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Proposed Extension of the PPP Loan Program: A Nice First Step….

By Thomas J. Salerno

As COVID-19 continues to wreak havoc on the world economy, at press time Congress is slowly grinding toward yet another extension of the unprecedented Payroll Protection Program Second Draw Loan bill, introduced on July 27, 2020. S. 4321 (the "proposed PPP III legislation") has become mired in partisan politics that is the hallmark of our age, but some version is likely to pass. After months of stunningly unnecessary litigation and convoluted legal machinations forced on debtors by the Small Business Administration (SBA)[1] in their dogmatic defense of the now infamous April 24, 2020, rule that categorically denied debtors in bankruptcy from accessing the PPP loans on the basis that debtors "present an unacceptably high risk of an unauthorized use of funds or non-repayment of unforgiven loans,"[2] the proposed PPP III legislation effectuates a stunning reversal of course and acknowledges (finally) that the SBA will grudgingly allow debtors (while still somewhat slimy) to access PPP III loans.[3]

The proposed PPP III legislation is certainly a step in the right direction. However, there are at least two aspects that merit further attention. The bankruptcy provisions are found in § 116 of the proposed PPP III legislation and are set forth below for ease of reference. Bottom line: In this author's opinion, there are two fixes Congress should consider making to the proposed PPP III legislation.

Issue One: "Dueling" Super-Priority Administrative Expenses Will Wreak Havoc on Traditional Financing Negotiations

Law of Unintended (or Perhaps Intended) Consequences

One of two things is true with respect to the proposed PPP III legislation: It either was written by people with no experience in chapter 11 cases, or it was written by people very knowledgeable in chapter 11 cases. If the former, then there are unintended consequences to the proposed PPP III legislation. If the latter, it is perhaps a clever tactic to give the SBA plausible deniability in keeping these loans out of debtors' hands in all events.

1. *Dueling Super-Priority Administrative- Expense Claims:* Section 116 (a) of the proposed PPP IIII legislation essentially states that if this PPP loan is made post-filing as a DIP loan under § 364 of the Bankruptcy Code, it will have super-priority administrative-expense priority if it is not forgiven. While on its face this may not seem an unusual protection, it will create material difficulties for debtors attempting to negotiate first-day orders and financing arrangements in chapter 11 cases.

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1 *See* Thomas J. Salerno, "Reports of a 'Debtor Bar' for PPP Loans Have Been 'Exaggerated,'" *ABI News & Analysis* (July 2, 2020). ("SBA Tango Article"), *available at* abi-org.s3.amazonaws. com/Newsroom/ABIBrief/SBATangoArticle.pdf. *See also* David M. Barlow, "A New Challenge For Debtors Who Received PPP Loans Under the CARES Act," *ABI News & Analysis* (July 30, 2020) (unless otherwise specified, all links in this article were last visited on Aug. 11, 2020). A version of this article appears in the September 2020 edition of the *ABI Journal*.

2 *See* Thomas J. Salerno & Christopher Simpson, "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 1/2," XXXVIX *ABI Journal* 6, 8-9, 58-62, June 2020, *available at* abi.org/abi-journal. Ironically, under some circumstances even convicted felons are eligible to receive PPP Loans. *See* Appellee's Petition for Rehearing *En Banc* Filed in the Hildago Cnty. Emergency Serv. Found., *appeal filed* Aug. 6, 2020 (Case No. 20-40368) (Document 00515519357).

3 Of course, there are other slimy PPP loan borrowers (besides convicted felons) who are not in bankruptcy, and they had access to the PPP Loans unfettered by this debtor bar. *See, e.g.*, "Man Spent PPP Funds on Hotels, Jewelry and $318,497 Lamborghini, Authorities Say," CNN (July 28, 2020), *available at* cnn.com/2020/07/28/us/ppp-funds-miami-lamborghini-trnd. A 29-year-old Miami man received nearly $4 million in PPP loans and decided that the best way to reinvigorate the economy was to spend the funds furiously on the local economy. Nothing helps ease the stress of a pandemic like a cobalt blue Lambo.

