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## Bankruptcy Courts Are Split on Whether a Chapter 11 Debtor Is Eligible for a PPP Loan Under the CARES Act

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### Background on the CARES Act and PPP Loans

Even with the recent clarification from the Small Business Administration (“SBA”) banning a debtor in possession’s eligibility for a loan under the Paycheck Protection Program (the “PPP”), some bankruptcy courts are granting injunctions barring the SBA from refusing loans to debtors in possession while others deny such injunctions. This issue is likely headed for appellate review as more companies enter bankruptcy desperately in need of financing.

On March 27, 2020, the Coronavirus Aid, Relief and Economic Security Act (the “CARES Act”) was enacted to, among other relief efforts, provide small businesses with loans under the PPP to help keep their workforce employed. But during the first few weeks after the CARES Act was enacted, it was unclear whether companies in bankruptcy are eligible for the PPP loans. While neither the statute nor the initial regulation disqualified them, the SBA adopted an application form (based on an earlier SBA form) that specifically disqualified debtors.

As part of the CARES Act, Congress provided an initial US\$349 billion for PPP loans (later increased by an additional \$310 billion) to help small



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businesses cover payroll and other expenses. Under the CARES Act, if at least 75% of a company's PPP loan was spent for payroll, it will be fully forgiven. While the CARES Act conditions eligibility for PPP loans on certain qualifications, it is silent about companies in bankruptcy. The SBA's first set of regulations issued on April 15, 2020, also did not include any provisions regarding a debtor's eligibility. Initially, the only place such restriction appeared was on the application form, which indicated that if an applicant is "presently involved in any bankruptcy," the loan would not be approved.

The SBA issued revised regulations on April 24, 2020, confirming that debtors in possession are ineligible to receive a PPP loan. Further, those regulations required a company that submitted an application for a PPP loan and subsequently, before the loan proceeds are disbursed, files for bankruptcy, to notify the lender of the bankruptcy filing and request cancellation of its application. The SBA based its decision to make debtors ineligible for PPP loans on the "unacceptably high risk for an unauthorized use of funds or non-payment of unforgiven loans."

### Bankruptcy Courts Are Split on Debtor Eligibility for PPP Loans

Since the April 24 revisions, numerous debtors have sought relief from bankruptcy courts from the April 24 restrictions on access to PPP loans. Debtors have argued that the PPP loan program is a "grant of aid necessitated by a public health crisis" and, therefore, precluding a debtor's participation solely because the debtor is in chapter 11 violates the prohibition on discrimination against Debtors in Bankruptcy Code Section 525(a).<sup>1</sup> The SBA has argued that Section 525(a) does not apply to loans and, because the PPP loans are in fact loans, it does not apply here. Moreover, the SBA asserts that it has rulemaking authority to limit eligibility for PPP loans. The SBA also notes that even if a debtor does not qualify for the PPP loans, it is not disqualified from other emergency relief.

Bankruptcy courts have split in answering these cases.

In the first decision addressing a debtor's eligibility for PPP loans, *Hidalgo County Emergency Service Foundation*<sup>2</sup>, Judge David Jones in the US Bankruptcy Court for the Southern District of Texas granted the debtor's motion for a temporary restraining order ("TRO") against the SBA after the debtor's PPP application was denied because of its status as a debtor. The order indicates that Hidalgo showed "a substantial likelihood of success on the merits for both its claim that SBA has exceeded its statutory authority and that it is in violation of 11 U.S.C. § 525(a) with respect to SBA requiring participating lenders to consider loan applications on a form that says PPP loans will not be approved if the applicant or any owner is presently involved in any bankruptcy."<sup>3</sup> Judge Jones found that excluding applicants currently involved in any bankruptcy was discriminatory and contrary to Congress's intent when enacting the CARES Act. Hidalgo was a particularly sympathetic applicant, providing ambulance service to much of rural South Texas. Several debtors have since filed adversary proceedings (and some cite Judge Jones' decision) to enjoin the SBA from barring a debtor in chapter 11 from receiving a PPP loan—Penobscot Valley Hospital (D.

