

Publications

Federal Reserve Follows SBA's Lead, Expands PPP Loan Access for Bank Insiders

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On April 17, the Federal Reserve Board (the Fed) announced an **interim final rule** that temporarily relaxes lending restrictions on member banks who make Paycheck Protection Program (PPP) loans to businesses owned by certain bank insiders. The Fed's decision aligns it with the Small Business Administration (the SBA), who clarified in an **interim final rule** issued on April 14 that, subject to certain restrictions, lenders can make PPP loans to businesses owned by outside directors and certain significant shareholders. In a statement announcing the rule change, the Fed acknowledged that insider lending restrictions "have prevented some small business owners from accessing PPP loans—especially in rural areas."^[1]

While the initial \$349 billion in PPP funding was exhausted last week, the Senate passed an interim emergency bill on April 21 approving an additional round of funding—\$320 billion—to replenish the PPP. The bill, which is expected to be voted upon this week by the House of Representatives, sets aside \$60 billion specifically for small and midsize banks, credit unions, and community development financial institutions. Once this additional funding is available, the Fed anticipates that the rule change "will help banks, particularly in smaller communities, to give effect to the PPP's purpose of helping small business to continue to operate under current economic conditions."^[2]

PPP Loans are Generally Excepted From the Fed's Insider Lending Restrictions

Section 22(h) of the Federal Reserve Act, and corresponding provisions of 12 C.F.R. 215 (Regulation O), allow member banks and their affiliates to grant "extensions of credit" to bank "insiders"^[3] and their "related interests,"^[4] subject to significant lending restrictions. These restrictions include individual and aggregate lending limits, restrictions on preferential loan terms, prior approval from the bank's board of directors, and heightened recordkeeping and public disclosure obligations. While intended to prevent abuses and eliminate favoritism, these restrictions create additional hurdles that can delay banks' ability to make loans and disburse funds quickly.

Under Section 22(h), “extensions of credit” is defined, in relevant part, to include “making or renewing any loan, granting a line of credit, or entering into any similar transaction as a result of which the person becomes obligated (directly or indirectly, or by any means whatsoever) to pay money or its equivalent to the bank.” Accordingly, PPP loans would normally be considered “extensions of credit” that are subject to Section 22(h) and Regulation O’s insider lending restrictions. While the PPP was intended to reduce administrative burdens—allowing banks to disburse much-needed funds as quickly and efficiently as possible—many local banks were unable process applications during the initial round of the PPP loan program, and many small businesses were unable to obtain loans, due to insider lending restrictions. In view of the fact that local business leaders frequently sit on the local bank’s board of directors in smaller communities, these smaller, rural communities were disproportionately impacted.

However, Section 22(h) expressly permits the Fed, by regulation, to exclude certain types of loans from the definition of “extensions of credit” if the Fed determines they “pose minimal risk.” Since PPP loans are 100% guaranteed by the SBA (and backed by the full faith and credit of the United States), contain standard loan terms that cannot be modified, and are only available between February 15, 2020 and June 30, 2020, the Fed determined, per the interim final rule, that PPP loans “pose minimal risk.” Thus, for the duration of the PPP, PPP loans are expressly excepted from the definition of “extensions of credit” and the corresponding provisions of Regulation O, and thus are generally not subject to insider lending requirements.

It is important to note that in the interim final rule, the Fed specifically states that its determination does not apply to Section 22(g) of the Federal Reserve Act or Section 215.5 of Regulation O, which collectively govern loans by member banks to executive officers. In addition, SBA lending restrictions continue to apply.

SBA Lending Restrictions Continue to Apply

SBA regulations state that “[b]usinesses in which the [l]ender . . . or any of its [a]ssociates^[5] owns an equity interest”^[6] are ineligible to receive 7(a) small business loans, which would normally include PPP loans. In its interim final rule announced on April 14, the SBA excepted certain insider-owned businesses from this restriction, including those businesses owned by outside directors and shareholders with a less than 30% equity interest in the lender.

However, the SBA additionally noted that certain insider loan restrictions continue to apply:

- Insider-owned businesses must follow the same processes as any similarly situated customer of the PPP lender.
- Favoritism by PPP lenders in processing time or prioritization of the insider’s PPP application is prohibited.
- The exception does not apply to a director or shareholder who is also an officer or key employee of the PPP lender. Officers and key employees of a PPP Lender may apply for PPP assistance from a different lender, but not from the PPP lender with which they are associated.

Additionally, the SBA offered important reminders for PPP lenders to consider when making PPP loans to insiders:

- PPP lenders should comply with all other applicable state and federal regulations concerning loans to insiders.
- PPP lenders should consult their own internal policies concerning insider lending.
- The “Authorized Lender Official” for each PPP loan is subject to the limitations described in the Lender Application Form, which states in relevant part: “Neither the undersigned Authorized Lender Official, nor such individual’s spouse or children, has a financial interest in the Applicant [Borrower].”

Conclusions

The temporary removal of certain insider lending restrictions by the Fed and SBA should alleviate funding challenges for some small businesses owned by certain bank insiders. When PPP lending resumes, it is critical that lenders strictly adhere to the insider restrictions that remain in effect, most notably by avoiding favoring or prioritizing insider-owned business applications. The Fed, Treasury and SBA have made clear that they intend to target and penalize, including by pursuing criminal charges, against those who abuse the PPP loan program.

Over the coming days, we expect that Congress will pass the new \$320 billion funding package to replenish the PPP loan program. We further expect that the SBA, the Treasury Department and the Fed will continue to issue guidance that will further clarify the PPP program. Given the fluid nature of these developments, lenders are strongly encouraged to seek advice from their legal adviser before participating in the PPP program and/or making PPP loans to bank insiders.

If you have any questions about this client alert, contact [Jeff Smith](#), [Kim Schaefer](#), [Tony Weis](#), [Scott Herkamp](#), or your Vorys attorney.

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Vorys COVID-19 Task Force

Vorys is continuing to monitor the COVID-19 outbreak and related guidance to Insurers. In addition, Vorys attorneys and professionals are counseling our clients on a myriad of others issues related to the outbreak. We have established a comprehensive COVID-19 Task Force, which includes attorneys with deep experience in the niche disciplines that we have been and expect to continue receiving questions regarding coronavirus. Learn more and see the latest updates from the task force at vorys.com/coronavirus.

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[1] The Federal Reserve. (2020, April 21). Federal Reserve Board announces rule change to bolster the effectiveness of the Small Business Administration's Paycheck Protection Program [Press release]. Retrieved from <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200417a.htm>.

[2] *Id.*

[3] “Insiders” include a bank’s executive officers, directors, or principal shareholders. 12 C.F.R. 215.2(h).

[4] An insider's "related interests" include, in relevant part, "a company that is controlled by that person." 12 C.F.R. 215.2(n).

[5] "Associate" is further defined as an "officer, director, key employee, or holder of 20 percent or more of the value of the Lender's ... stock or debt instruments, or an Agent involved in the loan process." 13 C.F.R. 120.10.

[6] 13 C.F.R. 120.110(o).