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Many EIDL Loans Will Cause Disaster For Unassuming Borrowers



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Separate and apart from the Paycheck Protection Program (“PPP”) is the Economic Injury Disaster Loan (“EIDL”) program. **Initially enacted many years ago** to provide loans to businesses that have suffered from major storms, droughts, and other federally-declared disasters, the SBA has already advanced over \$150 billion in EIDL money to borrowers who have verified that they have suffered “substantial economic injury” due to the effects of COVID-19.

The maximum EIDL loan amount is \$2 million, and the deadline to apply for these loans is December 31, 2020. Applicants previously could accept an “advance” of up to \$10,000 that is considered a “grant” and does not need to

be repaid. However, the SBA announced on July 11th that the EIDL advance program has been discontinued and the website provides the following:

- All available funds for the EIDL Advance program have been allocated. By law, SBA is not able to issue EIDL Advances once program funding has been obligated and is no longer available. EIDL loan applications will still be processed even though the Advance is no longer available.

EIDL loans bear interest at 3.75% and come with significant loan program requirements that very few borrowers are aware of or have thought about. Many such borrowers are already in default of their EIDL loans or inadvertently broke the law in applying for and receiving them. This will become more evident in months to come.

Many banks are already taking steps to get businesses of certain sizes and nature off of their books, especially if there is an issue with a borrower's PPP loan status, and whistleblowing employees and others may receive bounties for turning in unassuming employer borrowers who might not even be aware of the issues at hand.

We will be discussing these and other issues in a free webinar on Saturday, August 1st at 10:00 a.m. (EDT). Please e-mail info@gassmanpa.com with the subject "Saturday" for a link to join this 30-minute presentation by myself, Brandon Ketron CPA, JD, LL.M. and Kevin Cameron, CPA. We will also describe how the first \$10,000 of any EIDL loan is actually considered to be a grant that does not have to be repaid, except to the extent of amounts borrowed from the PPP program.

While a great many borrowers consider it to be a duty or an entitlement to borrow under the EIDL program, the standard of need appears to be much higher than the treacherous “necessity” standard that applies for PPP loans (as discussed in my article dated May 4, 2020) and while an EIDL loan is outstanding there can be no dividends or personal expenses paid by the business entity for its owners, as discussed below.

Further, EIDL loan proceeds cannot be spent on any expenses that were already funded and paid for by PPP loan proceeds or medical practice relief loan payments, and must be spent only on the following:

1. Payroll costs during business disruptions or substantial slowdowns;
2. Providing paid sick leave to employees unable to work due to the direct effect of COVID-19;
3. Mortgage payments;
4. Rent;
5. Meeting increased costs to obtain materials unavailable from the applicant’s original source due to interrupted supply chains; and
6. Repaying obligations other than those listed above that cannot be met due to revenue losses.

Further, SBA presentations and a Standard Operating Procedure document from 2018 provide the following to enumerate the ineligible uses of EIDL loan money:

EIDL proceeds may not be used for:

1. Payment of any dividends or bonuses;
2. Disbursements to owners, partners, officers, directors, or stockholders, except when directly related to performance of services for the benefit of the applicant;

- 3.** Repayment of stockholder/principal loans, except when the funds were injected on an interim basis as a result of the disaster and non-repayment would cause undue hardship to the stockholder/principal;
- 4.** Expansion of facilities or acquisition of fixed assets;
- 5.** Repair or replacement of physical damages;
- 6.** Refinancing long term debt;
- 7.** Paying down (including regular installment payments) or paying off loans provided, or owned by another Federal agency (including SBA) or a Small Business Investment Company licensed under the Small Business Investment Act. Federal Deposit Insurance Corporation (FDIC) is not considered a Federal agency for this purpose;
- 8.** Payment of any part of a direct Federal debt, (including SBA loans) except IRS obligations.
 - If a direct Federal debt is delinquent, your recommendation must be based on independent documentation from the appropriate Federal agency explaining how the delinquency will be cured.
 - If a direct Federal debt is delinquent because of the disaster, we should make arrangements with that Federal creditor to have payments deferred or a similar action taken to bring the delinquency current prior to approval of an EIDL. If the Federal creditor cannot or will not cooperate, the likely result will be a decline of the EIDL request. However, if the applicant has other resources or recoveries, we should generally allow (and perhaps require) those resources to be applied first to ineligible needs, such as the payment of direct Federal debt.
 - When processing during the injury period, it is generally appropriate for you to negotiate with Federal creditors to defer payments (or take

similar action) until the end of the injury period. You must document why this was or was not imposed.

