Punishing Debtors in Bankruptcy During COVID-19

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PUNISHING DEBTORS IN BANKRUPTCY DURING COVID-19

ABSTRACT

The 2019 Coronavirus Pandemic (COVID-19) led to widespread government-mandated lockdowns, causing numerous businesses to close their doors permanently. To assist financially distressed businesses and individuals during the pandemic, Congress passed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act). The Small Business Administration (SBA)—the agency tasked with implementing the CARES Act—distributed funds to individuals and businesses through the Paycheck Protection Program (PPP). Part of the SBA’s eligibility requirements to receive funding through the PPP included an exclusion provision that barred debtors presently involved in any bankruptcy proceeding from receiving any PPP funding. Many debtors in bankruptcy filed suits in federal bankruptcy courts across the United States to enjoin the SBA from excluding applicants solely based on their bankruptcy status. Courts, such as the Second Circuit and the United States Bankruptcy Court for the District of Maine, were split on whether the SBA violated Section 525(a) of the Bankruptcy Code or was within its right to deny PPP funding to debtors in bankruptcy. This Note explores the SBA’s rationale for excluding debtors in bankruptcy from PPP funding solely based on their bankruptcy status. This Note further analyzes the split court decisions regarding whether the PPP functioned more as a typical loan program or more as a grant. This Note then argues that the SBA’s decision to exclude debtors in bankruptcy from receiving PPP funding violated the anti-discrimination provision of the Bankruptcy Code. This Note further asserts that the courts siding in favor of the SBA incorrectly classified the PPP as a typical loan program. Lastly, this Note proposes solutions for the United States government to adopt more inclusive measures for business owners of all backgrounds and financial statuses in a future crisis like the COVID-19 pandemic.

INTRODUCTION

In March 2020, with the 2019 Coronavirus Pandemic (COVID-19) declared, state governments across the United States ordered people and workers to stay at home, leading businesses to halt operations and resulting in an overall reduction in economic activity.¹ Many businesses were forced to lay off employees and, in some cases, close their doors permanently.² As fears of an economic collapse grew, Congress passed the Coronavirus Aid,

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Relief, and Economic Security Act (CARES Act). Part of the CARES Act created the Paycheck Protection Program (PPP)—a stimulus relief program that provided small businesses with forgivable loans to pay their employees during COVID-19. The loans were guaranteed by the Small Business Administration (SBA) and issued by participating banks, credit unions, and other financial institutions.

Part of the SBA’s guidelines for PPP loans included an exclusion provision that barred debtors presently involved in any bankruptcy proceeding from receiving PPP funding, as well as any businesses that had permanently closed as a result of a bankruptcy filing. Small businesses that filed for bankruptcy sued the SBA in bankruptcy courts nationwide to remove the exclusion provision. Many business owners questioned whether the program functioned as a typical loan program or as a grant because businesses could receive full forgiveness on PPP loans if the funds were used for eligible purposes. The significant difference between a business loan and a grant is that loans require repayment, whereas grants do not. This distinction has implications on whether the SBA violated the anti-discrimination provision of Section 525(a) of the Bankruptcy Code, which provides, in pertinent part, that:

[A] governmental unit may not deny, revoke, suspend, or refuse to renew 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 or a bankrupt or a debtor under the Bankruptcy Act, or another person with whom such bankrupt or debtor has been associated, solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act, has been insolvent before the commencement of the case under this title, or during the case but before the debtor is granted or denied a discharge, or has

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5. Id.
not paid a debt that is dischargeable in the case under this title or that was
discharged under the Bankruptcy Act.10

In other words, if the PPP functioned as a grant rather than a loan, then
the SBA’s denial of funding to debtors in bankruptcy solely because of their
bankruptcy status would violate the anti-discrimination provision of Section
525(a) of the Bankruptcy Code.11 Many bankruptcy courts across the United
States, such as the Second Circuit and the U.S. Bankruptcy Court for the
District of Maine, are split on whether the SBA violated Section 525(a) of
the Bankruptcy Code or whether it was within its right to deny PPP funding
to debtors in bankruptcy.12

The Second Circuit in Springfield Hospital, Inc. v. Guzman shed light on
the issue in reversing the U.S. Bankruptcy Court for the District of Vermont’s
decision, which held that the SBA could not reject a debtor in bankruptcy
from receiving PPP funds.13 The Second Circuit conversely held that the SBA
did not violate the anti-discrimination provision of Section 525(a) of the
Bankruptcy Code because the PPP was a loan rather than a grant.14 In
contrast, the U.S. Bankruptcy Court for the District of Maine, in In re Calais
Regional Hospital, held that the SBA’s decision to reject debtors in
bankruptcy from participating in the PPP violated Section 525(a) because the
PPP was not a loan but a grant.15 These split decisions have led to widespread
confusion among debtors in bankruptcy and lenders participating in the
program.16 Lenders were particularly afraid that if they refused to follow the
SBA’s rules to exclude debtors in bankruptcy, the SBA would not guarantee
the loans, thereby shifting default risks back to the lender.17 With the split
court decisions causing extensive uncertainty, a single binding decision is
needed.