Anyone who has ever had to negotiate cash collateral, trade credit or a DIP loan at the outset of a case knows that super-priority administrative-expense priority is precisely what the other (traditional) lenders in the capital structure will seek and demand as part of cash-collateral use, or as part of ordinary DIP financing.[4] From a pure timing perspective, the PPP loans (intended as short-term "band aids") will not likely occur before more traditional uses of cash collateral, trade term negotiations or DIP financing are negotiated and approved. Hence, this super-priority administrative-expense spot will already be taken up by the other creditors in the capital structure.

As such, debtors will face a choice: either (1) go with a PPP loan as the sole source of DIP financing (and not seek to use cash collateral — not really an option in a chapter 11 case); or (2) forgo a PPP loan because it will put the debtor into conflict with the traditional lenders in the case (who will likely object, because lenders are entitled to super-priority administrative-expense priority if adequate protection proves inadequate). It creates a battle of the super-priority administrative claims. As they said in *Highlander*: "There can be only one!"[5]

2. *Congress Giveth and Taketh Away:* While the proposed PPP III legislation states that a lender cannot block a PPP DIP loan based on a "no further indebtedness" loan clause or prior cash-collateral use order,[6] that does not make obtaining cash-collateral use and adequate-protection rights by the debtor easier; indeed, it makes it tougher. Lenders will argue (and with some justification) that the ability of the debtor to "prime" the § 507 (b) protections given as part of cash-collateral use with a subsequent PPP loan is prejudicial to the lender and its rights in the cash collateral. Accordingly, they really are not protections at all.[7] Moreover, it is highly unlikely that the PPP loan (at best intended to be a near-term bandage, bridge-type of financial assistance) will be sufficient to carry any type of restructuring process.[8]

3. *Intentional Choice?* Was this an intentional part of the proposed PPP III legislation? In fact, it was. According to a knowledgeable person involved in the proposed PPP III legislation, the thought process was that by giving the SBA the first bite at the administrative-expense-priority apple, the inherently unscrupulous debtors (my words, not my source) will be kept in check by the other creditors who do not want to risk having the PPP loan (if not forgiven) go to the front of that line. In other words, the other creditors will keep the debtor "honest." While that is one way to deal with these inherently unscrupulous debtors, it will likely result in debtors forgoing the PPP loans altogether because they will create serious negotiating issues at the outset of the cases with the traditional lenders in the capital structure.[9]

4. *Win/Win for the SBA?* If Congress (and the SBA) is only now grudgingly acknowledging that its prior dogmatic positions are resulting in PPP loans entering bankruptcy cases anyway (albeit as general unsecured claims, as a result of the "SBA Tango"[10]), this provision in the proposed PPP III legislation as a practical matter may well act to effectively keep the PPP loans outside the reach of debtors if attempted as a DIP loan. The SBA will now be able to say (with an appropriate straight face): "Hey, we gave you what you wanted (availability of PPP loans in bankruptcy), and it's not our fault if the other lenders in the case insist that they also are entitled to a super-priority administrative-expense priority.[11] Choose your poison, debtor. We never wanted you to have these to start with!"

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4 *See* § 507(b) of the Bankruptcy Code, which states in pertinent part:

> If the trustee, under section 362, 363, or 364 of this title, provides adequate protection of the interest of a holder of a claim secured by a lien on property of the debtor and if, notwithstanding such protection, such creditor has a claim allowable under subsection (a)(2) of this section arising from the stay of action against such property under section 362 of this title, from the use, sale, or lease of such property under section 363 of this title, or from the granting of a lien under section 364(d) of this title, *then such creditor's claim under such subsection shall have priority over every other claim allowance under such subsection.*

5 *Highlander* (1986), *available at* en.wikipedia.org/wiki/Highlander(film).

