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A New Challenge for Debtors Who Received PPP Loans Under the CARES Act[1]

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"I keep going to a lot of places and ending up somewhere I've already been."
— Don Draper in "Mad Men"

The CARES Act and corresponding paycheck protection program (PPP) provisions continue to provide fertile ground for discourse concerning policy implications and legislative intent amid an unprecedented pandemic. In the early months of implementing the CARES Act's PPP provisions, the bankruptcy world was particularly fraught with such debate.[2] Courts across the country grappled with the SBA's authority to enforce rules prohibiting access to the $659 billion of relief afforded to small businesses solely based on their status as debtors in bankruptcy.

Although that phase of litigation appears to have concluded, debtors who received PPP loans and are now seeking loan forgiveness may need to clear a new hurdle. Specifically, lenders of the PPP loans may refuse to process a borrower's application for loan forgiveness because the applicant's filing of bankruptcy constituted a default under the terms contained in the PPP loans. Despite going to a lot of places and engaging in what has affectionately been referred to by one commentator as the "SBA Tango,"[3] debtors may end up somewhere they have already been: in front of a bankruptcy court seeking the relief necessary to have their PPP loan forgiven.

A New Hypothetical Challenge

Consider the following hypothetical: A small business applies for and receives a PPP loan. The small business uses the funds for approved purposes under the PPP provisions and would otherwise be entitled to forgiveness. Faced with continued financial problems caused by the pandemic, the small business files for bankruptcy and subsequently applies for loan forgiveness. The lender refuses to process the loan-forgiveness application because the loan defines an event of default to include the filing of a bankruptcy petition.

Now, the debtor, who otherwise qualified for loan forgiveness under the PPP provisions, is saddled with an unforgiven debt only because the debtor filed for bankruptcy. This latest approach comes on the heels of the numerous hurdles the SBA has already thrown up to limit access to these funds available to a certain group of distressed borrowers.

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[1] The author of this article is currently concluding his two-year clerkship for Hon. Daniel P. Collins of the U.S. Bankruptcy Court for the District of Arizona. The opinions herein are the author's alone and do not represent the opinion of Judge Collins or the District of Arizona. Nothing in this article should be construed as legal advice, nor should it be interpreted to represent the opinion of Judge Collins or the District of Arizona.

[2] For a review of this initial phase of litigation, interested readers can review "This DIP Loan Should Be Brought to You by Someone Who CARES, Part I" and "This DIP Loan Should Be Brought to You by Someone Who CARES, Part II," written by Thomas Salerno, Gerald Weidner, Chris Simpson and Susan Ebner, *available at* https://connect.abi.org/l/107412/2020-03-31/4gvq3z and https://connect.abi.org/l/107412/2020-04-27/4jv57x, respectively.

[3] *See* discussion of the "SBA Tango" in "Reports of a 'Debtor Bar' for PPP Loans Have Been Exaggerated," written by Thomas Salerno on July 2, 2020, *available at* https://abi-org.s3.amazonaws.com/Newsroom/ABI_Brief/SBATangoArticle.pdf.

The CARES Act

As discussed at great length in the suits seeking to enjoin the SBA from prohibiting access to PPP loans based solely on an applicant's filing for bankruptcy, the CARES Act's PPP provisions never once mention the word "bankruptcy." Section 1106 of the CARES Act details the requirements for a PPP loan to be forgiven. Section 1106(b) states that a PPP loan recipient is eligible for forgiveness of a PPP loan provided that the loan was used on payroll costs, any payment of interest on any covered mortgage obligation, any payment on any covered rent obligation and any covered utility payment. Section 1106(e) outlines what is required to be included in an application. Nowhere in any of these sections is an event of default mentioned or defined.

***Ipso Facto* Clauses**

Events of default based on a borrower filing for bankruptcy are common in financing agreements. So-called *ipso facto* clauses also have a long history in bankruptcy. The Fourth Circuit defines an *ipso facto* clause as a contractual provision that causes a debtor to immediately default under the terms of a contract upon filing for bankruptcy protection.[4] Bankruptcy courts generally disfavor *ipso facto* clauses.[5] The origins of the Bankruptcy Code's disapproval of *ipso facto* clauses are found in 11 U.S.C. §§ 541(c) and 365(e)(1).[6]

Possible Solutions

Debtors whose applications for loan forgiveness are rejected by a PPP lender based solely on a bankruptcy *ipso facto* clause may have a couple of procedural mechanisms at their disposal. Debtors could object to the lender's claim. Debtors could also consider initiating an adversary proceeding and seeking declaratory relief that the *ipso facto* clause is unenforceable. Under either of these options, debtors may consider relying on § 525's anti-discrimination provisions or alternatively argue that the *ipso facto* clause is unenforceable based on public policy.