Denial of Paycheck Protection Program Funding to Debtors in Bankruptcy Constitutes
Discriminatory Treatment Under Section 525 of The Bankruptcy Code, 29 AM. BANKR. INST. L.
12. Compare Springfield Hosp. Inc. v. Guzman, 28 F.4th 403 (2d Cir. 2022) (holding that the
SBA could deny a PPP loan to debtors in bankruptcy based on the applicant’s bankruptcy status;
PPP was a loan program rather than a grant, and therefore, the SBA did not violate Section 525(a)
of the Bankruptcy Code in denying debtors in bankruptcy a PPP loan), with In re Calais Reg’l Hosp.,
615 B.R. 354 (Bankr. D. Me. 2020) (holding that the SBA could not deny debtors in bankruptcy a
PPP loan solely based on the applicant’s bankruptcy status because the PPP was not a typical loan
program but more akin to a grant program; denying a grant to a debtor in bankruptcy solely because
of the applicant’s bankruptcy status violates Section 525(a) of the Bankruptcy Code).
13. See Guzman, 28 F.4th 403 at 408.
14. Id. at 427.
15. Burris, supra note 7; see also In re Calais Reg’l Hosp., 615 B.R. 354 at 359.
16. Howard M. Berkower, Confusion Mounts Regarding Bankruptcy Debtor Access to PPP,
MCCARTER & ENGLISH (June 6, 2020), https://www.mccarter.com/insights/confusion-mounts-
regarding-bankruptcy-debtor-access-to-ppp/.
17. Id.
Part I of this Note provides a brief background on the history and purpose of the SBA. Part II discusses the PPP and provides a framework for understanding how a court’s interpretation of the anti-discrimination provision of Section 525(a) is central to determining whether the SBA’s denial of PPP funding to debtors in bankruptcy violates the Bankruptcy Code. In Part III, this Note analyzes the split court decisions regarding whether the PPP was a loan or a grant. This section focuses on the U.S. Bankruptcy Court for the District of Maine’s decision favoring debtors and contrasts it with the Second Circuit’s decision siding with the SBA. Finally, Part IV of this Note proposes solutions for how the United States government should proceed in the event of a future crisis like the COVID-19 pandemic. This Note argues that the SBA should have exercised caution in the PPP rollout, advocating for the development of robust processes to determine eligibility and a reevaluation of risk levels when issuing loans to debtors in bankruptcy.

I. BACKGROUND: THE SMALL BUSINESS ADMINISTRATION

The United States Small Business Administration is an independent federal agency created in 1953 to assist entrepreneurs and small businesses across the country. The SBA offers various services to small businesses, such as providing business loans, assisting with management training and entrepreneurial development, aiding with government contract procurement, and advocating for small businesses in navigating federal regulatory requirements. The SBA is led by a single Administrator, who is appointed by the president and confirmed by the Senate, multiple Deputy Associate Administrators stationed at various SBA offices, a Chief of Counsel for Advocacy, and an Inspector General. The SBA has at least one office in every state and provides services to more than one million small businesses annually.

II. OVERVIEW OF SBA PROGRAMS

As previously noted, the SBA’s primary role is to provide small businesses with access to capital, entrepreneurial development, government contracting, and advocacy. Regarding access to capital, the SBA has several

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19. Id.
20. See SBA Leadership, U.S. SMALL BUS. ADMIN. (Sept. 12, 2023), https://www.sba.gov/about-sba/organization/sba-leadership (The current Administrator, Chief of Counsel for Advocacy, and Inspector General of the SBA is as follows: Isabella Casillas-Guzman, SBA Administrator; Major Clark, Deputy Chief Counsel for Advocacy, and Hannibal “Mike” Ware, Inspector General); see also SBA Leadership, Isabel Casillas Guzman, U.S. SMALL BUS. ADMIN. (Sept. 27, 2023), https://www.sba.gov/person/isabella-casillas-guzman.
22. Id.
loan programs facilitated by partnerships with banks, credit unions, and other financial institutions that issue loans to small businesses. The SBA partially guarantees these loans from annual funding it receives from Congress. The most common SBA loan program is the 7(a) Loan, which provides new and existing small businesses with a maximum loan of $5 million. This money can be used for short- and long-term working capital, refinancing business debt, and purchasing real estate and supplies to help grow the business.

Other loan programs include micro-loans, which provide loans of up to $50,000 to help small businesses with start-up expenses, and Disaster Relief Loans, which provide low-interest loans to businesses impacted by natural disasters.

The SBA provides free counseling and low-cost training to entrepreneurs and small businesses at more than 1,800 locations across the United States. The agency provides grants to operate different learning centers, known as Small Business Development Centers, that offer business counseling and training to both established small business owners and aspiring entrepreneurs. These centers provide assistance with business planning, strategic development, operational efficiency, financial management, sales strategies, and other business needs. Moreover, the SBA has a business mentoring program known as SCORE—a large network of volunteer business mentors dedicated to offering counseling services to small businesses.

The SBA also works with other federal departments and agencies, such as the Department of Commerce and the Department of Labor, to ensure some federal contracts are set aside for small business owners from certain socio-economic backgrounds. The SBA has several programs that help

23. Id.
24. Id.
26. Id.
27. Fay, supra note 21.
28. Id.
30. Id.
small businesses acquire federal contracts: the 8(a) Business Development program, which offers assistance to firms that are at least 51 percent owned and controlled by socially and economically disadvantaged individuals; Women-Owned Small Business, a program that provides set-asides to business at least 51 percent owned and controlled by women; and HUBZone, a program that provides federal set-asides for small business in economically depressed communities.\footnote{Small Disadvantaged Business, supra note 32; Types of Contracts, U.S. SMALL BUS. ADMIN. (2023), https://www.sba.gov/federal-contracting/contracting-guide/types-contracts#:~:text=Joint%20ventures%2C%20set%20asides%20for%20small%20businesses%2C%20for%20women%2C%20and%20economic%20zone%20set%20asides. “Set-aside contracts” are contracts the government reserves for specific small business owners based on their backgrounds. \textit{Id.} For example, the SBA sets aside contracts for disadvantaged small businesses, women-owned small businesses, and service-disabled veteran-owned small businesses. \textit{Id.} The purpose of government set-asides is to provide certain small businesses an advantage in obtaining government contract awards. \textit{Id.}}

Through its Office of Advocacy, the SBA works on behalf of small businesses to help them navigate the federal regulatory process.\footnote{Office of Advocacy, About, U.S. SMALL BUS. ADMIN., https://advocacy.sba.gov/about/ (last visited Nov. 29, 2023).} The Office of Advocacy provides economic research, policy analysis, and outreach support to small businesses nationwide through ten regional advocacy offices.\footnote{Id.}

