Emerging Trends From Bankruptcy Rulings On PPP Access

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One of the key tools for combating the economic impact on American businesses of COVID-19 and the related lockdown orders has been the Paycheck Protection Program, or PPP, which can be characterized as a conditional grant program intended to assist employers in financial distress to preserve their businesses by funding certain key operating expenses such as labor, utilities and rent.

However, employers that are in bankruptcy or have an owner that is in bankruptcy are being automatically disqualified from the PPP by the Small Business Administration, or SBA, despite the fact that other Section 7(a) loan programs have no such conditions.

This automatic disqualification policy has been highly criticized over the last two weeks, with at least four temporary restraining orders or preliminary injunctions and one final judgment being issued by various bankruptcy courts against the SBA to enjoin enforcement of this policy. One court even suggested that punitive damages against the SBA could be appropriate if the debtor found itself unable to obtain PPP funding as a result of this policy.

The issues raised in and by these court proceedings are addressed below. Companies and business owners that are experiencing financial distress and considering taking advantage of the PPP as well as lenders that are processing, or interested in processing, the PPP applications of such entities should be aware of these developments.

Background

Generally, the PPP assists businesses impacted by the ongoing pandemic by providing for quick funding on highly favorable terms to be used for certain critical operating expenses such as labor, rent and utilities, with loan forgiveness if the funds are used for such purposes.

The program is implemented by providing for SBA guarantees of new loans to employers made from approved lenders in an amount up to 2.5 times the employer's monthly payroll cost, with no personal guarantee or collateral requirements, no fees or charges other than a 1% interest rate, a six month deferment of interest payments, a 2 year maturity, and full loan forgiveness if 75% of the funds are used for payroll costs, interest on mortgages, rent and utilities.

The Coronavirus Aid, Relief, and Economic Security, or CARES, Act was enacted on March 27 as the largest economic relief plan in U.S. history, with the PPP as one of its key components. The PPP has been well received by all constituencies and eagerly sought by employers.

The initial authorized program amount of $349 billion was exhausted by April 16 and an additional $310 billion was authorized on April 24. As these additional funds are expected to be exhausted soon, further authorizations may be on the horizon as the economy continues

to be affected and unemployment remains at or near record levels.

Although the purpose of the PPP is to assist employers in distress, the SBA is barring any company in bankruptcy from the program. No such restriction applies for traditional SBA Section 7(a) loans,[1] where bankruptcy is only a credit factor to be considered with supplemental information in context.[2]

However, the first question on the PPP application required by the SBA asks whether the applicant or any owner of the applicant is presently involved in any bankruptcy and states that the loan will not be approved with an affirmative response.[3]

In addition, the SBA has published interim final rules stating that "if 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," noting that "providing PPP loans to debtors in bankruptcy would present an unacceptably high risk of an unauthorized use of funds or nonrepayment of unforgiven loans."[4]

This restriction and the SBA rationale have been widely and uniformly criticized within the restructuring community[5] and various elected officials have already reached out to the SBA requesting that the PPP be made available to borrowers in bankruptcy.[6]

As anyone who has been involved in a bankruptcy can attest, a debtor in bankruptcy operates with substantial reporting requirements and under significant oversight from the bankruptcy court; the U.S. Trustee Program; either the official committee of unsecured creditors or a trustee (depending on the applicable bankruptcy chapter); the general creditor body; and, in many cases, even the press.

Accordingly, the risk of an unauthorized use of PPP funds cannot be greater for a borrower in bankruptcy than for a borrower outside of bankruptcy, where the SBA does not require, much less request, any comparable oversight.

Similarly, the notion that a borrower in bankruptcy presents a higher risk of nonrepayment than a borrower outside of bankruptcy is empirically false[7] and ignores the many protections available for post-petition lenders that are not available to lenders for borrowers outside of bankruptcy.[8]

Such concern of credit risk also diverges from the purpose of the CARES Act, where PPP loans are specifically intended for distressed companies and the CARES Act expressly prohibits the SBA from requiring personal guarantees or collateral for the loans.

Companies that are contemplating commencing a bankruptcy case or that are in bankruptcy often have difficulty obtaining new financing on any terms. The highly favorable terms offered by the PPP would provide much-needed relief for debtors in bankruptcy.

