

New Developments Impacting Bankrupt Debtors in Applying for PPP Loans under New SBA Authority

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The Small Business Administration, which administers the Paycheck Protection Program, has issued rules denying PPP Funds to debtors in bankruptcy cases. In two cases decided in the past few days, bankruptcy courts have reached different conclusions on whether the SBA had the authority to deny those funds to bankrupt debtors.

Debtor Eligibility for PPP Funds under the CARES Act

On April 24, 2020, the Small Business Administration (SBA) posted yet another interim final rule, effective immediately, clarifying the SBA's intent to deny Paycheck Protection Program (PPP) funds to those applicants who have sought protection under the US Bankruptcy Code. However, as made evident by two opinions passed down by bankruptcy judges in Texas and Delaware in the past week, the question as to whether the SBA has the authority to deny PPP loans to debtor applicants remains unsettled and has, at least temporarily, created uncertainty for businesses both seeking and having sought protection under the US Bankruptcy Code.

As enacted, the PPP—unlike other programs under the CARES Act—contains no express limitation on the granting of loans to debtors in bankruptcy. The CARES Act grants the SBA broad rulemaking authority, and the SBA formulated the PPP borrower and lender applications and accompanying instructions. Since the CARES Act became effective, the SBA has from time to time published clarifying guidance relating to both the scope of the PPP and the application process.

Prior to April 24, no supplemental interim guidance from the SBA expressly stated that bankrupt borrowers need not apply. The PPP's Borrower Application Form, however, requires applicants to disclose whether they are "presently involved in any bankruptcy" and notes that if the answer is yes, "the loan will not be approved." The Lender Application Form similarly asks lenders whether the applicant has certified that "neither the Applicant nor any owner . . . [is] presently involved in any bankruptcy," noting that the loan "cannot be approved" if the answer is no. As such, the form

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would lead one to believe that an applicant's bankruptcy is a disqualifying act.

However, an Interim Final Rule entered by the SBA on April 24, Docket No. SBA-2020-0021, confirmed that if an applicant is a debtor in bankruptcy at the time the application is submitted, the applicant will not be approved for a PPP loan. Moreover, the Interim Final Rule states that if the applicant submits an application and then subsequently files for bankruptcy prior to the loan being disbursed, the applicant is ineligible to receive a PPP loan. In the latter scenario, the SBA places an affirmative duty on the applicant to notify its lender of its bankruptcy proceeding and request a cancellation of its loan application.

Relying on the Courts for Guidance

Given that the CARES Act and the Small Business Act do not explicitly limit or deny loans to debtors in bankruptcy, debtors have turned to the courts in recent weeks to challenge the SBA's rulemaking. Unfortunately, there now exists a split in authority regarding the SBA's ability to deny PPP loans to debtors.

The Chapter 11 Case of Hidalgo County Emergency Service Foundation, The US Bankruptcy Court for the Southern District of Texas

Simultaneous with the issuance of the April 24 Interim Final Rule, the Bankruptcy Court for the Southern District of Texas found that the Bankruptcy Code likely prevents the SBA from discriminating against potential borrowers strictly on the basis of a pending bankruptcy and that the denial of the loans on this basis probably exceeds the SBA's rulemaking authority.

The Hidalgo County Emergency Services Foundation is the primary provider of emergency medical transportation in a large swath of South Texas. It filed for Chapter 11 protection in October 2019 and has been operating as a debtor in possession.

Significantly, the Hidalgo County EMS has lost 30% of its business as a result of coronavirus and, as a result, sought funding through the PPP loan program. However, its application was denied.

Subsequently, the debtor filed a verified complaint on April 22, together with an application for a temporary restraining order, noting that there was no statutory provision in either the CARES Act or the Small Business Act prohibiting the extension of PPP loans to a debtor and debtor in possession under chapter 11 of the bankruptcy code. Accordingly, debtor sought a declaration from the court that the SBA had exceeded its authority and requested that the court restrain the SBA and financial institutions from denying its application.