\textbf{A. The Paycheck Protection Program}

With government-ordered shutdowns at the beginning of the COVID-19 pandemic, many small businesses were put in difficult economic positions, resulting in mass employee layoffs and business closures.\footnote{David Autor et al., The \$800 Billion Paycheck Protection Program: Where Did the Money Go and Why Did it Go There?, NAT’L BUREAU OF ECON. RSRCH. 1 (Jan. 2022), https://www.nber.org/system/files/working_papers/w29669/w29669.pdf; First Draw PPP Loan, U.S. SMALL BUS. ADMIN., https://www.sba.gov/funding-programs/loans/covid-19-relief-options/paycheck-protection-program/first-draw-ppp-loan (last visited Nov. 29, 2023).} In May 2020, the U.S. Bureau of Labor Statistics estimated that around 49,839,000 people could not work because they were laid off by their employer or lost their business due to the pandemic.\footnote{6.2 Million Unable to Work Because Employer Closed Or Lost Business Due to the Pandemic, June 2021, U.S. BUREAU OF LAB. STAT. (July 8, 2021), https://www.bls.gov/opub/ted/2021/6-2-million-unable-to-work-because-employer-closed-or-lost-business-due-to-the-pandemic-june-2021.htm [hereinafter 6.2 Million Unable to Work].} The Federal Reserve conducted a study that found around 200,000 small businesses in the United States were closed permanently due to the pandemic.\footnote{Leland D. Crane et al., Business Exit During the COVID-19 Pandemic: Non-Traditional Measures in Historical Context, Fed. RSRV. Bd. (Apr. 2021), https://www.federalreserve.gov/econres/feds/files/2020089r1pap.pdf.} In March 2020, in response to the economic distress caused by the COVID-19 pandemic, Congress passed the CARES Act—a $2 trillion stimulus bill designed to support individuals,
businesses, and hospitals. The CARES Act established the PPP, an $800 billion loan program administered under the SBA’s 7(a) Loan Program that provided small businesses with low-interest forgivable loans to cover various business expenses, such as employee payroll, health care benefits, mortgage obligations, rent, utilities, and interest on preexisting loans. The program allowed businesses with 500 or fewer employees to receive up to $10 million in funding to cover ten weeks of payroll expenses. Another beneficial feature of the PPP was that it provided borrowers the option to apply for loan forgiveness if they proved the funds were used for specific purposes, such as payroll, rent, and utilities.

The PPP allocated funding in three phases: (1) $350 billion on March 27, 2020; (2) $320 billion on April 24, 2020; and (3) $285 billion on December 27, 2020. The first and second phases of funding were known as “First Draw” PPP loans. These funds were available to sole proprietors, independent contractors, self-employed individuals, and small businesses with fewer than 500 employees. The third phase of funding occurred in 2021, opening the door for businesses that had not received a PPP loan in the first two phases. This phase also included an option for borrowers who already received a PPP loan to receive a “Second Draw” loan, provided that the business had fewer than 300 employees and could demonstrate at least a 25 percent reduction in gross revenue between comparable quarters in 2019 and 2020. According to the PPP data compiled by the SBA, 2,913,620 Second Draw Loans were approved in 2021, resulting in a net total of $208,784,831,505 in funding.

The PPP had less stringent eligibility requirements than typical SBA 7(a) Loans and more lenient underwriting procedures for borrowers to receive a loan. To qualify, small businesses had to: (1) operate a business; (2) be located in the United States; (3) have fewer than 500 employees; and (4) certify a need for the desired credit due to the adverse effects of the COVID-

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40. Id. at 28.
41. Autor et al., supra note 36, at 3-4.
42. Lettieri & Lyons, supra note 8.
43. Autor et al., supra note 36, at 3.
44. First Draw PPP Loan, supra note 36.
45. Autor et al., supra note 36; First Draw PPP Loans, supra note 36.
46. Autor et al., supra note 36, at 4.
19 pandemic.\textsuperscript{50} However, certain businesses were ineligible for PPP loans, such as those in bankruptcy at the time of the PPP loan application.\textsuperscript{51}

To improve efficiency and issue funding to borrowers more expediently, the PPP waived its standard “Credit Elsewhere” test, an underwriting process used to grant typical SBA 7(a) loans in which lenders are required to document whether a borrower can obtain loans from non-Federal, non-State, or non-local government sources without SBA assistance.\textsuperscript{52} For typical small business loans, a lender carries out an intensive process known as underwriting—a background check of the business’s creditworthiness to decide whether it should provide a borrower with a loan and under what terms.\textsuperscript{53} An underwriter analyzes the business by reviewing its financial history, its historical credit scores, how profitable the business has been, and whether the business has a strong professional reputation.\textsuperscript{54} To complete the underwriting process, borrowers typically have to provide the lender with an array of documents, including profit and loss statements, tax returns, business plans, balance sheets, and business debt schedules.\textsuperscript{55} Once all the documents are provided, the lender will conduct a review of the business and decide whether to approve the loan request.\textsuperscript{56} If the lender approves the loan, the borrower typically receives a loan contract that includes the terms and conditions of the loan, and then the funds are disbursed to the borrower.\textsuperscript{57}

To complete the underwriting process for the PPP, lenders could rely on borrowers to certify, in good faith, a number of factors, namely: (1) they had employees who were paid salaries and payroll taxes on or around February 15, 2020; (2) the current economic state makes the loan request necessary to support the business’s ongoing operations; and (3) the funds will be used to keep workers on the business’s payroll.\textsuperscript{58}

\textsuperscript{50} Small Business Size Regulations, 13 C.F.R. §120.100 (2023).
\textsuperscript{51} See 13 CFR §§ 120.110(b)–(j), (m)–(s); Dean W. Rutley et al., M&A Transactions & PPP Eligibility and Forgiveness Considerations, 35. No. 26 WESTLAW J. CORP. OFF. DIR. LIAB. (June 22, 2020).
\textsuperscript{54} Id.
\textsuperscript{55} Id.
\textsuperscript{56} Id.
\textsuperscript{57} Id.
Borrowers could also apply for total loan forgiveness.\(^{59}\) To qualify, borrowers had to demonstrate that they used at least 60 percent of the loan amount on payroll expenses, spent the full loan proceeds on payroll costs and other eligible expenses such as rent, utilities, payroll, and mortgage payments, and maintained pre-pandemic levels of full-time employment while keeping employee wages at least at 75 percent pre-pandemic rates.\(^{60}\) Borrowers could select a “covered period” of between eight and twenty-four weeks to meet the forgiveness criteria, which would begin on the date the loan was disbursed and end on the date selected by the borrower.\(^{61}\) To verify that the funds were used for the PPP’s intended purposes—and in order to receive full forgiveness—borrowers had to submit to the SBA: (1) payroll documents; (2) rent and mortgage statements; (3) utility invoices; and (4) other relevant documents.\(^{62}\)

