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

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“If the law supposes that, the law is an ass — an idiot!”
Charles Dickens
Oliver Twist (1838)

Let’s be candid: $349 billion just doesn’t go as far as it used to. In just two short weeks, the entire $349 billion allocation for small business loans under the landmark CARES Act Payroll Protection Program (PPP), part of the single-largest government stimulus package in history, was completely exhausted by the onslaught of distressed businesses (the “PPP I Loans”). The result of this eye-popping phenomenon was that the government passed “PPP II: The Sequel,” authorizing yet another $310 billion in PPP loan availability (the “PPP II Loans”). The lending institutions that will actually make these PPP loans (and the lawyers that both sue and represent them) rejoiced. Distressed small businesses, aghast at being too slow on the draw (or perhaps lacking clout at their banking institutions) to get a PPP I Loan, breathed a collective sigh of relief, but perhaps for naught: It is anticipated that the PPP II Loans will be exhausted in 72 hours. Like...
the never-ending *Rambo* movie franchise, are PPP III, IV and V Loans perhaps on the horizon?

On April 1, 2020, when the PPP I Loan program was introduced, the authors wrote *This DIP Loan Brought to You by Someone Who CARES!* (Or, “I’m from the Government and I’m Here to Help You”), Part One (“April 1 Article”). In the April 1 Article, the authors asserted that the PPP I Loans would be most effectively used as post-petition financing to distressed small businesses in bankruptcy. Certainly, one might assume (or perhaps hope) that Congress anticipated such a utilization, given that the same CARES Act that increased the debt limits to allow access to the Small Business Bankruptcy Act (SBRA), with its simplified structures to help small businesses navigate the sometimes unwieldy chapter 11 reorganization process, also authorized the PPP Loans. By increasing the debt limits for the SBRA, one would hope that Congress understood that the PPP Loans would be utilized by this increased constituency for the SBRA.

It seems evident that a small business may need to access bankruptcy protection to prevent permanent destruction by an unruly creditor during this pandemic, thereby furthering the legislative purpose to preserve small business. It is important to keep in mind that should these PPP Loans be used for payroll and other approved costs, they will be forgiven under the terms of the CARES Act. The Small Business Administration (SBA) therefore not only guarantees the PPP Loans, but will also pay the lenders making such loans if and when they are forgiven.

**Just Say “No” to Bankruptcy!**

While it is undisputed that nothing in the CARES Act itself precludes debtors in bankruptcy proceedings from accessing the PPP Loans, the SBA has publicly and unequivocally stated (on its approved application forms and otherwise\(^9\)\) that the pendency of a bankruptcy proceeding will result in the automatic denial of a PPP Loan.\(^{10}\) The lenders making these loans (the “Section 7(a) Lenders,” as the PPP Loans are made under section 7(a) of the Small Business Act) therefore make the pendency of a bankruptcy proceeding an automatic disqualification factor.\(^{12}\) As set forth in the SBA’s April 24, 2020, guidelines (the “April 24 Guidelines”):

> 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.

Moreover, certain commentators have suggested that the PPP Loans are made pursuant to Section 7(a) of the Small Business Act.\(^{13}\) As such, the prohibition on lending to borrowers in bankruptcy cases is implicated. The SBA does not itself lend money; rather, it guarantees loans made by Section 7(a) Lenders. Those loans and guarantees are not governed by Federal Reserve Act (FRA) § 13(3), so that should not be a roadblock to Section 7(a) Lenders providing PPP Loans to insolvent businesses, including bankruptcy debtors, or to the SBA guaranteeing those PPP Loans.\(^{14}\) FRA § 13(3) comes into play if

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10 The approved form of loan application was taken, understandably, from the forms of approved pre-CARES Act SBA guaranteed loan applications. One cannot help but wonder whether the bankruptcy questions were vestigial in that they were on pre-CARES Act forms and simply continued.