Having been barred by the SBA from the PPP without a compelling justification or explicit statutory authorization, employers in bankruptcy are turning to the courts. At least 11 such actions have been commenced to date, with substantively similar complaints alleging that the SBA's bankruptcy disqualification is impermissible discrimination by a governmental unit against the applicant on the basis of its bankruptcy[9] and should be set aside in accordance with the Administrative Procedure Act, or APA, as arbitrary and capricious, or exceeding the statutory authority granted to the SBA.[10]

The complaints seek a range of relief such as: (1) injunctive relief to require the SBA to process the debtor's PPP application; (2) declaratory judgment that the applicant is entitled to be considered for a PPP loan notwithstanding its status as a debtor in a bankruptcy case; (3) court compulsion of the SBA to process the PPP application by writ of mandamus; and (4) compensatory damages for failing to process and award a PPP loan, as well as fees and costs incurred in bringing the action.

The oppositions filed by the SBA to these complaints are also substantively similar, and generally argue that the PPP is a loan program and the failure to grant a loan on account of bankruptcy status is not impermissible bankruptcy discrimination; that the bankruptcy exclusion is a permissible exercise of the SBA's rulemaking authority for Section 7(a) loans under the CARES Act;[11] that consideration of the related APA claims is not an exercise of core jurisdiction by the bankruptcy court; and that injunctive relief against the SBA is not available under any circumstances.[12]

Discussion

Since April 24, five bankruptcy courts have granted temporary restraining orders or injunctions prohibiting the SBA and relevant lending institutions from considering the "presently involved in any bankruptcy" language when enforcing the debtor's PPP application,[13] and two bankruptcy courts have declined to provide such relief.[14]

As is always the case, these decisions are highly fact-specific and reflect the variance inherent to the multifactor balancing test that is required for preliminary injunctive relief. It is perhaps not surprising that hospitals or emergency medical service providers on the front lines of the coronavirus fight have been markedly more successful in obtaining their requested relief than other businesses.

However, while only one of these decisions is a final judgment,[15] some broad trends have emerged and may drive future proceedings in these actions as they progress through the courts.

First, the courts have uniformly disapproved of the SBA's positions on the underlying merits of its disqualification policy. No court has adopted the SBA's characterization of the PPP as a loan program, with almost all affirmatively rejecting that position and characterizing the PPP as a grant or support program.[16]

Also, most courts have rejected the use of bankruptcy status alone as a creditworthiness or underwriting standard, and the related rationale offered by the SBA in the fourth interim rule, as arbitrary and capricious or otherwise exceeding the SBA's delegated authority under the CARES Act.[17] Based on the courts' comments on the record and rulings to date, the SBA is not likely to have any greater success on these issues as these actions progress or in future actions.

Second, all of the courts granting relief for the debtors have found that the PPP is a government program subject to the antidiscrimination requirements of Section 525(a) and that the SBA's bankruptcy disqualification is impermissible under that provision. In so finding, most of these courts have relied on In re: Stoltz.[18]

As one court noted, "[o]f all the benefits a government can grant, free money might be the best of all. Denying plaintiff access to PPP funds solely because it is a debtor violates Section 525(a)."[19] Notably, it does not appear that any of the courts that refused to find impermissible bankruptcy discrimination considered Stoltz in rendering their rulings.

Third, while the courts agree that core jurisdiction exists for alleged violations of Section 525(a), at least one court has also found core jurisdiction over the related claims for judicial review of the SBA's rulemaking pursuant to the APA independent of any Section 525(a) issues.[20] While APA claims may not generally be within the core jurisdiction of bankruptcy courts, the claims at issue here regarding the bankruptcy exclusion may indeed arise only in a bankruptcy case, and accordingly, present an opportunity for courts to further develop these unsettled jurisdictional issues.

Fourth, the SBA is taking the position that declaratory or injunctive relief against the SBA is not available under any circumstances, irrespective of the APA or any violation of the Bankruptcy Code or any other statute, by operation of Title 15, Section 634(b)(1) of the U.S. Code.[21]

While the scope of declaratory or injunctive relief against the SBA is not frequently addressed and does not appear to be a settled question,[22] as indicated by the Santa Fe decision and the other four injunctions issued against the SBA, it does not seem likely that bankruptcy courts will accept the SBA's position and such outcomes may ultimately benefit other litigants against the SBA outside of the bankruptcy context.

Fifth, while the APA and discrimination claims in these actions in relevant part do not turn on applicant-specific facts, the courts have been reluctant to issue broad relief that would also be applicable to other debtors, and the debtors themselves have not pursued such remedies, perhaps understandably due to limited resources and incentive to incur the greater cost and procedural burdens that would be necessary for such broader relief.

