Entrapment-by-Estoppel: A Potential Future Defense for Lenders in PPP Fraud Cases

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The past decade has taught lenders much about regulatory enforcement risk. In the fallout of the 2008 financial crisis and collapse of the housing and related markets, the Department of Justice and other agencies aggressively stepped up investigations of lenders seen as complicit in the misconduct of borrowers and others. The echoes of that crackdown have been felt in the current COVID pandemic, with lenders exercising understandable caution when participating in the Payment Protection Program, given the obvious risks of fraud and the government's commitment to rooting it out.

Even with express promises from the Small Business Administration, enshrined in federal regulations, that lenders may rely on borrower representations in PPP applications and will not be punished for doing so, lenders have felt a degree of uncertainty. In particular, there is concern that if the government believes a lender knows or has reason to know that a borrower's application has misrepresentations, it may take action against the lender notwithstanding the SBA's assurances.

Although much remains to be seen, and lenders should stay vigilant, the Constitution provides at least one potential protection for those who take the government at its word in accepting borrower claims at face value. The entrapment-by-estoppel doctrine, derived from due process requirements and rarely invoked outside of criminal firearms cases, bars the government from prosecuting lenders or others who rely on assurances from the government that conduct is lawful. Although not tested in this particular context, several prior court decisions and the SBA's unusually firm assurances, suggest that the defense could play a role in future enforcement actions against lenders or their officers and employees arising from the crisis.

PPP fraud enforcement raises lender concerns

The quick and massive rollout of the PPP carved out a huge role for lenders, but also created obvious and enormous risks. Rapidly funneling hundreds of billions of taxpayer dollars to businesses while short-circuiting traditional underwriting practices invited fraud on a large scale. Knowing this, the government reacted by creating a new law enforcement apparatus, elevated PPP fraud enforcement to a top priority, and filed a raft of indictments against fraudulent borrowers.

Lenders understandably approached the program with caution, looking for assurances that they would not be held accountable for a borrower's misconduct. After years of enforcement of fraud on the TARP program had led to dozens of criminal indictments of banks and bankers – as well as innumerable civil claims by whistleblowers, shareholders, and others – there was little appetite for taking on clients and deals with heightened risk of fraud without such assurances and protections. These concerns were heightened by early criticism of the program itself and some lenders' activities, including their alleged prioritization of existing customers and other issues.

The government assures lenders that they can rely on borrower representations

In constructing the program, the government sought to reassure lenders by mitigating their risk and thereby induce them to join the PPP effort. Key to this reassurance was the SBA's publication of a First Interim Final Rule, 13 CFR Part 120. Structured as a series of questions and answers, the First Interim Final Rule explained repeatedly and emphatically that lenders' due diligence obligations were limited, they could rely on borrower representations, and they would not be held responsible for borrower misrepresentations. Among the specific promises were the following:

- Required underwriting "is limited to" (1) confirming receipt of borrower certifications contained in the SBA's PPP application form, (2) confirming receipt of information demonstrating that a borrower had and paid salaries and payroll taxes for employees at a certain date, (3) reviewing documents submitted with the PPP application to confirm the borrower's average monthly payroll costs, and (4) following applicable Bank Secrecy Act requirements.
- Lenders can "rely on borrower documentation for loan forgiveness," and "does not need to conduct any verification" if the borrower submits such documentation and "attests that it has accurately verified the payments for eligible costs."
- The SBA will "hold harmless any lender that relies on such borrower documents and attestation," notwithstanding "borrowers' failure to comply with program criteria"
- The SBA, in consultation with the Treasury Secretary, determined that such lender reliance was "necessary and appropriate" in light of Section 1106(h) of the CARES Act, which prohibits the SBA from taking administrative enforcement action against a lender that has received a borrower attestation.

The SBA has made clear that the purpose of these reassurances was to encourage lenders to relax their ordinary vigilance and process applications more quickly and efficiently, in order to further the PPP's goals of avoiding business collapse and unemployment during the pandemic.

To further enunciate these protections, the SBA published additional guidance in the form of "frequently asked questions" (FAQ), which it said lenders could "rely on" as stating the agency's interpretation of the CARES Act and the Interim Final Rule. It added that "the U.S. government will not challenge lender PPP actions that conform to" the FAQ guidance and the Interim Final Rule. In the FAQ, the SBA explained that lenders could "rely on the guidance provided in in confirming borrower average payroll costs, lenders are *not* required to "replicate" borrowers' calculations, but rather to perform a "good faith review, in reasonable time" of those calculations, and that for a recognized third-party payroll processor, "minimal review" would be reasonable. It also said that lenders were not required to make an "independent determination" regarding the applicability of the PPP's "affiliation rules," again affirming that lenders could "rely on borrowers' certification." It limited the Bank Secrecy Act compliance steps required for PPP loans, and it added that lenders could rely on a borrower's certification regarding the necessity of the loan request.