11 According to the Frequently Asked Questions published by the SBA on April 24, 2020:

**Eligibility of Businesses Presently Involved in Bankruptcy Proceedings**

*Will I be approved for a PPP loan if my business is in bankruptcy?*

**No.** 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. (Emphasis added)

12 The private lenders making these loans use the SBA-approved forms, and will follow the SBA’s regulations and guidance in making the loans. The reason is straightforward: The SBA guarantees these loans, and indeed the CARES Act earmarked billions to have the Treasury actually buy the loans made under this program. Hence, if the SBA takes the position that these loans cannot be made to debtors involved in bankruptcy proceedings, the Section 7(a) Lenders that actually make them and that will be looking ultimately to the federal government for payment will take that position so as not to risk impairing their own rights.

13 Section 1102 of the CARES Act in fact amended Section 7(a) of the Small Business Act to establish the PPP for covered loans, and the SBA’s Interim Final Rule states that “Section 1102 of the Act temporarily adds a new product, titled the ‘Paycheck Protection Program,’ to the U.S. Small Business Administration’s (SBA’s) 7(a) Loan Program.”

14 Interestingly, the SBA did not raise FRA § 13(3) as a defense to the TRO in [Hidalgo](https://www.sbnational.org) discussed below.
Section 7(a) Lenders want to participate in the federal PPP Liquidity (not “Lending”) Facility (PPPLF), but participation in the PPPLF is not a requirement to being a Section 7(a) Lender.\(^{15}\)

Respectfully, the SBA’s position is absurd. Not only is it directly contrary to the very remedial purposes of the CARES Act, but it is also not in the best economic interests of the federal government.

**The Four Hypotheticals**

To demonstrate the point that the current SBA position is adverse to the interests of the federal government, allow us to posit four hypotheticals for your consideration. It is undeniable that more bankruptcy proceedings will come from the economic morass that COVID-19 has wrought, and that surge in bankruptcy filings is already starting. Hence, the hypotheticals below (with the exception of Hypothetical Four) are all actually happening in real time.

- **Hypothetical One:** Borrower files bankruptcy (either a chapter 11 or an SBRA case),\(^{16}\) applies to a Section 7(a) Lender for a PPP II Loan, and is denied based on the pendency of the bankruptcy proceeding.\(^{17}\)

- **Hypothetical Two:** Borrower applies for a PPP II Loan, is approved by a Section 7(a) Lender, then files a bankruptcy proceeding before the loan is funded. The Section 7(a) Lender then promptly withdraws the approval of the PPP II Loan based on the bankruptcy filing. Timing is, indeed, everything.\(^{18}\)

- **Hypothetical Three:** The unfortunate Borrower in Hypothetical Two, realizing its mistake, obtains dismissal of the filed bankruptcy proceeding, then refiles its PPP II Loan application.\(^{19}\)

- **Hypothetical Four:** Borrower applies for a PPP II Loan, the loan is approved by a Section 7(a) Lender, and the PPP II Loan is funded. Borrower then commences a bankruptcy proceeding.

The SBA takes the position that PPP Loans are not available in Hypotheticals One and Two, nor in Hypothetical Three so long as the bankruptcy case is pending, but the SBA would have no issue at all in Hypothetical Four.

**Your Tax Dollars at Work?**

No disrespect is intended to the federal government in this article. The world economy is reeling, and we are all making our way in uncharted seas. The foregoing notwithstanding, the SBA position in the first three hypotheticals above is directly contrary to the economic interests of the federal treasury (and derivatively all of us as taxpayers). This is true for at least three reasons:

1. **Insolvency is not an issue here.** All of these borrowers will, at a bare minimum, have material liquidity issues (which is one test for insolvency: the inability to pay debts as they come due). That is the very reason for the PPP Loans and the CARES Act, so making “insolvency” an issue in the matter of PPP Loans is a contradiction in terms. Borrowers need the PPP Loans *because* they are insolvent.

2. The April 24 Guidelines notwithstanding, *this is not a “credit risk” issue.* These “loans” will be forgiven, assuming the proceeds are used for their intended purposes (and borrowers must certify that that is what the loan proceeds will be used for). Hence, is it really even a “loan” in that sense?\(^{20}\) Moreover, and as pointed out by Judge Jones in

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\(^{15}\) The PPPLF is an added incentive for private lenders, not a requirement for Section 7(a) Lenders to provide PPP Loans to small businesses.

