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Locke Lord QuickStudy: Saving Our Small Businesses – Considerations for Lenders upon the Default or Bankruptcy ?of a Paycheck Protection Program Borrower

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With the goal of providing financial relief to companies impacted by the COVID-19 pandemic, the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") amended the Small Business Act to allow the Small Business Administration ("SBA") to issue forgivable, unsecured loans with lengthy deferral periods (the "Loans") to struggling companies.[1] As compared to loans available in the commercial credit markets, the terms of the Loans are specifically designed to provide borrowers liquidity and flexibility. In particular, these terms allow borrowers more time (i) to spend the Loan proceeds so as to be eligible for full Loan forgiveness and (ii) to repay any unforgiven portion of the Loans. The borrowers also realized the substantial benefit of having the SBA guarantee repayment of 100% of the Loans—thereby expediting the underwriting process, and increasing the chances that these borrowers would be approved.[2] However, with most industries continuing to experience lagging demand and reduced revenue, and with no additional federal stimulus in sight (under the Paycheck Protection Program or otherwise), a number of borrowers can be expected to experience financial distress in the coming months. Some portion of these borrowers may file for federal bankruptcy protection—while the Loans are still outstanding, and before the Loans have been forgiven. The SBA has not yet provided any guidance regarding the treatment of Loans in bankruptcies, leaving lenders questioning what actions to take if a borrower defaults on the Loan and files for bankruptcy.

The uncertainty created by the absence of SBA guidance on this topic has been compounded by inconsistencies between the language of the CARES Act and the form of promissory note (the "Note") approved by the SBA and utilized by many lenders in connection with the issuance of the Loans. Specifically, there are ambiguities as to whether and when a lender can exercise remedies following a borrower's default on a Loan. Lenders must be wary of which language will ultimately take precedence when deciding whether to exercise any potential rights afforded to lenders in the event of a default on a Loan.

The CARES Act. The CARES Act states that a lender may not demand repayment of the unforgiven portion of a Loan until the forgiven portion of the Loan is remitted to the lender by the SBA. Presently, the borrower has until either (i) 24 weeks from the origination of the Loan or (ii) ?December 31, 2020, whichever is earlier (the "Covered Period"), to file an application for Loan forgiveness with the lender.[3] The lender then has 60 days to review and

approve a borrower's forgiveness ?application and submit the forgiveness application to the SBA. The SBA then has 90 days to remit the forgiven amount to the ?lender (or elect to further review the forgiveness application).[4] If the borrower fails to apply for forgiveness of the Loan, then the repayment of the Loan is deferred until 10 months after the last day of the Covered Period. Essentially, under the CARES Act, the lender may not require repayment of the Loan until either of the previously mentioned deadlines are met, regardless of whether the borrower defaults on the Loan and files for bankruptcy.

The Note. The Note, however, provides that a borrower will be in default of the Note if the borrower (i) becomes the subject of a proceeding under any bankruptcy or insolvency law, (ii) has a receiver or liquidator appointed for any part of its business or property or (iii) makes an assignment for the benefit of creditors.[5] The Note further provides that, upon a default under the Note, the lender may, without notice or demand, "require immediate payment of all amounts owing under the Note."[6] These provisions appear to give lenders the right to require immediate repayment of the entire Loan once the borrower files for bankruptcy—an accelerated remedy that would be in direct conflict with the plain language of the CARES Act.

Rather than exercising remedies and potentially running afoul of the timing restrictions contained in the CARES Act, a lender holding a defaulted Note may be better served to notify the borrower and the SBA of the default, and to request that the SBA purchase the Loan—all as provided under the SBA's guaranty of the full balance of the Note. The question then arises—what happens if the borrower files for bankruptcy *after* notification of default has been provided, but *before* the SBA has repurchased the Loan in accordance with the guaranty?

