline.

- Lenders must electronically submit an SBA Form 1502 indicating that Triple P loans funds have been disbursed within 20 calendar days after a Triple P loan is approved and by May 18, 2020, for loans approved before availability of the updated SBA Form 1502.

  The "SBA will make available a specific SBA Form 1502 reporting process through which lenders will report on PPP loans and collect the processing fee on fully disbursed loans ***to which they are entitled***" (emphasis added).

  - Lenders will not receive a processing fee: (1) prior to full disbursement; (2) if the loan is canceled before disbursement; or (3) if the loan is canceled or voluntarily terminated and repaid after disbursement (this situation is based on the new certification requirement).

5. Disclosure. Both lenders and their borrowers should expect information regarding the Triple P loans and the PPPLF to be publicly disclosed. The Federal Reserve has stated that it intends to disclose information regarding the PPPLF during the operation of that facility, including information regarding the participants, costs, revenues and other fees. Moreover, the Federal Reserve will disclose, one year after the termination of the PPPLF, the names and identifying details of each participant in the facility, the amount borrowed, the interest rate or discount paid, and information concerning the types and amount of collateral pledged or assets transferred in connection with the participation in the facility. The

[1] US Treasury Secretary Steven T. Mnuchin and US Small Business Administrator Jovita Carranza issued the following statement: On April 28, 2020, SBA to further ensure PPP loans are limited to eligible borrowers. The SBA has decided, in consultation with the Department of the Treasury, that it will review all loans in excess of $2 million, in addition to other loans as appropriate, following the lender's submission of the borrower's loan forgiveness application. Regulatory guidance implementing this procedure will be forthcoming.

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Federal Reserve expects to disclose information regarding the PPPLF during the operation of the facility, including information regarding participants, costs, revenues, and other fees.

Normally, the SBA releases the names of borrowers under the 7(a) program and the amounts borrowed. Recently, the SBA has denied Freedom of Information Act ("FOIA") requests. Specifically, the SBA has noted that "at this time, the agency is focusing efforts on assisting small businesses during this unprecedented disruption to the economy." The SBA has gone on to say, however, that "in the future, we will be able to turn our efforts to providing loan specific data to the public…."

In light of the hullabaloo regarding certain Triple P borrowers that have now returned the amounts received, there will be even more pressure for earlier disclosure. Banks have been advised to complete an SBA Form 1502 (not the 7(a) Form 1502, but one the SBA will one day modify for the Triple P) in order to obtain loan origination fees. It can be expected that the information on such forms will be publicly available whether by FOIA requests or online. Currently, such information can be accessed by SBA lenders on the Colson System for existing 7(a) loans.

6. Tally of Documents. In light of the positions of the Federal Reserve, the United States Treasury ("UST"), the SBA and the OCC (presumably the Federal Deposit Insurance Corporation ("FDIC") will follow), we believe banks need certain documents to help defend claims if, in fact, one does come – whether from a borrower, an unsuccessful applicant, the SBA or the Federal Reserve. At a minimum, these include:

- documentation related to the steps taken at origination of the loan (we call ours a Triple P loan "cheat sheet");
- a borrower certificate/hold harmless;
- potentially, a letter advising the customers of considerations for the return of funds or not to apply for funds in the event they cannot make certain certifications regarding need and liquidity to the SBA;
- policy regarding Triple P loan forgiveness;
- procedures related to loan forgiveness; and
- an interactive timeline reflecting the dates of the various guidance, FAQs, rules and statutes governing the Triple P.

7. Tax. On April 15, 2020, Tony Nitti wrote an article for *Forbes* magazine. His article, entitled "Ten Things We Need to Know About Paycheck Protection Program Loan Forgiveness," (here) included this specific issue: Can a Triple P borrower get forgiveness of a loan that was not taxable, and yet, still be able to deduct the expense? Mr. Nitti stated the following:

> This is a big one. Are payments made with forgiven funds deductible? Section 1106 of the CARES Act states that amounts forgiven on a PPP loan "shall be excluded from gross income." Easy enough. But Section 265 of the Internal Revenue Code provides that expenses "allocable to" tax-exempt income are not deductible; this prevents a "double dipping" of sorts, whereby a taxpayer would otherwise get both a deduction and tax-exempt income related to the same transaction or investment.
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> Historically, Section 265 has applied to items like interest expense incurred to generate tax-exempt interest income, but there's no reason to believe it couldn't apply to expenses paid with forgiven PPP proceeds.

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> In *Manocchio v. Commissioner*, an airline pilot paid for flight instruction and was ultimately 90% reimbursed under a federal program. The reimbursed payments were tax-exempt, leading the IRS to apply Section 265 and disallow any deduction related to the payment for the program.
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> Could the IRS apply a similar approach to forgiven PPP loans? Absolutely. After all, claiming deductions for amounts paid for by the federal government on a tax-free basis – and potentially generating a loss that can now be carried back to collect a refund of previously paid taxes – would be an extremely generous outcome.
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> But if an extremely generous outcome is what was intended, Congress could simply amend Section 265 to accommodate this situation. They've done it before, most notably in response to a previous Revenue Ruling that disallowed deductions of a minster of a church who received a tax-free housing allowance under Section 107.
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> Whatever the result, borrowers need guidance immediately.

