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Expert Analysis

PPP Loan Insurance: An Introduction and Overview

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Millions of small businesses sought and received funds pursuant to the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") under the Paycheck Protection Program (PPP) administered by Small Business Administration (SBA) approved lenders at the outset of the COVID-19 pandemic. The SBA provided these funds in the form of loans, but also provided a roadmap for eligible applicants to obtain loan forgiveness—including guidelines pursuant to which all or portions of the loans can be transformed into grants. In order to qualify for the program, applicant businesses were required to make a number of certifications regarding compliance with a relatively complex set of eligibility criteria, including certifications as to the necessity of receiving PPP funds and the size of their business. Now, as the dust begins to settle, businesses that received PPP funds face the risk of an SBA challenge to their eligibility to retain the PPP funds without a repayment obligation.

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The SBA has a six-year window in which to review (and potentially challenge) the accuracy of an applicant's certifications—a window which survives both the SBA's approval of the PPP loan and forgiveness of the loan repayment obligation. In response to the risk of SBA review, the insurance markets have recently introduced a novel insurance solution: PPP insurance. To prepare this introductory column on PPP insurance, we collaborated with our colleagues at HUB International, the fifth largest insurance broker globally. A significant portion of HUB's client base participated in the PPP program and, in the short period that PPP insurance has been in existence, HUB has counseled numerous clients regarding PPP insurance.

Eligibility Criteria and Risks

To demonstrate eligibility for PPP funds, an applicant must have certified, among other things, that it is a small business (typically by meeting an employee headcount test or an alternative size standard) and that PPP funds were necessary to support ongoing operations. But some of the

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PPP eligibility criteria is arguably vague, potentially exposing businesses to the risk of an SBA challenge to their certifications, even where the applicant made a good faith effort to ensure compliance with the criteria.

For example, applicants were required to certify on the PPP Borrower Application Form that the "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant" (commonly referred to as the "Necessity Certification"). The absence of sufficient guidance on the meaning of the word "necessary" may create uncertainty as to whether the SBA will agree that the applicant's Necessity Certification was accurate. Further, the SBA's guidance on the subject does little to address this concern. In one of its published Frequently Asked Questions ("FAQs"), the SBA clarified that each business must make the Necessity 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." Since the SBA did not further clarify what is meant by "significantly detrimental to the business," a business that declined to access sources of liquidity other than the PPP funds may face uncertainty as to whether the SBA will conclude that it was eligible to participate in the program.

Businesses may also face uncertainty about other eligibility requirements, including with respect to certifications regarding the maximum permitted number of employees (usually 500 employees for most types of businesses) or the so-called alternative size standard, which requires the business to fall below certain income and net worth thresholds.

PPP insurance represents a creative solution to a potentially meaningful risk, but it is a new product that will likely evolve further in a short period of time.

This uncertainty may be exacerbated by the SBA's affiliation rules, which require affiliated businesses to be considered a single business for purposes of these eligibility requirements. For example, subject to certain exceptions, the affiliation rules may require an applicant to aggregate the employees of all of the portfolio companies of a private equity fund.

SBA Review and Enforcement

The uncertainties associated with the eligibility criteria appear to give the SBA considerable discretion with respect to the evaluation of the eligibility of a particular participating business. Businesses may be concerned that the SBA will interpret the eligibility requirements in an inconsistent manner or be influenced by the current economic health of the business as opposed to the state of the business at the time of the loan application. Businesses may also be concerned that SBA enforcement activities will vary or be influenced by public or political pressures that arise during the six-year window, such as changes in political leadership or fiscal shortages. The potential uncertainty surrounding interpretation of eligibility criteria and enforcement activity only increases the perceived risk that a business will could face a challenge from the SBA.

At the conclusion of its review, the SBA may determine that a business did not meet certain criteria and is therefore not eligible for PPP loan forgiveness. The SBA would then have authority to require repayment of the PPP funds, plus interest (essentially treating the PPP funds as a loan). While the business would have the right to appeal the SBA determination, it likely would incur legal fees in doing so, without a guarantee of changing the outcome. In addition, if merited, the federal government could take more aggressive measures, including seeking fines and penalties or even treble damages pursuant to the False Claims Act.

What Does PPP Insurance Cover?