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After a hearing on April 24, Judge David R. Jones found no basis in the CARES Act for precluding chapter 11 debtors from receiving PPP loans that the company is not required to pay. Judge Jones authorized the debtor to file an application while striking the inquiry about being involved in bankruptcy. He directed the SBA and the bank administering the program to review the application “without any consideration of the involvement of [the debtor] . . . in any bankruptcy.”

A hearing will be held on May 8 to determine whether the temporary restraining order should be made a preliminary injunction.

The Chapter 11 Case of Cosi, Inc., US Bankruptcy Court for the District of Delaware

In contrast, in a decision by Delaware Bankruptcy Judge Brendan L. Shannon, handed down from the bench on April 30, the Delaware Court took the opposite position from the *Hidalgo County EMS* court, denying debtor Cosi, Inc.’s bid for a temporary restraining order barring the SBA from disqualifying the restaurant chain from applying for a PPP loan. Like the debtor in *Hidalgo County EMS*, Cosi argued that that the SBA’s exclusion of debtors from receiving relief is discriminatory and that the agency had exceeded its authority under the CARES Act. Judge Shannon, while expressing his dismay regarding the potential harm and consequences that will be caused to Cosi in denying its request for relief from the court, determined that he would defer to the April 24 directive from the SBA on how PPP loans are to be disbursed. And perhaps signaling a potential avenue forward for Cosi, and other debtors seeking PPP funds while in bankruptcy, Judge Shannon implored Cosi’s counsel as to whether an emergency motion to dismiss its Chapter 11 case was warranted so it could seek PPP funds.

The Dioceses of Rochester and Buffalo Sue the SBA in the US District Court for the Western District of New York

In recent weeks, other entities have filed complaints seeking relief similar to those of the *Hidalgo County EMS* and *Cosi* parties. For example, the Dioceses of Rochester and Buffalo, New York are currently debtors in separate bankruptcy cases pending before the Bankruptcy Court for the Western District of New York. Having recently been informed that their status as debtors in a bankruptcy disqualifies them as borrowers, the dioceses have together filed a complaint with the District Court for the Western District of New York seeking a determination that the SBA had exceeded its statutory authority, that the SBA rulemaking was arbitrary and capricious, and that the debtors have been discriminated against in violation of 11 U.S.C. § 525. A hearing on their request for a preliminary injunction is scheduled for May 15.

What does this all mean?

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There now exists a split in authority as to whether the SBA has acted within its congressionally mandated authority under the Small Business Act and CARES Act, leaving debtors and debtors in possession in limbo. Perhaps there will be further clarity on these issues after the *Hidalgo County EMS* preliminary injunction hearing, although that seems unlikely given the grounds cited by Judge Jones in support of the issuance of the temporary restraining order. Moreover, the district court's determination on the SBA's authority in the *Dioceses of Rochester and Buffalo* case remains pending, and we anticipate that further cases will be filed on this issue. These decisions will undoubtedly be subject to appellate proceedings, further creating uncertainty.

Without question, these decisions leave debtor applicants at a disadvantage both in applying for PPP loans and determining whether bankruptcy is a viable path for reorganization. And while appellate proceedings on these issues will likely move quickly, that guidance is of little help to debtors making hard decisions today. At this moment, those once considering bankruptcy as an avenue to reorganization may hold off filing in favor of receiving a loan, while simultaneously leaving themselves vulnerable to their creditors. Alternatively, those in bankruptcy may face the difficult decision to voluntarily dismiss their case, losing valuable protections, to qualify as a borrower and ensure the receipt of a loan that will allow the continued operations of their businesses.

We will continue to watch how these cases develop. If you have applied for or are considering applying for a PPP loan, and you have filed or are considering filing for bankruptcy as an avenue for financial relief, please contact our team at Bailey Glasser for assistance.

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Practice Areas

Bankruptcy & Business Reorganization