COVID-19: NEW SBA FORMS ASKING KEY NECESSITY AND LIQUIDITY QUESTIONS

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By: Rick Giovannelli, David C. Rybicki

Borrowers of Paycheck Protection Program (PPP) loans of US$2M or more will be required to complete a new form as part of the Small Business Administration (SBA) review process, which appears to ask key questions about private equity (PE) ownership, market capitalization, quarterly revenue, and COVID-related business impacts that happened after the PPP loan application, and this unhappy question for many of our clients:

- "On the date of Borrower's PPP loan application, was 20 percent or more of any class of Borrower's outstanding equity securities owned by a private equity firm, venture capital firm, or hedge fund (including a fund management by any such firm)? [Check] YES / NO"
    - *(Yes, the form was apparently designed by George Strait as most of the questions have check-the-box answers like this.)*

After studying the application, it appears that the SBA will be looking not only at the facts that existed at the time of PPP loan application, but also looking at how events actually unfolded for PPP borrowers after the fact.

We would like to note that the SBA has not, as far as we could find, officially released these forms, but we were able to locate the forms (SBA Form 3509, SBA Form 3510, Federal Register/Vol. 85, No. 207), through online and other resources, which appear genuine and consistent with publicly-available information.

- SBA previously announced that it would review all forgiveness applications for PPP loans with an original principal amount of at least US$2M.
- As part of its Office of Management and Budget reporting requirements, on Monday 26 October 2020, SBA published a notice in the Federal Register listing the time requirements to complete the various PPP forms. That notice referenced two unreleased forms called "Loan Necessity Questionnaires"–3509 for For-Profit Borrowers and 3510 for Nonprofit Borrowers.
- In an interview with *S&P Global Market Intelligence*, an SBA spokesperson indicated that the forms mentioned in the release would be were for borrowers of loans of "$2M and above."
    - Interestingly, the SBA notice references that these forms affect approximately 52,000 borrowers, which is 23,000 higher than reflected in the SBA-published loan data that shows only 29,000 borrowers who have loans above US$2M.
    - It is possible that there are approximately 23 thousand borrowers with loans of exactly US$2M, or that a large portion of that number comes from individual borrowers of under US$2M who have affiliated

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PPP borrowers that aggregate to US$2m. However, this seems somewhat unlikely, and it is difficult to reconcile the numbers.

So, with the caveat that we do not know for sure that these are accurate or final, here is what we know about the forms, though for now we will focus on the form 3509, which is for business for-profit borrowers:

- It appears that lenders are to provide the forms to borrowers, who then have 10 business days to complete the forms and submit the required but unspecified "supporting documentation."
- The form consists of two main parts:
  - A "Business Activity Assessment" that includes many questions relating to impacts on business activity during the borrower's covered period, which of course only occurred well after the borrower applied for its PPP loan and thus seem only loosely correlated, at best, to a determination of the borrower's good faith mindset at the time it applied for its PPP loan.
  - A "Liquidity Assessment" which asks both whether the borrower (or its parent) had any public securities (and if so, its market cap) and as noted above, whether, the 20 percent or more of the borrower's equity was owned by PE, venture capital (VC) or hedge funds, or a public company, but also then focus on how the borrower used its cash (not just PPP cash) - such as dividends, prepayment of debt, non-COVID cap ex, and (perhaps troublingly) whether the borrower had employees or owners with annualized compensation in excess of US$250 thousand.

You can see the questions for yourselves in the forms, but here are some observations on each of the two assessments:

Business Activity Assessment

- The first question asks for the borrower's revenues for Q2 2020 and, for comparison, Q2 2019 or, if they are seasonal, the respective Q3s (or Q1 2020 for newer businesses). For nonprofit borrowers on form 3510, this is measured in receipts, including grants and donations.
  - While this seems like a reasonable way to measure the actual impact of the pandemic on the borrower, it may bear little relation to what the borrower believed in good faith about the "economic uncertainty" (which is what the CARES Act required) or what it thought was going to happen at the time of its application.
  - It also may be largely irrelevant for borrowers who (a) were growing rapidly, where a return to Q2 2019 would be a significant decrease in actual activity or (b) borrowed in the PPP 2.0 wave, where the Q3 revenues might be more relevant for the purposes that SBA apparently wants to use here.
  - Ultimately, it remains to be seen whether SBA will deny forgiveness for borrower's whose revenues were not actually significantly reduced.
- The next several questions ask whether the borrower was ordered to, or voluntarily, shut down or "altered its operations" and if so, for how long, why and whether it had any CapEx relating to those alterations.
  - The three types of alterations that borrowers can check are interesting: (i) number of people in a location was limited, (ii) service was limited to outdoors, (iii) employee workspaces were reconfigured or (iv) other.

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- As are the reasons for why a borrower voluntarily ceased or altered operations: (i) employee(s) contracted COVID, (ii) supply chain was disrupted or (iii) other.
  - *Interesting that the SBA did not provide an option to address the customer demand-side of the equation, though borrowers can add that in the "other" box.*

- The final substantive question asks whether the borrower began any new capital improvement projects *NOT* related to COVID during the period from 13 March to the end of its forgiveness period.
  - *This is a bit of a puzzling question, and may be based on the SBA thinking that a borrower who commenced such a project during such period must have had plenty of cash and thus didn't "really need" the PPP loan.*

Liquidity Assessment

- The first question is probably the obvious one, how much cash (and equivalents) did the borrower have as of the last day of the calendar quarter before it applied for the PPP loan.
  - *For many borrowers who applied early in the process, this would be measured as of 31 December 2019, which could present a very misleading liquidity picture for a variety of seasonal and other timing reasons.*
    - For nonprofit borrowers, form 3510 goes on to ask whether the borrower holds any assets in any "endowment funds" and for the value of its non-cash investments, *which seems clearly aimed at ferreting out some of the institutions with large endowments that President Trump criticized for taking PPP loans*. In fact, the next question specifically asks whether the borrower is a "school, college and university" and, if so, what its annual tuition is and whether it offered tuition assistance for 2019-20.
    - Non-profit borrowers are also asked whether they are a health care provider and, if so, what their program service revenue was for Q2 2020 vs Q2 2019 (or, if they are seasonal, the respective Q3s).
    - All non-profit borrowers (including schools and health care providers) are asked whether they offered discounts on their services due to COVID-19.