Although this dynamic does not appear likely to change unless the SBA modifies its position, the applicants may be entitled to recover costs and fees for their trouble in accordance with the Equal Access to Justice Act.[23] A lender interested in providing PPP loans to applicants in bankruptcy[24] might consider obtaining such broader relief applicable to all of its PPP loan processing by bringing its own action against the SBA and seeking declaratory relief on these issues, or just join as a party in pending actions.

Finally, while not all plaintiffs have sought compensatory damages, some have and the courts have seemed amenable to such claims, with one court going so far as to state that if the SBA's actions result in the plaintiff not obtaining its requested PPP funding, "Plaintiff may file an adversary proceeding for compensatory and, if appropriate, punitive damages."[25]

While punitive damages may be outside the scope of remedies available to the bankruptcy court,[26] bankruptcy courts do have civil contempt power[27] and inherent sanction power[28] that may come into play if the SBA persists in asserting arguments that courts find to be "completely frivolous," "completely lacking in good faith," "inexplicable and highhanded," or "so weak [that] the Court has to wonder if [the SBA] really believes it."[29]

Two other aspects of the SBA's rulemaking with respect to PPP applicants are likely to be challenged soon and may face even harsher opposition from the courts than for the disqualification of applicants who are debtors in bankruptcy. First, the SBA is barring PPP applicants with "any owner ... presently involved in any bankruptcy"[30] or where "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."[31]

Second, the SBA is taking the position that "if the applicant or the owner of the applicant

becomes the debtor in a bankruptcy proceeding after submitting a PPP application but before the loan is disbursed, it is the applicant's obligation to notify the lender and request cancellation of the application. Failure by the applicant to do so will be regarded as a use of PPP funds for unauthorized purposes."[32] Notably, no similar principles exist for traditional SBA Section 7(a) loans, which look only to entities that control or are under the control of the applicant.[33]

Accordingly, the same rulemaking challenges and bankruptcy discrimination arguments raised against the SBA's bar of applicants that are debtors in bankruptcy remain applicable but with even greater force. In addition, the attempt to compel post-bankruptcy performance by the applicant is unlikely to be effective, and debtors in bankruptcy who receive and use PPP funds in accordance with the statute may be able to obtain declaratory relief from the bankruptcy court regarding the use of PPP funds for authorized purposes or other effective relief such as releases under a confirmed plan.

Conclusion

Debtors in bankruptcy have been diligently pursuing the significant benefits of the PPP despite opposition from the SBA. Although their prospects for success on the merits appear strong after the first round of litigation, absent additional PPP authorizations being enacted they may find themselves with only claims for compensatory damages and costs against the SBA. Other penalties, however, may be available if courts continue to find the SBA's positions to be "completely frivolous" or "lacking in any good faith."

Some debtors have also requested and received emergency approval to dismiss their cases in order to obtain their PPP funds and then refile their bankruptcy case, a course of action that is not prohibited by the SBA but would leave the SBA in a significantly worse position with the PPP as a pre-bankruptcy loan rather than as a post-bankruptcy loan with those attendant protections.

Finally, while it is not likely that the applicants will expend resources to obtain broader relief that go beyond their own unique needs, a lender wishing to provide PPP loans to applicants in bankruptcy might consider obtaining the necessary broader relief to help guide it in extending future the PPP loans.

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[1] The PPP is implemented as an addition to the SBA's traditional section 7(a) loan programs provided pursuant to 15 U.S.C § 636(a). CARES Act (Pub. L. 116-136, 134 Stat. 281) § 1102(b).

[2] See, e.g., SBA Form 1919, Borrower Information Form (eff. Jan. 1, 2018) at 2, available at https://www.sba.gov/document/sba-form-1919-borrower-information-form; SBA SOP 50 10 5(K), Lender and Development Company Loan Programs (eff. Apr. 1, 2019) at 37, 180, available at https://www.sba.gov/document/information-notice-5000-19004-issuance-sop-

50-10-5k; cf. 13 CFR Part 120.110 (identifying various ineligible parties for SBA section 7(a) loans without including involvement in bankruptcy).

[3] SBA Form 2483, Paycheck Protection Program Borrower Application Form (eff. Apr. 3, 2020) at 1, available at https://www.sba.gov/document/sba-form-2483-paycheck-protection-program-borrower-application-form.

[4] Fourth Interim Rule (eff. Apr. 24, 2020), Docket Number SBA-2020-0021, 13 CFR Parts 120 and 121, RIN 3245-AH37, 85 Fed. Reg. at 23,451, available at https://www.sba.gov/sites/default/files/2020-04/Interim-Final-Rule-04%2024%2020.pdf.

