COVID-19: LOOMING FALSE CLAIMS ACT LIABILITY FOR PAYCHECK PROTECTION PROGRAM LOANS

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In response to the economic crisis caused by the spread of COVID-19, Congress passed the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") on March 27, 2020, which President Donald J. Trump subsequently signed into law. [1] The CARES Act establishes the Paycheck Protection Program ("PPP"), under which the Small Business Association ("SBA") will guarantee up to $349 billion [2] in loans to help small businesses continue operating during the COVID-19 crisis. [3] A small business, together with its affiliates, [4] can borrow up to $10 million under the CARES Act and have that amount fully forgiven if the company and affiliates use that money on payroll and other approved expenses. [5] Banks began accepting PPP loan applications on April 3rd, and small businesses are scrambling for funds before they are completely depleted. As of April 7th, banks had processed $70 billion in taxpayer-backed loans for 250,000 small businesses. [6] Although swift extension of PPP loans is essential in the face of the economic situation, the federal government ("Government") is keenly aware that the expedited timeline will heighten the risk of fraud in obtaining Government funds. Critically, these risks exist for small businesses, as well as their private equity firms and investment funds.

Businesses and their investment entities hoping to benefit from loans under the PPP should be aware of their potentially significant liability exposure under the federal False Claims Act ("FCA") based, in part, on the unprecedented pressure the COVID-19 crisis is placing on virtually all sectors of the nation's economy and operations. Specifically, in order to secure support under the PPP before funds are exhausted, businesses may choose to submit applications without the same careful review that is usually undertaken for a Government-underwritten loan or other payment. Due to time pressure, loan administrators also may not be able to fully vet PPP-related applications before issuing funds. Additionally, the CARES Act and the PPP are currently devoid of finalized interpreting rules, regulations, and significant guidance. While this is likely to change in the near future, small businesses that have applied for and received PPP-related funds before the issuance of such guidance are essentially "flying blind" and thereby risk exposing themselves to FCA liability.

Once the dust settles from the COVID-19 and financial crises, it is inevitable that the U.S. Department of Justice ("DOJ") and the FCA relator's bar will initiate actions, including qui tam lawsuits, to recover PPP-related funds allegedly obtained from the Government in a false or fraudulent manner. This reality is likely to mirror enforcement efforts taken in the wake of the 2008 financial crisis to recover funds issued under the Troubled Asset Relief Program or "TARP," which were extensive and resulted in billions of dollars in record FCA recoveries for the Government. As a result, small businesses applying for and accepting PPP loans should proceed with caution, as the next several years are likely to be defined by substantial Government enforcement actions and *qui tam* lawsuits surrounding PPP funds.

Key Takeaways:

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1. The SBA's swift extension of PPP loans is essential in the face of the COVID-19 and economic crises; however, minimal guidance currently exists to help small businesses and their investment entities ensure that their applications for and receipt of PPP loans are proper.
2. The Government is keenly aware that the expedited timeline and the lack of existent guidance surrounding PPP-related payments will heighten the risk of fraud in obtaining Government funds.
3. In particular, businesses receiving PPP loans should be aware that certain PPP loan applications and payments will be subjected to potential scrutiny once the current crisis abates, as the Government takes a "pay and then chase" approach under the FCA and whistleblowers pursue *qui tam* lawsuits.
4. Given potential FCA exposure, small businesses and their investment entities that accept PPP loans should be extremely diligent in ensuring PPP loan applications provide accurate information, and borrowers should meticulously document how PPP-related funds are used.

