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4 Steps For Avoiding FCA Traps For SBA Lenders

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Recent U.S. Department of Justice enforcement and qui tam suits demonstrate that Small Business Administration lenders face increasing risk of liability under the False Claims Act. This article provides an overview of SBA programs, describes traps for potential liability, and highlights steps that SBA lenders can take to reduce FCA exposure.

Small Business Administration Loans

The SBA does not directly lend money, but instead relies on third parties to provide loans that the agency guarantees. The SBA has a large loan portfolio, totaling over $118 billion in fiscal year 2015.[1] General small business loans (Section 7(a) loans) make up the largest portion of the portfolio, with $23.6 billion gross loans approved last fiscal year. Real estate and equipment loans (CDC/504 loans) make up another $4.3 billion of annual gross loans approved. The SBA also offers microloans and disaster loans, and helps small businesses get access to government contracting opportunities through programs such as HUBZone, which provides assistance to qualified small businesses located in historically underutilized business zones.[2]

The SBA has established a detailed set of regulations intended to establish controls against fraud and ensure that the loans actually focus on small businesses. These regulations only apply to small business loans that involve government guarantees, while additional regulatory requirements apply to small business lenders that do not seek government support.[3]

Through the Section 7(a) loan program, the SBA guarantees loans that private lenders make to eligible small businesses. Lenders must enter into a loan guaranty agreement with the SBA, which requires the lender to make certain certifications of compliance with SBA standard operating procedures before lending money. The certifications contain many requirements, which create numerous places in which a company may slip up, in turn creating potential FCA exposure. Most Section 7(a) lenders participate in the General Purpose Lender Program, which requires the lender to submit information about the borrower to the SBA, which then decides whether or not to guarantee the loan. Under the Preferred Lender Program, the lender can approve certain loans without any submissions to the SBA.[4] Even if lenders become preferred lenders, there are still some types of loans that must be guaranteed through the General Purpose Lender Program. The SBA typically guarantees 75 percent of the total Section 7(a) loan amount. At the backend, if a loan defaults, a lender seeking to recover the guaranteed portion of a loan needs to meet SBA standards and certify that a loan has been closed, disbursed, and serviced in compliance with the SBA standard operating procedures, and that other guidelines have been met.

The SBA 504 loan program provides long-term capital to qualifying businesses to purchase, lease or improve fixed assets such as equipment or real estate. Usually, 504 loan projects are financed by three parties: 50 percent by a third-party lender, 40 percent by a "certified development company" (made on behalf of the SBA and 100 percent guaranteed), and a contribution from the borrower of at least 10 percent of the project cost. The SBA relies on certified development companies (CDCs) to arrange, close, service, liquidate and collect on 504 loans from small businesses. The SBA authorizes hundreds of CDCs, which are nonprofit corporations.

Some of the CDCs participate in the SBA's Accredited Lenders Program (ALP), while others participate in the Premier Certified Lender Program (PCLP). The CDCs in the ALP submit borrower information to the SBA. The SBA then decides whether the businesses are credit-worthy and whether to guarantee the loan through the 504 program. The CDCs in the PCLP determine the credit-worthiness and whether to guarantee the loans on their own without the participation of the SBA. Because CDCs face less regulation, and oversight they are required to bear a share of any losses suffered (usually 10 percent) and to maintain a loan loss reserve fund, which serves as a secure source for payment should the loans not be paid. This reserve fund must be 1 percent of the original principal amount of the CDC's outstanding PCLP loans. When a PCLP loan defaults, the PCLP CDC is responsible for undertaking all reasonable efforts to collect the loan on behalf of the SBA. PCLP CDCs must also handle servicing, liquidating, and debt-collection litigation, whereas the SBA handles these tasks for ALP CDCs. Congress has, from time to time, authorized different ways to structure these loans and reserves, including through various pilot programs.[5]

