Lenders, Financial Institutions Face Unique Exposure Under New COVID-19 Legislation

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Overview

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- Paycheck Protection Program (PPP) Timeline – Confusion and Speed Create Risks
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Introduction

- **PPP has in many ways been a great success, but it has not been without its issues and frustrations.**
- **PPP stats:**
  - 5,459 lenders have participated in PPP, as of June 30, 2020.
  - 4,856,647 approved loans.
  - $520,629,017,523 approved dollars.
  - Average loan size of $107,199.

Source: https://www.sba.gov/funding-programs/loans/coronavirus-relief-options/paycheck-protection-program

PPP Timeline

- CARES Act signed into law – March 27
- SBA releases first set of PPP documents for borrowers and lenders – March 31
- First Interim Final Rule related to PPP – April 2
- PPP application process commences – April 3
- SBA released first set of PPP FAQs – April 3

PPP Timeline

- First round of PPP funding exhausted – April 16
- Second of PPP funding opens – April 27
- PPP Flexibility Act signed into law – June 5
- PPP application period ended – June 30
- PPP application deadline extended until Aug. 8 – July 4

Confusion and Speed Creates Risks

- PPP rolled out extremely quickly
- SBA rules and guidance slow to materialize
- Lack of time to train employees regarding the nuances of PPP
- All hands on deck approach at many financial institutions
- Potential for lack of oversight of individual lenders inside a financial institution
- Non-SBA lenders and non-traditional lenders
- Change in tone of the program and its complexity over time
- Lender role in loan forgiveness

Paycheck Protection Program: Bank Liability Assessment under the False Claims Act

CARES Act: Paycheck Protection Plan (PPP)

- **Coronavirus Aid, Relief, and Economic Security (CARES) Act**
- **Title I**
  - Establishes the PPP, and amends the Small Business Act (SBA) to authorize participating lenders to make loans to eligible small businesses.
- **Sec. 1102(a)(2) – Lenders shall consider whether the borrower:**
  - was in operation on Feb. 15, 2020; and
  - had employees for whom the borrower paid salaries and payroll taxes.

Hold Harmless Provision

- **Sec. 1106(h) – Hold Harmless**
  - If a lender has received the documentation required under this section from an eligible recipient attesting that the eligible recipient has accurately verified the payments for costs of payroll, lease/mortgage/utility obligations:
    - enforcement action may not be taken against the lender under sec. 47(e) of the SBA relating to loan forgiveness for such covered payments; and
    - the lender shall not be subject to penalties by the Administrator relating to loan forgiveness for the payments.

Interim Final Rule 1

- **Lenders may rely on borrower documentation for loan forgiveness.**
  - No need to conduct verification if the borrower attests that it has accurately verified the payments for eligible costs.
  - Why?
    - Sec. 1106(h) prohibits enforcement action or penalties if the lender has received a borrower attestation.
  - Best practice:
    - Perform a good faith review, in reasonable time, of the borrower’s calculations and supporting documents.

Profiles, Inc. v. Bank of America Corp.

- **District of Maryland, April 13, 2020**
  - Small business in Maryland filed a class action suit against Bank of America (BofA).
    - Claimed that BofA was applying "unlawful eligibility criteria that are contrary to the express eligibility provisions in [sic] the CARES Act."
    - Moving the court for a temporary restraining order (TRO) to enjoin BofA from imposing borrowing restrictions under the PPP.

Profiles, Inc. v. Bank of America Corp. (cont'd)

- **The court denied the TRO:**
  - "Nothing in the text [of the CARES Act] evidences Congress's intent to enable PPP loan applicants to bring civil suits against PPP lenders."
  - "Neither the Act nor the Interim Final Rule imposes prohibitions on what lenders may do in their processes for accepting or processing applications."
  - "Given the plain statutory language, the Court is not at liberty to impose further limitations on lenders."
- **Appeal filed (and pending) in the Fourth Circuit.**

The False Claims Act (FCA): 31 U.S.C. § 3729 et seq.

- **Liability for knowingly present[ing], or caus[ing] to be presented, a false or fraudulent claim for payment or approval [to the government].**
  - § 3729(a)(1)(A)
- **Liability for knowingly mak[ing], us[ing], or caus[ing] to be made or used, a false record or statement material to a false or fraudulent claim.**
  - § 3729(a)(1)(B)

FCA Definitions

- **“Knowing” and “Knowingly”**
  - Has actual knowledge of the information;
  - Acts in deliberate ignorance of the truth or falsity of the information; or
  - Acts in reckless disregard of the truth or falsity of the information; and
  - No requirement for proof of specific intent to defraud.
- **“Material”**
  - Having a tendency to influence, or be capable of influencing, the payment or receipt of money or property.