[5] See, e.g., Salerno, T.J., Weidner, G., Simpson, C., Ebner, S., This DIP Loan Should Be Brought To You By Someone Who CARES! (Or "You Can't Get There from Here"): A Plea for Rationality: Part Two, ABI Commentary (Apr. 28, 2020), available at https://abi-store.s3.amazonaws.com/documents/This_DIP_Loan_SHOULD_Be_Brought_to_You_By_Someone_Who_CARES!.pdf.

[6] See, e.g., Letter dated April 24, from Sen. Susan M. Collins, R-Me.,, available at https://s.wsj.net/public/resources/documents/Collins%20Letter.pdf?mod=article_inline; Letter dated April 24, 2020 from Sen. Patrick Leahy, D-Vt., Sen. Bernie Sanders, I-Vt., and Rep. Peter Welch, D-Vt., available at https://s.wsj.net/public/resources/documents/Sanders,%20Leahy%20Letter.pdf?mod=article_inline.

[7] See, e.g., Espen Eckbo, B., Li, K. and Wang, W., Rent Extraction by Super-Priority Lenders (Mar. 13, 2020), Tuck School of Business Working Paper No. 3384389 (2019), available at https://ssrn.com/abstract=3384389 (reviewing data on DIP loans over the period 1988-2014 and finding "a near-zero likelihood of less than full repayment.") (citations omitted).

[8] For example, authorized post-petition indebtedness has at least administrative expense priority, which would be significantly more favorable for the SBA than the general unsecured status that would apply for a PPP loan disbursed to a distressed borrower prior to commencing its bankruptcy case, and commonly receives super-priority status, which would be even more favorable for the SBA by providing for repayment ahead of even other administrative expense claims. See 11 U.S.C. § 364(c)(1).

[9] See 11 U.S.C. § 525(a) (" ... a governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to, condition such a grant to, discriminate with respect to such a grant against ... a person that is or has been a debtor" under the Bankruptcy Code).

[10] See generally 5 U.S.C. § 706(2)(A), (C) (providing that courts "shall ... hold unlawful and set aside agency action, findings, and conclusions found to be – (A) arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law ... [or] (C) in excess of statutory jurisdiction, authority, or limitations, or short of statutory right").

[11] See CARES Act § 1102(a)(2) (implementing 15 U.S.C. § 636(a)(36)(B), providing that "[e]xcept as otherwise provided in this paragraph, the Administrator may guarantee covered loans under the same terms, conditions, and processes as a [traditional section 7(a) loan].").

[12] See 15 U.S.C. § 634(b)(1) (providing that the SBA may be sued, "but no attachment, injunction, garnishment, or other similar process, mesne or final, shall be issued against the Administrator or his property.").

[13] Hidalgo Cnty. Emergency Serv. Found. v. Carranza (In re Hidalgo Cnty. Emergency Serv. Found.), No. 20-2006 (DRJ) [Dkt. 16] (Bankr. S.D. Tex. Apr. 24, 2020) (hereinafter, "Hidalgo"); Penobscot Valley Hosp. v. Carranza (In re Penobscot Valley Hosp.), No. 20-1005 (MAF) [Dkt. 18] (Bankr. D. Me. May 1, 2020); Calais Reg'l Hosp. v. Carranza (In re Calais Reg'l Hosp.), No. 20-1006 (MAF) [Dkt. 21] (Bankr. D. Me. May 1, 2020); Roman Catholic Church of the Archdiocese of Santa Fe v. United States of Am. Small Bus. Admin. (In re Roman Catholic Church of the Archdiocese of Santa Fe), 2020 Bankr. LEXIS 1211, No. 18-13027 (DTT) [Dkt. 15] (Bankr. D. N.M. May 1, 2020) (hereinafter, "Santa Fe") (converting the preliminary injunction hearing into a trial on the merits pursuant to FRCP 65(a)); Springfield Hosp., Inc. v. Carranza (In re Springfield Hosp., Inc.), 2020 Bankr. LEXIS 1205, No. 20-01003 (CAB) [Dkt. 20] (Bankr. D. Vt. May 4, 2020) (hereinafter, "Springfield").

[14] Cosi, Inc. v. U.S. Small Bus. Admin. (In re Cosi, Inc.), No. 20-50591 (BLS) [minute entry] (Bankr. D. Del. Apr. 30, 2020); Asteria Educ., Inc. v. Carranza (In re Asteria Educ., Inc.), No. 20-05024 (CAG) [minute entry] (Bankr. W.D. Tex. Apr. 30, 2020).