Potential for False Claims Act Liability

The FCA imposes a civil penalty of up to $21,563[6] per claim, as well as treble damages on any party who presents false or fraudulent claims for payment to the government. While originally enacted to prosecute Civil War profiteers, the FCA applies to anyone who presents a false claim to the government, causes someone to present a false claim, or presents something falsely that is likely to influence a claim to the government. The FCA has increasingly taken on a much broader scope, particularly as the government, and its programs and contracting, have grown and as those programs face increasing losses and costs. For example, the DOJ and the U.S. Department of Housing and Urban Development have used the FCA as a significant vehicle to recover from Federal Housing Administration lenders as a vehicle to recapitalize the FHA loan reserve fund following skyrocketing defaults of FHA guaranteed loans during the financial crisis. The FCA can be enforced either by the DOJ or through private relator qui tam suits, and companies and individuals potentially face in addition to civil liability, criminal penalties for FCA violations.[7] Additionally, companies that are found liable may not be able to contract with the government or participate in government programs in the future.

Recent FCA enforcement as applied to SBA lenders presents a number of themes that can provide insight into strategies for lenders to mitigate their risk.[8] The scope of potential claims includes claims of violation of SBA requirements focused directly on fraud prevention, as well as numerous other SBA regulatory requirements.[9]

First, SBA lenders and loans of all shapes and sizes can be subject to FCA claims. All lenders, big and small, face the risk of FCA liability, including recently a lender with the second-largest SBA 504 program loan portfolio,[10] as well as smaller lenders.[11] While a large number of defaulting loans may signal underlying issues that attract attention from the government or private relators,[12] sometimes even one large defaulting loan can attract attention.[13] SBA lenders that have confronted FCA liability include those that actively used the SBA programs to set up an elaborate scheme to defraud the government[14] and those that have acted in a manner that appears more like negligence than a malicious effort to defraud.[15] Additionally, SBA lending companies are not the only ones that can be on the hook; company officers, such as the CEO, may have to pay part of the settlement.[16]

Second, FCA liability can come from both government investigation and private suits. Private litigants have included disgruntled employees or contractors and have included a hedge fund that spent years investigating a lender's practices.[17] The DOJ has also pursued cases, often with the aid of the SBA inspector general.[18] Not only can cases arise from different parties; sometimes even when one litigant does not succeed, another party can continue to pursue the case. In one qui tam case, for example, the DOJ originally declined to intervene, and the case was dismissed because the relator was not the original source of the publicly disclosed information.[19] Following the dismissal, the government decided to investigate and take over the suit, leading to a $26.3 million settlement.[20]

Third, despite having differing levels of oversight and exposure, both preferred lenders and regular lenders are at risk for investigation or private suits. Like direct endorsement FHA-insured lenders, SBA preferred lender programs, such as the Preferred Lender Program with Section 7(a) loans and the Premier Certified Lender Program with 504 loans, give the lenders the responsibility for vetting and approving loans. A pattern of loan defaults or particularly large defaults thus raise the specter of claims that the lender did not properly evaluate or document the defaulted loans.[21] Preferred lenders must carefully follow regulations, loan approval processes, and document that compliance. Regular lenders, whose loans are approved by the SBA, face a different set of circumstances where failure to obtain or provide the government with relevant information can be a source of liability.[22]

Fourth, recent cases identify areas that require particular care. It is important to adjust to changed circumstances or changes in the market. For instance, one lender failed to realize the impact the surrounding financial market could have on its ability to comply with regulations.[23] Lenders should also report changes in borrowers' financial positions to the SBA during the approval process, as well as after.[24] Lenders need to make sure to conduct due diligence, and document those efforts, and cannot simply rely on the information presented by the borrower.[25] Additionally, participation in a trial programs approved by Congress creates particular exposures, because there is a lack of structure around well-trodden approaches. Lenders need to take special care to rigorously follow regulations and adjust to the requirements.[26]

Future Exposure and Mitigating Risk for Lenders

Recent suits and settlements, as well as experience with FCA cases in other areas such as FHA lending, health care and government contracting, suggest ways in which SBA lenders can lower the risk of FCA liability, as well as when they should turn to counsel for help.