I. FALSE CLAIMS ACT LIABILITY FOR SBA-UNDERWRITTEN LOANS

The FCA allows both the Government and individual whistleblowers, also called relators, to bring claims against persons or entities who knowingly—defined as actual knowledge, with reckless disregard, or in deliberate ignorance—submit false claims to the Government for payment. [7] Potential exposure under the FCA includes treble damages, steep monetary penalties, and the payment of attorneys' fees. Given that PPP loan applications, forgiveness calculations, and related payments are submitted to and paid by the SBA, small businesses that seek PPP funds are subject to FCA liability. As set forth below, PPP-related funding is characterized by required certifications and related uncertainties that heighten the risks of FCA exposure for small businesses. Additionally, because they are ultimately forgivable if the funds are used for eligible purposes, [8] PPP loans effectively function as grants to small businesses. This potential *de facto* grant status increases the risk of Government scrutiny and investigation into applications for, and utilization of, PPP funds.

a. PPP Applications and Certifications

Applicants seeking PPP funds must certify certain facts for determination of eligibility to receive funds. Specifically, the applicants must certify in "good faith" that:

5. the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient;
6. funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments;
7. the eligible recipient does not have an application pending for a PPP loan for the same purpose and duplicative of amounts applied for or received under a covered loan; and
8. during the period beginning on February 15, 2020, and ending on December 31, 2020, the eligible recipient has not received amounts under Section 7(a) of the Small Business Act for the same purpose and duplicative of amounts applied for or received under a covered loan. [9]

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False certifications potentially expose an applicant to liability under the FCA if those certifications are alleged to have been false when made. [10] FCA liability can be triggered by alleged falsity surrounding certifications that are either expressed or implied. [11] The nature of the PPP-related certifications leaves ample room for the Government and whistleblowers to bring FCA actions. For example, the PPP loans are currently coupled with significant ambiguity related, in part, to the following questions:

9. What is the specific meaning of “good faith” in connection with PPP certifications?
10. What are the benchmarks for making receipt of funds “necessary . . . to support . . . ongoing operations?” [12]
11. What if funds were used for eligible purposes, including payroll, mortgage payments, lease payments, or utility payments, [13] but also were allegedly used for some unstated purpose?
12. What if investment funds or private equity firms own smaller affiliates? Does this preclude the smaller affiliates from receiving the “small business” loans under the PPP?

While additional regulations and other guidance documents answering these questions may be forthcoming, the current ambiguity creates potential liability exposure for small businesses because of the rapid payment of PPP funds. Regarding the use of “good faith,” it is unclear whether the term's inclusion in the PPP certifications has any effect in lessening potential FCA exposure, [14] as the Government and whistleblowers could argue that certifications must always be made in good faith when viewed through the lens of FCA liability. Similarly, the CARES Act does not attempt to explicate the contours of funding that may or may not be “necessary” to support a small business's “ongoing operations.” Moreover, uncertainty exists surrounding what the term, “eligible purposes,” might fully encompass as it relates to PPP funding and whether payroll, mortgage payments, lease payments, and utility payments are exhaustive.

b. Private Equity Firms and Investment Funds

Even for larger companies, such as private equity firms and investment funds, the PPP loan process also poses potential FCA risks through their direct connections to and control over small businesses. For example, it is certainly conceivable that the Government or whistleblowers might argue that a private equity firm or investment company “knew” it was not small business, but “caused” affiliate “small businesses” to submit PPP loans in order to receive millions of dollars from the Government that should have been paid to others. As liability under the FCA can extend to entities and individuals that cause others to submit false claims and make false certifications, private equity firms and investment funds may find themselves embroiled in FCA lawsuits in the future surrounding PPP loans. The realities of this potential risk are underscored by the fact that some journalists have already expressed a commitment to scrutinizing hedge funds and private equity firms that are perceived to improperly seek funds under the PPP through their affiliates or otherwise. [15]

c. Compliance With SBA FAQs Not a Shield Against Liability

Given that the CARES Act only recently became law, there are no finalized regulations or rules, and very little guidance, to assist small businesses in navigating some of the ambiguities surrounding PPP loans that create potential exposure under the FCA. One of the primary pieces of guidance that currently exists surrounding the PPP loans is the SBA's “PPP Frequently Asked Questions ('FAQs').” The SBA's FAQs maintain, in part:

