

The Intersection of PPP Loans and Bankruptcy: The Road to Economic Viability Just Got Bumpier

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The COVID-19 pandemic, the ongoing health crisis, and the effects of “shelter in place” orders have resulted in a slow motion economic catastrophe. In response to these unprecedented times, many businesses are exploring multiple options to survive the economic downturn. A popular government stimulus program may be unavailable to applicants already in bankruptcy; but a recent series of decisions by U.S. Bankruptcy Courts may provide a window of opportunity.

The Coronavirus Aid, Relief, and Economic Stimulus (“CARES”) Act was passed by Congress to provide a package of emergency economic assistance and support to individuals, families, and businesses. Among the measures established by the CARES Act, the Paycheck Protection Program (“PPP”) offers loans to small businesses through the Small Business Administration (“SBA”) to cover payroll and other day-to-day operating expenses. Provided the businesses use the funds for permitted expenditures and meet other criteria, the federal government will forgive the loans. Though PPP loans are intended to provide a lifeline to struggling businesses so they can keep their employees on the payroll and make it through the crisis, the SBA has declared that bankruptcy debtors need not apply.¹

A number of debtors have challenged the SBA’s exclusion of businesses that are in bankruptcy from eligibility for the PPP. In a recent decision, the U.S. Bankruptcy Court for the Southern District of Texas temporarily enjoined the SBA from considering Hidalgo County Emergency Service Foundation’s status as a bankruptcy debtor in evaluating the company’s PPP loan application.² Hidalgo County EMS is the primary provider of EMS services to a large portion of its service area in South Texas. This EMS provider filed a Chapter 11 bankruptcy petition before the pandemic hit and the CARES Act was passed. Post-petition, Hidalgo applied for a PPP loan to shore up its finances and allow it to continue operations in the face of COVID-19 challenges. Hidalgo’s lender rejected its application for a PPP loan because of the pending Chapter 11 case. Hidalgo filed an adversary proceeding asking the Court to prohibit the SBA from considering its status as a debtor in evaluating its PPP application.

Hidalgo challenged the SBA’s application process on two grounds. First, it claimed that the SBA exceeded its authority to administer the PPP by denying applicants with a pending bankruptcy because neither the applicable section of the CARES Act nor the SBA’s Interim Final Rule on the program prohibited debtors from participating. Hidalgo also challenged the SBA’s position as violating the Bankruptcy Code’s prohibition in 11 U.S.C. § 525(a) on governmental units discriminating against debtors. In a May 8, 2020 hearing on Hidalgo’s motion to convert the temporary restraining

¹ On April 24, 2020, the SBA issued an update to its Interim Final Rule on the PPP program in which it stated unequivocally its view that applicants who have sought protection under the U.S. Bankruptcy Code are ineligible to apply for a PPP loan. See <https://www.sba.gov/document/policy-guidance--ppp-interim-final-rule-promissory-notes-authorizations-affiliation-eligibility> (last accessed May 11, 2020). The SBA also stated that if a business is approved for a PPP loan and files bankruptcy before the loan is funded, the business must notify the lender and will no longer be eligible to receive the loan proceeds.

² *Hidalgo County EMS Foundation v. Jovita Carranza, in her capacity as Administrator for the U.S. Small Business Administration*, Case No. 20-2006 (Bankr. S.D. Tex.)

order to a preliminary injunction, the Bankruptcy Court granted Hidalgo's motion. The judge found that the PPP is not a loan program, but is a support program to which debtors should have access. The Bankruptcy Court expressly held that there is no rational basis for the SBA's exclusion of debtors, declined to give deference to the SBA's updated Interim Final Rule, and determined that discrimination had occurred in violation of 11 U.S.C. § 525(a).

Other debtors have filed similar claims in an effort to keep their Chapter 11 cases on track. For example, the Diocese of Rochester, New York, and the Diocese of Buffalo, New York, both Chapter 11 debtors in the Bankruptcy Court for the Western District of New York, filed a joint complaint against the SBA in the U.S. District Court for the Western District of New York following the rejection of their PPP loan applications because they are bankruptcy debtors. A hearing on the Dioceses' request for a preliminary injunction is scheduled for May 15, 2020.

At least two restaurant chains have sought relief from the SBA's exclusion of debtors. On April 29, 2020, a Delaware bankruptcy judge denied Cosi, Inc.'s bid for a temporary restraining order similar to that entered in Hidalgo. The judge reportedly expressed dismay at the consequences that would follow from Cosi's inability to obtain a PPP loan to help fund its reorganization plan and keep its employees on the payroll. Nevertheless, the Court determined that it lacked authority to grant Cosi's request in light of the SBA's recently amended guidance on PPP loans. Another restaurant chain, Trudy's Texas Star, Inc., filed an adversary proceeding against the SBA in the U.S. Bankruptcy Court for the Western District of Texas on April 30, 2020. In a hearing on May 7, 2020, the Bankruptcy Court denied Trudy's request for a temporary restraining order.

A number of debtor hospitals have fared better than restaurants. For example, hospitals in Maine and Vermont recently obtained injunctive relief against the SBA in their respective bankruptcy cases. The pleadings submitted by both hospitals included letters of support from their U.S. Senators to the SBA expressing concern that financially distressed hospitals are unable to access badly needed payroll relief under the SBA's rules interpreting the PPP. Thus, the pressure continues to mount on the SBA to reconsider its interpretation of PPP loan eligibility.

In a parallel development, courts may soon consider whether companies who applied for and received PPP loans and then filed bankruptcy petitions will be able to retain the funds. For example, TooJay's Management LLC and its thirty-three subsidiaries filed Chapter 11 petitions on April 29, 2020. According to its petition, TooJay's received a PPP loan in excess of \$6.4 million shortly before filing.

We will continue to track these cases as they work their way through the court system to keep you up to date on these important issues.