\(^{16}\) All of the hypotheticals assume a restructuring bankruptcy proceeding and not a chapter 7 liquidation.

\(^{17}\) See *In re Blue Ice Inv. LLC*, Case No. 2:20-bk-2208-DPC (Bankr. D. Ariz.) (“Blue Ice”); *In re Archdiocese of Santa Fe* (Bankr. D.N.M.); *In re Elemental Processing LLC*, Case No. 19-33497 (Bankr. S.D. Tex.) (“Elemental”); and *In re Hidalgo County Emergency Service Foundation*, Case No. 19-20497 (Bankr. S.D. Tex.) (“Hidalgo”). All of the cases referenced in Hypothetical One involve adversary proceedings wherein the debtors sued the SBA asserting that the SBA exceeded its authority in disqualifying borrowers in bankruptcy from the PPP Loan programs. As of the date of this article, one of these adversary proceedings has resulted in a TRO (next court hearing is May 8, 2020) (“Hidalgo”), and in one the parties have stipulated to continue a hearing scheduled for April 27, 2020, in order to conduct more discovery (although the factual issues don’t seem to be particularly relevant in this dispute) and further brief the matter (“Blue Ice”).

\(^{18}\) See *Village East Inc.*, Ch. 11 (Case No. 20:3114-jal) (Bankr. W.D. Ky.).

\(^{19}\) See *In re Just Big Stuff Nursery Inc.*, Case No. 10-23984-LMI (Bankr. S.D. Fla.) (chapter 12) (Docket 166) (“Big Stuff Nursery”); *In re Advanced Power Technologies LLC*, Case No. 20-13304-PGH (Bankr. S.D. Fla.) (Docket 60) (“Advanced Power”).

\(^{20}\) Judge David Jones, presiding over the Hidalgo case, granted a TRO on April 25, 2020 (Dkt. No. 18), in an adversary proceeding wherein the debtor sought an injunction against the SBA on the basis
Hidalgo, there is nothing in the CARES Act that references creditworthiness or excludes borrowers in bankruptcy from being considered.\textsuperscript{21}

For the same reasons, the Section 7(a) Lenders do not have any creditworthiness considerations for the PPP Loan borrowers, since the “loans” (whether forgiven or not) are backed by the full faith and credit of the federal government. There is no underwriting being done here;\textsuperscript{22} it is simply processing paperwork.\textsuperscript{23} Hence, “credit risk” here is a red herring and ought not be identified as a consideration at all.

3. \textit{Perhaps most importantly, the SBA’s position is directly contrary to its economic interests.} In Hypotheticals One and Two, if the PPP Loan is made as post-petition financing, it is at a minimum legally entitled to administrative expense priority in the bankruptcy proceeding (assuming it is not simply forgiven under the terms of the CARES Act).\textsuperscript{24}

Conversely, by insisting that borrowers dismiss their bankruptcies (as in Hypothetical Three) and then refile the bankruptcy once the PPP Loan is funded,\textsuperscript{25} or wait until the PPP Loan is funded and then file for bankruptcy (as in Hypothetical Four), both of which would presumably pass muster under the SBA rules and regulations (as borrowers are not required to waive any rights to file bankruptcy as a condition to getting the PPP Loans\textsuperscript{26}), the SBA puts itself in the position of entering the bankruptcy proceeding as a general unsecured creditor. Of course, that means (absent fraud and forgiveness) that the PPP Loan would be subject to being discharged or having its recovery otherwise subject to \textit{pro rata} dilution and recovery. Indeed, if the SBA is truly concerned about “the unacceptable high risk of … non-repayment of unforgiven loans” as set forth in the April 24 Guidelines, these PPP Loans should absolutely be made \textit{in} bankruptcy cases, not \textit{outside} of them.

Why is this in the economic interest of the federal government (or taxpayers)?