9. Pay any penalty resulting from noncompliance with a law, regulation or order of a Federal, state, regional, or local agency;

10. Contractor malfeasance; and

11. Relocation.

In summary, a very high percentage of EIDL borrowers are in violation of civil and criminal statutes and loan provisions because of one or more of the following:

1. They did not have the degree of Substantial Injury as the law requires when they applied and received the loans.
2. They have spent loan monies on prohibited expenses.
3. They have paid dividends or personal expenses for their owners.

Here is more detail on these requirements, but borrowers should seek counsel from their lawyers under the attorney client privilege and not rely upon any one article or commentator in deciding what to do with respect to their situation.

Businesses that received an EIDL loan are unable to pay dividends, even if these come from earnings having nothing to do with EIDL loan monies.

Borrowers often do not realize that the law and the loan agreement prevents them from taking dividends out of their company until the entirety of the loan is paid back. EIDL loans are 30-year loans with an interest rate of 3.75%. This means that theoretically, businesses will not be able to take out dividends for over 30 years if they received an EIDL loan and do not repay it in full.

Most small businesses have elected to be taxed as S corporations. If these businesses pay wage to their owners they are required to pay employment taxes. If an S corporation pays out dividends, however, they are not required to pay employment taxes on these, although the law does require that reasonable wages be paid to owners. It is a typical practice for many small businesses to take out dividends, but now it is illegal for those who have received EIDL loans.

Further, S corporation shareholders will be unable to make distributions, either directly or indirectly, to themselves or others without written consent from the SBA. The agreement also broadly defines what is considered a “distribution,” including any advances, loans or bonuses, but remains vague in describing how this consent is to be obtained. As it is now the SBA is almost unreachable by phone, meaning that this consent requirement for any and all distributions is likely to be broken by many without intention.

If lenders who have conventional loans owed by EIDL borrowers see that they are in default of their EIDL loan covenants, they may have to declare the commercial loans to be in default, which can cause a great calamity.

The agreement also requires that any borrower may not relocate his or her business without prior written permission from the SBA and if the borrower receives any funds from non-EIDL sources to help with Coronavirus-related injuries then those funds must be turned over to the SBA. These sources include but are not limited to insurance proceeds, claims for civil liabilities, and grants from other governmental agencies or private entities.

Record Retention and Casualty Insurance Requirements.

The SBA requires businesses to keep records of how the EIDL loan is spent, and provide the SBA with this information by 90 days after the loan is repaid. This means that for businesses that repay the loan on time, they will have to keep financial statements for over 30 years.

In addition, the EIDL loan agreement requires the borrower to maintain hazard insurance based upon 80% of all insurable assets of the borrower. This coverage must be acquired within 12 months of obtaining the loan.

What is “Substantial Economic Injury” for purposes of EIDL Qualification?

This is probably the biggest criminal exposure for EIDL borrowers. When applying for an EIDL loan, borrowers had to state that the reason the loan was needed was due to a “substantial economic injury.” As set forth in longstanding SBA regulations, and as stated in the EIDL application [SEE APPLICATION], “substantial economic injury generally means a decrease in income from operations or working capital with the result that the business is unable to meet its obligations and pay ordinary and necessary operating expenses in the normal course of business.” Substantial economic injury is also defined in the US Code of Federal Regulations at Book 13, Code of Federal Regulations, Section 123.300, which states the following:

(a) If your business is located in a declared disaster area, and suffered substantial economic injury as a direct result of a declared disaster, you are eligible to apply for an economic injury disaster loan.

1. Substantial economic injury is such that a business concern is unable to meet its obligations as they mature or to pay its ordinary and necessary operating expenses.
2. Loss of anticipated profits or a drop in sales is not considered substantial economic injury for this purpose.

