BURR ALERT

Are You Down with PPP? Not if You're a DIP: SBA Seeks to Exclude Debtors in Bankruptcy Proceedings from Receiving PPP Loans

By Erich N. Durlacher and Samantha A. Orender | May 5, 2020

Is a debtor-in-possession (DIP) eligible to receive a Paycheck Protection Program (PPP) loan under the Coronavirus Aid, Relief, and Economic Security Act (the CARES Act)? Such a simple question. But, as is often the case, the answer is complicated. The CARES Act is silent on a debtor-in-possession's eligibility for a PPP loan[1]; the Small Business Administration (SBA) has said a debtor-in-possession is not eligible for a PPP loan; and, the bankruptcy courts have fallen on both sides of the issue. Clear as mud. But, it is not unexpected when the government is trying to push out hundreds of billions of dollars in a matter of weeks. This ambiguity coupled with the irresistible lure of "free money" has prompted some debtors to seek injunctive relief against the SBA in order to get a piece of the pie.

THE PAYCHECK PROTECTION PROGRAM (PPP).

The CARES Act was signed into law on March 27, 2020 in the midst of the coronavirus pandemic in the United States. Sections 1102 and 1106 of the Act created the PPP to provide $349 billion in financial support for small businesses and their employees. After these funds were exhausted in a couple of weeks, Congress passed the Payroll Protection Program and Health Care Enhancement Act, which injected another $310 billion into the PPP. These funds are likewise expected to be exhausted in short order.

The PPP is administered by the SBA through its Section 7(a) loan program. In very general terms, a company with under 500 employees may be eligible for a PPP loan equal to the lesser of $10 million or 2.5X its average monthly payroll.[2] PPP loans carry a maximum annual interest rate of 1% with principal and interest payments deferred for the first 6 months. PPP loans will be forgiven, in whole or in part, if the proceeds are used to retain and pay employees (at least 75% must be spent on payroll expenses), rent, utilities, and interest on mortgage obligations during the 8 weeks following disbursement.

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[1] The CARES Act expressly excludes debtors in bankruptcy proceedings from receiving Title IV loans. *See* Section 4003(c)(3)(D)(i)(V). But, PPP loans are Title I loans under Section 1102 of the CARES Act. Section 1102 does not contain a similar eligibility restriction.

[2] The PPP's size eligibility requirements may be greater for a specific industry based upon the size standards established by the SBA for the particular industry. Additionally, businesses with more than 1 physical location that have been assigned a North American Industry Classification System (NAICS) code beginning with "72" are eligible if no more than 500 employees per location. The SBA's affiliation rules in 13 CFR §121.301(f) also apply when determining the applicant's size.

WHERE AGAIN IS THAT "NOT IN BANKRUPTCY" QUALIFIER FOR PPP LOANS?

The CARES Act does not impose a "not in bankruptcy" eligibility qualifier on PPP loans. In fact, it does not impose any "creditworthiness" criteria. Nevertheless, the SBA has determined that debtors in bankruptcy are ineligible to receive PPP loans. In the first weeks of the program, the SBA promulgated guidance (interim final rules and frequently asked questions) and created a **Borrower Application Form**. While the early guidance was silent on the eligibility of a debtor in bankruptcy to receive a PPP loan, the application requires an applicant's certification that it is not "presently involved in any bankruptcy." Subsequently, the SBA issued an April 24, 2020 **Interim Final Rule** that states "[i]f the applicant or the owner of the applicant is the debtor in a bankruptcy proceeding, either at the time it submits the application or at any time before the loan is disbursed, the applicant is ineligible to receive a PPP loan."

In explaining the reasons for this policy decision, the SBA cited the need for expedited underwriting and stated that "providing PPP loans to debtors in bankruptcy would present an unacceptably high risk of an unauthorized use of funds or non-repayment of unforgiven loans." The SBA regulations go on to state that the Bankruptcy Code "does not require any person to make a loan or a financial accommodation to a debtor in bankruptcy." (The SBA regulations do not address the bankruptcy protections available to post-petition lenders or the bankruptcy court's supervision of debtors in bankruptcy proceedings).

