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Loans?**

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Introduction

In response to the economic fallout of the global COVID-19 pandemic, Congress passed the Coronavirus Aid, Relief, and Economic Security Act (the “CARES Act”), which makes government-guaranteed loans available to qualified small businesses through the Paycheck Protection Program (“PPP”).¹ The PPP was not created as a standalone program but was added to the existing section 7(a) program, which subjects the PPP to existing conditions and regulations, as well as existing Small Business Administration (the “SBA”) authority.² The CARES Act expressly gives the SBA “[e]mergency rulemaking authority” to “issue regulations” carrying out the PPP.³ And it provides that the SBA “may guarantee covered loans under the same terms, conditions, and processes” as section 7(a).⁴ The use of the permissive word “may” vests the SBA with discretionary authority.⁵ Subsequently, the SBA decided, when implementing the PPP, that bankruptcy debtors would be explicitly ineligible for the PPP loans

¹ See Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, §§ 1102, 1106(a)(1)–1107(a)(1), 134 Stat. 281, 301 (2020).

² See *id.*

³ *Id.* § 1114.

⁴ *Id.* § 1102(a)(2)(B).

⁵ *Id.*

resulting in a swarm of litigation as to whether the SBA exceeded its statutory authority.⁶ This has led to conflicting decisions around the country.

On December 27, 2020, President Trump signed the Consolidated Appropriations Act, 2021 (the “CAA”), which contains provisions that provide some debtors with access to the program on the condition that the SBA provide its written consent.⁷ This recent legislation seems to have cleared up the confusion regarding a bankruptcy debtor’s ability to receive PPP loans, at least to courts that appear to agree that Congress intended to bestow authority on the SBA regarding the regulation of the PPP. Yet, this issue has continued to be a source of frustration for bankruptcy debtors.

This memorandum discusses the establishment of the PPP in the CARES Act, the amendments to the PPP through the passing of the CAA, and how courts have addressed the issue of the SBA’s authority under these new amendments implemented by the CAA. Part I of this memorandum examines the CARES Act, Part II analyzes the amendments to the PPP and its accessibility to bankruptcy debtors under the CAA, and Part III reviews how some courts have applied the CAA to chapter 11 bankruptcy debtors seeking relief.

I. The Paycheck Protection Program as established by the Coronavirus Aid, Relief, and Economic Security Act.

The CARES Act established the PPP which allocated \$349 billion for guaranteed loans as authorized under paragraph (36) of section 7(a) of the Small Business Act, as added by section 1102(a) of the CARES Act.⁸ Administered by banks through the SBA, the PPP established loans

⁶ See Business Loan Program Temporary Changes; Paycheck Protection Program—Requirements—Promissory Notes, Authorizations, Affiliation, and Eligibility, 85 Fed. Reg. 23,450, 23,451 (Apr. 28, 2020) (to be codified at 13 C.F.R. pt. 120 & 121).

⁷ See Consolidated Appropriations Act, 2021, Pub. L. No. 116-160, 134 Stat. 1182 (2020).

⁸ See Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, §§ 1102, 1106(a)(1)–1107(a)(1), 134 Stat. 281, 301 (2020).

of up to \$10 million that are to be used to cover eligible expenses (e.g., payroll, rent, utilities).⁹ The PPP loans have advantageous terms, including (1) no collateral or personal guarantees are required; (2) the loans mature in two years; (3) the interest rate is 1%; and (4) the loans may be fully forgiven.¹⁰

The PPP is unlike any other section 7(a) loan program. Generally, section 7(a) loans do not contain a forgiveness feature, and the SBA's guarantee of the loan is limited to 75-85% of the loan amount, leaving the lender at risk for the balance.¹¹ Yet, a PPP loan is 100% guaranteed by the SBA, and if a borrower uses the PPP loan proceeds to fund eligible operating expenses during a particular time, that portion of the loan proceeds will be forgiven, resulting in the loan becoming a grant.¹² The SBA is required to pay to the lender that portion of a PPP loan that is forgiven as well as interest on the forgiven principal amount.¹³

Neither the CARES Act nor the SBA initially addressed bankruptcy debtors and their eligibility or ineligibility to PPP loans. Section 1102(a)(1)(G) of the CARES Act provides some guidance on eligible recipients, stating an eligible recipient shall in good faith certify:

(I) that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient;

(II) acknowledging that funds will be used to retain workers and maintain payroll or make mortgage payments, lease payments, and utility payments;

(III) that the eligible recipient does not have an application pending for a loan under this subsection for the same purpose and duplicative of amounts applied for or received under a covered loan; and

⁹ *See id.* § 1102(a)(1)(E)–(F)(i).

