



May 14, 2020

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# Preparing for an SBA PPP Audit: The Necessity Certification

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**UPDATE:** On May 13, 2020, the SBA issued FAQ #47 extending the date for borrowers to repay PPP loans under the necessity certification safe harbor to May 18, 2020. The date was extended to give borrowers an opportunity to review and consider FAQ #46. FAQ #46 granted borrowers a new safe harbor: “Any borrower that, together with its affiliates, received PPP loans with an original principal amount of less than \$2 million will be deemed to have made the required certification concerning the necessity of the loan request in good faith.”

Borrowers with loans of \$2 million or more, when combined with affiliates, to the extent the affiliation rules apply, may be audited by the SBA to determine if the necessity certification was made in good faith. However, these borrowers will have the ability to repay the loan if a determination is made by the SBA that the necessity certification was not made in good faith. If the loan is repaid, the SBA has said it will not pursue enforcement or refer the matter to other agencies to enforce civil monetary or criminal penalties.

Note that this guidance from the SBA does not preclude other agencies from pursuing enforcement, even without the SBA referring the matter to the other agency. Further, the SBA may still pursue enforcement and associated penalties with respect to other requirements of the PPP, including other certifications, eligibility, and loan amount calculations. The SBA’s prior guidance and the issues we set forth below still apply for audits of loans relating to the necessity certification.

*This is part of our Preparing for an SBA PPP Audit Series, which is aimed at providing informed and real-time guidance on how to comply with the PPP and prepare for an audit by the SBA. It examines common questions from borrowers relating to the necessity certification, eligibility, calculation of the loan amount, use of the PPP loan proceeds and obtaining loan forgiveness. Each article will provide you with a checklist of what you should consider*

including in your loan file.

Additional articles:

- *SBA Issues New Safe Harbor for the Necessity Certification for Paycheck Protection Program Loans – New Guidance as of May 13, 2020*
- [Preparing for an SBA PPP Audit Series: Determining the Forgiveness Amount of Your Paycheck Protection Program \(PPP Loan\)](#)
- [ALERT – Paycheck Protection Program 2.0: New Rules and Additional Guidance as of April 26, 2020](#)
- [Comparing Paycheck Protection Program and Emergency Economic Injury Disaster Loan Options for Small Businesses Under the CARES Act](#)
- [The Cares Act: The Affiliation Rules and How They Impact Eligibility Under the Paycheck Protection Program](#)

In the past couple of weeks, inquiries from businesses have gone from questions about PPP eligibility and how to use PPP loans to panicked calls asking, “should I return my PPP loan?”

The panic stems from the recent focus by the Small Business Administration (SBA) on what is now coined the “necessity certification” in the PPP loan application. The necessity certification in the PPP loan application requires an authorized representative of the applicant to certify “[c]urrent economic uncertainty makes this loan necessary to support the ongoing operations of the Applicant.”

On April 23, 2020, the SBA issued FAQ #31, which provides that all borrowers should “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 PPP loan application.” <sup>[1]</sup> Businesses are supposed to certify in good faith that their PPP loan request is necessary, 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. While many businesses in both the first round of funding and even the second round of funding had already submitted their applications, the SBA seems to be applying this new

guidance retroactively by adding a safe harbor for any borrower that applied for a PPP loan prior to April 23, 2020. Any borrower that applied for a PPP loan prior to April 23, 2020 and repays the loan in full by the extended deadline of May 18, 2020 will be deemed by the SBA to have made the required certification in good faith. The example they gave was that 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. The safe harbor was added to the Interim Final Rule that came out on April 24, 2020. On April 28, 2020, the SBA added FAQ #37, which applied FAQ #31 to businesses owned by private companies.[\[2\]](#)

On April 28, 2020, Secretary of the Treasury Steven Mnuchin declared that any business who receives more than \$2 million in PPP loan proceeds will be audited and businesses borrowing from the PPP could face potential criminal liability for improperly seeking funds. On April 29, 2020, the SBA added FAQ #39 stating that “to further ensure PPP loans are limited to eligible businesses in need” 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.[\[3\]](#)

Many businesses who have received PPP loan proceeds have stopped using the loan funds or not accessed them at all because of the uncertainty out there regarding the necessity certification and the potential criminal penalties. It is important that borrowers understand the law and how it applies to them when analyzing whether there is a “need” for the PPP loan to continue operations given the potential criminal liability.

Below are some of the issues with respect to the recent SBA guidance on the necessity certification:

- The assessment of economic need for a PPP loan that FAQ #31 calls upon borrowers to make “under the standard established by the CARES Act and PPP regulations” is problematic if the standard was anything other than concluding that current economic uncertainty made the loan request necessary to support the ongoing operations of the applicant. Apart from that standard, no other standard

appears in the CARES Act or any of the Interim Final Rules issued by the SBA.

