Affiliate and Family Member Relationships Under the Paycheck Protection Program:
Top Five Things for Lenders to Know in Navigating Potential Conflicts of Interest

As the Paycheck Protection Program ("PPP") is about to re-open following passage of a bill that will provide additional $310 billion in funds to the program (including funds reserved for loans by certain small and mid-sized lenders), the rules of the Small Business Administration ("SBA") that prohibit or restrict loans to the small business ventures of bank officers, directors, and investors – and their family members – again take on renewed importance. Because the SBA rules on conflicts of interest and self-dealing range widely over individuals and small companies, they present compliance risk as well as reputation and litigation risk. The necessary speed in making loans under the program before the additional funds are exhausted, however, makes it extremely difficult for a lender to develop new policies and procedures that are specific to the program.

Accordingly, a lender should take special care that the officers (and directors) who review or approve PPP loan applications adhere to the lender's conflict-of-interest and recusal policies and that common sense continues to drive the approval process. A lender should also require any officer or director to notify the lender's PPP team of any application in which the officer or director, or a family member, may have an interest. Here are key principles to keep in mind in managing potential conflicts of interest:

1 With one notable exception, a lender may not make a PPP loan to an entity in which a director or an officer has (or recently has had) an equity interest.

This prohibition extends to any equity interest of any size and to equity interests held within the previous six months. Thus, a director or officer cannot "save" a PPP loan from this conflict of interest by divesting shortly before a loan application is filed. The SBA rules do not define "officer," although the term is generally understood to include any employee who has the legal capacity to agree to and sign documents on behalf of an institution. The prohibition on loans to entities in which a director or officer has an equity interest does not extend to close relatives of a director or officer, but they are caught up in other rules.

Recently, the SBA announced an important exception: it waived the ethical requirements, including this prohibition, on PPP loans to entities in which an ownership interest (whether controlling or not) is held by an outside director or a shareholder of less than a 30% equity interest in the lender. Such loans similarly are no longer subject to the Federal Reserve's rules on loans to insiders in Regulation O. Inside directors, larger investors, and officers remain subject to the SBA's prohibition.

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2 A loan to a small business in which a relative of an officer or director has an interest is subject to a rule against self-dealing.

The SBA rules prohibit self-dealing by an "Associate" of a PPP lender. The term "Associate" includes any entity in which a "Close Relative" of a director, officer, key employee, or holder of 20% or more of the value of the lender's stock or debt instruments owns or controls at least 20% of the entity's stock or debt instruments. A Close Relative includes a spouse and any parents, children, siblings, or spouses of the same. Thus, under the rules, a loan to an entity in which an officer's or a director's son-in-law held a 20% non-controlling interest, and in which the officer or director was part of the decision making process, would be a loan to an Associate of the lender – and therefore potentially self-dealing.

This situation may come as a surprise to bankers since a similar loan would be covered under Regulation O only if an executive officer (rather than any officer) were involved and if the director were to receive a tangible economic benefit from the loan.

The risk of self-dealing can be avoided by the recusal of an officer or a director from the review or approval of a PPP loan application involving a family member. A lender should confirm that its existing policies on conflicts of interest and recusals are satisfactory. An unavoidable risk is that an officer may not know all of the entities in which, say, a son-in-law has a 20% interest – but there is an expectation that loan officers will know the businesses in which their family members are engaged. Given the pace of the PPP lending process and imperfect knowledge, a full-blown recusal process and an extended due diligence effort into relatives of loan officers are not realistic possibilities. The SBA appears to recognize these facts: the borrower application form deals only glancingly with family relationships, asking for the identities of owners of 20% or more of the applicant's equity.

We recommend that a lender make a specific effort to remind loan officers of the lender's existing conflict-of-interest policies and recusal requirements and to encourage any officer or director to alert the lender's PPP lending team of applications in which the officer or director, or a family member, may have an interest. A loan officer should be vigilant when reviewing the named owners of an applicant.

3 "Close Relatives" of officers and directors may also be swept up in separate SBA affiliation rules used to determine employee size.

PPP loans generally are available only to companies with 500 or fewer employees. If two or more companies are affiliated, then their employee counts must (with a handful of exceptions) be aggregated. If the aggregated count exceeds 500, neither the company nor its affiliates are eligible. The definition of affiliate is similar to that in Regulation W, although the voting stock ownership threshold is 50% under the SBA rules in contrast with 25% in Regulation W.

A bank should be aware that the SBA creates a rebuttable presumption of affiliation where there is an "identity of interest" – that is, identical or substantially identical business or economic interests among "Close Relatives." Under this presumption, otherwise unrelated companies are presumed to be affiliated if they are operated by Close Relatives and do business in the same or similar industry in the same geographic area. The PPP application materials account for this requirement through a question on the borrower's application form that asks whether the applicant or any owner of the applicant is an owner of any other business, or has common management with, any other business. An applicant also must certify that it employs no more than 500 employees (or a greater number as identified by the SBA for an industry).

A lender is entitled to rely on an applicant's representations and certifications in a PPP application, and the PPP timeline is so short that a lender cannot do much to test them. Still, when a lender has a reason to doubt a particular statement, it should make a further inquiry with the applicant.

4 Even if the SBA rules do not preclude a PPP loan, Regulation O and fiduciary principles still apply to decisions on PPP loans.

The CARES Act and the PPP do not make any changes to Regulation O, which imposes dollar limits and procedural requirements on a bank's loans to insiders and their related interests. A bank should be sure that its PPP lending operation adheres to the bank's Regulation O procedures. Simply because a loan involving an officer or director is permissible under the SBA rules does not mean that the loan is permissible under Regulation O, which reaches some individuals that the SBA rules do not. Perhaps most critically, the SBA rules should apply to officers and directors of the lending entity only, while portions of Regulation O cover loans to executive officers and directors of a bank's holding company and affiliates. In addition, while Regulation O's definition of immediate family is considerably narrower than the definition of Close Relative in the SBA rules, Regulation O covers any loan to any party if the proceeds are used for the tangible economic benefit of an insider, a provision that could reach loans that the SBA rules do not.

A bank's PPP loan to a business in which an officer or director of the bank has any interest would bring his or her duty of loyalty into play. Consistent with such duty, the officer or director must be recused from any role in the review of approval of the loan.

5 Directors should keep litigation and reputation risks in mind when considering any aspect of a PPP lending program.

The board of a PPP lender should conduct careful – and well-documented – oversight of the lender's PPP program. Lenders are caught in the middle of two sets of parties with an intense interest in PPP. On one side, because the SBA will forgive PPP loans with taxpayer money, several federal entities, including the SBA, Treasury, the Justice Department, a lender's primary federal regulator, and Congress, can be expected to devote considerable resources to monitoring lender compliance. On the other side, because the SBA's funds are limited, not all applicants will receive PPP loans even if they are qualified. Claims against lenders already have been filed. The terms of the PPP attempt to place the compliance burden on borrowers, but a lender should expect greater scrutiny than these terms might suggest.

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