

ALERTS

SBA Bankruptcy Battle

Hillary Crabtree, Reid Dyer and Luis Lluberás

MVA COVID-19 Resource Center

04.2020

On April 15, 2020, the SBA issued an Interim Final Rule (“IFR”) for the Paycheck Protection Program (“PPP”) component of the Coronavirus Aid, Relief, and Economic Security Act (“CARES Act”). The PPP allows qualified businesses to receive loans equal to 2.5 times their average monthly payroll, up to \$10 million, which may be fully forgiven if the proceeds are used for payroll and related expenses (subject to certain caps), rent, utilities, and interest on debts incurred prior to February 15, 2020.

Pursuant to the IFR, the SBA determined that businesses that are currently debtors in proceedings under the United States Bankruptcy Code, 11 U.S.C. § 101, *et seq.* (the “Bankruptcy Code”) are not eligible to be approved for a PPP loan:

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. 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.

The Administrator, in consultation with the Secretary, determined 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. In addition, the Bankruptcy Code does not require any person to make a loan or a financial accommodation to a debtor in bankruptcy. The Borrower Application Form for PPP loans (SBA Form 2483), which reflects this restriction in the form of a borrower certification, is a loan program requirement. Lenders may rely on an applicant’s representation concerning the applicant’s or an owner of the applicant’s involvement in a bankruptcy proceeding.

IFR § (III)(4). This exclusion of eligibility for bankruptcy debtors is not found within the text of the CARES Act or the Small Business Act. Instead, it was implemented through the IFR and the required use of the SBA’s PPP application form, which provides that PPP loans will not be approved if the applicant (or any owner) is currently in bankruptcy. As a result, bankruptcy debtors adversely affected by the COVID-19 pandemic have been unable to avail themselves to the loans issued subject to the PPP.

However, in an order entered on April 25, 2020, the U.S. Bankruptcy Court for the Southern District of Texas issued a Temporary Restraining Order (“TRO”) that allowed a debtor to apply for the PPP program notwithstanding the bankruptcy prohibition in the IFR. *Hildalgo County Emergency Service Foundation v. Carranza (In re Hildalgo County Emergency Service Foundation)*, Adv. P. No. 20-02006 (Bankr. S.D. Tex. Apr. 25, 2020). In *Hildalgo*, the Debtor, which alleged that it would have otherwise been eligible for a PPP loan except for the fact that it was a bankruptcy debtor, filed an adversary proceeding seeking a TRO and preliminary injunction forcing the SBA to remove references to a PPP applicant’s bankruptcy status from its PPP loan applications, PPP loan policies and procedures, and PPP loan agreements.

SBA BANKRUPTCY BATTLE

In granting the TRO, the bankruptcy court found that the Debtor had shown a substantial likelihood of success on the merits of its claims that the SBA (1) had exceeded its statutory authority in including the bankruptcy prohibition in the IFR and (2) was in violation of Section 525(a) of the Bankruptcy Code with respect to the IFR requirement that SBA participating lenders use the SBA's form providing that "PPP loans will not be approved if the applicant or any owner is presently involved in any bankruptcy."

As a result, the TRO authorized the Debtor to submit a PPP application with the words "or presently involved in any bankruptcy" stricken from the SBA's form (and any other forms, applications, and documents) and required the SBA to consider the application without any consideration of the Debtor's bankruptcy. The SBA was also precluded from making or conditioning approval of any PPP loan guaranty to the Debtor contingent on the Debtor not being "presently involved in any bankruptcy."

The bankruptcy court has scheduled a further hearing for May 8, 2020, to rule on the Debtor's request for a preliminary injunction.

While *Hildago* represents one case in one district, the granting of a TRO could be indicative that other bankruptcy courts will find that the bankruptcy prohibition contained in the IFR contravenes Section 525(a) of the Bankruptcy Code. Section 525(a) generally prohibits discrimination against debtors by governmental units, providing, in relevant part: "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" While the SBA argued that Section 525(a) does not apply to lending or loan guaranties, the *Hildago* court, at least initially, has ruled otherwise. As a result, notwithstanding the SBA's position adopted in the IFR, a PPP loan remains a possible avenue of financing for debtors, albeit one that, at least currently, requires seeking similar relief to that obtained in *Hildago* from a bankruptcy court.