

SBA Clarifies PPP Loans and Bankruptcy

by Steven T. Waterman and Rachel P. Stoian

Since the first round of Paycheck Protection Program (PPP) loans, there has been confusion regarding eligibility for businesses or owners associated with bankruptcy. This resulted in substantial litigation between debtors in possession in chapter 11 reorganization cases and SBA (or lenders). SBA in every case argued (and in the clear preponderance of cases prevailed) that any applicant (or one with a 20% owner) in a chapter 11 bankruptcy was not eligible for a PPP loan. Congress did not help in PPP round 2 as it “clarified” the law by stating that the SBA “may” permit debtors in possession in reorganization cases to obtain PPP loans. SBA chose NOT to permit chapter 11 businesses in reorganization. Thank you Congress for a total failure in resolving the problem. After all, which businesses are in greatest need for assistance?

Thus, the bankruptcy confusion continued in PPP round 2. The PPP application requires that each applicant and any owner of 20% or more of the applicant certify that it is NOT “presently involved in any bankruptcy” in order to be eligible. Could there be a more amorphously phrased question? Unsurprisingly, this has created consternation by lenders in interpreting what “presently involved in any bankruptcy” means and creating greater stress among applicants or owners that have been “involved” in bankruptcy cases.

On April 6, 2021, SBA finally provided some guidance by issuing FAQ 67. SBA states that three conditions terminate involvement in a bankruptcy case. First, if an individual was involved in a chapter 7 bankruptcy, then that individual is no longer “involved” in the bankruptcy once a discharge order is entered. Second, if the applicant (or 20% owner) has been a debtor in a case under chapter 11, 12, or 13, then the applicant is no longer “presently involved in any bankruptcy” once a plan confirmation order has been entered. Third, under any bankruptcy chapter, once an order dismissing the case is entered, then the bankruptcy involvement ends. In each of the three circumstances, the order must be entered before the filing of the PPP application.

Although the release of FAQ 67 provides guidance, the theoretical underpinnings are

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suspect and leaves other questions unanswered. The guidance appears focused on the grant of a discharge. Once a discharge is granted in a chapter 7 then the individual is no longer “involved” under the SBA Guidance but that individual’s bankruptcy case remains open and the individual’s ownership interest in the applicant remains property of the bankruptcy estate – subject to sale by the trustee or abandonment. This could create a disruption of the applicant’s business. SBA provides no guidance of this issue. For example, an individual owning 80% of a business files a chapter 7 and the discharge order is entered (in many cases about 120-150 days after filing). At that point the individual is no longer “involved” in the bankruptcy and the business may apply for the PPP loan. Then, after receipt of PPP loan proceeds, the chapter 7 bankruptcy trustee takes control of or sells the business. It seems this is not likely what SBA had in mind.

The Bankruptcy Code governs the effect of a confirmed chapter 11 plan re-vesting property in the debtor and providing a discharge of debt (with certain limitations). At plan confirmation the applicant is no longer “involved” in a bankruptcy, and the applicant may apply for and be granted a PPP loan. However, all plan payments have not yet been completed or even commenced – and may extend for years in the future. This is a great benefit for a chapter 11 debtor which can now anticipate the future receipt of PPP loan proceeds as part of a plan. In chapters 12 and 13 a discharge does not occur until completion of all payments under the plan. But the debtor may apply for and obtain the PPP upon confirmation and then use the proceeds. All of this raises the question of why applicants in need of PPP loans and presumably relying on them to fund their bankruptcy plans are required to wait for confirmation to apply for such a loan. Indeed, the only tangible result is unnecessary delay which may spell the demise of businesses that cannot make it to the confirmation finish line, thereby undercutting the very purpose of PPP loans.