- The portion of FAQ #31 saying, “Borrowers must make a 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” is not in the CARES Act or any of the Interim Final Rules. The PPP application imposes no requirement for the applicant to submit financial information or other documentation supporting the borrower’s current business activity or the ability to access other sources of liquidity.
- It is unclear whether the SBA expects other credit, such as existing lines of credit, to be accessed as a source of liquidity. The CARES Act specifically waives the typical SBA 7(a) loan requirement that a borrower must be able to obtain credit elsewhere. By plain interpretation of the waiver, there cannot be an expectation that a borrower’s access to credit elsewhere preclude them determining the PPP funds were necessary, particularly when considering that the terms of the other credit are not as favorable as a PPP loan (with respect to standard loan terms or simply with respect to the forgiveness element).
- There is no clarity around what constitutes “ongoing” operations. The time period that borrowers would consider “ongoing” will likely go beyond the eight-week covered period. In light of “current economic uncertainty,” and absent some breakthrough in handling the virus, things may look bleak for almost all businesses over a long period of time making it necessary to access PPP funds now to avoid depleting capital in a manner that would be significantly detrimental to the business.
- The definition of “good faith” imposed by the SBA in its Standard Operating Procedures relating to Section 7(a) Loans is “the absence of any intention to seek an unfair advantage or to defraud another party; i.e., an honest and sincere intention to fulfill one’s obligations in the conduct or

transaction concern.” Beyond that definition, there is nothing in the CARES Act or subsequent Interim Final Rules that expands or adds to that definition of good faith.

- FAQ #31 starts out by stating “all borrowers must assess their economic need for a PPP loan under the standard established by the CARES Act and PPP regulations at the time of the loan application.” Based on this statement, it seems like the assessment in question needed to be made at the time of the loan application, however, the safe harbor is providing a “second chance” to make the assessment to those who applied before April 23, 2020. It is not clear to what degree intervening events, interim business results or a changed appreciation for the extent and length of the economic impact of the coronavirus (compared to early April expectations) may or should be considered by the borrower.

It is possible that an audit of PPP loans the SBA might assert that the standard expressed in FAQ #31 should be applied in assessing whether a borrower acted in good faith in making the necessity certification. Based on FAQ #31, the standard seems to require borrowers to take into account (1) their current business activity, and (2) their ability to access other sources of liquidity, and then, presumably, determine if those sources are sufficient to support ongoing operations “in a manner that is not significantly detrimental to their business.”

If the intent of the CARES Act is to carry out the over-arching goal of Congress to keep workers paid and employed, then it would seem that the support of ongoing operations would be the expectation that workers would continue to be paid and employed at the level of business operations prior to the onset of the pandemic. The other component of the standard would be that, considering revenues from ongoing activities along with other sources of liquidity, the level of employment and payments made to employees would be maintained at pre-pandemic levels without any significant detriment to the business.

Borrowers could be found criminally liable if borrowers knowingly made false statements in the PPP loan application. This includes all certifications made by the borrowers in the PPP application, not just

the necessity certification. The fraud investigations being reported to date relate to false statements regarding employee headcount or payroll amounts. We do not know yet how the SBA will pursue, or whether there is any real likelihood in successfully pursuing, criminal (or even civil) penalties against borrowers for making the necessity certification in bad faith because of the subjective nature and vagueness of the standard.

We recommend that borrowers paper their files with documents in support of why the loan was necessary due to current economic uncertainty at the time the application was submitted and now. A focus on the impact to workers and payroll will likely be beneficial in the event of an audit by the SBA. Below is a checklist of what borrowers may want to include in its PPP loan file:

- Internal document detailing necessity of loan and overall strategy for PPP funds at the time the application was submitted, considering the impact on headcount and compensation of employees
- Financial records
- Records documenting access to capital markets (if applicable)
- Current business activity and sources of liquidity
- Memorandum from legal counsel discussing the good faith standard and whether the business acted in good faith when making the necessity certification

Continue to follow our other articles in the Preparing for an SBA PPP Audit series, which will cover more compliance issues borrowers will want to be aware of to protect themselves from an SBA audit.

For more information, please contact [Becky Moore](#), [Marty Mooney](#), [Shannon Kuhl](#) and [Maria Kroeger](#) or any attorney in Frost Brown Todd's [Financial Services](#) industry team.

*To provide guidance and support to clients as this global public-health crisis unfolds, Frost Brown Todd has created a [Coronavirus Response Team](#). Our attorneys are on hand to answer your questions and provide guidance on how to proactively prepare for and manage any coronavirus-related threats to your business operations and workforce.*

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[1] Question #31: Do businesses owned by large companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?

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.

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 14, 2020 will be deemed by SBA to have made the required certification in good faith.

[2] Question #37: Do businesses owned by private companies with adequate sources of liquidity to support the business's ongoing operations qualify for a PPP loan?

Answer: See response to FAQ #31.

[3] Question #39: Will SBA review individual PPP loan files?

Answer: Yes. In FAQ #31, SBA reminded all borrowers of an important certification required to obtain a PPP loan. To further

ensure PPP loans are limited to eligible borrowers in need, 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. Additional guidance implementing this procedure will be forthcoming.

The outcome of SBA's review of loan files will not affect SBA's guarantee of any loan for which the lender complied with the lender obligations set forth in paragraphs III.3.b(i)-(iii) of the Paycheck Protection Program Rule (April 2, 2020) and further explained in FAQ #1.

[4] Question: FAQ #31 reminded borrowers to review carefully the required certification on the Borrower Application Form that "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." SBA guidance and regulations provide that any borrower who applied for a PPP loan prior to April 24, 2020 and repays the loan in full by May 14, 2020 will be deemed by SBA to have made the required certification in good faith. Is it possible for a borrower to obtain an extension of the May 7, 2020 repayment date?

Answer: SBA is extending the repayment date for this safe harbor to May 14, 2020. Borrowers do not need to apply for this extension. This extension will be promptly implemented through a revision to the SBA's interim final rule providing the safe harbor. SBA intends to provide additional guidance on how it will review the certification prior to May 14, 2020.

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