\textbf{A Rational Approach, Please}

The COVID-19 pandemic and its economic fallout are creating enough economic, legal and personal challenges. It is time for the federal government to stop asserting positions that only harm the very constituency that the CARES Act was intended to assist, create burdens on an already stressed court system, and create additional fees, costs and delays for borrowers in bankruptcy. Given the speed with which the PPP I Loans and very likely the PPP II Loans have been exhausted by desperate small businesses trying to keep their heads above this rising tide, the continued insistence of the SBA on the position that bankruptcy is an automatic disqualifying event for PPP Loans may well freeze out this group of borrowers just by the delay in adjudication of the issue.

It is worth remembering that the SBRA and the PPP are complementary tools to accomplish the same goal: to save small businesses from an unprecedented and costly collapse. Small businesses generate an estimated 44 percent of all U.S. eco-

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\textsuperscript{22} As observed in Hidalgo:

Judge Davis: “In fact, there really is no underwriting that’s done, right? I mean, aren’t the [Section 7(a) Lenders] authorized to simply accept what’s on the form and act just on the form, and so long as they rely on the form, then they are protected; isn’t that the way it works?”

SBA Counsel: “From the interim rule I’ve read, yes…”

Hidalgo Tr. at 16-17, 22-23.

\textsuperscript{23} And arguably a lucrative undertaking at that. It has been reported that the Section 7(a) Lenders have earned $10 billion in fees to process this paperwork. See NPR Report. That is, frankly, understandable: The number of borrowers alone is enough to overwhelm the staff of any Section 7(a) Lender, itself operating under the social distancing and shelter-in-place types of orders occurring throughout the U.S.

\textsuperscript{24} See Bankruptcy Code § 364(a).

\textsuperscript{25} Both the Big Stuff Nursery and Advanced Power cases were expressly dismissed “without prejudice.” It does not require clairvoyance to know that the borrower, once the PPP Loan is funded and if needed, can and will file its bankruptcy again.

\textsuperscript{26} Nor would such requirements likely be enforceable as a legal matter in any event.
The widespread loss of small businesses therefore would be devastating to the U.S. economy. During this unprecedented pandemic, the PPP and SBRA could and should be coordinated tools to accomplish a joint goal of the CARES Act and SBRA: to save small businesses from devastating collapses. For small businesses, the actions of one creditor are often enough to cripple the business. During this time of forced shut-downs and the economic aftermath, a small business may need to quickly access bankruptcy protection to prevent garnishment of its payroll account, the seizure of essential equipment or a landlord lockout. Each of these events will likely result in the permanent closure of the small business during this pandemic. As many creditors and landlords are themselves under pressure, creditors may feel compelled to take collection actions. It would be a fatal policy misstep to “tie the hands” of small businesses by restricting their access to bankruptcy protection at a time when small businesses need this protection the most.

Many small businesses (especially those whose operations are shut down by shelter-in-place ordinances) are struggling to survive. Some small businesses may receive enough support through the PPP Loans to survive. For others, the PPP Loan is only enough to keep the business going for a few weeks until it can re-open and begin generating revenue again. If the goal of the PPP is to help small businesses survive economic hardships caused by the COVID-19 pandemic through funding payroll costs, rent, interest and utilities during the initial shelter-in-place period, then it is illogical to require those businesses to give up the benefits of reorganization in bankruptcy (which may enable these businesses to effectuate larger changes to their capital structures to emerge as more viable business enterprises that are hopefully around long after the PPP is of mere historical interest and gone).

Resolution of this issue is critical for the borrowers that need these funds and need them immediately. A rational approach is sorely in order. In the words of Judge Jones at the April 24, 2020, Hidalgo hearing, “But this can’t be what Congress intended. This can’t be the way we are supposed to treat our fellow man in this time. It’s inconceivable to me that this distinction [between a borrower in bankruptcy and one not in bankruptcy] could be drawn.”

Wise words indeed.

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28 Id. According to the 2019 Press Release, “nominal small business GDP measured $5.9 trillion in 2014, the most recent year for which small business GDP data are available.”
29 Hidalgo Tr. at 32.