Maine)<sup>4</sup>; Calais Regional Hospital (D. Maine)<sup>5</sup>; Springfield Hospital Inc. (D. Vermont)<sup>6</sup>; Roman Catholic Church of the Archdiocese of Santa Fe (D.N.M.)<sup>7</sup>; Starplex Corp. (D. Arizona)<sup>8</sup>; Organic Power (D.P.R.)<sup>9</sup>; Cosi (D. Del.)<sup>10</sup>; Asteria Education (W.D. Tex.)<sup>11</sup>; Americore Holdings, LLC (E.D. Ky.)<sup>12</sup>; Breda (D. Maine)<sup>13</sup>; KP Engineering (S.D. Tex.)<sup>14</sup>; Springfield Medical Care Systems, Inc. (D. Vermont)<sup>15</sup>; Areway Acquisition, Inc. (N.D. Ohio)<sup>16</sup>; PCT International, Inc. (D. Arizona)<sup>17</sup>; and Trudy's Texas Star, Inc. (W.D. Tex.).<sup>18</sup> The motions for several parties are still pending.

Several courts have agreed with Judge Jones that this restriction violates Section 525(a) because it discriminates against a debtor solely because of its status as a debtor, and granted TROs against the SBA.<sup>19</sup> Judge David Thuma in the US Bankruptcy Court for the District of New Mexico also agreed with Judge Jones that the SBA exceeded its statutory authority by trying to prohibit bankruptcy debtors from getting PPP fund. Additionally, two debtors—the Diocese of Rochester and the Diocese of Buffalo N.Y.—have filed a joint complaint in the US District Court for the Western District of New York seeking similar relief.<sup>20</sup> Judge Jones in the Southern District of Texas is the first judge to enter a preliminary injunction against the SBA. On May 11, the SBA appealed the preliminary injunction.

In one of the recent cases addressing PPP loans, a bankruptcy judge in New Mexico has gone further to compel the SBA to act on the PPP loan application for the Archdiocese of Santa Fe without regard to the applicant's status as a chapter 11 debtor. In that decision, Judge Thuma said that the SBA decided to “rewrite the PPP's eligibility requirements in a way that was arbitrary and capricious, beyond its statutory authority, and in violation of 11 U.S.C. §525(a).” To the extent courts decide on appeal that the SBA acted within its authority to exclude debtors and such exclusion is not a violation of Section 525 of the Bankruptcy Code, it is unclear whether a debtor will have to immediately repay any amount funded under the PPP. On the other hand, a debtor might successfully argue that once a loan is funded following court order, any appeal is in fact moot.

Other courts, however, including the influential Delaware Bankruptcy Court, have denied debtors' requests for a TRO. While the Delaware Court expressed dismay with the rule, it found it does not have authority to enjoin the SBA from enforcing its rules.<sup>21</sup> The Bankruptcy Court for the Western District of Texas reached a similar conclusion.<sup>22</sup>

Finally, although the regulations state that a debtor is not eligible for PPP loans, it is clear that many bankruptcy courts will require the SBA and lenders to review the application of a debtor without considering the applicant's status as a debtor. If the court finds it has authority to enjoin the SBA from enforcing its rules, more debtors may be able to access the PPP loans. Some companies, however, may be unwilling or unable to wait for that and, given the restriction on PPP loans, are seeking dismissal of their chapter case to pursue PPP loans.<sup>23</sup>

At such a critical juncture when debtors need approval for PPP loans and

need the funds immediately, all businesses are desperately waiting for some certainty. Courts will continue to grapple with whether the SBA has authority to restrict PPP loans for debtors and, even if so, whether the courts have authority to enjoin the SBA from enforcing such rules. Hopefully courts are able to resolve the issue and debtors will have a clear answer before the funds available for PPP loans run out.

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<sup>1</sup> Section 525(a) provides “a governmental unit may not deny . . . 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 under this title . . . solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act . . .” 11 U.S.C. § 525(a). Courts had previously ruled that such discrimination is contrary to the “central purpose of the Bankruptcy Code to give debtors a fresh start.” See *In re Stolz*, 315 F.3d 80, 87, 94 (2d Cir. 2002); *In re Exquisito Services, Inc.*, 823 F.2d 151, 154–55 (5th Cir. 1987) (finding that the Air Force’s decision to not renew Exquisito’s food service contract under the SBA’s 8(a) program violated Section 525(a) because that decision was solely based on Exquisito’s bankruptcy filing). In *Hidalgo County Emergency Service Foundation v. Jovita Carranza*, the court noted that the PPP loan program is essentially a support program—not a loan program and, therefore, the SBA’s decision to make all debtors ineligible for funds allocated to the PPP loan program violates Section 525(a).