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> Borrowers . . . may rely on the guidance provided in this document as SBA's interpretation of the CARES Act and of the [PPP Interim Final Rule]. The U.S. government will not challenge lender PPP actions that conform to this guidance, and to the PPP Interim Final Rule and any subsequent rulemaking in effect at the time. [16]

On its face, this guidance appears to offer some insulation from liability for small businesses accepting PPP-related funds. However, this apparent safe harbor is unlikely to result in meaningful protections from FCA exposure. Specifically, whether actions "conform" to guidance or rulemaking is a fact-intensive question in FCA actions. This room for interpretation creates room for FCA liability. As such, the Government or whistleblowers could argue that any small, perceived deviation from the guidance creates grounds for liability.

It is also important to note that, over the past few years, DOJ has taken somewhat shifting positions regarding whether Government guidance documents and a defendant's actions contrary to such guidance can be the sole or primary basis for FCA liability. For example, a 2018 DOJ memorandum, dubbed the "Brand Memo," prohibited the DOJ from using "its enforcement authority to effectively convert agency guidance documents into binding rules." [17] Since then, DOJ has substantially backtracked on this position, such that there is a considerable lack of clarity as to whether and to what extent actions contrary to guidance documents can form a basis for FCA liability. [18] This ambiguity is particularly relevant to the PPP application process, discussed above, in light of DOJ's express statement that obligations created by "contract or certification" can still be enforced even in the absence of an equivalent statutory or regulatory requirement. [19] Adding to the uncertainty, the Supreme Court recently held that regulatory guidance that establishes or changes a substantive legal standard cannot be given effect unless it goes through a formal 60-day notice-and-comment period. [20] As the SBA's FAQs did not undergo the required notice-and-comment period, an argument can be made under *Azar v. Allina Health Services* that the Government and whistleblowers cannot rely on noncompliance with the SBA FAQs, without more, to establish FCA liability. However, the notable lack of clarity regarding the potential role of regulatory guidance in establishing FCA liability lends itself to the Government or whistleblowers highlighting non-conformity with guidance offered in the SBA's FAQs as a basis for an FCA action against PPP borrowers.

d. Government Recovery Strategy: Pay and Then Chase

The volume of PPP loan applications and the speed with which they are being processed makes the Government's ability to vet the legitimacy of each PPP payment impossible. Prior to the nationwide spread of COVID-19 and the enactment of the CARES Act, the Government recognized this issue surrounding the payments of SBA loans in times of crisis. Specifically, in 2019, the SBA Office of Inspector General ("OIG") reported to Congress:

> OIG and [Government Accountability Office] audits have identified that SBA's disaster loans have been vulnerable to fraud and losses in the past because loan transactions are often expedited in order to provide quick relief to disaster survivors, and disaster lending personnel, who are brought into the workforce quickly, may lack enough training or experience. [21]

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The same concerns apply to PPP-related payments, and may be particularly pronounced during the COVID-19 pandemic, given the paralysis of the nation's economy across multiple industries and the speed with which the SBA is expected to process and distribute PPP loans. During the SBA's biggest fiscal year, it guaranteed approximately $30 billion in loans. [22] However, the CARES Act requires the SBA to issue more than ten times the amount of those loans in a few months in order to meet the needs of the crisis. This expedited timeline will likely lead to certain payment errors and unqualified borrowers receiving funds to which they are not entitled. Because the SBA is paying funds as expediently as possible to meet the emergent issues of the current crises, the Government—through the DOJ and other Government enforcement agencies—will pursue improperly distributed funds after they are paid.