6 The proposed language for changes to § 364(g)(2) states: "The trustee may incur debt described in paragraph (1) notwithstanding any provision in a contract, prior order authorizing the trustee to incur debt under this section, *prior order authorizing the trustee to use cash collateral under section 363*, or applicable law that prohibits the debtor from incurring additional debt."

7 In fact, it is likely there will be a prior cash-collateral use order (since a cash-collateral use order, either by agreement or otherwise, will generally be a "first-day" order in order for any ongoing business to keep operating). Accordingly, if the first-day order is entered giving the cash-collateral lienholder the § 507 (b) protections, and then the debtor seeks a PPP loan, which, if granted, "primes" (as a matter of law) the super-priority administrative expense of the lender, doesn't that violate law-of-the-case doctrine? Regardless of the prohibition on "other indebtedness" restrictions, the proposed PPP legislation says nothing about the preclusion of a default provision in a cash-collateral/DIP loan agreement if the protections afforded the cash-collateral/DIP lender's § 507 (b) protections are impaired. Can the bankruptcy court's PPP loan-approval order retroactively change the rights of the lender in the prior cash-collateral use order?

8 I also recognize that the SBA rejoinder here is simple: "Just be a good debtor and use the money like you said you would use it, and it will be forgiven. No problem!" That, of course, ignores that forgiveness happens at such future time, and cash-collateral use (and negotiations) happen immediately. It also ignores the dynamic that the SBA, with whatever the "regulation *du jour*" it puts out in the future, can (as it has) change the rules of the game on forgiveness, thereby making ultimate forgiveness less certain, even if the money is used as directed. This leads to yet more uncertainty, and — wait for it — more litigation!

9 The proposed PPP III legislation's grant of a super-priority administrative expense is mandatory in its scope; it is not likely possible that the courts can "subordinate" the PPP loan's super-priority administrative-expense position if the legislation is enacted in its current form. While it is possible that the other lenders will adjust to this "line-cutting" by the SBA, at the outset of chapter 11 cases the dynamics are fraught with uncertainty. The last thing a debtor looking to keep its doors open, employees paid and lights on needs is yet another hurdle by the SBA.

10 *See* "SBA Tango" article, *supra* n.1.

11 To paraphrase (and with apologies to) Orson Welles, "[W]hile all super-priority administrative expenses may be equal, some are more equal than others."

Proposed Resolution

If Congress really wants to help here, the better approach would be for any post-filing PPP loan to be afforded general administrative-expense priority under § 503(b)(1), not super-priority administrative expense under the Proposed PPP III Legislation's revisions to Bankruptcy Code § 364(g)(1). This would be like post-filing trade credit, for example.

Issue Two: SBA Still Has Discretion to Make PPP Loans Based on "Sound Value"

What's Not in the Proposed Legislation that Needs to Be?

The PPP loans are part of the Coronavirus Aid, Relief, and Economic Security (CARES) Act and are administered by the SBA under § 7 (a) of the Small Business Act.[12] One of the issues spawning the litigation surrounding whether the SBA could systemically exclude debtors from the PPP loans, in addition to the SBA's rule-making authority, is a determination by the SBA under the Small Business Act that making the PPP loan was of "sound value."

As previously discussed, the SBA has publicly stated that it does not believe that debtors are honest. If the SBA retains the discretion to deny PPP III loans on the basis of "sound value" under § 7(a), it does not require a crystal ball to foresee that the SBA can certainly state that PPP III Loans are not of "sound value" — hence, notwithstanding this legislative exercise, these loans will still not be approved.