¹⁰ *See id.* § 1102(a)(1)(J)–(P); Business Loan Program Temporary Changes; Paycheck Protection Program, 85 Fed. Reg. 20,811, 20,813 (Apr. 15, 2020) (to be codified at 13 C.F.R. pt. 120).

¹¹ McCarter & English, LLP, *Confusion Mounts Regarding Bankruptcy Debtor Access to PPP*, JD SUPRA (June 29, 2020), <https://www.jdsupra.com/legalnews/confusion-mounts-regarding-bankruptcy-15878/>.

¹² *See* CARES Act § 1106(c).

¹³ *See id.*

(IV) during the period beginning on February 15, 2020 and ending on December 31, 2020, that the eligible recipient has not received amounts under this subsection for the same purpose and duplicative of amounts applied for or received under a covered loan.¹⁴

Following the passing of the CARES Act, on April 15, 2020 the SBA published an interim final rule implementing the PPP (the “First Interim Rule”).¹⁵ On April 28, 2020, the SBA issued another interim final rule (the “Second Interim Rule”), which barred bankruptcy debtors from the PPP, stating that if 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.”¹⁶

The Second Interim Rule led to several challenges of whether the SBA has the authority to restrict debtor borrowers from being able to participate under the PPP.¹⁷ The Courts of Appeals for the Fifth and the Eleventh Circuits found that the bankruptcy courts exceeded their authority when they issued injunctions against the SBA Administrator, concluding, albeit for different reasons, that the SBA’s exclusion of debtors from the scope of PPP loans was within its authority as authorized by Congress through the CARES Act. Moreover, according to the Fifth and Eleventh Circuits, the SBA was immune from bankruptcy court injunctions.¹⁸

¹⁴ *Id.*

¹⁵ See Business Loan Program Temporary Changes; Paycheck Protection Program, 85 Fed. Reg. 20,811, 20,812 (Apr. 15, 2020) (to be codified at 13 C.F.R. pt. 120).

¹⁶ Business Loan Program Temporary Changes; Paycheck Protection Program—Requirements—Promissory Notes, Authorizations, Affiliation, and Eligibility, 85 Fed. Reg. 23,450, 23,451 (Apr. 28, 2020) (to be codified at 13 C.F.R. pt. 120 & 121).

¹⁷ See Jiun-Wen Bob Teoh, Alison Bauer, *Chapter 11 Debtors Gaining Momentum in Eligibility for PPP Loans*, Foley Hoag LLP (May 8, 2020), <https://foleyhoag.com/publications/alerts-and-updates/2020/may/chapter-11-debtors-gaining-momentum-in-eligibility-for-ppp-loans>.

¹⁸ See *In re Gateway Radiology Consultants, P.A.*, 983 F.3d 1239, 1251, 1254–56 (11th Cir. 2020) (referencing bankruptcy court's finding that SBA action was in violation of section 525 of the Bankruptcy Code, but not explicitly ruling or addressing that separate legal issue); *In re Hidalgo Cty. Emergency Serv. Found.*, 962 F.3d 838, 840 (5th Cir. 2020) (reversing bankruptcy court's injunction against SBA based on provisions of anti-injunction act protecting the SBA without otherwise expressly opining on the anti-discrimination or lawfulness of SBA Rule).