First, the cases and broader FCA experience demonstrate that lenders need effective FCA compliance strategies that involve good policies and other measures to ensure compliance with all regulations, as well as good documentation of that compliance, particularly associated with borrower assessment and underwriting. SBA lenders should not only establish good policies that follow regulations, but must also put in place well-structured controls and periodic reviews or audits to ensure implementation of those policies. Merely having policies on the books does not do the job and may actually increase the risk of liability.

Second, SBA lenders should be attuned to any indication that policies or procedures have been violated. That means encouraging internal reporting of violations and conducting regular reviews to facilitate early detection of any would-be violation. A lender could potentially learn of a problem, for example, from a report to a hotline, a departing employee's exit interview, or a request for information (such as a subpoena or a civil investigative demand) from the SBA or the DOJ. Internal suspicion of violation of company policies or procedures that affect loan approval or collection should raise the level of attention and should trigger an appropriate response. Internal investigations may be required, which in turn could lead to corrective action, changes in policies or procedures, or self-reporting to the SBA. Turning a blind eye only aggravates the problem and increases exposure.

Third, if the government comes knocking, that may suggest that they have a tip or even that a sealed qui tam case against the lender has been filed, and the DOJ is deciding whether to intervene. Under these circumstances, the need for investigation and remediation becomes even more paramount. An FCA case can involve a bet-the-company financial situation or the risk of being barred from participation in government programs, requiring careful attention to defense and resolution.

Finally, mitigating exposure involves engaging experienced counsel early on in preparing a compliance program, in reacting to an identified problem, and in defending potential litigation. At each inflection point, key strategies need to be considered to manage and lessen risk and exposure.

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[1] This number may be further adjusted as the contracting data for FY 2015 is not completed until the third quarter of FY2016. SBA Agency Fin. Rep. Fiscal Year 2015, at 9.

[2] Completely apart from lending activities, the SBA facilitates small business contracting opportunities with United States government agencies. As federal contracting dollars awarded to small businesses increase, so too has the government's focus on identifying and prosecuting small business certification fraud under the False Claims Act. See, e.g., http://www.mofo.com/~/media/Files/Articles/2015/10/151021FCAImpactDOJsIncreasedSmallBusinessFocus.pdf. Thus, for example, DOJ and the SBA OIG obtained a settlement of over $20 million associated with false certifications by a company and its officers that the company was a woman-owned small business. United States ex rel. Sharon Shadic v. UFC Aerospace, No. 12 Civ. 2594 (WHP), 2015 WL 9921169 (S.D.N.Y. Oct. 18, 2015).

[3] One example of this is the Consumer Financial Protection Bureau's push to expand its regulation of small business lending. See Client Alert "CFPB Poised to Expand Regulation to Small Business Lending:

Expect the Unexpected" (May 24, 2016), available at
http://www.mofo.com/~/media/Files/ClientAlert/2016/05/160524CFPBPoisedtoExpandRegulation.pdf

[4] For instance, banks often partner with the SBA as preferred lenders to make loans to small businesses. https://www.justice.gov/opa/pr/pittsburgh-based-bank-pay-us-failing-engage-prudent-underwriting-practices-sba-loan.

[5] For instance, Congress authorized a Loan Loss Reserve Program for 504 loans that use a risk-based methodology in evaluating loans. See Final Agency Decision Permanently Revoking Authority to Participate in 504 Loan Program and Permanently Transferring 504 Loan Portfolio at 3, United States v. EDF Resource Capital, Inc.,
No. 2:13-cv-01158 (E.D. Cal. Dec. 17, 2012).

[6] As of Aug. 1, 2016, the penalty increased from $11,000. 81 Fed. Reg. 42491 (June 30, 2016).

[7] DOJ has a policy in favor of parallel civil and criminal proceedings.
See http://www.law360.com/articles/759309/3-ways-the-yates-memo-may-affect-fca-cases.