Universal Health Servs., Inc. v. U.S. ex rel. Escobar

- **Liability under the FCA for implied false certification.**
  - "When a defendant submits a claim, it impliedly certifies compliance with all conditions of payment." Id. at 1995.
  - Liability may arise where:
    - (1) The claim does not merely request payment, but also makes specific representations about the goods or services provided; and
    - (2) The defendant's failure to disclose noncompliance with material statutory, regulatory, or contractual requirements makes those representations misleading half-truths.
  - Key is whether "a defendant knowingly violated a requirement that the defendant knows is material to the Government's payment decision." Id. at 1996.
    - Subjective Standard: "[M]ateriality looks to the effect on the likely or actual behavior of the recipient of the alleged misrepresentation." Id. at 2002.

Post-Escobar

- **U.S. v. Wells Fargo & Co., 943 F.3d 588 (2nd Cir. 2019)**
  - The FCA "does not reach frauds directed at private entities that only incidentally lead to payments with money provided by the government." Id. at 596.
  - Analysis—intent to defraud government or private entity.
    1. Whether officer or employee of the U.S.
    2. Whether agent of the U.S.
    3. Whether the fraudulent loan request that was knowingly presented to private entity is a claim under the FCA because the money requested is provided by the U.S.

Post-Escobar

- **U.S. v. Raza, 876 F.3d 604 (4th Cir. 2017).**
  - Defendants were employees of SunTrust, and prepared fraudulent mortgage loan applications containing false information (false employment claims, inflated incomes, overstated assets).
  - Defendants' argument: Escobar dictates that the applicable test for materiality in fraud prosecution is subjective.
  - Court held that "the correct test for materiality … is an objective one, which measures a misrepresentation's capacity to influence an objective "reasonable lender." Id. at 621.

Potential Risks and Key Considerations

Four Potential Buckets of Risk

1. **FCA and FIRREA Claims by the Government and Whistleblowers**
   - What is a ***good faith*** review of the loan application and forgiveness application?
   - What about **Know-Your Customer** rules; **AML Compliance**?
   - Hold harmless:
     - For relying on "eligible" borrower reps. But what about ***ineligible*** borrowers that the lender should have known about?
     - Confined to forgiveness, and confined to SBA action.
   - Real world examples:
     - Arkansas Mo;
     - "Can't we just split the company?"

Four Potential Buckets of Risk

2. **Class Actions**
   - Fair Lending
   - CARES Act
3. **Agent Claims**
   - Recent DOJ civil investigative demand
   - Class actions filed across the country
   - *Alliant CPA v. BofA et al.*
4. **Claims by borrowers for failing to obtain forgiveness**
   - You ruined my business allegations
   - Claims not for the fee amount but for "ruining the business" – i.e., enterprise value claims

Will Your BPL Respond?

- **Definition of “Professional Services” or “Borrower”**
  - Is it limited to customers? Customers pursuant to a written contract? Customers that pay a fee?
  - Ask your broker why?
- **Exclusions**
  - Does the policy exclude government claims/investigations?
  - “Ill-gotten” gains and/or “disgorgement.”
  - Are FCA claims insurable or will the carrier raise a public policy defense?
  - Ask your broker why?

Will Your BPL Respond?

- **Allocation**
  - What happens if only part of the claim is covered?
  - How are costs and legal fees allocated?
  - If not 100% coverage for “mixed” claims, ask your broker why?
- **Limits**
  - Did you buy limits without the CARES Act in mind?
    - Fee earnings
    - Treble damages

Consider Wrapping the Policy

- **A difference-in-condition / wrap policy may be available**
- **Features include:**
  - Full coverage of fines, penalties, etc. with tools to limit coverage and insurability defenses
  - Retro date to start of CARES program with a 6- or 10-year tail to match FCA statutes of limitation and repose
  - Extremely broad, manuscript cover that locks in the value of your CARES Act fees

Compliance Tips

Compliance Tips: SBA Audits

- **SBA Interim Final Rule on 6/1: Any loan of any size may be reviewed by the SBA at the SBA's discretion.**
- **Lenders will be notified in writing of an SBA audit.**
  - Lender must notify borrower within five (5) business days of the audit;
  - Borrowers then must respond to SBA questions and have an opportunity to provide additional information; and
  - The SBA may deal directly or indirectly with the lender to facilitate this process with the borrower.

Compliance Tips: Regulatory Reporting

- **Per SBA guidance, account and report PPP loans as loans in Schedule RC-C (Loans and Lease Financing Receivables).**
- **SBA Form 1502**
  - Must be completed within 10 calendar days after loan disbursement or cancellation;
  - Must be updated monthly by lenders participating in the SBA's 7(a) loan program for collection of payment and loan information; and
  - May be used by lenders to report PPP loan disbursements, cancellations, voluntary terminations.

Compliance Tips (cont'd)

- **Comply with all other applicable regulations, e.g.:**
  - Equal Credit Opportunity Act (ECOA)
  - Unfair, Deceptive, or Abusive Acts or Practices (UDAAP)
  - Community Reinvestment Act (CRA)
  - Fair lending and redlining requirements
- **Best practices:**
  - Review (even if not as stringently as typical underwriting process) for red flags or indications of fraud
  - Meticulous recordkeeping

Q&A

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