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Phone: +1 646 783 7100 | Fax: +1 646 783 7161 | customerservice@law360.com

Banks May Avoid Prosecutors' PPP Fraud Wrath, For Now

By **Jon Hill**

Law360 (May 28, 2020, 8:38 PM EDT) -- With Paycheck Protection Program fraud cases popping up across the country like spring flowers, thousands of lenders that have participated in the coronavirus relief loan program could be forgiven for worrying the crackdown is coming for them too. But experts say banks can rest easy, at least for now, with the primary focus still on borrower fraud.

Federal prosecutors **on Friday** accused a Beverly Hills film distribution executive of misusing PPP funds to help cover his personal credit card expenses and a car loan, the latest in a string of cases the U.S. Department of Justice has brought since opening an investigation into abuse of the Small Business Administration-run loan program.

The action came a week after Reuters reported the DOJ had issued subpoenas to major banks involved with the program, which was intended to help stave off mass layoffs when the COVID-19 crisis hit by throwing practically free money at small businesses in the form of forgivable loans.

Although easy access was supposed to be a feature rather than a bug of the program's design, the DOJ's investigation reflects concerns among officials that some of the hundreds of billions of dollars dished out hasn't ended up in the right hands. But while banks occupy a pivotal role as gatekeepers to the program, they're unlikely to be in the crosshairs for the time being, according to attorneys who spoke to Law360.

"The initial charges that have come out have all focused on individuals that allegedly flat-out lied," said Ray McKenzie, co-founding partner of WTAII PLLC and a former federal prosecutor in Maryland. "If the banks have the proper internal controls, the proper base level of diligence to stay clear of anti-money laundering issues, I think they probably are going to be OK."

Yet lenders are facing plenty of other scrutiny with respect to the $660 billion loan program, including class actions over the handling of borrower applications and questions about possible discrimination.

Earlier this month, for example, nearly a dozen big banks were asked to turn over information on their PPP lending practices by New York Attorney General Letitia James, who said she's looking into whether women- and minority-owned small businesses were treated fairly.

But the program does come with key liability protections for banks that were crafted to encourage their participation and speed in handing out loans. For one, they were given wide berth to rely on borrowers' representations and certifications at the initial application and later loan forgiveness stages, and are not expected to police borrowers' compliance with the program's rules more generally.

Instead, those rules state lenders "will be held harmless" for borrower violations and stress that individual borrowers will face consequences if there's fraud or other misuse of funds.

"[Lenders'] underwriting obligation is generally limited to confirming that borrowers have submitted proper documentation," said Andrew Goldstein, a Cooley LLP partner and former senior federal prosecutor in New York. "The burden is really on the borrower to get it right and not for the bank to do its own substantive review of the underlying documentation."

Yet Goldstein, who was also a top deputy to former special counsel Robert Mueller, said banks could still face civil and even criminal exposure if they ignore obvious warning signs of fraud by borrowers, don't collect all the necessary loan documents, or otherwise fail to comply with their usual anti-money laundering policies, which the program's rules specify all lenders must have in place.

It is systematic lapses along these lines that could come back to bite banks, not individual instances of borrower fraud per se, according to Goldstein and McKenzie. But as prosecutors investigate the latter, they may start to uncover the former.

"The focus at least initially is going to be looking at businesses and not the banks themselves," McKenzie said. "But if the DOJ sends out 50 subpoenas for 50 different individuals, and it just so happens that 30 of those individuals engaged in fraud and they were all at one particular bank, that bank can expect the government will come knocking for a closer look at their internal procedures."

But the DOJ's reported move to subpoena banks doesn't mean its investigation is already tilting in this direction. Although McKenzie cautioned that only those inside the investigation can be fully sure what their subpoenas might be getting at, prosecutors probably were just trying to pull bank records that could show fraud by certain PPP borrower suspects.

"When I was a prosecutor, I probably sent out hundreds," McKenzie said of the subpoenas. "If I had a target in view, one of my first stops after getting phone records and that type of thing was to get bank records."

And in some cases, the banks themselves may have given prosecutors an invitation to come calling by flagging possibly bogus PPP borrowing, according to Richard Gordon, director of the Financial Integrity Institute at the Case Western Reserve University School of Law.

Under federal anti-money laundering rules, banks must submit what are known as suspicious activity reports, or SARs, to the U.S. Treasury Department when they detect potential fraud or other criminal activity occurring in their accounts, effectively sending up a flare that can tip off federal authorities to investigate further.

In that sense, the receipt of a subpoena may be a sign that a bank has followed through on its anti-money laundering obligations as a PPP lender rather than fallen short, Gordon said.

"It could be that these banks are doing their customer due diligence properly," Gordon said. "They looked and saw where folks may have been basically lying on their applications, and they filed a whole bunch of SARs. That would then go over to DOJ."

In Gordon's view, this scenario is a far more likely explanation for the subpoenas than one where federal prosecutors are beginning to come after the banks themselves for anti-money laundering breaches connected to the loan program.

That's in large part because the program is still so new, he explained. Launched in April, the PPP hasn't been around long enough for examiners to surface the kind of serious, pervasive anti-money laundering problems that could trigger a criminal investigation, nor is the DOJ's probe likely to have reached a point where prosecutors would be ready to shift their focus from borrowers to banks.

"It's hard for me to imagine that the Justice Department would just so quickly start investigating banks for some sort of criminal breach of the Bank Secrecy Act," Gordon said, referring to the main federal anti-money laundering statute. "That's technically conceivable, but I think it's pretty much practically inconceivable."

Goldstein said the PPP borrower fraud cases that have so far emerged from the investigation also haven't shown evidence pointing to significant internal control failures by banks, though he noted it's in the early days.

Still, given there are at least several weeks of lending capacity left in the program, Goldstein said prosecutors may be keen to keep their attention on individual borrowers right now so as to deter would-be fraudsters. There's also a risk that moving against banks at this stage could chill lenders' willingness to participate in the program, he added.

But those considerations may evolve as time wears on and the heat of the COVID-19 crisis begins to cool.

"The emphasis of the government right now is largely on getting the [PPP] money out the door and into the hands of people who need it," Goldstein said. "When this emergency time is over and the economy is back to somewhat more normal, then the priorities are going to change. I think that's when you'll see the greatest amount of scrutiny into a good number of these loans."

Goldstein said he wouldn't be surprised if some of the more egregious PPP borrower fraud cases eventually lead prosecutors to start looking into whether the banks involved had, at a minimum, turned a blind eye to the abuse of the loan program. Larger patterns of borrower fraud may also be uncovered that result in scrutiny for specific banks.

"Without question, it's likely that large portions of this program down the road will be investigated, both recipients of loans and, yes, the banks that were acting in some respects as the middlemen for these loans," Goldstein said. "When there are billions of dollars going out the door, investigators will look at what happened to that money and whether there was fraud in obtaining that money from the government."

But in the meantime, McKenzie said the best thing banks can do is stick to the basics: while PPP lenders have faced pressure to move as quickly as possible to help struggling small businesses, those that assiduously follow the program's rules and take care not to cut corners with their anti-money laundering procedures won't have to worry about a reckoning.

"If you're dotting your I's and crossing your T's in that regard, I think you're probably fine," McKenzie said.

--Editing by Philip Shea and Emily Kokoll.