**B. Effectiveness of the PPP**

While many small businesses benefitted from the funds received from the PPP, many saw the program as ineffective and having minimal impacts on the overall economy.\(^{63}\) Specifically, many large corporations such as Shake Shack and the Los Angeles Lakers were able to qualify for loans, which angered struggling small business owners across the country who claimed that larger corporations that did not need the funding were taking advantage of the program.\(^{64}\) With the lenient eligibility requirements and almost non-existent underwriting procedures, the program was vulnerable to many fraudulent actors.\(^{65}\) As a result, it is estimated that over $100 billion was stolen by scammers.\(^{66}\) It is also questionable whether the program actually kept workers employed or simply gave businesses an extra stimulus check with no strings attached.\(^{67}\) Many economists who examined the program in depth found that the PPP saved around 1.4 million to 3.2 million

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60. Autor et al., supra note 36.
62. PPP Loan Forgiveness, supra note 59.
64. Id.
66. Id.
67. Horsley, supra note 63.
jobs across the United States, which, considering the $2 trillion allocated for COVID-19 relief spending, demonstrates a lack of success.68

Further, given that the SBA was in a panic to get funds out to small businesses as soon as possible, the agency constantly updated its guidelines by implementing interim rules, leaving many small business owners confused about whether they were eligible for the loan.69 Small business owners presently involved in a bankruptcy proceeding were especially confused as the SBA initially excluded any debtors in bankruptcy from applying but then changed its position toward the end of the program.70 At the start of the PPP, bankruptcy debtors were ineligible for PPP funding because the SBA concluded that providing PPP loans to debtors in bankruptcy would be “an unacceptably high risk of an unauthorized use of funds or non-repayment of unforgiven loans.”71 As the funds allocated for the PPP were close to drying up, the SBA changed its tune and allowed Chapter 11 debtors with confirmed reorganization plans to apply for PPP loans.72 However, this change was too late for many small business owners going through bankruptcy proceedings.73

Prior to the SBA’s change in guidance concerning debtors in bankruptcy, small business owners involved in a bankruptcy proceeding challenged the SBA’s bankruptcy exclusion provision and filed lawsuits in bankruptcy courts across the country, seeking injunctions to prevent the SBA from enforcing the provision.74 Courts were split on whether the SBA exceeded its authority in denying debtors in bankruptcy PPP loans or whether the exclusion violated the anti-discrimination provision of Section 525(a) of the Bankruptcy Code.75

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72. Berkower, supra note 70.
73. Id.
74. Id.
75. Id.

Under Section 525(a) of the Bankruptcy Code, a governmental unit, such as the SBA, may not
deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant . . . to a person that is or has been a debtor under this title or a bankrupt or a debtor under the Bankruptcy Act . . . solely because such bankrupt or debtor is or has been a debtor under this title or a bankrupt or debtor under the Bankruptcy Act.76

Application of this provision protects debtors who are currently or have been involved in a bankruptcy proceeding from discrimination in receiving services to conduct business.77 On April 28, 2020, the SBA issued an interim rule regarding the eligibility of businesses presently involved in a bankruptcy proceeding.78 The rule stated that “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.”79 The ensuing debate centered on whether the SBA’s decision to exclude debtors in bankruptcy violated the anti-discrimination provision of Section 525(a) of the Bankruptcy Code.80 Many debtors sued the SBA in an effort to remove the exclusion provision, and courts issued split rulings on whether the SBA exceeded its authority.81 The real question courts had to address was whether the PPP functioned as a true loan program or a grant, as this distinction impacts significantly their interpretation of the anti-discrimination provision.82

D. DIFFERENCES BETWEEN BUSINESS LOANS & BUSINESS GRANTS

The primary difference between a business loan and a grant is that grants do not have to be repaid, whereas loans must be repaid under specified terms.83 Grants can be issued by private organizations or the government and are generally given to existing businesses that meet certain qualifying criteria and agree to use the money for specified purposes.84 Businesses that do not

76. Koban, supra note 11.
77. Id.
79. Id.
80. Burrus, supra note 7.
81. Id.
82. Id.
use the grant money for approved purposes will have to pay back the funds to the grantor. Many grants are designed to help business owners from underrepresented groups, such as women, African Americans, and veterans, who historically have experienced difficulty obtaining capital from traditional funding sources, while other grants serve to promote research initiatives or to support local economies experiencing financial hardships as a result of natural disasters. For example, the Girlboss Foundation is an organization that provides business grants of $15,000 exclusively to businesses owned by women entrepreneurs working in fashion, design, music, and the arts, while the SBA’s Small Business Innovation Research program provides funding to small businesses engaged in scientific research and development to encourage organizations to participate in scientific research that promotes the general public.

The process for obtaining a grant can be quite difficult because businesses need to meet certain requirements and attest that they will use the funds for specified purposes, generally aimed at the public good. The application process can also be quite long, as business owners first need to determine for which grant, if any, they are qualified and then submit a significant amount of documentation that supports why they should receive it. The documents required for a grant application typically address a number of questions, including:

1. What is the business’s mission statement and history?
2. Why should this business receive a grant?
3. What need or problem is the business hoping to address?
4. How much money will the business need to support its goal?
5. What additional funding will the business need to support itself in the future?