Proposed Resolution[13]

Once again, if Congress really wants to help here, the proposed PPP III legislation should amend the Small Business Act as follows:

> PAYCHECK PROTECTION PROGRAM LOANS TO DEBTORS ARE OF SOUND VALUE. — Section 7(a)(6) of the Small Business Act (15 U.S.C. 636(a)(6)) is amended—
> (1) in paragraph 6(B), by striking "and" at the end;
> (2) in paragraph 6(C), by striking the period at the end and inserting "; and"; and
> (3) by adding at the end the following: "(D) any covered loan under section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a) (36)) to a person who is a debtor in a case under title 11 of the United States Code shall be of sound value to the same extent as a covered loan made to a person who is not a debtor in a case under title 11 of the United States Code, and the status of a person as a debtor in a case under title 11 shall not make such person ineligible to obtain a covered loan under section 7(a)(36) of the Small Business Act (15 U.S.C. 636(a)(36)) or to obtain forgiveness with respect to such covered loan."

This takes the discretion away from the SBA based solely on the status of the potential borrower being in a bankruptcy proceeding, and it avoids the next round of potential litigation. The proposed PPP III legislation is a good first effort. Now Congress needs to fine-tune it so we can all get back to the business of restructuring.

Text of the Proposed Legislation

> SEC. 116. BANKRUPTCY PROVISIONS.
> (a) IN GENERAL. — Section 364 of title 11, United States Code, is amended by adding at the end the following:
> "(g)(1) The court, after notice and a hearing, may authorize a debtor in possession or a trustee that is authorized to operate the business of the debtor under section 1183, 1184, 1203, 1204, or 1304 of this title to obtain a loan under section 7(a) (36) of the Small Business Act (15 U.S.C. 636(a) (36)), and such loan shall be treated as a debt to the extent the loan is not forgiven under section

12 15 U.S.C. § 636(a)(6).

13 Credit for this proposed legislative fix goes to **Andrew C. Helman** (Murray Plumb & Murray; Portland, Maine), whose tireless advocacy on these issues has advanced the ball on this significantly.

1106 of the CARES Act (15 U.S.C. 9005) with priority equal to a claim of the kind specified in subsection (c)(1) of this section.
"(2) The trustee may incur debt described in paragraph (1) notwithstanding any provision in a contract, prior order authorizing the trustee to incur debt under this section, prior order authorizing the trustee to use cash collateral under section 363, or applicable law that prohibits the debtor from incurring additional debt.
"(3) The court shall hold a hearing within 7 days after the filing and service of the motion to obtain a loan described in paragraph (1)."
(b) ALLOWANCE OF ADMINISTRATIVE EXPENSES.—Section 503(b) of title 11, United States Code, is amended —
(1) in paragraph (8)(B), by striking "and" at the end;
(2) in paragraph (9), by striking the period at the end and inserting "; and"; and
(3) by adding at the end the following:
"(10) any debt incurred under section 364(g)(1) of this title."
(c) CONFIRMATION OF PLAN FOR REORGANIZATION. — Section 1191 of title 11, United States Code, is amended by adding at the end the following:
"(f) SPECIAL PROVISION RELATED TO COVID–19 PANDEMIC.— Notwithstanding section 1129(a)(9)(A) of this title and subsection (e) of this section, a plan that provides for payment of a claim of a kind specified in section 503(b)(10) of this title may be confirmed under subsection (b) of this section if the plan proposes to make payments on account of such claim when due under the terms of the loan giving rise to such claim."
(d) CONFIRMATION OF PLAN FOR FAMILY FARMERS AND FISHERMEN.— Section 1225 of title 11, United States Code, is amended by adding at the end the following:
"(d) Notwithstanding section 1222(a)(2) of this title and subsection (b)(1) of this section, a plan that provides for payment of a claim of a kind specified in section 503(b)(10) of this title may be confirmed if the plan proposes to make payments on account of such claim when due under the terms of the loan giving rise to such claim."
(e) CONFIRMATION OF PLAN FOR INDIVIDUALS. — Section 1325 of title 11, United States Code, is amended by adding at the end the following:

"(d) Notwithstanding section 1322(a)(2) of this title and subsection (b)(1) of this section, a plan that provides for payment of a claim of a kind specified in section 503(b)(10) of this title may be confirmed if the plan proposes to make payments on account of such claim when due under the terms of the loan giving rise to such claim."

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