While this “pay and then chase” tactic is certainly nothing new and often defines the Government's approach to FCA actions involving federal payments in other contexts such as health care, the current crisis is unique. The volume of Government payments over a short period of time and the direct connection between the payments and a pervasive national crisis will likely trigger substantial enforcement actions for several years. This position is reinforced by recent history. In the wake of the 2008 financial crisis, the Government quickly distributed funds under TARP. In the years that immediately followed, Government and whistleblower enforcement actions led to record-setting FCA recoveries, including accounting for the lion's share of the nearly $6 billion recovered in fiscal year 2014. [23] Borrowers must also keep in mind that—as was seen in some cases involving federal funds received during the 2008 financial crisis and subsequent FCA recoveries—even seemingly minor, technical, or understandable errors on applications during an emergency period can be perceived or “spun” as fraud years after the crisis.

While it is unclear at this stage what FCA actions might look like surrounding the receipt of PPP loans, the 2008 financial crisis and the payment of TARP-related funds provide a powerful comparator and a potential harbinger of the FCA landscape that may lie ahead.

II. KEY TAKEAWAYS

Recognition of the unique emergency nature of the crisis and the inclusion of the “good faith” language in certifications of compliance in the PPP loan application process may evidence the Government's intent to provide loan recipients more room to avoid exposure in this uncertain time. In other COVID-19 enforcement areas, federal prosecutors have indicated that they are uninterested in pursuing well-meaning individuals and companies making genuine efforts to operate legally and compliantly while navigating uncharted waters during the pandemic. [24] In an enforcement scenario, borrowers could point to the current exigencies, ambiguities in the CARES Act, and conformance with SBA guidance documents in seeking to refute claims of FCA liability. However, given the current lack of specific case law and the unique nature of the COVID-19 crisis, it is unclear how much traction this line of argument may hold in the context of FCA actions brought against PPP borrowers. Additionally, even if the Government chooses not to bring an enforcement action against a particular borrower, that borrower could still be subject to a qui tam action brought by a whistleblower on the Government's behalf.

Given these uncertainties, applicants should be extremely diligent in ensuring PPP loan applications provide accurate information and borrowers should meticulously document how PPP-related funds are used. Although the

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present circumstances are exigent and uncertain, many PPP loan applications will likely be subjected to second-guessing by the Government and whistleblowers once the crisis abates. In particular, borrowers concerned about their eligibility under the program, including private equity groups and other investors, should consider the potential legal, financial, and reputational fallout of applying for PPP funds and consult with legal counsel.

K&L Gates' investigations, enforcement and white collar practice group is continuing to monitor FCA actions and Government enforcement priorities in light of COVID-19 and will continue to provide periodic updates on developments.

NOTES:

[1] CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT, Pub. L. No. 116-136, 134 Stat. 281 (2020). For additional discussion regarding the CARES Act and other legal implications of the COVID-19 crisis, please see our Responding to COVID-19 Resource Center.

[2] On April 7th, Treasury Secretary Steven Mnuchin asked congressional leaders to commit another $250 billion to the PPP by April 10. *See* Pete Schroeder, *Mnuchin seeks additional $250 billion in small business relief from Congress by Friday*, REUTERS (Apr. 7, 2020), https://www.reuters.com/article/us-health-coronavirus-trump-banks/mnuchin-seeks-additional-250-billion-in-small-business-relief-from-congress-by-friday-idUSKBN21P34W. However, on April 9th, the Senate failed to pass legislation approving the requested additional funds. See Susan Cornwell, David Morgan, More aid for small businesses fails in partisan fight in U.S. Senate, REUTERS (Apr. 9, 2020), https://www.reuters.com/article/us-health-coronavirus-usa-congress/more-aid-for-small-businesses-fails-in-partisan-fight-in-u-s-senate-idUSKCN21R21K.

[3] Pub. L. No. 116-136, 134 Stat. at 293.

