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First Charges for Paycheck Protection Program Loan Fraud and the Implications for Borrowers and Lenders

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On March 27, 2020, President Trump signed into law the Coronavirus Aid, Relief, and Economic Security (“CARES”) Act, providing \$2 trillion of stimulus relief to address the economic impact of the COVID-19 virus. Among the features of this stimulus relief is the Paycheck Protection Program (“PPP”), which initially provided \$349 billion in funding for forgivable loans for qualifying businesses in a program administered by the Small Business Administration (“SBA”) and the U.S. Department of the Treasury. A second round of funding provided an additional \$310 billion in forgivable loans.

Naturally, the infusion of \$2 trillion in the U.S. economy comes with substantial risk of fraud. This, at a time when U.S. Attorney General William P. Barr has directed U.S. Attorney’s Offices to prioritize the detection, investigation, and prosecution of COVID-19-related crime.^[1] The latest example of such a prosecution – and the first instance of a federal prosecution of PPP fraud – was announced just last week, and included charges against two individuals in the District of Rhode Island for fraudulently misrepresenting, among other things, the existence of fictitious employees and their corresponding payroll expenses, in order to obtain SBA loans.^[2]

The Rhode Island prosecution is perhaps not particularly noteworthy in its own right. Indeed, the allegations of fraud in that case appear egregious, and also well supported by compelling evidence, including the potential testimony of one or more FBI undercover agents who posed as bank compliance officers, information from a cooperating witness, and the results of email search warrants revealing highly incriminating documentary evidence. Similar prosecutions involving such allegedly blatant conduct are likely to recur. But others may be premised upon even less clear evidence. This article contemplates potential prosecutions and enforcement actions brought against more sophisticated borrowers and lenders, even when acting in good faith, but under ambiguous and evolving circumstances and even contradictory guidance.

Thus, we examine two emerging issues below: (1) the potential for enforcement against borrowers who, while acting in good faith, may later be viewed as having obtained loans that were not “necessary” in light of murky (or even contradictory) guidance; and (2) potential exposure for lenders in the event employees (such as loan officers) turn a blind eye to plainly inappropriate loan applications.

Borrower Liability and *United States v. Staveley*

The criminal complaint against David Staveley and David Butziger is apparently the product of a multi-agency investigation including the FBI, IRS-Criminal Investigations, SBA Office of Inspector General, and the FDIC Office of Inspector General.^[3] According to the complaint, both Defendants allegedly conspired to seek PPP loans for four different businesses, none of which were actually operating pre-COVID-19, despite the loan eligibility criteria to the contrary, and all of which lacked the employees claimed in the loan documents, among other fraudulent statements.^[4] In total, the Defendants sought approximately half a million dollars. While the Rhode Island prosecution is an extreme example, borrowers should remain alert to the risk of

potential enforcement actions in connection with PPP loans even when acting in good faith.

For example, as our Firm has noted in a prior client alert,^[5] the borrowers are required to initial, among a host of other certifications, that “[c]urrent economic uncertainty makes this loan request **necessary** to support the ongoing operations of the Applicant.”^[6] As the SBA advised in guidance initially issued on April 23, 2020, “borrowers must certify in **good faith** that the PPP loan is necessary” and in so certifying “take 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.”^[7]

But in the wake of widely publicized examples of large institutions taking advantage of loans,^[8] the SBA offered the additional guidance 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, and such a company should be prepared to demonstrate to SBA, upon request, the basis for its certification.”^[9] (Somewhat confusingly, however, the very same paragraph of the guidance notes that “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),” even while requiring the good faith certification to necessity.^[10]) The SBA also offered a limited safe harbor to applicants who acquired SBA loans but returned them by a specific date. That date was originally May 7, but was subsequently extended to May 14 (the date by which the SBA said it would offer further guidance on the necessity certification, which was ultimately released on May 13^[11]), and most recently has been extended to May 18.^[12]

On May 13, 2020, the SBA offered new guidance on what it would deem a “necessary” loan.^[13] Specifically, the updated guidance provides a broad safe harbor with respect to loans with a principal amount of less than \$2 million. (Recall that, as prior guidance made clear, a borrower’s loan forgiveness application will automatically trigger an audit of loans valued in an amount greater than \$2 million, and in some cases loans in other amounts.^[14]) The new guidance states, in relevant part: “[a]ny 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.”^[15] Notably, the updated guidance also states, “given the large volume of PPP loans, this approach will enable SBA to conserve its finite audit resources and focus its reviews on larger loans, where the compliance effort may yield higher returns.”^[16]

On first appearance, this seems likely to increase the risk of fraud. Borrowers would do well to treat the SBA’s line-drawing as a matter of administrative convenience to the agency, not as a blank check for borrowers to obtain loans without a bona fide necessity. To be sure, as a matter of administrative discretion SBA has now said that loans of less than \$2 million are unlikely to be audited. But other agencies and the U.S. Department of Justice in particular may well treat the new guidance as merely establishing a **presumption** of necessity. That presumption unquestionably makes difficult, if not impossible, prosecutions based solely upon improper necessity certifications. But other risks remain, including prosecutions brought for bank fraud where other false statements in loan applications can be proved.