PPP insurance addresses the risk that the SBA determines, during its six-year review window, that certain of the policyholder's eligibility certifications were inaccurate when made. The insurance policy primarily covers repayment of the PPP funds, plus interest, during the policy period, which is designed to mirror the six-year review window. This repayment coverage may be of particular utility to businesses seeking to engage in financial planning during the six-year review window and could potentially allow a business to avoid taking a reserve in its financials for the amount of the PPP funds. For businesses with multiple and transitory owners (including law firms and accounting firms), PPP insurance can protect against the risk that some of the current owners or partners will leave the business or retire prior to the SBA review, thereby burdening the remaining owners or partners with the risk of repaying the PPP funds.

Similar repayment coverage is not likely to be available under any other type of insurance policy. Although directors and officers (D&O) liability insurance policies often provide coverage for government investigations, D&O insurers may take the position that a required return of PPP funds due to the SBA's determination that the policyholder was ineligible for loan forgiveness constitutes uncovered disgorgement or, alternatively, does not constitute covered loss.

PPP insurance does have certain important coverage limitations. A PPP insurance policy will contain an exclusion for fraud in certifications or information provided to the SBA. Also, the PPP insurance policy will contain a statement of material facts that sets forth the relevant facts about the business upon which the certifications were based. If there are material inaccuracies in that statement, the insurer may have grounds to avoid coverage. In addition, although the scope of coverage is continuing to evolve, PPP insurance policies will likely exclude coverage where the SBA denies loan forgiveness for reasons other than inaccuracies in the Necessity Certification or certifications related to business size, including where the business used the PPP loan proceeds in violation of the program requirements. Prospective policyholders should closely review the terms and conditions of the PPP insurance policy to determine exactly when coverage is triggered, and the requirements for appealing an adverse SBA determination.

The Application Process

Before issuing an insurance policy, insurer representatives will conduct a thorough underwriting of the applicant's eligibility for PPP funds. The insurer will seek information about the impact of the COVID-19 pandemic on the applicant's business, the applicant's access to alternative sources of liquidity, the business' financial performance and evidence that the business met the size/headcount requirements after taking into account the affiliation rules.

An ideal candidate for PPP insurance bears some risk that it will have to repay PPP funds because of the vagueness of the eligibility requirements and the unpredictability of how the federal government will interpret and enforce these requirements, but also participated in the program in good faith and can present a colorable and defensible basis for its position that it met the eligibility criteria.

Separately, an ideal policyholder candidate received, and intends to retain, $2 million or more in PPP funds. This threshold is not an absolute requirement, but the insurers charge minimum premiums that make it disproportionately expensive to insure risks associated with loans of less than $2 million. In addition, businesses that received loans of at least two million dollars have an increased risk of an SBA challenge because the SBA has announced that it will conduct reviews of every business that received $2 million or more in PPP funds.

Mergers and Acquisitions

PPP insurance can be of particular interest to the parties to a merger or acquisition where the target company received, and intends to retain, PPP funds. In that situation, the buyer is likely to be unwilling to accept the risks associated with a potential SBA challenge to the target's eligibility to retain the PPP funds, and the parties may prefer to seek PPP insurance in lieu of a seller indemnity. Parties also may be concerned that the transaction itself could increase the chances of an SBA challenge to the target's eligibility.

There are two principal challenges to obtaining PPP insurance in the context of a transaction. First, the private banks that issued the PPP loans typically included change of control provisions in the loan documents. These provisions prevent a business that received PPP loans from being acquired without first obtaining a waiver from the bank. Further, the SBA is reportedly requiring the lenders to obtain SBA consent before granting such a waiver. While obtaining the required waiver and consent could delay a transaction, PPP insurers are unlikely to provide PPP insurance if the target is not in compliance with the change of control provisions in the loan documents.

Second, the SBA's affiliation rules essentially give present effect to agreements in principle to enter into a transaction, such that a counter-party in a prospective merger may be treated as a present affiliate for purposes of meeting the eligibility requirements. Accordingly, companies that received PPP loans may face increased eligibility risks if they consummate transactions that were already under negotiation at the time that they applied for the PPP funds. These businesses may be unable to meet the underwriting requirements of PPP insurers.

Looking Forward

Little information is currently available concerning the SBA's review and enforcement plans. PPP insurance represents a creative solution to a potentially meaningful risk, but it is a new product that will likely evolve further in a short period of time. Concord Specialty Risk, one of the market leaders in underwriting transactional and contingent risk, has already bound a number of PPP insurance policies and reports significant interest amongst potential insureds, with over 50 new submissions received this summer. Given the complexity of the PPP program and PPP insurance, participating businesses should consult with knowledgeable attorneys and insurance brokers for assistance in evaluating whether PPP insurance is likely to provide them with protection from risks associated with an SBA review of their eligibility to retain PPP funds.