Inexplicably, the SBA regulations do not address what happens if a distressed company files for bankruptcy protection immediately after receiving the PPP funds (*e.g.*, **TooJay's Original Gourmet Deli**, which filed for bankruptcy right after receiving a $4.6 million PPP loan at the end of April). The SBA regulations address only the case of an applicant filing for bankruptcy after completing its PPP application, but before receiving the PPP loan proceeds. In such case, the applicant is required to withdraw its application and the failure to do so "will be regarded as a use of PPP funds for unauthorized purposes."

THE DEBTORS GO ON OFFENSE – THE TRO CASES.

Given the high demand for "forgivable" PPP loans (*i.e.*, free money), the ambiguity over a debtor's eligibility has generated a flurry of lawsuits in the past few weeks. Several debtors have filed lawsuits seeking injunctive relief against the SBA. These lawsuits generally advance two main arguments: (1) the SBA's guidance exceeds its statutory grant (Section 1102 does not impose a "not in bankruptcy" eligibility requirement); and (2) the denial of a PPP loan based on the applicant being in bankruptcy is impermissible discrimination under Section 525(a) of the Bankruptcy Code (the PPP loans are really grants or support programs that fall under Section 525's protection against discriminatory treatment). Another recent case also found the SBA's actions arbitrary and capricious under Section 706(2)(A) of the Administrative Procedure Act (APA).

HIDALGO.

In particular, consider *In re Hidalgo County Emergency Service Foundation*, Case No. 19-20497, Adv. P. No. 20-2006 (Bankr. S.D. Tex.). On April 22, the Hidalgo County Emergency Service Foundation (Hidalgo) filed suit against the SBA stating that it needed a PPP loan to continue operating. Notably, Hidalgo is the primary 911 patient transfer provider in Hidalgo County in South Texas, and due to loss of revenue from the coronavirus, it would be unable to cover its upcoming payroll and continue to provide front-line medical services during the crisis. On April 24, the United States Bankruptcy Court for the Southern District of Texas issued a **temporary injunction** against the SBA, holding that it could not deny a PPP loan to Hidalgo due solely to its status as a Chapter 11 debtor in bankruptcy. As reflected in the hearing **transcript**, U.S. Bankruptcy Judge David R. Jones stated that "[t]his isn't a loan program. This is a support program. . . There is no collateral valuation, there is no creditworthiness test." He further stated that the temporary restraining order was in the public interest, because Hidalgo is a "'front line' health care provider… vitally important even in normal times, and even more so now for victims of COVID-19 in South Texas."

Does the Bankruptcy Court have the authority to enjoin the SBA in this context? Finding that the Court had jurisdiction over the matter pursuant to Section 1334 of the Bankruptcy Code and that this was a core proceeding under 28 USC Section 157, the *Hidalgo* Court held that the SBA had exceeded its statutory authority under the CARES Act by categorically prohibiting debtors in bankruptcy from qualifying for PPP loans and that the SBA had violated section 525(a) of the Bankruptcy Code, which prohibits governmental units from denying "a license, permit, charter, franchise, or other similar grant" to a debtor in bankruptcy. But, in recognition that it could not command the SBA and the lender to issue the loan to Hidalgo, the Court directed the SBA and the lender to review the PPP application without any consideration of Hidalgo's bankruptcy. Judge Jones even acknowledged in the hearing transcript that he was uncertain about his authority to enjoin the administrator of the SBA. In closing, Judge Jones said "my Article Three colleagues will tell me that I am wrong, and I will accept that criticism. But this can't be what Congress intended. *This can't be the way that we are supposed to treat our fellow man in this time.*"

COSI.

In the U.S. Bankruptcy Court for the District of Delaware, U.S. Bankruptcy Judge Brendan L. Shannon went the other way. In *Cosi Inc. v. Small Business Administration et al.*, case number 1:20-ap-50591, the Court did not grant the request for a temporary restraining order by Boston-based casual dining restaurant chain Cosi Inc. (Cosi). Although Judge Shannon was "dismayed at the consequences" of the SBA's decision to disqualify debtors in bankruptcy from the PPP, he determined that the Bankruptcy Court "does not have the statutory power to enjoin the agency." Rather than go against the SBA's policy, Judge Shannon suggested that Cosi could file an emergency motion to dismiss its Chapter 11 case in order to seek a PPP loan, revealing an unintended consequence of the SBA's policy. The SBA's policy may lead some debtors to dismiss their cases solely in order to obtain a PPP loan and then potentially refile after their PPP loan is funded before declaring bankruptcy.[3]

[3] In fact, this is happening already. *See In re Advanced Power Technologies, LLC*, Case No. 20-13304-PGH, ECF No. 60 (Bankr. S.D. Fla. Apr. 24, 2020)(case dismissed without prejudice so debtor could apply for a PPP loan); *but cf. In re Capital Restaurant Group, LLC*, Case No. 19-65910-WLH, ECF No. 192 (Bankr. N.D. Ga. Mar. 28, 2020)(case dismissed with prejudice against re-filing for 1 year to prevent debtor's circumvention of SBA's eligibility guidance).