Generally, documents addressing these questions consist of a business plan, income statements, balance sheets, projected financial figures, and a project description. Other grant organizations, such as the WomensNet, have less stringent application requirements and request only a one-page

85. Ludwig, supra note 9.
86. Axelton, supra note 83; Johnson, supra note 84.
89. Axelton, supra note 83.
91. Id.
summary of the recipient’s business idea and what they plan to do with the money if awarded a grant.92 If a grant application is approved, the grantor will transmit the funds to the grantee, who will then submit documents, such as financial records and progress reports, to ensure the funds are being used for appropriate purposes.93

Business loans, on the other hand, have a different set of requirements and goals, with the key difference being that the funds received must be repaid with interest.94 Business owners apply for loans to finance their different business needs, which may include covering business expenses, such as rent, utility payments, or employee wages.95 Businesses may also need loans to purchase new equipment or to help expand the business to a new location.96 Loans are typically repaid over five to ten years, depending on the loan size.97 While the issuers of grants are typically motivated by serving a public good, loans are generally issued by banks or credit unions primarily motivated by making money by charging interest on the loans they give out.98 Thus, because lenders are profit-motivated, they want to ensure the loans they issue will be paid back.99

To determine whether a business can repay a loan, lenders assess a number of risk factors, such as the business’s credit and payment history, income, and overall financial situation.100 Lenders evaluate these risk factors by looking at what is known as the “5 Cs,” which include:

1. Credit History, which is a borrower’s track record of managing credit by making payments over time.
2. Capacity, a borrower’s ability to afford payments measured by income and business track record history.
3. Collateral, which is property or other assets a borrower owns that the lender can take possession of in the event the borrower cannot repay the loan.
4. Capital, which is a borrower’s savings, investments, and other liquid assets that can be used to repay the loan.

92. Apply Now for This Month’s Amber Grant, WOMENS NET, https://ambergrantsforwomen.com/get-an-amber-grant/apply-now/ (last visited Nov. 29, 2022).
93. Axelton, supra note 83.
94. Id.
95. Schooley, supra note 88.
96. Id.
97. Id.
98. Ludwig, supra note 9.
99. Axelton, supra note 83.
100. 5 Cs of credit - What lenders look for, WELLS FARGO, https://www.wellsfargo.com/financial-education/credit-management/five-c/#!/text=Your%20income%20and%20employment%20history,DTI%20%20may%20be%20evaluated (last visited Nov. 29, 2023).
5. Conditions, meaning how will the borrower use the loan money they receive.\textsuperscript{101}

Loans also offer more flexibility to borrowers in how they decide to use the funds, whereas grants are typically given only for specific purposes.\textsuperscript{102}

Given the differences between business loans and business grants, many small business owners across the United States reasonably questioned whether the PPP functioned as a grant or as a loan.\textsuperscript{103} The SBA took the position that the PPP was a typical business loan, while debtors in bankruptcy took the position that the Program functioned as a grant, and therefore, excluding debtors in bankruptcy from receiving a PPP loan violated Section 525(a) of the Bankruptcy Code.\textsuperscript{104}

III. BREAKDOWN OF SPLIT COURT DECISIONS

On April 28, 2020, the SBA issued an interim final rule excluding debtors in bankruptcy from receiving PPP funding.\textsuperscript{105} Shortly thereafter, debtors in bankruptcy initiated lawsuits in Bankruptcy Courts across the country, seeking to enjoin the SBA from enforcing this provision.\textsuperscript{106} Courts were forced to address whether the SBA’s decision to exclude debtors in bankruptcy from receiving PPP loans violated the anti-discrimination provision of Section 525(a) of the Bankruptcy Code, primarily by deciding whether the PPP was a grant or a loan.\textsuperscript{107} The outcomes varied across many courts, with some ruling in favor of the SBA, upholding its exclusionary rule, while others sided with the debtors.\textsuperscript{108}

A. BANKRUPTCY COURTS SIDING IN FAVOR OF THE DEBTORS

Several courts sided with the debtors, holding that the SBA exceeded its authority in denying debtors a PPP loan and, in doing so, violated Section 525(a) of the Bankruptcy Code. In \textit{In re Calais Regional Hospital}, a Chapter 11 debtor-hospital sought a temporary restraining order (TRO) to require the SBA to approve its PPP loan application, arguing that it had been discriminated against in its application for a loan solely because it was a debtor in bankruptcy.\textsuperscript{109} The court sided with the debtors by entering it TRO

\textsuperscript{101} Id.
\textsuperscript{102} Axelton, \textit{supra} note 83.
\textsuperscript{103} Burrus, \textit{supra} note 7.
\textsuperscript{104} Id.
\textsuperscript{105} Business Loan Program Temporary Changes; Paycheck Protection Program—Requirements—Promissory Notes, Authorizations, Affiliation, and Eligibility, 85 Fed. Reg. 23,450-01 (codified at 13 C.F.R. pts. 120-21).
\textsuperscript{106} Burrus, \textit{supra} note 7.
\textsuperscript{107} Koban, \textit{supra} note 11.
\textsuperscript{108} Burrus, \textit{supra} note 7.
and enjoining the SBA from denying it a PPP loan because such denial would violate Section 525(a). As the court explained:

The CARES ACT is a grant of aid necessitated by a public health crisis. It is one of many responses by federal, state, and local governments designed to help citizens weather an unprecedented storm. Likening a covered loan under the PPP to a garden-variety loan that is not be protected under 525(a) may miss the point. The court noted that while the PPP is classified as a loan under the CARES Act and has specific loan features, such as interest rates and repayment terms, focusing on these details alone fails to consider the program’s true purpose: to help businesses stay afloat during COVID-19. Thus, given the functional nature of the PPP, the court held that participation in the PPP could be characterized as an “other similar grant” within the meaning of Section 525(a).