Similarly, in the later Interim Final Rule on Revisions to Loan Forgiveness and Review Procedures (Loan Forgiveness IFR), and the related FAQ on Loan Forgiveness, the SBA expressly limited the lender's role in the forgiveness application process generally to determining that it received all certifications and documents the borrower was required to submit, and, based on the numerical data submitted by the borrower, confirming the borrower's numerical calculations regarding amounts of permitted loan proceeds usage. While the lender should work with the borrower to remedy any "errors in the borrower's calculation or material lack of substantiation in the borrower's supporting documents" and "must confirm that the information provided by the lender to SBA accurately reflects lender's records for the loan," the lender need do no more than that - the Loan Forgiveness IFR specifically states that "the lender does not need to independently verify the borrower's reported information if the borrower submits documentation supporting its request for loan forgiveness and attests that it accurately verified the payments for eligible costs."

The dilemma: what if the lender has reason to know the borrower is lying?

Despite the SBA's assurances, some lenders have continued to express uncertainty. In particular, lenders have asked what would happen if a lender knew or had reason to believe that a borrower's attestations or documentation were false, and the borrower did not actually qualify for a PPP loan or forgiveness. For example, if by virtue of a pre-existing relationship with the borrower, a lender employee knew or had reason to believe that the borrower exceeded the PPP employee count threshold, or did not have employees as of February 15, 2020, or did not intend to use the loan proceeds for permitted purposes, or was otherwise ineligible, could they still rely on borrower certifications to the contrary? Or could they and the lender be subject to civil or criminal enforcement for aiding and abetting fraud?

Under each of the criminal statutes that have been most frequently invoked in PPP prosecutions – 18 U.S.C. §§ 1341/1343 (mail/wire fraud), § 1344 (bank fraud), § 1014 (false statement to bank), and § 1001 (false statement to government) – the government is required to prove that the defendant acted "knowingly" – that it knew false representations were being made. The same is true for aiding and abetting liability under 18 U.S.C. § 2, as well as liability under the False Claims Act.

"Knowledge," moreover, does not require certainty. Under the "willful blindness" (or "deliberate ignorance") doctrine, a person can act "knowingly" if he or she "was aware of a high probability" of a certain fact (e.g., borrower representations were false or a borrower was ineligible) and he or she "deliberately avoided learning the truth." Prosecutors often use this "ostrich instruction" to accuse defendants of putting their "head in the sand" and ignoring obvious signs of certain facts contradicting representations they or others have made. It is not hard to imagine the government viewing a lender's ignoring red flags regarding a borrower's ineligibility as equivalent to knowledge of falsity.

Equally worrying for lenders is how these principles would be applied in a prosecution or civil enforcement case. While a defendant might insist that he acted in good faith, relying on the borrower's certification and the SBA's assurances that no more was required, it would be up to a jury to decide what was in his head when he processed the fateful application. And juries are neither predictable nor consistently sympathetic to banks or bankers accused of fraud. Just as importantly, prosecutors know the latter, and can use it as leverage in plea or settlement negotiations.

A potential defense: entrapment-by-estoppel

If the enforcement winds do shift against lenders, and DOJ seeks to penalize those who it asserts relied on questionable borrower certifications, the entrapment-by-estoppel doctrine may provide a useful response – both in court and at the bargaining table.

Entrapment by estoppel (sometimes called "official misleading") is an affirmative defense to criminal charges based on the Constitution's due process clauses. Although different jurisdictions define the elements differently, federal courts generally find that the defense applies when (1) an authorized agent of the U.S. government told the defendant that certain conduct would be lawful; (2) the defendant relied on that advice in engaging in the conduct; 3) the reliance was reasonable; and thus (4) the prosecution would be unfair. *See, e.g., United States v. Schafer*, 625 F.3d 629, 637 (9th Cir. 2010).[1]

The defense has a solid lineage, originating over sixty years ago in *Raley v. Ohio*, 360 U.S. 423 (1959). In that case, defendants were charged with contempt of a state legislative commission for

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[1] As stated in *Schafer*, the Ninth Circuit also requires that the government official have been "made aware of all the relevant historical facts." *Id.* at 637.

refusing to answer questions about Communist Party activities, even though the commission chairman had erroneously led them to believe that they could assert their privilege against self-incrimination and decline to respond. The Supreme Court eventually found that to affirm their convictions "would be to sanction the most indefensible sort of entrapment by the state – convicting a citizen for exercising a privilege which the state clearly had told him was available to him." *Id.* at 425-426. "The Due Process Clause," the Court said, does not "permit convictions to be obtained under such circumstances." *Id.* at 439. *See also United States v. Laub*, 385 U.S. 475, 487 (1967) (defendant cannot be convicted government "actively misl[ed]" it through "authoritative assurance that punishment will not attach").