II. 2021 Amendments to the Paycheck Protection Program.

The CAA provided another \$284.45 billion in PPP loans and amended provisions of the CARES Act to make some bankruptcy debtors eligible for PPP loans.¹⁹ Rather than the usual unsecured status, unforgiven PPP loan debts receive administrative expense priority status under sections 364(c)(1) and 503(b) of the Bankruptcy Code.²⁰ The amendments to section 364 also provide that a debtor may obtain a PPP loan notwithstanding existing cash collateral or debtor-in-possession financing that would otherwise prohibit subsequent borrowing.²¹ Section 364(g)(1) title 11 of the United States Code (the “Bankruptcy Code”) was amended so that the court, after a hearing, may authorize a debtor, “under section 1183, 1184, 1203, 1204, or 1304,” to obtain a loan under section 7(a) of the Small Business Act “and such loan shall be treated as a debt to the extent the loan is not forgiven under section 1106 of the CARES Act . . . with priority equal to a claim of the kind specified in subsection (c)(1) of this section.”²² Thus, PPP loans are available to subchapter V, chapter 12 and chapter 13 debtors.²³ Through omission, chapter 11 bankruptcy debtors remain excluded from obtaining PPP loans.²⁴

Congress explicitly allowed certain debtors, including family farmers and certain consumer debtors, to obtain PPP loans, subject to the discretion of the SBA.²⁵ If the SBA approves, courts, upon filing and service of a motion to obtain a loan described in (g)(1), must hold a hearing within seven days and “at such hearing, the court may grant relief on a final

¹⁹ See Consolidated Appropriations Act, 2021, Pub. L. No. 116-160, 134 Stat. 1182, §§ 320, 323(d)(1)(A).

²⁰ See *id.* § 320(a).

²¹ See *id.*

²² *Id.*

²³ See *id.*

²⁴ Thomas J. Salerno, *The "New and Improved" PPP Loan Package! Part 3*, 40 AM. BANKR. INST. J. 51, 51–52 (2021).

²⁵ See *id.*

basis.”²⁶ However, despite protections and priority of payment this amendment would afford PPP loans to debtors in bankruptcy, as of the date of this Memorandum, the SBA has yet to give its consent. Indeed, in its interim final rule (“Third Interim Rule”), published in response to the CAA, the SBA refused to yield its position that debtors in bankruptcy are ineligible for PPP loans.²⁷ Therefore, not only do chapter 11 bankruptcy debtors remain ineligible for PPP loans but so do subchapter V, chapter 12 and chapter 13 bankruptcy debtors.

III. How Courts have Applied the CAA

Absent any contrary statutory guidance, it seems likely that courts will restrict post-bankruptcy PPP loans to the types of debtors explicitly identified in the CAA and that prepetition PPP loans will not be entitled to special priority status in bankruptcy.²⁸

A. The District of Maine Bankruptcy Court: Without SBA Approval, Bankruptcy Debtors Remain Ineligible

In *In re Penobscot Valley Hospital*, the bankruptcy court for the District of Maine found that the SBA was within its authority prescribed to it under the CARES Act to deny eligibility to a chapter 11 debtor, and further that until the SBA accepts the charge it was given under the CAA, bankruptcy debtors remain ineligible to participate in the PPP.²⁹ In *In re Penobscot Valley Hospital*, the Maine bankruptcy court concluded that the SBA was expressly given discretion as the Administrator of the PPP in the CARES Act and that the courts, as authorized under the CAA, are allowed to authorize a debtor in three types of cases to obtain a PPP loan but only after

²⁶ *Id.*

²⁷ See Business Loan Program Temporary Changes; Paycheck Protection Program as Amended by Economic Aid Act, 86 Fed. Reg. 3,692, 3,698 (Jan. 14, 2021) (to be codified at 13 C.F.R pt. 113, 120, & 121).

²⁸ An examination of recent cases shows courts infer that Congress intended to exclude general chapter 11 debtors from post-petition PPP loans under the CAA. See *In re Destileria Nacional, Inc.*, No. 20-01247, 2021 WL 415869, at *6 (Bankr. D.P.R. Feb. 5, 2021).