Other courts have taken similar stances to the Calais court when determining whether the PPP is a typical loan or a grant. In In re Roman Catholic Church of Archdiocese of Santa Fe, the U.S. Bankruptcy Court for the District of New Mexico sided in favor of the church-debtor by granting it a temporary injunction against the SBA’s rejecting of the debtor’s PPP loan application. In this case, the debtor filed for Chapter 11 bankruptcy on December 3, 2018, and remained in bankruptcy through the beginning of the pandemic. However, government-issued “lockdown” and “stay-at-home” orders prohibited mass gatherings and required all non-essential businesses to halt operations. These orders severely affected the financial condition of the Archdiocese, whose majority source of revenue came from money collected at masses and during Holy Week, which occurred during the lockdown orders. These orders caused the Archdiocese to lose $300,000 a month in revenue that it would have otherwise received without the lockdown orders. This loss led the Archdiocese to apply for a PPP loan, but the SBA

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111. See In re Calais Reg’l Hosp., 615 B.R. at 359.
112. Id.
113. Id.
116. Id.
117. Id. at 652.
118. Id.
denied its application due to its bankruptcy status.\textsuperscript{119} The Archdiocese then filed an adversary proceeding against the SBA, challenging the SBA’s interim rule that excluded debtors in bankruptcy from receiving PPP loans and sought a preliminary injunction.\textsuperscript{120} The court sided in favor of the Archdiocese, holding that the SBA’s decision to exclude debtors in bankruptcy from receiving a PPP loan (1) was arbitrary and capricious; (2) exceeded the SBA’s authority under the CARES Act; and (3) was discriminatory treatment in violating of Section 525(a) of the Bankruptcy Code.\textsuperscript{121} Importantly, the court’s decision noted that the PPP is not a typical loan program but a grant:

The Court Finds that the Defendant’s decision to exclude bankruptcy debtors from the PPP is arbitrary and capricious. While a borrower’s bankruptcy status is relevant for a normal loan program, the PPP is the opposite of that. It is not a loan program at all. It is a grant or support program. The statute’s eligibility requirements do not include creditworthiness. Quite the contrary, the CARES ACT makes PPP money available regardless of financial distress. Financial distress is presumed. Given the effect of the lockdown, many, perhaps, most applicants would not be able to repay their PPP loan. They do not have to, because the “loans” are really grants. Repayment is not a significant part of the program. That is why Congress did not include creditworthiness as a requirement.\textsuperscript{122}

Here, the court emphasized the requirement that PPP funds were used for specific purposes, such as payroll, mortgage interest, rent, or utilities, to qualify for forgiveness.\textsuperscript{123} Therefore, the forgiveness aspect of the PPP made it more like a grant than a loan. By firmly asserting that the PPP should be classified as a grant rather than a loan, the court positioned the SBA’s decision to exclude debtors in bankruptcy—based solely on their bankruptcy status—as a clear violation of the anti-discrimination provision outlined in Section 525(a) of the Bankruptcy Code.\textsuperscript{124}

\section*{B. Bankruptcy Courts Siding in Favor of the SBA}

Two U.S. Circuit Court decisions dealt a blow to bankruptcy debtors’ hopes of obtaining a PPP loan.\textsuperscript{125} In the first case, \textit{In Re Hidalgo Country Emergency Services Foundation v. Carranza}, the Fifth Circuit vacated a preliminary injunction entered by the U.S. Bankruptcy Court for the Southern District of Texas that prevented the SBA from refusing to deny a PPP loan to

\begin{thebibliography}{99}
\bibitem{119} Balmat, supra note 114.
\bibitem{120} Id.
\bibitem{121} Id.
\bibitem{122} Id.
\bibitem{123} In re Roman Cath. Church, 615 B.R. at 654.
\bibitem{124} Id. at 657.
\bibitem{125} In re Hidalgo Cnty. Emergency Serv. Found., 962 F.3d 838 (5th Cir. 2020); Springfield Hosp. Inc. v. Guzman, 28 F.4th 403 (2d Cir. 2022).
\end{thebibliography}
an emergency service foundation, *Hidalgo*, which was in Chapter 11 bankruptcy. Similar to the previously mentioned cases, the debtor in *Hidalgo* filed an adversary proceeding against the SBA in bankruptcy court, arguing that the SBA’s exclusion of debtors in bankruptcy from receiving a PPP loan: (1) violates Section 525(a) of the Bankruptcy Code, (2) is arbitrary and capricious, and (3) exceeds the SBA’s statutory authority. The Bankruptcy Court sided with the debtor, holding that its claim had a substantial likelihood of showing that the SBA exceeded its statutory authority and that the debtor would likely succeed in its claims that the SBA’s exclusion of a debtor in bankruptcy violates Section 525(a) of the Bankruptcy Code. The Fifth Circuit vacated the Bankruptcy Court’s preliminary injunction against the SBA on the ground that under Title 15 of the United States Code, Section 634(b)(1), “no . . . injunction . . . shall be issued against the Administrator or his property.” In other words, Section 634(b)(1) prohibits a court from issuing an injunction against the SBA. The Fifth Circuit, however, did not address the SBA’s eligibility criteria to exclude a debtor in bankruptcy from receiving a PPP loan, which created an opportunity for other courts to weigh in on whether the SBA’s PPP regulations violated Section 525(a) of the Bankruptcy Code.

One such court that heavily addressed whether the SBA’s decision to exclude debtors in bankruptcy from receiving a PPP loan violates Section 525(a) of the Bankruptcy Code was the Second Circuit in *Springfield Hospital Inc. v. Guzman*. The Second Circuit was the first federal circuit court to hold that the SBA could deny a PPP loan solely because of a debtor’s bankruptcy status. This case was a direct appeal filed by the SBA after the U.S. Bankruptcy Court of the District of Vermont granted the debtor’s motion for a temporary restraining order to enjoin the SBA from denying it a PPP loan. Like other Bankruptcy Court decisions, the Bankruptcy Court for the District of Vermont found that PPP loans functioned as a grant to help businesses weather the financial struggles imposed on them due to COVID-19 by relying on the fact that the PPP offered full forgiveness and lacked any

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126. *In re Hidalgo Cnty.*, 962 F.3d at 840.
127. Id.
129. *In re Hidalgo Cnty.*, 962 F.3d at 840 (omissions in original).
130. Ramsey & Baxter, supra note 128.
131. *In re Hidalgo Cnty.*, 962 F.3d at 840.
133. Burrus, supra note 7.
creditworthiness or underwriting procedures. The Second Circuit addressed the issue of whether PPP funds were a loan or a grant under Section 525(a) directly and held that “the PPP is a loan guaranty program and not an ‘other similar grant,’ and that Section 525(a) ‘does not apply to PPP loans.’” The court then reversed the Bankruptcy Court’s judgment and vacated the permanent injunction against the SBA. The court reached its decision by looking at the plain meaning of Section 525(a), which provides:

[A] governmental unit may not deny, revoke, suspend, or refuse to renew a license, permit, charter, franchise, or other similar grant to . . . a bankrupt or a debtor under the Bankruptcy Act . . . solely because such bankruptcy or debtor is or has been . . . a bankrupt or debtor under the Bankruptcy Act.