Although the defense has most often been used in cases involving unlawful firearms sales, it has sometimes arisen in response to charges of fraud or false statements, and has been based on agency announcements regarding regulatory provisions. In *United States v. Pennsylvania Indus. Chem. Corp. ("PICCO")*, 411 U.S. 655 (1973), the defendant company was charged with violating the Rivers and Harbors Act of 1899, but claimed that it had relied on the Army Corps of Engineers' misleading interpretation of the statute regarding what conduct would be considered illegal. *Id.* 659-660. The Supreme Court held that "to the extent that the regulations deprived [the company] of fair warning as to what conduct the government intended to make criminal, we think there can be no doubt that traditional notions of fairness inherent in our system of criminal justice prevent the government from proceeding with the prosecution." *Id.* 674.

In *United States v. Levin*, 973 F.2d 463 (6th Cir. 1992), an ophthalmologist was charged with Medicare fraud, mail fraud, false claims, and false statements for a scheme involving provision of surgical supplies as inducements for the ordering of certain medical devices. In response to questions from the device manufacturers, the Health Care Financing Administration provided several letters and issued a publication stating that the program would not violate agency regulations. *Id.* at 465. The agency's statements were "circulated through the targeted professional medical community" by the manufacturers, and the defendants relied on them in participating in the program. *Id.* The trial court dismissed virtually all the counts, and the Sixth Circuit affirmed, finding that the undisputed government statements and defendant's reliance precluded any prosecution consistent with due process. *See, generally, id.*

Importantly, some courts have dismissed indictments based on entrapment by estoppel notwithstanding a jury verdict, or even before they ever reached a jury. In *PICCO,* the Supreme Court held that the due process principles it cited should prevent the government from even "proceeding with the prosecution." 411 U.S. at 674. In *Levin*, the Sixth Circuit approved of the pre-trial dismissal of charges, given that there was no dispute as to what advice the government had provided. *Id.* at 469-470. Other courts (though not all) have agreed that the trial judge is empowered to dismiss indictments

without trial or despite a jury's decision by finding that the elements of entrapment by estoppel are met.[2] As these courts have explained, this is because the defense does not merely negate criminal intent or some other element of the offense, "it negates the criminality of the act" itself, and goes to the fundamental fairness of the proceeding. *United States v. Conley*, 859 F.Supp. 909, 928-929 (W.D.Pa. 1994) (quoting *United States v. Brady*, 710 F.Supp. 290, 296 (D.Colo. 1989)). After all, forcing a defendant to endure prosecution and trial for relying on government assurances denies due process regardless of the outcome of the trial.

While the entrapment by estoppel defense is rarely successful with judges or juries, that is generally because the key elements are missing or dubious. The defendant may claim reliance on the words of an official who may be unidentified or unavailable to testify, the statement may not be recorded or corroborated by other witnesses, the speaker may not qualify as an authorized government agent, or the advice may be vague, uninformed, or inapplicable to the defendant's specific conduct.

But those defects would not seem to apply in the PPP context. Like the agencies in *PICCO* and *Levine*, the SBA has gone on record with its position on compliance. Its Interim Final Rule and FAQ are not only written and recorded, but are published in the Federal Record and in other official sources. And the advice is not only relatively clear about lenders' rights of reliance, but specifically calculated to induce lenders to drop their guard and push funds out rapidly – all for the greater public good of staving off economic calamity. Those facts present a strong case for estoppel when relying on borrower representations, regardless of whether red flags are identified in hindsight.

Just as importantly, the ability to use the defense to avoid or overcome a jury's decision could provide additional comfort. Banks and bankers are not enormously popular among jury pools at the best of times, and the vilification often increases in times of economic hardship and regulatory reprisal. A judge may be able to evaluate the government's conduct and questions of reasonable reliance with a cooler and less biased head, reducing the degree of litigation risk for defendants who contest charges. That dynamic, in turn, can strengthen lenders' position during investigations and negotiations with the government, as the specter of incensed jurors could give prosecutors less leverage.

Caveats

To be sure, entrapment by estoppel is no silver bullet, and this article is not meant to be prescriptive. It goes without saying that no lender would be well-advised to approve a PPP application

[2] *See United States v. Conley*, 859 F.Supp. 909, 928-929 (W.D.Pa. 1994); *United States v. Brebner*, 951 F.2d 1017, 1025 (9th Cir. 1991); *United States v. Hedges*, 912 F.2d 1397, 1405 (11th Cir. 1990); *United States v. Tallmadge*, 829 F.2d 767 at 772, 774-75 (9th Cir. 1987).

despite indicia of fraud or false borrower certifications, or to ignore signs that the borrower is not PPP-eligible. The agency's guidance does make clear that lenders have at least *some* gatekeeping obligations, particularly BSA compliance and "good faith" review of customer documents.

Also note that the assurances in the Interim Final Rules and the FAQs do not apply to the Main Street Lending Program. Although that program was also created by the CARES Act, it does not relax ordinary due diligence requirements, and the above analysis would not apply, by analogy or otherwise, to that program.

But when memories of the current crisis's exigencies fade, and regulators' remorse over loosened standards turns into enforcement actions against lenders, the government should be held to its own rules and guidance. And an often-overshadowed due process defense may yet enjoy its day in the sun.

Buchalter's team of SBA PPP experts can help you understand these ever-changing program requirements.

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