²⁹ See *In re Penobscot Valley Hosp.*, 626 B.R. 350 (Bankr. D. Me. 2021).

the Administrator submits a determination making such debtors eligible.³⁰ There, the Plaintiffs, Penobscot Valley Hospital and Calais Regional Hospital, asked the court to cast aside the SBA's rule and declare them eligible to participate in the PPP.³¹ The Plaintiffs initially challenged the SBA's authority to implement the bankruptcy exclusion, coupled with a claim of unlawful discrimination under section 525 of the Bankruptcy Code, and subsequently argued that the SBA transgressed the procedures outlined in the APA.³² The court disagreed, stating, “it is not for the Judiciary to second-guess a reasonable rule promulgated by an agency in the exercise of the authority delegated by Congress.”³³ The court further reasoned that courts generally must not substitute its policy preference for the SBA's policy preference.³⁴

The court recognized that the CARES Act requires “all PPP applicants to certify that they are experiencing some degree of financial distress related to the uncertainty created by COVID-19.”³⁵ The court highlighted the concern that PPP loan funds will be used to pay administrative creditors not used for its intended purpose and how debtors are perceived to be more likely to cease operations than non-debtors suffering from financial distress unrelated to COVID-19.³⁶ The Plaintiff asserted that lending to reorganizing chapter 11 debtors is relatively safe and simple and, therefore, those debtors should not be excluded from the PPP, but the court did not agree.³⁷

³⁰ *See id.* at 368–69.

³¹ *See id.* at 355.

³² *See id.*

³³ *Id.*

³⁴ *See id.* (citing *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837, 866 (1984) (“When a challenge to an agency construction of a statutory provision, fairly conceptualized, really centers on the wisdom of the agency's policy, rather than whether it is a reasonable choice within a gap left open by Congress, the challenge must fail.”)).

³⁵ *Id.* at 368 (citing 15 U.S.C. § 636(a)(36)(G)(i)(I) (requiring PPP applicants to certify “that the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient”)).

³⁶ *See id.*

³⁷ *See id.*

The court noted that many reorganizations fail despite the debtors' best efforts and due to section 1112 of the Bankruptcy Code³⁸ and "any PPP funds remaining with the estate upon conversion might not be used to fund payroll or other operating expenses that would render the loan forgivable, but instead could be paid to the trustee, professionals employed by the trustee, or a host of other chapter 7 administrative expenses."³⁹ Even if, during a chapter 11 case, a PPP loan obtained administrative expense status, if later converted to a chapter 7 case, the administrative expenses of the chapter 7 case would take priority over the chapter 11 case expenses.⁴⁰ The reality is if PPP loan funds were instead used for liquidation expenses, "the PPP loan would not be forgiven and the SBA would be liable on its guarantee of the unforgiven loan balance in the event of non-payment."⁴¹ Because a reorganization may become a liquidation at any moment, and liquidation would not further the purposes of the PPP, the court concluded that the SBA did not err in determining that PPP loan proceeds might be diverted for purposes outside the intended scope of the CARES Act in a bankruptcy case.⁴²

The court further noted that such a conclusion is strengthened by the recent amendments to the PPP in the CAA, which amended section 364 of the Bankruptcy Code and allowed bankruptcy courts to authorize a debtor in three types of cases to obtain a loan under 15 U.S.C. § 636(a)(36).⁴³ The court emphasized that this amendment is only applicable after the Administrator submits a determination that any such debtor would be eligible for a loan under

³⁸ The Bankruptcy Code provides a mechanism by which a chapter 11 reorganization may be converted to a liquidation in which any unencumbered assets would be distributed in accordance with the waterfall contained in section 726. *See* 11 U.S.C. § 1112 (2018).

³⁹ *Id.*

⁴⁰ *See id.* (citing 11 U.S.C. §§ 507(a)(2), 726(b) (2018)).

⁴¹ *Id.* at 369.

⁴² *See id.*

⁴³ *See id.* at 368 n.7.

section 636(a)(36).⁴⁴ Concluding, the court stated that this discretion expressly given to the Administrator does not stretch to general chapter 11 debtors and applies only to subchapter V, chapter 12, and chapter 13 cases.⁴⁵