[15] Notably, the Santa Fe court converted the hearing on the requested preliminary injunction into a trial on the merits pursuant to FRCP 65(a)(2) after considering the time sensitivity of the issues, its ability to provide effective relief, to prevent accrual of a "substantial damages claim," and the limited relevant factual issues. Santa Fe at 1 n.1. The other decisions on this issue have been in the context of temporary restraining orders or preliminary injunctions and the related balancing test, which requires consideration of likelihood of success on the merits, the likelihood of irreparable harm absent the requested relief, the balance of the equities, and the public interest.

[16] See, e.g., Springfield at 6 ("The CARES Act is not a statute enacted to increase the availability of commercial loans. Rather, the CARES Act is a grant of financial aid necessitated by a public health crisis."); Santa Fe at 14 ("The PPP is not a loan program. It is a grant or support program."); April 24, 2020 Hearing Transcript, No. 20-02006 (DRJ) (hereinafter, "Hidalgo Hrg. Tr.") at 29:6-7 ("[The PPP] isn't a loan program. It is a support program.").

[17] See, e.g., Santa Fe at 12 ("Defendant's justification for excluding bankruptcy debtors is so weak the Court has to wonder if Defendant really believes it."); Hidalgo Hrg. Tr. at 29:19-20 ("there is no creditworthiness test ... to make that argument is simply frivolous."); Id. at 32:6 ("I find the arguments [that the SBA has less control or oversight over use of PPP loan proceeds with a debtor in bankruptcy] to lack any good faith."); cf. April 30, 2020 Hearing Transcript, No. 20-50591 (BLS) (hereinafter, the "Cosi Hrg. Tr.") at 58:15-19 ("the SBA is entitled to a measure of deference and, again, I'm not authorized to substitute my preference or judgment for those of the SBA, nor can I find that the decision is arbitrary and capricious.").

[18] Stoltz v. Brattleboro Housing Auth. (In re Stoltz), 315 F.3d 80 (2d Cir. 2002). See, e.g., Springfield at 6 (analyzing and relying on Stoltz); Santa Fe at 13-14 (same). In Stoltz, the Second Circuit analyzed the "other similar grant" language of section 525(a) and held that a public housing lease was such a grant, reasoning that the property interests protected by section 525(a) are those that "are unobtainable from the private sector and essential to a debtor's fresh start." Stoltz v. Brattleboro Housing Auth. (In re Stoltz), 315 F.3d 80, 88-90 (2d Cir. 2002).

[19] Santa Fe at 14.

[20] Compare, e.g., Santa Fe at 7-8 (core jurisdiction exists with respect to the asserted APA claims pursuant to 28 U.S.C. § 157(b)(2)(A)); with Cosi Hrg Tr. at 56:17-19 (without section 525 discrimination, "I would likely lack core jurisdiction to enter the relief that's requested.").

[21] See, e.g., Opposition to Plaintiffs' Motion for Temporary Restraining Order and/or Preliminary Injunction, No. 20-50591 (BLS) [Dkt. 15] at 10.

[22] See, e.g., Ulstein Mar., Ltd. v. United States, 833 F.2d 1052, 1057 (1st Cir. 1987) (holding that the SBA is protected from injunctions interfering with its internal workings but does not have "blanket immunity from every type of injunction" particularly "judicial review of agency actions that exceed agency authority where the remedies would not interfere with internal agency operations. ").

[23] 28 U.S.C. § 2412.

[24] In addition to any market, economic or relationship benefits from providing a PPP loan, the position of a lender with prepetition loans to the applicant could be improved if the applicant obtains PPP funding used to support the underlying business and assets.

[25] Santa Fe at 15.

[26] 11 U.S.C. § 106(a)(3) ("The court may issue against a governmental unit an order, process, or judgment . . . but not including an award of punitive damages.").

[27] See 10 Collier on Bankruptcy ¶ 9020.01 (16th ed. 2020).

[28] See 2 Collier on Bankruptcy ¶ 105.02 (16th ed. 2020).

[29] See, e.g., Hidalgo Hrg. Tr. at 29:1-2, 32:6; see also Santa Fe at 11-12, 15.

[30] SBA Form 2483, Question 1.

[31] Fourth Interim Rule § III.4.

[32] Fourth Interim Rule § III.4.

[33] SBA Form 1999, p. 1; see also 13 CFR Part 121.301.