Paycheck Protection Program: An Overview of Fair Lending Risks

Skadden

May 19, 2020

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One Manhattan West
New York, NY 10001
212.735.3000

1440 New York Ave NW,
Washington, D.C. 20005
202.371.7000

Since the Paycheck Protection Program (PPP) of loans guaranteed by the Small Business Administration (SBA) was originally rolled out on April 3, 2020, some advocates have expressed disappointment that Congress did not explicitly instruct lenders to reserve a portion of these loans for minority-owned businesses or for businesses located in majority-minority areas. Others have expressed concerns about perceived disparities in PPP lending on the basis of race.

Congress reacted to this criticism when it expanded the PPP program on April 23, 2020, setting aside $30 billion of the $310 billion in new funding for loans made by credit unions, community banks and "community financial institutions," a category that includes "minority depository institutions."[1] In addition, lawmakers encouraged the SBA to "work with lenders to ensure fair access and require lenders to report on PPP lending to minority-owned businesses relative to their overall lending," and also requested that the SBA and the Department of the Treasury make clear that the Equal Credit Opportunity Act (ECOA) applies to PPP loans.

Just how effective these efforts have been in expanding lending to minority-owned businesses remains to be seen. However, while the second round of the PPP is now nearing completion, the scrutiny of these high-profile loans — as well as any future rounds of PPP — is likely to continue. In addition, fair lending risk associated with small business lending in general is likely to intensify in the coming years, as the Consumer Financial Protection Bureau (CFPB) moves toward requiring the collection of race-based data in connection with such lending. Accordingly, this is an excellent time for lenders to assess and mitigate the fair lending risks associated with small business lending generally, and PPP loans in particular.

Fair Lending Issues and Risk Mitigation

The fair lending requirements of the ECOA and its implementing regulation, Regulation B, apply to business credit, including small business loans. Accordingly, any practices that discriminate against an applicant (including any corporation, partnership, cooperative or association) with respect to race, ethnicity or any other prohibited basis, could subject a lender to liability under the ECOA.

[1] A "minority depository institution" is defined, in relevant part, as a depository institution where 51% or more of the stock is owned by one or more "socially and economically disadvantaged individuals." 12 U.S.C. § 1463 note.

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While regulators have not issued specific fair lending guidance with respect to PPP loans, the Office of the Comptroller of the Currency (OCC) has strongly encouraged the tracking of PPP lending in low- and moderate-income census tracts, distressed areas and underserved areas. OCC Bulletin 2020-45 (Apr. 27, 2020). The OCC has also encouraged institutions to monitor their PPP lending data, noting that "[m]aintaining and monitoring this information, where available, in the administration of the SBA PPP is a prudent banking practice consistent with the principles of safety and soundness and fair access and fair treatment of borrowers, and other applicable legal requirements." *Id.* And finally, the OCC has observed that prudent lending practices may include "documenting implementation decisions — such as the bank's business justifications and any alternatives considered — when setting eligibility criteria, establishing processes for considering applications, and approving or denying PPP applications." *Id.*

For its part, the CFPB — which has fair lending enforcement authority with respect to business-purpose lending — has encouraged small businesses, in a recent blog post, to file complaints if they suspect lending discrimination relating to the PPP or other loans or workout requests in connection with race, sex or other prohibited bases. Patrice Alexander Ficklin, *et al.*, CFPB Blog, "The importance of fair and equitable access to credit for minority and women-owned businesses" (Apr. 27, 2020). According to this blog post, the CFPB intends to focus on denials where applicants meet advertised standards, the offering of higher rates or worse terms than advertised, and discouragement of applications. In addition, on May 6, 2020, the CFPB issued FAQs regarding application of the ECOA/Regulation B adverse action notification requirements to the PPP, underscoring the continuing need to focus on nondiscriminatory administration of the PPP.

Potential fair lending risks relating to the PPP and other small business lending programs include the following.

Existing customer requirements or other overlays. A number of lenders are the subjects of litigation alleging that they have limited the availability of PPP loans to existing customers, or that they have prioritized processing larger PPP loan applications or applications received through a particular line of business with the lender. While these lawsuits have not been brought under fair lending laws, they have nonetheless characterized these practices as violating SBA rules, and at least one lawsuit has alleged that these practices are "discriminatory."[2] Limiting PPP loans to existing customers may also attract scrutiny as a form of "overlay," in much the same way that lender overlays on FHA loans (such as heightened credit score requirements) attracted considerable negative attention nearly a decade ago. *See* "NCRC accuses 22 lenders of unfair lending; mortgage industry responds," *Housingwire.com* (Dec. 8, 2010).

Consequently, to the extent that lenders impose eligibility requirements for PPP loans beyond those required by the PPP program, they should document the business necessity for the additional requirements. One such business justification, for example, may be that lenders are able to process PPP applications from existing customers faster, before the PPP funds had been exhausted, because existing customers have already passed Know Your Customer requirements. Lenders may also wish to assess disparate impact risk and alternatives that may serve the same business interest advanced by the additional requirements, but in a less discriminatory manner. *See* 12 C.F.R. part 1002, Appendix I, para. 6(a), cmt. 2.