B. A Puerto Rican Bankruptcy Court found the SBA rules were within its authority under the CARES Act and the CAA.

The Bankruptcy Court for the District of Puerto Rico, adopted the reasoning in *In re Penobscot Valley Hospital*, finding the exclusion of bankruptcy debtors from PPP loans did not violate the anti-discrimination provisions of section 525 of the Bankruptcy Code.⁴⁶ In this case, Destilería Nacional, Inc. (“Destilería”) filed a voluntary petition for relief under Chapter 11 of the Bankruptcy Code and a month later requested a PPP loan.⁴⁷ Banco Popular de Puerto Rico (“BPPR”) approved the PPP loan, and disbursed \$88,500.00 (the “PPP Funds”).⁴⁸ Destilería deposited the PPP Funds in a separate bank account and commenced making disbursements from the loan proceeds to cover payroll, rent or utility expenses.⁴⁹ Shortly after approving the loan, BPPR filed a motion alleging that Destilería was ineligible for the PPP loan or for forgiveness of the PPP loan.⁵⁰ Destilería filed a qualified objection to BPPR's motion, arguing that Destilería was eligible to receive a PPP loan pursuant to the CARES Act.⁵¹ The court ultimately granted

⁴⁴ *See id.*

⁴⁵ *See id.*

⁴⁶ *See In re Destilería Nacional, Inc.*, No. 20-01247, 2021 WL 415869, at *5 (Bankr. D.P.R. Feb. 5, 2021) (citing *In re Penobscot Valley Hosp.*, No. 19-10034, 2020 WL 3032939, at *14 (Bankr. D. Me. June 3, 2020), *aff'd in part sub nom. Penobscot Valley Hosp. v. Carranza*, 620 B.R. 1 (D. Me. 2020)) (“The PPP is not a grant that is similar to a license, permit, charter, or franchise. The PPP is not a permission granted by the government to allow persons to engage in economic activity; it is a government-guaranteed program of credit extension on generous terms with forgiveness features intended to aid small businesses and incentivize them to retain employees during an unprecedented economic downturn.”)).

⁴⁷ *See id.* at *1–3.

⁴⁸ *See id.*

⁴⁹ *See id.*

⁵⁰ *See id.*

⁵¹ *See id.*

BPPR's request that the \$88,500.00 be disbursed to Destilería as an administrative expense priority claim.⁵²

The court reasoned the SBA rules were within its authority and are not arbitrary and capricious because Congress, through the CARES Act, authorized the SBA to administer PPP loans and its eligibility requirements.⁵³ The court narrowed its focus to the first and fourth implementing rules published by the SBA.⁵⁴ While the First Interim Rule did not address the eligibility of bankruptcy debtors, it did require applicants to submit "SBA Form 2483 which specifically provides that if the applicant answers 'Yes' to the question of being involved in any active bankruptcy, then the PPP loan will not be approved."⁵⁵ In contrast, the Fourth Interim Rule explicitly declared that bankruptcy debtors are not eligible for PPP loans.⁵⁶ Thus, the court concluded that bankruptcy debtors are not eligible for PPP loans.⁵⁷

Even if the parties had updated their legal arguments with the CAA amendments, the court found that it would not have changed the outcome of the case.⁵⁸ The court first noted that Destilería did not file under Subchapter V and thus CAA's amendments would not affect Destilería.⁵⁹ Next, the court reviewed the CAA's amendments to section 525 of the Bankruptcy

⁵² *See id.* at *7.

⁵³ *See id.* at *5 (citing 15 U.S.C. §§ 636(a), 9012 (2018)).

⁵⁴ *See id.*

⁵⁵ *Id.*

⁵⁶ *See id.*

⁵⁷ *See id.* (citing *In re Gateway Radiology Consultants, P.A.*, 983 F.3d 1239, 1257 (11th Cir. 2020); *In re Penobscot Valley Hosp.*, No. 19-10034, 2020 WL 3032939, at *15 (Bankr. D. Me. June 3, 2020), *aff'd in part sub nom. Penobscot Valley Hosp. v. Carranza*, 620 B.R. 1 (D. Me. 2020)).

⁵⁸ *See id.* at *6.