The plain language of Section 525(a), as the court explained, clearly indicates that the PPP is not a grant within the meaning of the statute and points to the fact that Congress chose to characterize PPP loans as “loans” rather than grants under the CARES Act.

Additionally, even though the PPP offered loan forgiveness, the Second Circuit found that the PPP functioned not as a grant but as a loan guaranty program. Specifically, the court noted that the PPP fell under Section 7(a) of the SBA’s typical loan program for small businesses, in which the same terms and conditions that applied to 7(a) loans also applied to PPP loans. Funds disbursed from the PPP had similar attributes to typical business loans, such as a fixed interest rate, maturity date, refinancing terms, and deferral mechanism. Even with the option to apply for loan forgiveness, the court held that the PPP was not transformed from a loan to a grant because forgiveness was not guaranteed, and a borrower could decide whether to apply for forgiveness.

IV. WHAT SHOULD THE UNITED STATES GOVERNMENT DO IN THE EVENT OF A FUTURE PANDEMIC?

While new COVID variants continue to resurface, many Americans have returned to their pre-pandemic lives. However, another pandemic is always

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134. Scott, supra note 132.
136. Id.
137. Id. at 418 (omissions in original); 11 U.S.C. § 525(a).
138. Guzman, 28 F.4th at 423.
139. Id.
140. Id.
141. Scott, supra note 132.
142. Guzman, 28 F. 4th at 424.
possible. The COVID-19 pandemic devastated the United States population and became the biggest threat to the world economy since the 2008 financial crisis. According to the Centers for Disease Control and Prevention, more than one million COVID-19-related deaths have been reported in the United States since January 1, 2020. Business closures and mass layoffs were rampant across the country. The economic perils caused by COVID-19 also brought a new era of government involvement in directly addressing the crisis. While the United States government’s response to COVID-19 was far from perfect, it did its best to address the problem by implementing many relief programs, such as the CARES Act, to help small businesses weather the storm. Small businesses play a huge role in the United States economy, comprising 99.9 percent of all businesses and employing nearly half of all Americans. The adverse economic impacts of COVID-19 hit small businesses especially hard. As previously discussed, the U.S. Bureau of Labor Statistics estimated that by May 2020, around 4,839,000 people had been laid off by their employers or lost their business due to the pandemic. A study conducted by the Federal Reserve found that around 200,000 small businesses in the United States were closed permanently because of the pandemic. Given the importance small businesses play in the economy, the PPP emerged as a vital tool in averting an economic collapse, but it was far from perfect, particularly with regard to its discrimination against debtors in bankruptcy. If the United States is ever subjected to another pandemic, a few solutions can address the harsh treatment that debtors in bankruptcy experienced during the PPP.

The first solution would be overturning the Second Circuit’s decision in Springfield. While the court’s holding shed some light on whether PPP funds

were a loan or a grant, its decision does not serve the public interest, as small business owners, particularly debtors in bankruptcy, face greater risks of harm in being denied a PPP loan compared to the harm the SBA would face if they were forced to grant PPP loans to debtors.\textsuperscript{155} The Second Circuit’s decision essentially sent the message to debtors that even though the entire country was suffering economically because of COVID-19, debtors had to suffer even more without any COVID-19 relief assistance. The country was in a dire financial situation due to COVID-19, and debtors in bankruptcy faced even greater risks of complete closure by being denied PPP loans.\textsuperscript{156} The harms debtors faced outweighed the harms the SBA would face if they were ordered to accept debtors’ PPP applications, especially since PPP funds did not have to be repaid if they were used for their specified purpose.\textsuperscript{157}

The Second Circuit’s decision to side with the SBA’s policy to exclude debtors in bankruptcy as a means to screen for creditworthiness singles out debtors in bankruptcy because other borrowers did not face similar scrutiny.\textsuperscript{158} The PPP had many features of a typical loan program, such as interest rates, maturation dates, refinancing terms, and deferral mechanisms.\textsuperscript{159} Considering a borrower’s bankruptcy status is relevant for a traditional loan program, but the PPP was not a normal loan—it was a program initiated solely to combat the public health and economic crisis caused by the COVID-19 pandemic.\textsuperscript{160} The CARES Act did not include any bankruptcy exclusion provision for PPP loans, and, in fact, the Act did not require a borrower to undergo a creditworthiness check because it was presumed that businesses were already in financial distress.\textsuperscript{161} The SBA adopted the policy to exclude debtors in bankruptcy from receiving a PPP loan based on the rationale 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.”\textsuperscript{162} The Second Circuit noted that this policy decision to exclude debtors in bankruptcy is a way to screen for creditworthiness.\textsuperscript{163} Further, the SBA’s reasoning that debtors pose a higher risk of not being able to qualify for forgiveness is completely misguided, considering the fact that debtors in bankruptcy are under the

\textsuperscript{155} In re Calais Reg’l Hosp., 615 B.R. 354, 360 (Bankr. D. Me. 2020).

\textsuperscript{156} Id.

\textsuperscript{157} Id.

\textsuperscript{158} Springfield Hosp. Inc. v. Guzman, 28 F.4th 403, 424 (2d Cir. 2022).

\textsuperscript{159} Id. at 423.

\textsuperscript{160} In re Roman Cath. Church of Archdiocese of Santa Fe, 615 B.R. 644, 654 (Bankr. D.N.M. 2020).


\textsuperscript{162} Durlacher, supra note 161.