[4] SBA regulations define a “small business concern” as “a concern, including its affiliates, that is independently owned and operated, not dominant in [its] field of operation . . . , and qualified as a small business under the criteria and size standards in 13 CFR part 121.” 48 C.F.R. § 2.101. SBA size eligibility requirements vary based on types of economic activity, or industry, generally under the North American Industry Classification System (NAICS). See 13 C.F.R. § 121.101(a). Such a concern is “not dominant in its field of operation” when it “does not exercise a controlling or major influence on a national basis in a kind of business activity in which a number of business concerns are primarily engaged. In determining whether dominance exists, consideration must be given to all appropriate factors, including volume of business, number of employees, financial resources, competitive status or position, ownership or control of materials, processes, patents, license agreements, facilities, sales territory, and nature of business activity.” 48 C.F.R. § 2.101.

[5] Pub. L. No. 116-136, 134 Stat. at 298–99. In a significant subsequent development, the SBA specified in its April 2, 2020 Interim Final Rule that, in order to qualify for loan forgiveness, at least 75% of the loan amount must be spent on payroll costs. Interim Final Rule, Docket No. SBA-2020-0015 (Apr. 2, 2020).

[6] Eric Werner, Jeff Stein & Renae Merie, *Treasury's Mnuchin seeks additional $250 billion to replenish small-business coronavirus program*, WASH. POST (Apr. 7, 2020), https://www.washingtonpost.com/us-policy/2020/04/07/treasury-coronavirus-small-business/.

[7] 31 U.S.C. § 3729.

[8] Pub. L. No. 116-136, 134 Stat. at 298; Interim Final Rule, Docket No. SBA-2020-0015 (Apr. 2, 2020).

[9] Pub. L. No. 116-136, 134 Stat. at 291.

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[10] 31 U.S.C. § 3729.
[11] *See* United Health Servs. v. United States *ex rel.* Escobar, 136 S. Ct. 1989, 2001 (2016).
[12] Pub. L. No. 116-136, 134 Stat. at 291.
[13] *Id.* at 298.
[14] *Id.* at 291.
[15] *See, e.g.,* Stephanie Ruhle (@SRuhle), TWITTER (Apr. 3, 2020, 6:47 AM), https://twitter.com/SRuhle/status/1246026408599719936.
[16] Paycheck Protection Program Loans Frequently Asked Questions, Treasury, https://home.treasury.gov/system/files/136/Paycheck-Protection-Program-Frequenty-Asked-Questions.pdf (last visited, Apr. 9, 2020).
[17] Memorandum from the Associate Attorney General, U.S. Dep't of Justice to Heads of Civil Litigating Components, United States Attorneys (Jan. 25, 2018), https://www.justice.gov/file/1028756/download.
[18] *See* Party's Compliance with Guidance (Justice Manual 1-20.204) (updated Dec. 2018), https://www.justice.gov/jm/1-20000-limitation-use-guidance-documents-litigation#1-20.204.
[19] *Id.*
[20] *Azar v. Allina Health Servs.,* 139 S. Ct. 1804, 1810, 1817 (2019).
[21] U.S. Small Bus. Admin. Office of Inspector Gen., *FY 2021 Congressional Budget Justification* (Jan. 2020), https://www.sba.gov/sites/default/files/2020-02/SBA-OIG-FY-2021-CBJ.pdf.
[22] Press Release, U.S. Small Bus. Admin., SBA Small Business Lending Momentum Continues in FY18 (Oct. 15, 2018), https://www.sba.gov/node/1629321.
[23] Press Release, U.S. Dep't of Justice, Justice Department Recovers Nearly $6 Billion from False Claims Act Cases in Fiscal Year 2014 (Nov. 20, 2014), https://www.justice.gov/opa/pr/justice-department-recovers-nearly-6-billion-false-claims-act-cases-fiscal-year-2014.
[24] *See* Mark A. Rush, *et al*., *COVID-19: Government Enforcement in the Time of a Pandemic,* K&L GATES (Mar. 25, 2020), http://www.klgates.com/covid-19-government-enforcement-in-the-time-of-covid-19-03-25-2020/.

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