Client Alert: Further Changes to Paycheck Protection Program Necessary to Avoid Catastrophic Consequences at Forgiveness Stage

JULY 31, 2020

A version of this alert appeared in the Boston Business Journal.

The Paycheck Protection Program ("PPP") is arguably one of the United States government's most popular fiscal responses to the coronavirus pandemic. PPP offers a working capital loan to small businesses, delivered by private banks, which can be forgiven if the business spends the money on the right things. Unfortunately, the current version of the forgiveness application could leave many businesses saddled with debt that they took on believing they would never have to repay it.

To obtain loan forgiveness, the borrowing business must spend the funds on (1) payroll, (2) rent, (3) utilities, and/or (4) interest on preexisting funded debt. Moreover, it must pay these expenses during the "covered period." If the business reduces salaries, furloughs or terminates employees during the covered period, that could impact how much of the loan it can discharge. The covered period is thus, central to the loan forgiveness calculation.

Initially, the covered period was 8 weeks. Since the amount of a PPP loan is 2.5 times a business's monthly payroll, the duration of the covered period made sense. In early June, after it was perceived that businesses were struggling to spend their PPP loan funds during the 8-week period, Congress passed the Paycheck Protection Program Flexibility Act ("Flex Act"), which enlarges the covered period to 24 weeks and gives businesses that extra time to spend the money. The Flex Act is not very flexible, however. Businesses are still limited to borrowing 8 weeks' worth of operating expenses, but their payroll and employment decisions will be assessed over a 24-week period. This incongruity places an unintended burden on borrowers. The Flex Act is essentially telling businesses that they can have 8 weeks of payroll funding provided they agree not to reduce salaries or terminate employees for an additional 16 weeks. Congress could not have intended such a result when it conceived of PPP.

A business probably cannot split the difference either. Under current guidance, it cannot spend PPP funds in, say, 16 weeks and use that as its covered period in the forgiveness calculation. On June 22, the Treasury issued an Interim Final Rule that addressed applying for forgiveness before the end of the 24-week period. The Rule provides an example where the business reduces an employee's salary during the covered period and mandates that the business account for the costs saved by the reduction over the full 24-week period. In other words, a business is financially penalized for actions that it takes after the PPP loan has run out but before the covered period has expired.

Consider the following:

> A business with 25 employees borrows $200,000. Its PPP loan was sized based on the business's payroll spend over a historic 8-week period. The business spends the money entirely on payroll in 10 weeks. By week 12 the business is experiencing revenue shortfalls and has to terminate 13 employees in order to survive for the remainder of the year. By the end of the 24-week covered period its employee head count has dropped from 25 to 12.

Under the current version of the Small Business Administration's forgiveness application, the forgivable amount in our example ($200,000) is reduced by the quotient obtained by dividing the average number of employees during the covered period by 25. Although the business will get credit for employing the 13 terminated employees for the first 12 weeks of the covered period, the forgiveness calculation looks at each employee's weekly hours over the entire covered period. An employee who works 40 hours in week one is counted as "1" employee. But if she is terminated after week one, then she only counts as "0.5" of an employee by the end of week 2, and "0.3" of an employee by week 3, and so on. In our example, the 13 terminated employees will end up counting as only 6.5 employees through 24 weeks. The business will only be able to claim 18.5 employees during the covered period, which will reduce the amount of the original PPP loan eligible for forgiveness from $200,000 to $148,000 ($200,000 x [18.5/25]).

The Flex Act provides a limited exception where a reduction in employees during the covered period will not count against loan forgiveness if the business:

> "is able to document an inability to return to the same level of business activity as such business was operating at before February 15, 2020, due to compliance with requirements established or guidance issued by the Secretary of Health and Human Services, the Director of the Centers for Disease Control and Prevention, or the Occupational Safety and Health Administration during the period beginning on March 1, 2020, and ending December 31, 2020, related to the maintenance of standards for sanitation, social distancing, or any other worker or customer safety requirement related to COVID-19."

Perhaps this exception would excuse the 13 terminations in our example. It will depend on how banks – who have 60 days to review forgiveness applications and make a determination – interpret it. As it is written, the exception appears to require more than general economic conditions in order to excuse employee terminations.

There is simply no reason why a business that successfully channels $200,000 to its employees during the pandemic should be on the hook for $52,000 because it was unable to maintain its payroll after the PPP loans were exhausted. There is also no good reason why the business in our example should not be able to use a covered period of 10 weeks, commensurate with when it spent the PPP loan funds. That would lead to the proper result: 100% forgiveness. The SBA should act immediately to address this problem. Congress should amend the legislation to the extent necessary. Failure to act will lead to a crisis later this year as many small businesses will be unable to maintain pre-pandemic salary and employment levels once their PPP loans have run out.