The updated guidance also makes clear that “borrowers with loans greater than \$2 million that do not satisfy this safe harbor may still have an adequate basis for making the required good-faith certification, based on their individual circumstances in light of the language of the certification and SBA guidance.”^[17] With respect to these larger borrowers receiving greater than \$2 million in loans, the SBA also advises:

If SBA determines in the course of its review that a borrower lacked an adequate basis for the required certification concerning the necessity of the loan request, SBA will seek repayment of the outstanding PPP loan balance and will inform the lender that the borrower is not eligible for loan forgiveness. If the borrower repays the loan after receiving

notification from SBA, SBA will not pursue administrative enforcement or referrals to other agencies based on its determination with respect to the certification concerning necessity of the loan request.^[18]

This too may offer an incentive for larger borrowers to obtain funds with no clear necessity (i.e., the availability of other sources of liquidity) and seemingly with little risk of negative consequences. But this would also be mistaken. After all, although the SBA may not pursue enforcement action or a criminal referral, criminal authorities may discover such improper loan applications independently, and not view them quite so charitably. In addition, borrowers should be mindful that the SBA's "frequently asked questions" guidance explicitly states that it does not carry the force of law.^[19]

In sum, the latest SBA guidance reduces – but does not eliminate entirely – the risk to borrowers regarding their good faith certification to necessity. And it does nothing to allay concerns if false statements are made regarding a host of other PPP loan application certifications and requirements. Thus, large and small borrowers alike should still give careful thought to their need for SBA loans, and how they will demonstrate such necessity in the event of a later inquiry or audit. They must do so, furthermore, in light of still evolving guidance from the SBA that is also somewhat contradictory. Borrowers should document efforts to obtain alternate financing or liquidity from other sources, and preserve documentary evidence of the results of those efforts. Similarly, borrowers should maintain accurate books and records on the disposition of loan proceeds received in order to be able to demonstrate that funds were ultimately used for their intended purpose.

In addition to the latest guidance on necessity certifications, which may make it harder for prosecutors to charge borrowers with making improper necessity certifications, the subjectivity of the necessity requirement (even as applied to amounts above the \$2 million threshold) may make criminal convictions more difficult, given the requirement of proof of intent, and the need for the government to sustain its burden of proof "beyond a reasonable doubt." Even so, the risk of prosecution has not vanished, nor the risk of civil penalties (provable under a lower, "preponderance of the evidence" standard), and the financial costs, distraction and negative publicity of an investigation, even one that is ultimately exonerating. Borrowers should continue to work closely with legal counsel to ensure compliance with loan requirements.

Potential Lender Liability

The current Interim Rules and guidance place the burden on borrowers to provide accurate disclosures to lenders. Indeed, the guidance states that lenders are entitled to rely upon the representations of the borrowers.^[20] Notwithstanding this reassurance, lenders should not expect blanket immunity for potential knowing and intentional misconduct or willful blindness on the part employees (e.g., loan officers) who process improper or ineligible loan applications. And under longstanding criminal law governing the vicarious liability of entities such as corporations, a corporation can be criminally liable for the acts of its employees when those employees are acting within the scope of their employment and at least in part for the benefit of their employer.^[21]

Overall, if lenders rely in good faith upon the representations and certifications of applicants, and follow applicable Bank Secrecy Act and other regulatory requirements, the exposure of lenders may be limited. Notwithstanding this fact, lenders should continue to apply the same high compliance standards to ensure that employees do not willfully ignore certifications known to be untrue or that at least seem highly implausible.

For example, Interim Finalized Rule 3.b states the following regarding lender underwriting obligations:

What do lenders have to do in terms of loan underwriting? Each lender shall i. Confirm receipt of borrower certifications contained in Paycheck Protection Program Application form issued by the Administration; ii. Confirm receipt of information demonstrating that a borrower had employees for whom the borrower paid salaries and

payroll taxes on or around February 15, 2020; iii. Confirm the dollar amount of average monthly payroll costs for the preceding calendar year by reviewing the payroll documentation submitted with the borrower's application; and iv. Follow applicable [Bank Secrecy Act and implementing regulations] requirements.^[22]