[8] It is important to note that the SBA has the ability to undertake separate investigations of potential fraud apart from the Department of Justice and has done so, including through its Inspector General.

[9] See United States ex rel. Brickman v. Business Loan Express, LLC, No. 1:05-CV-03147-JEC, 2007 WL 4553474, at *1 (N.D. Ga. Dec. 18, 2007). Business Loan Express made false certifications at many different stages of the application process.

[10] See Final Agency Decision Permanently Revoking Authority to Participate in 504 Loan Program and Permanently Transferring 504 Loan Portfolio at 9, EDF Resource Capital, No. 2:13-cv-01158. EDF had 2,300 loans whose balances totaled $1.3 billion.

[11] See Saehan Bank v. Kim, Case No. 4:09-cv-00740 (N.D. Okla. 2009).

[12] See Brickman, No. 1:05-CV-03147-JEC, 2007 WL 4553474..

[13] See U.S. ex. Rel. Hosp. Management, Inc. v. Pinnacle Bank, Case No. 2:12-cv-00095 (D. Wyo. 2013); Saehan Bank, Case No. 4:09-cv-00740.

[14] Brickman, No. 1:05-CV-03147-JEC, 2007 WL 4553474. Business Loan Express created an elaborate scheme utilizing numerous shrimp boat loans.

[15] U.S. Dep't of Justice, Pittsburgh-based Bank to Pay U.S. for Failing to Engage in Prudent Underwriting Practices on SBA Loan Guarantees (Jan. 25, 2013),
https://www.justice.gov/opa/pr/pittsburgh-based-bank-pay-us-failing-engage-prudent-underwriting-practices-sba-loan [hereinafter PNC]. PNC relied on unaudited financial statements when determining the creditworthiness of the borrowers and ended up paying $7.1 million to settle False Claims Act claims.

[16] See U.S. Dep't of Justice, EDF Resources Capital Inc. and CEO Pay $6 Million for Alleged Violations Related to Small Business Administration Loan Program (Aug. 28, 2015),
https://www.justice.gov/opa/pr/edf-resources-capital-inc-and-ceo-pay-6-million-alleged-violations-

related-small-business. EDF’s CEO paid $200,000 of the settlement. This occurred in August 2015, a month before the DOJ’s Yates Memo was released, which encouraged bringing cases against individuals as well as companies.

[17] Brickman, No. 1:05-CV-03147-JEC, 2007 WL 4553474. This case is believed to be the first FCA case to involve a hedge fund.

[18] See PNC, supra note 14.

[19] Brickman, No. 1:05-CV-03147-JEC, 2007 WL 4553474, at *8.

[20] New York Small Business Lender to Pay U.S. $26.3 Million to Resolve False Claims Act Allegations, Dep’t of Just., May 6, 2010, https://www.justice.gov/opa/pr/new-york-small-business-lender-pay-us-263-million-resolve-false-claims-act-allegations.

[21] See Final Agency Decision Permanently Revoking Authority to Participate in 504 Loan Program and Permanently Transferring 504 Loan Portfolio at 49, EDF Resource Capital, No. 2:13-cv-01158.

[22] See Pinnacle Bank, Case No. 2:12-cv-00095; Saehan Bank, Case No. 4:09-cv-00740; see also Brickman,
No. 1:05-CV-03147-JEC, 2007 WL 4553474.

[23] Final Agency Decision Permanently Revoking Authority to Participate in 504 Loan Program and Permanently Transferring 504 Loan Portfolio at 22, EDF Resource Capital, No. 2:13-cv-01158.

[24] Pinnacle Bank, Case No. 2:12-cv-00095; Saehan Bank, Case No. 4:09-cv-00740.

[25] PNC, supra note 14.

[26] Final Agency Decision Permanently Revoking Authority to Participate in 504 Loan Program and Permanently Transferring 504 Loan Portfolio at 49, EDF Resource Capital, No. 2:13-cv-01158.