⁵⁹ *See id.*

Code and found none of the conditions present, concluding again that the SBA's actions are not discriminatory under the provisions of section 525 of the Bankruptcy Code.⁶⁰

Lastly, the court reviewed the CAA's amendments of section 364 of the Bankruptcy Code.⁶¹ Destilería argued that section 364 of the Bankruptcy Code is not applicable because it "only requires that the Trustee or Debtor in Possession obtains leave to obtain post-petition credit to the extent that such post-petition loan will be given administrative expense status."⁶² Destilería contended that in this case, under the "CARES Act the PPP Funds are not loans but grants. Alternatively, even if the PPP Funds were considered a loan and not a grant, leave from Court is not required under Section 364(a)."⁶³ The court disagreed, reasoning that prior-court authorization to obtain post-petition credit under section 364(b) is required if the transaction is not "in the ordinary course of business."⁶⁴ However, the existence of the PPP is a result of extraordinary circumstances and, therefore, since the court concluded that PPP loans are a loan, an application under section 363 is required, irrespective of eligibility issues.⁶⁵

Conclusion

Congress established the PPP loans as part of the CARES Act, but as the Administrator of the PPP, the SBA barred bankruptcy debtors from being eligible for such loans. Attempting to be more inclusive and to allocate additional funds, Congress passed the CAA which expanded PPP loans to some categories of debtors, who can qualify for such loans upon the U.S. Trustees'

⁶⁰ *See id.* (noting this section of the Bankruptcy Code provides "that no person may be denied relief under three conditions: (1) the foreclosure moratorium and right to request forbearance (15 U.S.C. § 9056); (2) the forbearance of mortgage payments for multifamily properties (15 U.S.C. § 9057); and (3) the temporary moratorium on eviction filings (15 U.S.C. § 9058)").

⁶¹ *See id.*

⁶² *Id.*

⁶³ *Id.*

⁶⁴ *Id.*

⁶⁵ *See id.*

receipt of the SBA's approval. Despite the SBA previously proclaiming that providing "PPP loans to debtors in bankruptcy would present an unacceptable high risk of an unauthorized use of funds or non-payment of unforgiven loans," with the new Administration the SBA's perspective may change.⁶⁶

The new Administrator of the SBA, Isabel Guzman, has a long history of public service. Formerly part of Biden's transition team for the SBA, she is aware of the issues involving the SBA (presumably including those in the PPP area and bankruptcy).⁶⁷ Additionally, recently sworn in Secretary of Treasury Janet Yellen⁶⁸ was a "vocal proponent of proactive and preemptive measures to aid the economy."⁶⁹

Given both candidates' public service background, it has been speculated that the SBA will give the approval necessary for the CAA's limited debtor eligibility provisions to move forward.⁷⁰ However, until the SBA changes its position or Congress passes another series of

⁶⁶ Jiun-Wen Bob Teoh & Alison Bauer, *Chapter 11 Debtors Gaining Momentum in Eligibility for PPP Loans*, FOLEY HOAG LLP (May 8, 2020), <https://foleyhoag.com/publications/alerts-and-updates/2020/may/chapter-11-debtors-gaining-momentum-in-eligibility-for-ppp-loans>.

⁶⁷ Her prior experience includes a three-year stint as the SBA's deputy chief of staff and senior advisor to the Administrator from 2014 to 2017 under President Obama (prior to the January 2020 appointment of Ms. Carranza, the current SBA Administrator), and after that she acted as the director of California's Office of Small Business Advocate, part of the Governor's Office of Business and Economic Development. See Dominick Reuter, *Meet Isabel Guzman, the New Head of the SBA who Biden Chose to Navigate "a Crossroad Moment for Small Businesses,"* BUS. INSIDER (February 24, 2021), <https://www.businessinsider.com/biden-sba-isabel-guzman-small-business-administrator-2021-1>.

⁶⁸ Ms. Yellen was an economist for the Board of Governors for the Federal Reserve for five years, and then a board member on the Federal Reserve under President Bill Clinton for three years. See *Janet Yellen*, U.S. Dep't of Treasury, <https://home.treasury.gov/about/general-information/officials/janet-yellen> (last visited Mar. 6, 2020). She was also a member of the Federal Reserve Board of Governors from 2004 to 2010, and became chair of the Federal Reserve under President Barack Obama, where she served from 2013 to 2018. See *id.*

⁶⁹ Thomas J. Salerno, *The "New and Improved" PPP Loan Package! Part 3*, 40 AM. BANKR. INST. J. 51, 54 (2021).

⁷⁰ See *id.*

relief bills to include bankruptcy debtors without being contingent on the SBA, it seems courts agree that bankruptcy debtors remain excluded from consideration for PPP loans under the CAA.