\textsuperscript{163} Guzman, 28 F.4th at 424.
supervision of the Bankruptcy Court and the U.S. Trustee’s office.\textsuperscript{164} Upon filing for bankruptcy, debtors are subject to submitting monthly operating reports and providing bank statements to the supervising court and U.S. Trustee’s office.\textsuperscript{165} Unsecured creditors have full access to see how a debtor spends their money, and they also have access to the same financial documents the court receives.\textsuperscript{166} Businesses not in bankruptcy do not face the same level of scrutiny or have the same reporting requirements as debtors in bankruptcy, so it is possible that non-debtors pose an even greater risk of misusing PPP funds.\textsuperscript{167} The court in \textit{Santa Fe} pointed out that Congress deliberately omitted a creditworthiness requirement because it presumed that most businesses applying for a PPP loan were already in financial distress.\textsuperscript{168} Moreover, given the impacts COVID-19 had on the economy, most businesses would not have been able to repay their PPP loan.\textsuperscript{169}

Similarly misguided is the Second Circuit’s position that the forgiveness aspect of the PPP does not transform it from a loan to a grant.\textsuperscript{170} The purpose of the PPP was to provide a financial lifeline for small business owners and their employees during COVID-19.\textsuperscript{171} Given the importance small businesses have on the economy, the public interest would be best served by ensuring that small businesses do not fail. One way to achieve this outcome is by providing forgivable grants that enable small businesses to pay their employees.\textsuperscript{172} The PPP did not have the same motivations or purposes as typical business loans, which are to provide capital to business owners to invest in their businesses and for lenders to make a profit by charging interest.\textsuperscript{173} Grants, on the other hand, are awarded specifically to serve a public good and do not require repayment if funds are used for their intended purposes.\textsuperscript{174} The PPP was a public good that had set criteria for how the funds should be used to allow borrowers to qualify for forgiveness.\textsuperscript{175} The Second Circuit points out that even though the PPP had a forgiveness option, forgiveness was not guaranteed, and, therefore, this does not make the PPP a grant.\textsuperscript{176} The Second Circuit fails to appreciate that funds awarded by grants are also not guaranteed, given that a grantee must repay the grantor if the funds are not used for their intended purposes.\textsuperscript{177} Accordingly, overturning

\textsuperscript{164} \textit{In re Roman Cath. Church}, 615 B.R. at 656.
\textsuperscript{165} \textit{Id.}
\textsuperscript{166} \textit{Id.}
\textsuperscript{167} \textit{Id.}
\textsuperscript{168} \textit{Id.}
\textsuperscript{169} \textit{Id.} at 654.
\textsuperscript{171} Durlacher, \textit{supra} note 161.
\textsuperscript{172} \textit{Frequently Asked Questions}, \textit{supra} note 150.
\textsuperscript{173} Axelton, \textit{supra} note 83.
\textsuperscript{174} Schooley, \textit{supra} note 88.
\textsuperscript{175} \textit{PPP Loan Forgiveness}, \textit{supra} note 59.
\textsuperscript{177} Axelton, \textit{supra} note 83.
the Second Circuit’s decision and replacing it with a decision similar to the Santa Fe court’s line of reasoning is one solution to ensure that debtors in bankruptcy would not be further discriminated against.

Another solution would be to take what we learned from the PPP and develop better policies and procedures that can be more inclusive to a broader array of small business owners, particularly debtors in bankruptcy. One policy improvement might include a transparency reporting requirement for debtors in bankruptcy as a prerequisite to participate in the PPP or other similar emergency funding programs. As previously mentioned, the SBA’s primary rationale for excluding debtors in bankruptcy was that they posed too high a risk of being unable to meet the forgiveness requirements due to their bankruptcy status. A transparency reporting requirement, like those imposed by the Bankruptcy Code and Bankruptcy Rules, could alleviate this concern. Under the Federal Rules of Bankruptcy Procedure Section 2015(a)(2)–(3), after a debtor files a bankruptcy petition, it must file periodic reports and summaries with the U.S. Trustee and Bankruptcy Court that disclose details about ongoing business operations. The reports the debtors provide include: (1) statements of receipts and disbursements; (2) balance sheets; (3) cash-flow statements; (3) schedules of accounts receivable; (4) tangible assets; and (4) post-petition debts.

The SBA should adopt a similar policy in future emergency relief programs. Debtors would be required to provide the SBA and lenders with information similar to what they already submit to the U.S. Trustee and Bankruptcy Court, ensuring the appropriated funds align with the particular program’s intended purposes. While this requirement may seem strict, it can provide many benefits to all involved parties. Foremost among these is the mitigation of the SBA’s main primary—that debtors pose too high a risk of default. From the debtor’s perspective, this approach offers reassurance, enabling them to access crucial funding during public health crises when access to capital is vital to ensure their business’s survival.

CONCLUSION

The SBA’s decision to deny PPP loans to debtors in bankruptcy violated Section 525(a) of the Bankruptcy Code. To weather the storm of the COVID-19 pandemic, Congress enacted the CARES Act by implementing the PPP loan program to help small businesses pay their employees and cover other

179. Durlacher, supra note 161.
182. Gaither, supra note 71.
typical business expenses. The program was not a typical loan program as it did not require recipients to undergo a creditworthiness test, and the funds received did not have to be repaid if they were used for their required purposes, making the PPP more of a grant than a loan. Therefore, excluding debtors in bankruptcy from receiving a PPP loan was discriminatory conduct by the SBA in violation of Section 525(a) of the Bankruptcy Code.

Although the PPP has concluded, and life in the United States is gradually returning to normal post-COVID-19, the potential for future crises, propelled by emerging variants, remains a pertinent concern. If such a situation occurs again, the SBA must develop better policies and procedures that are more inclusive of all types of small business owners, including debtors in bankruptcy. The SBA can accomplish this by implementing policies and procedures that require transparent reporting requirements similar to those debtors face under the Bankruptcy Code and Bankruptcy Rules. These policies will benefit all parties involved—lenders will have more assurance that the loans they issue to debtors in bankruptcy will be repaid, the government can avoid a flood of litigation for implementing discriminatory policies, and debtors will receive the benefit of not having to miss out on a funding opportunity. During difficult times when the entire country is struggling financially, more inclusive and better-planned policies will also serve the public interest.

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