- Next, the SBA asks whether a borrower has paid any "dividends or capital distributions" between 13 March and the end of its covered period.
  - The question exempts tax distributions by a "partnership or S-corporation" (*do not worry, this should cover LLCs too, which are tax partnerships; remember that the SBA is stuck in the 1950s regarding capital structures*), in an amount limited to actual tax liability on profits in the first three quarters of 2020, 110 percent of the pro rata share of last year's "tax liability on distributions" (*too bad if you had phantom income?*), or the pro rata share of tax liability on total distributions in 2020 (*which seems somewhat circular, but may be aimed at non-capital distributions of profits or guaranteed payments?*). It's also not clear whether we are using the greatest or least of these measures.

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- While the tax exception is oddly phrased, this question is not a surprise as SBA has been focused on ensuring that borrowers are not paying their owners to the detriment of employees and, as we have predicted, is apparently looking askance at borrowers who were able to make such distributions.

- Similarly, the next question asks if the borrower prepaid any debt before it was "contractually due" during that same period.
  - *Note that while debt that was accelerated by a lender would likely be deemed to have been "contractually due," debt that was prepaid as part of a change of control might not neatly fit into this exception for fairly technical reasons (e.g., in most cases buyers of companies with outstanding debt will pay the target debt via the funds flow immediately prior to closing of the sale in order to avoid triggering the default (and to deliver the company debt-free).*
- The next two questions ask whether any of the borrower's employees or owners were compensated at an annual rate in excess of US $250 thousand (annualized), and if so how many of each and how much in total was paid to each such cohort.
  - *This is not supported by the CARES Act and is a strange question that may be based on some sort of assumption that a borrower who could afford to pay such highly compensated personnel such amounts may not have "needed" the loans. This question could signal that forgiveness may be especially challenging for medical and dental practices, law firms, and other professional service firms who borrowed PPP loans.*
- The next series of questions ask about the for-profit borrower's equity capitalization and ownership:
  - Whether the borrower or a parent had publicly traded stock, and if so its market cap on the date of the PPP application.
  - If the borrower was privately owned what was the book value of its shareholder equity as of the last day of the calendar quarter before it applied
    - (*again, using 31 December could create some interesting answers here)*
  - Is the company a subsidiary (at least 50 percent owned by) of another company, and if so who is the parent and is it incorporated outside the United States?
  - Is the company an affiliate or subsidiary of a foreign state-owned enterprise?
    - (*I'm guessing that under the current administration, borrowers who would check yes here may want to not apply for forgiveness*)
- And of course, the borrower is asked whether 20 percent or more of its equity is owned by a public company, or a PE "firm," VC "firm," or hedge fund (the SBA tries to eliminate any ambiguity from its use of this phrase in its FAQs by adding "or any fund managed by any such firm").
  - *This is not a surprise and likely signifies enhanced scrutiny of these borrowers, as we all expected.*
- Remember that the former head of the Department of Justice's (DOJ) Civil Division—the unit with primary responsibility for CARES-related False Claims Act (FCA) lawsuits—tipped his hat to this during a laundry-

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list speech of the DOJ's COVID/FCA priorities back in June (our Investigations, Enforcement, and White Collar team notes that the DOJ is definitely looking for some “exemplary” cases in this area):

Our enforcement efforts may also include, in appropriate cases, private equity firms that sometimes invest in companies receiving CARES Act funds. When a private equity firm invests in a company in a highly-regulated space like health care or the life sciences, the firm should be aware of laws and regulations designed to prevent fraud. Where a private equity firm takes an active role in illegal conduct by the acquired company, it can expose itself to False Claims Act liability. A pre-pandemic example is our recent case against the private equity firm Riordan, Lewis, and Haden, where we alleged that the defendants violated the False Claims Act through their involvement in a kickback scheme to generate referrals of prescriptions for expensive treatments, regardless of patient need. Where a private equity firm knowingly engages in fraud related to the CARES Act, we will hold it accountable.

- Finally, the forms ask whether the borrower has received any other CARES Act benefits and, if so, what and how much.
    - *We originally assumed this was designed to ferret out prohibited use of the Employee Retention Tax Credit; however, the question specifically “exclude[s] tax benefits.”*

Remember, we cannot be sure that these forms are the official or final forms, but those of you with companies which have US$2 million or more in PPP loans may begin receiving something like this from your banks in the near future. Please share your copies of them if they look different than what we have referenced, and of course, please let us know if we can be of assistance.

KEY CONTACTS



RICK GIOVANNELLI
CHAIR

CHARLOTTE
+1.704.331.7484
RICK.GIOVANNELLI@KLGATES.COM



DAVID C. RYBICKI
PARTNER

WASHINGTON, DC
+1.202.778.9370
DAVID.RYBICKI@KLGATES.COM

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