Items i and ii only require the bank to "[c]onfirm receipt." On first appearance, item iii requires a bank to do more. However, recent SBA guidance confirms "the lender [is not required] to replicate every borrower's calculations."^[23] It further states, "[p]roviding an accurate calculation of payroll costs **is the responsibility of the borrower**, and the borrower attests to the accuracy of those calculations on the Borrower Application Form."^[24] However, the same guidance seems not to relieve lenders of responsibility entirely, and requires lenders to conduct a "good faith review." And even though such review may be minimal, a lender who becomes aware of a borrower's errors, or a "material lack of substantiation" in the borrower's supporting materials, "should work with the borrower to remedy the issue":

Lenders are expected to perform a good faith review, in a reasonable time, of the borrower's calculations and supporting documents concerning average monthly payroll cost. For example, minimal review of calculations based on a payroll report by a recognized third-party payroll processor would be reasonable. In addition, as the PPP Interim Final Rule indicates, lenders may rely on borrower representations, including with respect to amounts required to be excluded from payroll costs.

...

If the lender identifies errors in the borrower's calculation or material lack of substantiation in the borrower's supporting documents, the lender should work with the borrower to remedy the issue.^[25]

This language suggests that lenders are not merely acting as passive conduits for the government's distributions of loan proceeds. Rather, lenders are expected to exercise some minimal level of good judgment and good faith. When acting accordingly, lenders will benefit from the SBA's deference in several ways, including in the assumption that it is not a lender's responsibility to make an independent determination on applicable "affiliation rules," and that they can instead rely on the borrower's certification.^[26] Lenders are also protected by "hold harmless" language with respect to their reliance on borrower's certifications when it is time to "forgive" a PPP loan.^[27]

A lender's exercise of good faith could be tested in any number of scenarios. For example, borrowers must certify that "[d]uring the period beginning on February 15, 2020 and ending on December 31, 2020, [they have] not and will not receive another loan under the Paycheck Protection Program."^[28] If the loan officer is not actually aware of the applicant's receipt of a prior loan, but through a series of key strokes could query a database to determine this fact, the lender could perhaps incur liability for failing to do so.

Thus, lenders should not abandon the traditional "know your customer" protocols and other compliance procedures with which financial institutions are familiar. And lenders, like borrowers, should also take note that the SBA's "frequently asked questions" guidance makes clear that it does not carry the force of law.^[29]

Conclusion

The unprecedented scale of the CARES Act stimulus, and the dire need of many businesses for the lifeline the PPP offers, creates conditions ripe for fraud. Although liability is most likely to arise on the side of borrowers, given the deferential approach to lenders, lenders themselves are not without some degree of risk. Indeed, the Special Inspector General overseeing 2008 financial crisis relief packages ("SIGTARP") recovered \$900 million in fiscal 2019 year alone.^[30] And SIGTARP data reveals 430 individuals were charged criminally, including 105 bankers indicted, 92 bankers convicted,

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and 76 bankers sentenced to imprisonment.^[31] A significant number of borrowers were also charged and convicted in SIGTARP-related investigations.^[32] The prospect of some enforcement actions being brought against borrowers and lenders under the CARES Act seems likely.

As noted in an earlier client alert,^[33] the CARES Act seeks to prevent fraud through creation of the Special Inspector General for Pandemic Recovery and the Pandemic Response Accountability Committee akin to SIGTARP. Both CARES Act oversight elements are well-funded and broadly empowered to pursue potential fraudulent activity.^[34] It should not surprise anyone if CARES Act prosecutions of borrowers and lenders alike increase in time. Borrowers and lenders should therefore be forewarned and forearmed.