Until we receive guidance from the IRS that payments are not deductible when funded by a forgiven Triple P loan, there may be a reasonable position that such payments indeed can be deducted. True, Section 265 of the Internal Revenue Code provides that expenses allocable to tax-exempt income are not deductible. In addition, general tax principles disallow a deduction when there is no net economic outlay (e.g., when expenses are reimbursed). Denying a deduction for payments that are funded by a forgiven Triple P loan would be consistent with Section 265 and general tax principles.

As drafted, Section 1106 of the CARES Act provides that amounts that are forgiven on a Triple P loan are excluded from gross income. It does not expressly deny a deduction for payments when funded by a Triple P loan that is ultimately forgiven. Congress has not yet expressed any specific intent regarding the deductibility of these expenses. It is possible that Congress intends for taxpayers to have a "windfall" of both an income exclusion and a tax deduction in this situation (on the ground that the CARES Act is intended to provide immediate benefit to taxpayers). However, as the *Forbes* article pointed out, when Congress adopted the CARES Act, Congress amended other provisions of the Internal Revenue Code, but did not amend Section 265 of the Internal Revenue Code. Presumably, Congress was aware that it did not amend Section 265. If Congress intended a windfall, it could have clarified whether Section 265 applies to a deduction for payments funded by a forgiven Triple P loan. Triple P borrowers should raise these questions with their tax preparers.

8. FDIC FAQs. The FDIC, like the Federal Reserve and the OCC, have issued frequently asked questions as well. These FAQs provide guidance on a number of issues. The FDIC FAQs contain some interesting information. First, the FDIC stated that it is considering the Triple P loans for purposes of determining deposit insurance assessments. Presumably, what the FDIC is alluding to is that it will carve such loans out of the formula used to determine how much each institution should pay to the Deposit Insurance Fund. In this manner, the treatment of Triple P loans for deposit insurance assessment purposes would align with the treatment given to them for capital purposes by the bank regulators.

9. CRA. The FDIC also notes that most loans originated under the Triple P will receive CRA credit. The FAQs state that loans to for-profit businesses in amounts of a million dollars or fewer are considered small business loans. It also notes that Triple P loans to small businesses could receive consideration as innovation or flexible lending practices. It goes on to say that loans to small businesses in amounts greater than a million dollars that "create or retain jobs would qualify as community development loans under a) economic development if the loans create or retain jobs or b) revitalization/stabilization if the loans benefit primarily low- and moderate-income areas or distressed middle-income areas" (emphasis added). Thus, there is an argument to be made that virtually all of the Triple P loans should receive CRA credit either under the lending test or as community development loans. Instead of a focus on low- to moderate-income ("LMI") individuals, the FDIC, like the OCC, under the Triple P, will look to see whether the borrowers themselves are in LMI areas. Accordingly, banks

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should geocode where the borrowers are located to see if an argument can be made that those areas meet the test.

10. Agents. One controversial issue has related to whether lenders have retained accounting firms and others to act as their agents with regard to Triple P loans. The American Institute of Certified Public Accountants ("AICPA") recommended to accounting firms that, before they seek to serve in an agency capacity to lenders, they reach out to the lenders directly. Specifically, the AICPA says:

> To help advance a clear and orderly loan application process, we're recommending the CPA contact the lender prior to offering assistance and performing advisory work to the client. This will ensure the lender has agreed to compensate the CPA firm for its service.
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> If the lender agrees to compensate the CPA firm for its service, the relationship should be documented and disclosed to the small business. Documentation could take the form of a letter, sent by the CPA to his/her client, that describes the services to be performed by the CPA firm to assist and advise the client on the appropriate completion of the application. The letter could include the following: compiling payroll reports necessary to calculate average monthly payroll costs (i.e., PPP-compliant payroll cost report or master payroll report or other documentation relating to compensation and other eligible payroll costs); calculating average monthly payroll costs in accordance with PPP guidance; and reviewing final application before submission.

We have previously noted that Rule 159 applies to third parties seeking an agent fee pursuant to an SBA 7(a) loan. The AICPA recommendations provide further support for lenders to evaluate the use of such form.

There will be more to follow. Apparently, the SBA believes that "the only constant in life is change" – Heraclitus.

Contacts

Peter G. Weinstock
pweinstock@HuntonAK.com

Caitlin A. Sawyer
csawyer@HuntonAK.com

Patrick Boot
pboot@HuntonAK.com

Dean Elazab
delazab@HuntonAK.com

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