ROMAN CATHOLIC CHURCH OF THE ARCHDIOCESE OF SANTA FE.

On May 1, 2020 in *In re Roman Catholic Church of the Archdiocese of Santa Fe*, 18-13027 (Bankr. D. N.M.), the New Mexico Bankruptcy Court found that the SBA's decision to exclude debtors in bankruptcy from the PPP violated not only section 525(a) of the Bankruptcy Code, but also found that policy to be arbitrary and capricious under Section 706(2)(A) of the Administrative Procedure Act (APA). The Court held that the PPP is not a loan program, where an applicant's creditworthiness would of course be relevant, but (just as *In re Hidalgo*) found it to be more like a grant:

> While a borrower's bankruptcy status clearly is relevant for a normal loan program, the PPP is the opposite of that. It is not a loan program at all. It is a grant or support program. The statute's eligibility requirements do not include creditworthiness. Quite the contrary, the CARES Act makes PPP money available regardless of financial distress. Financial distress is presumed. Given the effect of the lockdown, many, perhaps most, applicants would not be able to repay their PPP loans. They don't have to, because the "loans" are really grants. Repayment is not a significant part of the program. That is why Congress did not include creditworthiness as a requirement.

By turning to the judicial review provisions of the APA, the New Mexico Bankruptcy Court found that its jurisdiction was proper. The Court cited *New Mexico Health Connections v. United States Department of Health & Human Services (*946 F.3d 1138 (10th Cir. 2019)) for the proposition that "[i]n reviewing an APA challenge to agency action, a district court acts as an appellate court." It stated that "[t]he scope of the court's 'review under this standard is 'narrow' and the court 'is not to substitute its judgment for that of the agency,'" but that courts nevertheless "retain an important role 'in ensuring the agencies have engaged in reasoned decisionmaking.'" (*Judulang v. Holder*, 565 U.S. 42 (2011).)

Judge Thuma ruled "it was arbitrary and capricious for [the SBA] to engraft a creditworthiness test where none belonged." He also found a violation of Section 525(a) of the Bankruptcy Code similar to *Hidalgo*, but went even further by declaring the archdiocese could seem compensatory and, if appropriate, punitive damages if the SBA's action precluded it from receiving a PPP loan.

"WHAT DO YOU SAY YOU DO AGAIN?" - DOES THE TYPE OF DEBTOR MATTER?

Based on the cases that have been successful for debtors, the type of business seeking PPP funding might also matter. As of the date of this article, four of the five successful cases were health care businesses (see *In re Hidalgo*; *In re Penobscot Valley Hospital*, 19-10034 (Bankr. D. Me.); *In re Calais Regional Hospital*, 19-10486 (Bankr. D. Me.); and *In re Springfield Hospital, Inc.*, 19-10283 (Bankr. D. Vt.)). In contrast, there are two cases where the SBA's regulations were upheld (*In re Cosi*, a restaurant chain, and *In re Asteria Education, Inc.*, 20-50169 (Bankr. W.D. Tex.)[4], a software company).

[4] Judge Craig A. Gargotta of the U.S. Bankruptcy Court for the Western District of Texas Thursday denied Asteria Education Inc.'s request for a temporary order against the SBA.

In line with this trend, some members of **Congress** have urged the SBA to create a waiver so that "essential health organizations, such as critical access hospitals and federally qualified health centers" may access the PPP.

CONCLUSION.

As these cases continue to work themselves through the courts, otherwise PPP-eligible debtors will need to decide which strategy affords them the best opportunity for getting a PPP loan. Although the amount of PPP funds is limited and may be exhausted soon, there is always a chance there will be a third round of funding. In the meantime, a debtor's need for liquidity during these trying times and the prospect of "free money" provides a powerful incentive to fight for inclusion in the PPP.

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