Chapter 11 Debtors Gaining Momentum in Eligibility for PPP Loans

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Businesses in chapter 11 bankruptcy cases were barred from receiving federal loans under the Paycheck Protection Program ("PPP"), part of Congress's Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"). The PPP, which is backed by the Small Business Association ("SBA"), grants loans up to $10 million to small businesses for up to 2.5 times their average monthly payroll, ("PPP Loans"). PPP Loans may be forgiven, fully or in part, if the borrower maintains employee head count and payroll at pre-COVID-19 levels and uses the loan for payroll and permitted expenses, such as rent, utilities and interest on debt. As such, PPP Loans present the lifeline distressed small businesses need to stay afloat during the pandemic. Yet, the very entities that need it the most, business which commenced bankruptcy cases, were precluded by the SBA from being eligible to receive such loans. A handful of debtors have successfully fought back.

Nothing in the CARES Act itself precludes debtors in bankruptcy cases from accessing PPP Loans. However, the SBA's loan application form required applicants to state whether they were involved in a bankruptcy, and if the answer was "yes", lenders would not approve the loan. As recently as April 28th, the SBA clarified its position through guidelines stating that a debtor in bankruptcy, either at the time it submits the application or before the loan funds are disbursed, is ineligible to receive a PPP loan. Failure by the applicant to notify the lender that it commenced a bankruptcy case after the application but before disbursement of the funds and to request cancellation would be deemed use of PPP funds for unauthorized purposes. The SBA posited that "providing PPP loans to debtors in bankruptcy would present an unacceptable high risk of an unauthorized use of funds or non-repayment of unforgiven loans."

Naturally, the SBA has faced legal challenges from various businesses in bankruptcy seeking PPP Loans. For example, Cosi, the flatbread chain that filed for bankruptcy relief on February 24th, filed a lawsuit in the United States Bankruptcy Court for the District of Delaware, challenging the SBA's denial of its $3.7 million emergency loan on grounds that the company is in the midst of bankruptcy proceedings. In its complaint, Cosi alleged that the exclusion is arbitrary and capricious and violates the stated purposes of the CARES Act -- to protect small businesses from the economic impacts of COVID-19. Moreover, the SBA's position may inspire debtors to voluntarily dismiss their chapter 11 cases to get PPP Loans before refiling. This could result in PPP Loans being treated as unsecured debt that can be discharged rather than postpetition debtor-in possession loans. And the SBA position violates Section 525(a) of the Bankruptcy Code which bars the government from denying "a license, permit, charter, franchise, or other similar grant" solely on the grounds that the entity is or has been a debtor.

A few bankruptcy courts have sided with debtors. On April 25, a challenge was upheld by the United States Bankruptcy Court for the Southern District of Texas in In re Hidalgo County Emergency Service Foundation, Case No. 19-20497, which issued a Temporary Restraining Order (TRO) prohibiting the SBA and the lender from rejecting the debtor's loan application because the debtor was in chapter 11 proceedings. Another TRO was entered in a Maine small hospital case, enjoining the SBA from denying the loan on grounds that the applicant was a chapter 11 debtor in violation of Section 525(a). The judge stated that the "Cares Act is a grant of aid necessitated by a public health crisis" and ordered the SBA to hold funds in the event that the debtor was eligible for a PPP loan. Calais Regional Hospital v. Carranza (In re Calais Regional Hospital), 20-1006. Similarly a TRO was issued in Springfield Hospital, Inc. v. Carranza, Adv. No. 20-1003 (Bankr. D. Vt.). Taking it a step further, the United States Bankruptcy Court for the District of New Mexico actually ordered the SBA to fund the loan when it held that the SBA's actions were "arbitrary and capricious and changed the Cares Act eligibility requirements without authority. In re Roman Catholic Church of the Archdiocese of Santa Fe, Case No. 18-13027. The New Mexico Bankruptcy Court further made clear that that if the debtor does not receive a PPP loan due to the SBA's actions, it would consider compensatory and punitive damages. These decisions fortify that debtors in bankruptcy should not be discriminated against in the grant of federal aid which was never intended to take into account the creditworthiness of the borrower.

Foley Hoag has formed a firm-wide, multi-disciplinary task force dedicated to client matters related to the novel coronavirus (COVID-19). For more guidance on your COVID-19 issues, visit our Resource Portal or contact your Foley Hoag attorney.

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