Debtors who choose to argue that the lender's refusal to process the loan-forgiveness application based on a bankruptcy filing violates § 525's anti-discrimination provisions may be aided by Treasury Secretary Steven Mnuchin's recent comments before the House Small Business Committee. On July 17, 2020, Treasury Secretary Mnuchin suggested that the Trump administration would support a proposal from U.S. banks that the paycheck protection program should see loans under $150,000 automatically converted into grants.[7] As those who followed

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[4] *In re Jones*, 591 F.3d 308, 312 (4th Cir. 2010).

[5] *In re EBCI Inc.*, 356 B.R. 631, 640 (Bankr. D. Del. 2006) (citing *In re James Cable Partners L.P.*, 154 B.R. 813, 816 (M.D. Ga. 1993); *In re Hutchins*, 99 B.R. 56, 57 (Bankr. D. Colo. 1989)). *See also In re Heward Bros.*, 210 B.R. 475, 479 (Bankr. D. Idaho 1997) (stating that "[g]enerally, a prepetition agreement to waive a benefit of bankruptcy is void as against public policy"); *In re James Cable Partners L.P.*, 154 B.R. 813, 816 (M.D. Ga. 1993), *aff'd*, 27 F.3d 534 (11th Cir. 1994) (referring to "a basic bankruptcy policy that abhors the operation of so-called '*ipso facto*' clauses[,] … which trigger a default … upon the happenstance of bankruptcy"); *In re Hutchins*, 99 B.R. 56, 57 (Bankr. D. Colo. 1989) (stating that "[b]ankruptcy default clauses are not favored and are generally unenforceable under the Bankruptcy Code"); *In re Perry*, 25 B.R. 817, 820 (Bankr. D. Md. 1982) (enforcement of "bankruptcy clauses … would result in forfeitures contrary to the spirit of the Code, a result which courts of equity strain to avoid").

[6] Both §§ 541(c) and 365(e)(1) expressly prohibit the enforcement of *ipso facto* clauses in the context of determining what constitutes property of the estate and executory contracts.

[7] Ryan Tracy, "Mnuchin Calls for Forgiving PPP Loans to Smallest Businesses," *Wall St. J.* (July 17, 2020), *available at* https://www.wsj.com/articles/mnuchin-suggests-automatic-forgiveness-of-paycheck-protection-program-loans-11595000522.

the litigation between debtors and the SBA will recall, the classification of PPP money as "loans" or "grants" was determinative for many courts in holding that § 525 did not apply. Those courts determined that § 525's anti-discrimination provisions did not apply because § 525(a) only prohibits a governmental unit from discriminating against debtors in denying a "license, permit, charter, franchise, or other similar ***grant***" (emphasis added).

Treasury Secretary Mnuchin's recent suggestion provides debtors with ammunition for the argument that money provided for under the PPP provisions is in fact a "grant." Treasury Secretary Mnuchin's comments are consistent with comments previously made by Sen. Marco Rubio (R-Fla.).[8] Although § 525(a) only applies to a governmental unit and not to private lenders who made these loans, lenders will have a difficult time arguing that the *ipso facto* default provisions contained in their loan documents were the result of rules promulgated by the SBA.

As to the public policy argument, debtors have ample case law supporting bankruptcy courts' tendency to look to public policy to refuse to enforce *ipso facto* clauses.[9] Not only do *ipso facto* clauses arguably contradict the fresh-start policy of the Bankruptcy Code, they also go against the intent to provide forgivable loans to small businesses adversely impacted by the pandemic.

Conclusion

The hypothetical presented above is a novel issue for debtors and differs from the SBA's prohibition against debtors having access to the PPP loans in the first place. To begin with, in this hypothetical it is the lender bank who is arguably violating the Bankruptcy Code, not the SBA. Unlike the situation in which the SBA enforced rules prohibiting access to PPP loans based on an applicant's status as a debtor in bankruptcy, the lender bank is refusing to process loan-forgiveness applications. Furthermore, although the SBA arguably had the rule-making authority as an agency to promulgate and enforce such rules it deemed necessary to carry out legislative intent, the lenders do not have the benefit of courts applying the *Chevron* deference. While some courts justifiably deferred to the SBA and refused to enjoin the agency from enforcing rules that prohibited debtors from accessing the funds, lenders will not enjoy the same deference. Lenders will have to argue that these *ipso facto* clauses are enforceable and that they do not violate the Bankruptcy Code or public policy.

As debtors have already learned, although the PPP provisions seemingly provided much-needed relief in times of unparalleled economic uncertainty, there is no such thing as a free lunch. Whether it is the SBA or the private lenders creating the hurdles, debtors seem to end up somewhere they have already been: being denied forgiveness of loans seemingly intended to serve as a lifeline in trying times.

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[8] Yuka Hayashi, "Demand for Small-Business Loans Cools," *Wall St. J.* (May 8, 2020), *available at* https://www.wsj.com/articles/demand-for-small-business-loans-cools-11588930201.

[9] *See* fn. 5, *supra*.