Preferential treatment. As noted above, $30 billion of the $310 billion allocated by Congress in the second round of PPP was for credit unions, community banks and "community financial institutions," including "minority depository institutions." However, in reauthorizing the PPP, Congress did not explicitly permit lenders to prioritize applications from minority-owned small businesses, such as by processing them more quickly or giving them a place at the head of any queue. As a consequence, lenders were not (and are not) permitted to directly favor minority-owned businesses, including by providing different underwriting or pricing standards, priority processing or a greater level of assistance, absent the creation of a "special purpose credit program" meeting the requirements of Regulation B.

Insofar as lenders wish to affirmatively benefit minority-owned businesses in future extensions of the PPP (or other lending initiatives) they could consider implementing a special purpose credit program. Such a program, however, requires careful review and analysis, as it can generally be created only for the purpose of extending credit to persons who, "under the organization's customary standards of creditworthiness, probably would not receive such credit or would receive it on less favorable terms than are ordinarily available to other applicants applying to the organization for a similar type and amount of credit." 12 C.F.R. § 1002.8(a)(3)(ii). Other requirements for special purpose credit programs include that they be administered pursuant to a written plan, and that the plan contain information supporting the need for the particular program. *Id.* at 100.2(a)(3)(i). *See also*, CFPB Official Interpretation of 1002.8(a).

Another strategy for mitigating fair lending risk is to implement "second review" programs, pursuant to which declined PPP applications from minority-owned businesses are re-underwritten

[2] A recent lawsuit against the SBA alleges that it discriminated against minority- and woman-owned businesses by delaying the ability of businesses without employees, such as sole proprietorships, from applying for PPP loans. *Infinity Consulting Group, LLC v. U.S. Department of the Treasury*, No 8:20-cv-00981-GJH (D. Md. filed Apr. 17, 2020).

by a second underwriter and compared with applications from similarly situated nonminority-owned businesses to confirm the basis for the denial. And to the extent that lenders affirmatively advertise future PPP offerings or other small business lending programs, they may wish to consider a program of targeted marketing to minority businesses or in minority areas, especially to applicants that might not normally seek credit from that creditor.

Consistent processes. Some of the lawsuits noted above have alleged that lenders with multiple application channels or lines of business have different policies and procedures for eligibility or processing of PPP loans, which has led, for example, to prioritization of PPP loans from larger customers. Any such differences may be amply justified, but nonetheless enhance the risk that the institution will be deemed to have treated similarly situated applicants differently based on a prohibited factor rather than legitimate customer needs.

To mitigate these risks, lenders who do not have consistent processes across channels should document the rationale for any differences. Risk may also be reduced to the extent that lenders inform applicants of the different channels for applying for PPP loans or other small business loans within the institution and the eligibility criteria for each channel to the extent that those criteria differ across channels.

Discretion. Discretion in the lending process by a lender or third parties has historically been a source of enhanced fair lending risk under both disparate impact and disparate treatment theories. With respect to the PPP, the eligibility and pricing criteria set by the SBA are essentially fixed, thus making the baseline risk relatively low. However, lenders are responsible for verifying information necessary to approve a loan, which may as a practical matter involve a degree of discretion, such as determining whether the borrower has sufficiently documented its payroll expenses, whether to impose tolerances for documented expenses, and verifying other PPP eligibility requirements. Likewise, some lenders may exercise discretion in deciding which PPP applications to prioritize, or the level of assistance in helping applicants provide the necessary information to qualify the loan. The bottom line is simple: To best mitigate risk, lenders should determine where discretion may exist in their processes, and then ensure that they have appropriate guidance, training and documentation in exercising this discretion.

Fair lending testing. Lenders could engage in fair lending testing designed to identify differences in processing times, document verification and level of assistance, as well as to assess the impact of credit overlays or other lender requirements that go beyond the requirements of the PPP. To define minority-owned businesses for internal fair lending testing purposes, lenders could consider whether a business is considered “minority-owned” under SBA standards and/or whether a business is located in a minority area.

In addition, to assess redlining and marketing risk, lenders may wish to review future (or prior) penetration rates of PPP applications or other small business loan applications from minority-owned businesses or areas with high minority populations. To provide the appropriate context for these results, it is important to consider the “denominator” or relevant population to determine how equitably a lender has served different types of businesses and areas of the community (such as minority and low- to moderate-income areas). Lenders may wish to compare their penetration rates against peer small business lending data or other benchmarks using various public data sources and/or a lender’s own small business lending data. These data sources may indicate demand for PPP loans in different areas, and thus serve as an important touchpoint for interpreting penetration rate fair lending analyses.

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In sum, while Congress deliberates whether to further expand the PPP program or other small business initiatives, lenders may wish to assess their fair lending compliance management systems and consider fair lending testing for PPP and other small business lending programs to satisfy regulatory expectations and mitigate fair lending risk.

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Contacts

Anand S. Raman
Partner / Washington, D.C.
202.371.7019
anand.raman@skadden.com

Austin K. Brown
Counsel / Washington, D.C.
202.371.7142
austin.brown@skadden.com

Darren M. Welch
Counsel / Washington, D.C.
202.371.7804
darren.welch@skadden.com

Nicole M. Cleminshaw
Associate / Washington, D.C.
202.371.7588
nicole.cleminshaw@skadden.com