The entire United States is considered a declared disaster area because of COVID-19, but proving that the business suffered “substantial economic injury” to the point of being “unable to meet its obligations, or pay its ordinary and necessary operating expenses” may be hard to do for many businesses that have cash on hand from PPP loans that will be forgiven, as well as from other sources. This is why it is important for businesses to

consult with an attorney to better understand if their loan was legitimate, and if not, repay the loan as soon as possible.

It is certainly of interest that the lower “necessity” standard that applies for PPP loans has been the subject of governmental and Trump administration pronouncements that borrowers are “in big trouble” if they did not satisfy the requirement, while nothing seems to have been said about this much higher EIDL loan hurdle. A great many EIDL loan borrowers will be well advised to return their EIDL loans, with interest at 3.75%, before whistleblowers become active, or governmental agents come knocking.

There are insurance carriers that are actually writing policies for PPP borrowers to pay for government investigations and fines that may be imposed if a PPP loan was not “necessary” but we are not aware of any such policies for EIDL loans.

Collateral Requirements for EIDL loans.

Many EIDL borrowers forgot or were unaware that there was a collateral agreement in the application for loan amounts greater than \$25,000. This differs from PPP loans that have no collateral requirements.

The collateral agreement for an EIDL loan is vigorous and will generally prevent the borrower from pledging collateral to any other lender, and may cause existing lenders to declare their loans to be in default if provisions of the existing loans prevent given collateral status to any other lender.

The Collateral includes the following tangible and intangible personal property that Borrower now owns or shall acquire or create immediately upon the acquisition or creation thereof, including but not limited to:

- Inventory;
- Equipment;
- Instruments, including promissory notes;

- Chattel paper, including tangible chattel paper and electronic chattel paper;
- Documents;
- Letter of credit rights;
- Accounts, including healthcare insurance receivables and credit card receivables;
- Deposit accounts;
- Commercial tort claims;
- General intangibles, including payment intangibles and software; and
- As-extracted collateral as such terms may time to time be defined in the Uniform Commercial Code.

The Collateral section of the loan agreement also indicates that a borrower will not sell or transfer any of the collateral without written consent from the SBA, unless the collateral is inventory sold in the normal course of business. Additionally, borrowers may not seek any advances on superior liens on the EIDL loan collateral without the written consent of the SBA. These provisions greatly restrict a business owner's independence in making day-to-day decisions on behalf of the business.

Borrowers who received an EIDL payment should be well aware of the rules and regulations related to them. For answers to specific questions, borrowers should speak with a qualified CPA and Attorney to best understand the short and long-term requirements for receiving these loans, and may want to start with an attorney who can hire the CPA to keep communications under the attorney client privilege.

The best path forward for many EIDL borrowers will be to pre-pay the loan once it is clear that it is probably not needed, to allow the business to “meet

its obligations as they mature, or to pay its ordinary and necessary operating expenses.”

Lack of Privacy.

Further, all EIDL borrowers will find that their private details are available in the public records because of the Freedom of Information Act, enumerated at 5 U.S.C. § 552. This law does not require disclosure of financial statements, marketing strategies, or loan applications. Further, personal home email addresses, telephone numbers, social security numbers, and birth records will remain protected. The information that is generally disclosed by the SBA includes the names of the officers and directors of the borrower, SBA awarded contracts, and the types and amounts of SBA loans.

Concluding Thoughts.

It is important to discuss all loan options with a bank or other lending authority to ensure that obtaining a Coronavirus-related SBA loan will not in any way affect other outstanding loan covenants. In many situations, violating an outstanding loan covenant can increase the interest rate on that loan or even cause the loan to be considered in default.

Kevin Cameron, a knowledgeable CPA whose advice has been imperative in drafting this article, remains unsure whether he will recommend this loan to those not in a financial emergency. “Even then,” he added, “I’d recommend strictly following the terms so [borrowers] can try to avoid the civil and potentially criminal penalties.” He ends by stressing that “the civil penalty alone can be 150% of the loan amount.”

It is important for borrowers to consult with their CPA, attorney, and banker, and to read the loan agreement carefully prior to applying. While the simplistic process of obtaining SBA loans has made it easy for the average citizen to receive financial assistance, it has also reduced the

likelihood of these citizens reading the agreements they are signing and doing research beforehand. As noted above, many of the provisions that have been released restrict the independence of business owners and, if one is not too careful, may allow the SBA to essentially become a “partner” of the business.

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