<sup>2</sup> *In re Hidalgo County Emergency Service Foundation*, Case No. 19-20497 (Bankr. S.D. Tex. April 25, 2020).

<sup>3</sup> Temporary Restraining Order, *Hidalgo County Emergency Service Foundation v. Jovita Carranza*, Adversary No. 20-2006 (Bankr. S.D. Tex. April 25, 2020) [ECF No. 18], ¶ 2.

<sup>4</sup> *In re Penobscot Valley Hospital*, Case No. 19-10034 (Bankr. D. Maine, May 1, 2020).

<sup>5</sup> *In re Calais Regional Hospital*, Case No. 19-10486 (Bankr. D. Maine, May 1, 2020).

<sup>6</sup> *In re Springfield Hospital Inc.*, Case No. 19-10283 (Bankr. D. Vt. May 4, 2020).

<sup>7</sup> *In re Roman Catholic Church of the Archdiocese of Santa Fe*, Case No. 18-13027 (Bankr. D.N.M. May 1, 2020).

<sup>8</sup> *In re Starplex Corp.*, Case No. 20-02208 (Bankr. D. Ariz. Mar. 4, 2020).

<sup>9</sup> *In re Organic Power*, Case No. 19-01789 (Bankr. D.P.R. April 1, 2020).

<sup>10</sup> *In re Cosi, Inc.*, Case No. 20-10417 (Bankr. D. Del. Apr. 30, 2020).

<sup>11</sup> *In re Asteria Education, Inc.*, Case No. 20-50169 (Bankr. W.D. Tex. Apr. 30, 2020).

<sup>12</sup> *In re Americore Holdings, LLC*, Case No. 19-61608 (Bankr. E.D. Ky. Dec. 31, 2019).

<sup>13</sup> *In re Breda*, Case No. 18-10140 (Bankr. D. Maine Mar. 18, 2018).

<sup>14</sup> *In re KP Engineering, LP*, Case No. 19-34698 (Bankr. S.D. Tex. Aug. 23, 2019).

<sup>15</sup> *In re Springfield Medical Care Systems, Inc.*, Case no. 19-10285 (Bankr. D. Vermont June 26, 2019).

<sup>16</sup> *In re Areway Acquisition, Inc.*, Case No. 20-11065 (Bankr. N.D. Ohio Feb. 25, 2020).

<sup>17</sup> *In re PCT International, Inc.*, Case No. 19-14586 (Bankr. D. Arizona Nov. 15, 2019).

<sup>18</sup> *In re Trudy's Texas Star, Inc.*, Case No. 20-10108 (Bankr. W.D. Tex. April 30, 2020).

<sup>19</sup> The following cases have granted TROs against the SBA—Penobscot Valley Hospital (D. Maine); Calais Regional Hospital (D. Maine); Springfield Hospital Inc. (D. Vermont); Roman Catholic Church of the Archdiocese of Santa Fe (D.N.M.); Organic Power (D.P.R.); Americore Holdings, LLC (E.D. Ky.); KP Engineering (S.D. Tex.); Springfield Medical Care Systems, Inc. (D. Vermont). Some cases have considered whether the SBA is entitled to sovereign immunity and determined that the language of Section 106(a) unequivocally expresses Congress' intent to abrogate sovereign immunity with respect to Sections 105, 106, and 525 of the Bankruptcy Code.

<sup>20</sup> Case No. 20-06243 (W.D.N.Y. Apr. 15, 2020).

<sup>21</sup> *In re Cosi, Inc.*, Case No. 20-10417 (Bankr. D. Del. Apr. 30, 2020)

<sup>22</sup> *In re Asteria Education, Inc.*, Case No. 20-50169 (Bankr. W.D. Tex. Apr. 30, 2020); *In re Trudy's Texas Star, Inc.*, Case No. 20-10108 (Bankr. W.D. Tex. April 30, 2020).

<sup>23</sup> *In Advanced Power Technologies, LLC*, Case No. 20-13304-PGH, ECF No. 60 (Bankr. S.D. Fla. Apr. 24, 2020).

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