1. See Memorandum of U.S. Attorney General William P. Barr to U.S. Attorneys (Mar. 16, 2020) (“Every U.S. Attorney’s Office is . . . hereby directed to prioritize the detection, investigation, and prosecution of all criminal conduct related to the current pandemic.”).
2. See Press Release, U.S. Dep’t of Justice, *Two Charged in Rhode Island with Stimulus Fraud* (May 5, 2020), available at <https://www.justice.gov/opa/pr/two-charged-rhode-island-stimulus-fraud>; see also Criminal Compl., *United States v. Staveley, Mag. No. 20-34* (D.R.I. May 4, 2020).
3. See Press Release, U.S. Dep’t of Justice, *Two Charged in Rhode Island with Stimulus Fraud* (May 5, 2020), available at <https://www.justice.gov/opa/pr/two-charged-rhode-island-stimulus-fraud>.
4. *Id.*
5. Judith B. Kassel, *SBA Clarifies Certification Regarding Necessity Of Loan – Companies May Repay Loans By May 7 Without Adverse Consequences*, available at <https://www.saul.com/publications/alerts/sba-clarifies-certification-regarding-necessity-loan-%E2%80%93-companies-may-repay-loans-may-7-without>.
6. *Small Business Administration Paycheck Protection Program Borrower Application Form at 2* (emphasis added), available at <https://www.sba.gov/document/sba-form-2483-paycheck-protection-program-borrower-application-form>.
7. Department of the Treasury, “*Paycheck Protection Program Loans: Frequently Asked Questions*” (hereinafter “SBA FAQ”) at Question 31 (last updated May 13, 2020) (emphasis added), available at <https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequently-Asked-Questions.pdf>.
8. Those large institutions that applied for, received, and later returned SBA funding, reportedly include the National Basketball Association team the L.A. Lakers, Ruth’s Chris Steak House, and Shake Shack.
9. *Answer to SBA FAQ 31*.
10. *Id.*
11. *Id. at Question 43*. The SBA had said it would imminently offer further guidance on criteria relating to necessity in an Interim Final Rule. See Small Business Administration, 13 CFR Part 120, Docket No. SBA-2020-0026, RIN 3245-AH41, Business Loan Program Temporary Changes; Paycheck Protection Program – Requirements – Extension of Limited Safe Harbor with Respect to Certification Concerning Need for PPP Loan Request (May 8, 2020), available at <https://www.sba.gov/document/policy-guidance-ppp-interim-final-rule-extension-limited-safe-harbor-respect-certification-concerning-need-ppp-loan> (“SBA, in consultation with the Department of the Treasury, will issue additional guidance before May 14, 2020 concerning how SBA will review the required certification to help PPP borrowers evaluate whether they may have misunderstood or misapplied the statutory certification standard.”).
12. See *Answer to SBA FAQ 47* (May 13, 2020) (“SBA is extending the repayment date for this safe harbor to May 18, 2020, to give borrowers an opportunity to review and consider FAQ #46.”).
13. *Id. at Question 46*.
14. “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.” *Answer to SBA FAQ 39*.
15. *Id.*
16. *Id.*

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17. *Id.*
18. *Id.*
19. SBA FAQ at n.1 (“This document does not carry the force and effect of law independent of the statute and regulations on which it is based.”).
20. For instance, the guidance states that “[t]he U.S. government will not challenge lender PPP actions that conform to this guidance, and to the PPP Interim Final Rules and any subsequent rulemaking in effect at the time.” See SBA FAQ Introduction. The guidance similarly states that “[l]enders may rely on a borrower’s certification regarding the necessity of the loan request.” Answer to SBA FAQ 31.
21. See, e.g., *United States v. Singh*, 518 F.3d 236, 249 (4th Cir. 2008) (“We have recognized that ‘a corporation is liable for the criminal acts of its employees and agents done within the scope of their employment with the intent to benefit the corporation.’”); *United States v. Ionia Mgmt. S.A.*, 526 F. Supp. 2d 319, 323 (D. Conn. 2007), *aff’d*, 555 F.3d 303 (2d Cir. 2009) (“Whether an agent is acting within the scope of his employment can then be measured by whether he or she is acting with authority and with an intent to benefit the employer.”); *United States v. Potter*, 463 F.3d 9, 25 (1st Cir. 2006) (“[T]he district judge correctly ruled that a corporation may be held liable for ‘the criminal acts of its agents’ so long as those agents are acting within the scope of employment. The test is whether the agent is ‘performing acts of the kind which he is authorized to perform,’ and those acts are ‘motivated—at least in part—by an intent to benefit the corporation.’”) (citations omitted).
22. Small Business Administration, 13 CFR Part 120, Docket No. SBA-2020-0015, RIN 3245-AH34, Business Loan Program Temporary Changes; Paycheck Protection Program (April 15, 2020), available at <https://home.treasury.gov/system/files/136/PPP-IFRN%20FINAL.pdf> (emphasis added).
23. Answer to SBA FAQ 1.
24. *Id.* (emphasis added).
25. *Id.* (emphasis added).
26. Answer to SBA FAQ 4.
27. Small Business Administration, 13 CFR Part 120, Docket No. SBA-2020-0015, RIN 3245-AH34 Business Loan Program Temporary Changes; Paycheck Protection Program (April 15, 2020) at 3(c), available at <https://home.treasury.gov/system/files/136/PPP-IFRN%20FINAL.pdf>.
28. Small Business Administration Paycheck Protection Program Borrower Application Form at 2, available at <https://www.sba.gov/document/sba-form-2483-paycheck-protection-program-borrower-application-form>.
29. SBA FAQ at n.1.
30. See SIGTARP Semiannual Report to Congress (Oct. 30, 2019) at 3, available at https://www.sig tarp.gov/Quarterly%20Reports/October_30_2019_Report_to_Congress.pdf.
31. *Id.* at 32.
32. See *id.*
33. Jennifer L. Beidel & Justin C. Danilewitz, *Business Applicants for COVID-19 Funding Must Exercise Caution*, available at <https://www.saul.com/publications/alerts/business-applicants-covid-19-funding-must-exercise-caution> (discussing Special Inspector General for the Troubled Asset Relief Program and its recovery efforts).
34. See *id.* (explaining funding and oversight powers).

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