

SBA and Treasury Department Sued Over PPP Loan Guidance on the Good Faith Necessity Certification

Coronavirus Legal Advisory

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On May 4, 2020, three California-based technology firms—Zumasys Inc. and two of its subsidiaries (the “Tech Companies”)—filed suit in California federal court to block recent Small Business Administration (“SBA”) guidance in the form of [Frequently Asked Questions](#) (“FAQs”), which were issued after media outlets reported many publicly traded companies received millions in Paycheck Protection Program (“PPP”) loans. The FAQs are causing great uncertainty for businesses that have received PPP loans as they grapple with whether to return them. See *Zumasys, Inc. et al v. United States Small Business Administration et al* (8:20-cv-00851), California Central District Court, Filed: 05/04/2020.

The underlying dispute involves how to harmonize two distinct provisions of Section 1102 of the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”), which established PPP as a new form of SBA 7(a) business loan (“SBA Business Loan”) to provide financial assistance to qualified businesses to pay their workforce during the COVID-19 pandemic. On the one hand, Section 1102(a)(2)(I) clearly eliminates the requirement for SBA Business Loans that “a small business concern [be] unable to obtain **credit elsewhere**” (emphasis added). “Credit elsewhere” is defined as “the availability of credit from non-Federal sources on reasonable terms and conditions taking into consideration the prevailing rates and terms...for similar purposes and periods of time” (Section 3(h) of the Small Business Act, 15 U.S. Code Section 632). On the other hand, Section 1102(a)(2)(G) requires a PPP loan applicant to in good faith certify that “the uncertainty of the current economic conditions **makes necessary the loan request to support the ongoing operations** of the [applicant]” (emphasis added) (the “Good Faith Necessity Certification”).

In an effort to “thread the needle” of these two somewhat conflicting provisions and address the public outcry over a number of large public companies receiving PPP loans, FAQ 31 states that in making the Good Faith Necessity Certification, applicants must take “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.” The FAQ goes on to state that it is unlikely that public companies with the ability to access public markets will be able to make the Good Faith Necessity Certification, and establishes a “safe harbor” allowing borrowers to repay PPP loan funds

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obtained based on a misunderstanding or misapplication of the required certification standard, which has now been extended to May 18. On April 28, the SBA issued FAQ 37, which makes clear that private companies must perform the same analysis in providing the Good Faith Necessity Certification.

The Tech Companies are seeking a court order that would bar the SBA and the Treasury Department from enforcing FAQ guidance found in questions #31 and #37 and have challenged the legality of the FAQs by further contending they:

- Undermine the CARES Act, which provides that “an impacted borrower is presumed to have been adversely impacted by COVID-19”
- Result in a bait and switch for employers who obtained PPP funds in order to retain their employees with the expectation of loan forgiveness, but now are pressured to repay the PPP funds with money they must borrow, putting employers in a worse position than if they had furloughed their employees in the first place
- Exclude public companies from receiving PPP loans, making the FAQs adverse to the goal of keeping American workers employed

McCarter & English, LLP, will continue to monitor and report on cases that impact the availability of PPP proceeds and loan forgiveness.

While we await further SBA guidance on how it will review the Good Faith Necessity Certification during the loan forgiveness phase of PPP, which guidance the SBA intends to provide before May 14 (see FAQ 43), we believe it prudent for PPP loan recipients to carefully review and formally document the factors and circumstances facing their businesses since the onset of the pandemic in March 2020, including the effect of the pandemic on business operations, profitability, cash flow, pipeline, projections, and sources and uses of liquidity for the balance of the calendar year. In so demonstrating that its board fully evaluated the material information reasonably available and formed a reasonable basis for the Good Faith Necessity Certification, a borrower should be able to withstand any principled review by the SBA, in the same way that under the “business judgment rule,” courts will not second-guess an informed board which exercises its reasonable judgment in its decision making, even if its decision does not result in a favorable outcome for the company.