

A PPP Lender's Dilemma: What to Do If a PPP Loan Is in Default?

Coronavirus Legal Advisory

06.26.2020

Related People:

Howard M. Berkower

The CARES Act established the Paycheck Protection Program ("PPP") under Section 7(a) of the Small Business Act (Section 7(a)) to provide forgivable loans that are fully guaranteed by the Small Business Administration ("SBA") in order to aid qualified small businesses to keep workers on the payroll. As created by the CARES Act, if a borrower uses its PPP loan proceeds to fund payroll and other eligible operating expenses during a designated time period ("Covered Period"), that portion of the loan proceeds up to the entire loan amount will be forgiven, resulting in a PPP loan becoming essentially a grant.

The [PPP Flexibility Act](#) (H.R. 7010) (the "Flexibility Act") enacted earlier this month makes the forgiveness requirements of the PPP more flexible by increasing the amount of time a borrower has to spend loan proceeds, lowering the amount of proceeds that are to be used for payroll costs and providing additional safe harbors for full-time-equivalent employee reductions. As a result of these enhancements, it is likely that a greater percentage of PPP loans will qualify for forgiveness of the entire loan amount.

A PPP loan is unlike any other Section 7(a) loan as a result of, among other things, its (i) forgiveness feature, (ii) 100% SBA guarantee, (iii) below-market interest rate, (iv) lack of collateral requirement, and (v) limited streamlined origination procedures. These PPP features were designed to expedite relief to small businesses from the economic devastation wrought by the pandemic. It is therefore surprising that in rolling out the PPP, the SBA and the Treasury Department decided not to draft a new promissory note template for the PPP but rather to authorize the use of the SBA promissory note for a standard Section 7(a) loan, SBA Form 147. As a result, the [SBA form of the PPP Note](#) ("PPP Note"), used by banks and other lenders in the origination of most PPP loans, contains a number of provisions that conflict with the very purpose of the PPP and has created unnecessary uncertainty for PPP lenders and servicers.

In particular, the PPP Note provides for, among others, the following "events of default": (i) a default by the borrower on any other loan with the lender, (ii) a default by the borrower on any loan or agreement with another creditor, if the lender believes the default may materially affect the borrower's ability to repay the PPP loan, (iii) the borrower fails to pay any taxes when due, (iv) the borrower has an adverse change in its financial condition or business operation that the lender believes may materially affect the borrower's ability to repay the PPP loan, (v) the borrower reorganizes, merges, consolidates, or otherwise changes

ownership or business structure without the lender's prior written consent, (vi) the borrower becomes the subject of a civil or criminal action that the lender believes may materially affect the borrower's ability to repay the PPP loan, and (vii) the borrower (a) becomes the subject of a proceeding under any bankruptcy or insolvency law, (b) has a receiver or liquidator appointed for any part of its business or property, or (c) makes an assignment for the benefit of creditors ((a) to (c) collectively, "Bankruptcy").

Upon the occurrence of any event of default, the lender may, but is not required to, call the loan immediately due and payable. Acceleration of the loan is not mandatory even in the case of a default resulting from a Bankruptcy. In our experience, most debt instruments provide for immediate acceleration without any further action by a lender in the case of a default caused by a Bankruptcy. In any event, upon a Bankruptcy, a lender would require relief from the automatic stay to implement any remedy. Indeed, a debtor subject to a Chapter 11 Bankruptcy is usually allowed to continue to use PPP loan proceeds to pay payroll and other permitted operating expenses. *See In Re Toojay's Management LLC, et al.* Bankruptcy No. 20-14792-EPK, Bankr. Ct. SD Fla. Order of May 1, 2020.

As PPP lenders become aware of one or more circumstances that constitute an event of default or in which lenders must determine whether the circumstance affects the borrower's ability to repay the PPP loan and thereby constitutes an event of default, lenders are placed in a most difficult position without the benefit of any guidance from the SBA. What does it mean to materially affect a borrower's ability to repay a PPP loan, if substantially all of the PPP loan will likely be forgiven? If upon an event of default a lender accelerates a PPP loan during the Covered Period it would seem that a borrower will be precluded from having any portion of the PPP loan forgiven—a principal goal of the PPP in the first instance.

Furthermore, unlike all other Section 7(a) loans in which the SBA guarantees up to 85% of the entire loan, a PPP loan is fully guaranteed by the SBA so that a PPP lender has "no skin in the game." In essence, a PPP loan is funded by the lender with the understanding that the SBA will refund that portion of the loan that is forgiven and any remaining outstanding loan balance that the borrower fails to pay, in both instances with accrued interest thereon. Accordingly, the SBA is the real party in interest in a PPP loan, and it would seem to follow that the decision whether to accelerate the loan upon a default—particularly during the Covered Period and thereafter until the forgiveness amount has been funded by the SBA—should be made by the SBA.

Most lenders originated PPP loans based on the assumption that as long as it reasonably followed SBA guidance in the origination and processing of the loan forgiveness application, the SBA would make the lender whole. Therefore, the overarching concern for a lender is to do no harm that may cause the SBA to fail to honor its 100% guarantee. Unfortunately, without SBA guidance, a lender cannot be certain as to whether the SBA will second guess its decisions and actions made in connection with the occurrence of a default.

Absent further SBA guidance, particularly since, unlike most other Section 7(a) loans, a PPP loan is not secured by any collateral or the guarantee of the owners of a borrower, it would seem prudent upon the occurrence of a default that a PPP lender should (a) promptly notify the borrower of the default but not accelerate the loan until the SBA has funded any outstanding loan forgiveness application, (b) promptly notify the SBA of the default, and (c) "put" the loan to the SBA under its 100% guarantee, so that the lender can be taken out of the loan.

The process to notify the SBA is as follows:

1. Contact the SBA servicing center prior to requesting SBA honor guaranty.

Contact the SBA Servicing Center to request the loan be placed in liquidation status and transferred to the National Guaranty Purchase Center. Please visit [SBA Servicing Centers](#).

2. Submit the SBA's guaranty purchase package and associated tab pages.

SBA designed the [Guaranty Purchase Package](#) and associated tabs ("Purchase Package") to assist lenders of 7(a) loans with assembling requests for SBA to honor loan guaranties. Fill out and submit the associated tab pages, Memorandum, and Certification electronically to the SBA using [Send This File](#).

3. Submit the following documents with the purchase package and associated tab pages.

- SBA [Loan Guaranty Demand Letter](#). Use the SBA Loan Guaranty Demand Letter form to request that SBA purchase the guaranteed portion of a 7(a) loan. (See Tab 1.)
- SBA Promissory Note (See Tab 4.1.)
- [SBA Form 1149 – Transcript of Account](#)
- [SBA Wire Transform Form](#) (See Tab 10.1.)
- Memorandum detailing the event of default should be submitted with the Purchase Package. (See Tab 7.2.)
- Certification stating loan proceeds were disbursed to the Borrower in accordance with the following allowable PPP uses: to pay (1) payroll costs, (2) certain employee benefits relating to healthcare, (3) interest on mortgage obligations, (4) rent, (5) utilities, and (6) interest on any other existing debt obligations incurred before February 15, 2020, for the applicable Covered Period, which has been extended to 24 weeks pursuant to the Paycheck Protection Flexibility Act, unless the Borrower elects to keep the original 8-week period. (See Tab 5.)

Note: The Entire Purchase Package along with associated tabs pages, Memorandum, and Certification should be electronically submitted to the SBA.

McCarter & English, LLP, can assist lenders with requesting that the SBA honor a PPP loan guaranty upon a borrower's default.