1. Forgiveness. The language of the CARES Act provides that a borrower *shall* be eligible for full Loan forgiveness, so long as the Loan proceeds were used for permitted uses.[7] The CARES Act does not contain any provisions allowing the SBA to limit or deny Loan forgiveness if a borrower files for bankruptcy. Similarly, the SBA issued an Interim Final Rule on April 28, 2020, which states that a company may not obtain a Loan if the company files for bankruptcy prior to applying for a Loan or prior to the distribution of a Loan.[8] Just like the CARES Act, this SBA Interim Final Rule is silent regarding the impact of borrowers applying for bankruptcy after the Loan is distributed.[9] A borrower may therefore be able to argue that the Note (and the forgiveness provisions contained therein) remains enforceable in accordance with its terms, notwithstanding an intervening bankruptcy filing. Likewise, a lender may be able to make a logical and good faith argument that the guaranty remains fully enforceable notwithstanding a subsequent bankruptcy filing by the borrower.

The SBA, in turn, might argue that the forgiveness obligation does not mature until the loan proceeds have been fully utilized by the borrower. In the event loan proceeds have not been fully utilized at the time of a bankruptcy filing, the SBA could argue that the conditions for forgiveness were not satisfied, and that the lender should have the right to require repayment of the unused funds. A borrower could respond to this argument by seeking authority to use cash collateral in accordance with the terms of the Bankruptcy Code.[10] Upon receiving such authorization, the borrower/debtor could then spend the remaining Loan proceeds so as to perfect the entitlement to forgiveness of such Loan.[11] Because neither the CARES Act, nor the Note, specifically contemplates this scenario, further litigation could ensue over the borrower's entitlement to debt forgiveness under these facts and circumstances.

2. SBA Guaranty. Because 100% of the Loan is backed by the SBA guaranty, lenders have little to no risk that the Loan will ultimately not be repaid if a borrower files bankruptcy and the Loan is discharged.[12] Although the Loan is

unsecured and has the same low priority for repayment in a bankruptcy proceeding as any other unsecured debt, the lender will still be made whole by the SBA if the Loan is discharged.

It appears the Senate is attempting to address the fact that the Loans are subordinate to other debt in a bankruptcy proceeding and, as a result, the Continuing Small Business Recovery and Paycheck Protection Program Act (the "Small Business Recovery Act") has been introduced in the Senate. If enacted, the Small Business Recovery Act would give the Loans priority over secured debt and several administrative expenses in a bankruptcy proceeding.[13] This may be an indication that Congress is beginning to address the likelihood of a surge of bankruptcies in the near future, or may just be an act of self-preservation to ensure that the government's debt is repaid ahead of other creditors' debt.

Bankruptcy Considerations in General. Case law surrounding the treatment of Loans in bankruptcy proceedings is still emerging and provides little guidance. Lenders should be aware of potential pitfalls in bankruptcy proceedings that may impact Loan repayment. In particular, lenders will need to protect and preserve their claims under the Note, so as to avoid any defenses to the guaranty based on the impairment of the SBA's position.

When a company files for Chapter 11 bankruptcy, an automatic stay is imposed at the time of filing which suspends all collection activities by lenders to collect any outstanding debts of the borrower.[14] This automatic stay applies to both secured and unsecured lenders, and includes lenders that have issued Loans.[15] Acts taken by a lender to collect on debts during an automatic stay are typically invalid as a matter of law and the court may also impose monetary sanctions on a lender for violating the automatic stay. Notably, the automatic stay would curtail any potential rights afforded to lenders under the Note, unless the lender is able to have the automatic stay lifted by court order.

It is also important for lenders to monitor bankruptcy proceedings to ensure the SBA guaranty survives the proceeding. While typically seen in cases where the guarantor of the debt is not a government entity, in some instances a debtor's Chapter 11 plan may provide for the release of a third-party guarantor's obligation to repay the debt.[16] If the lender does not object to the Chapter 11 plan before it is confirmed, or in certain cases where the lender affirmatively votes against the plan but the court approves the plan regardless, the lender has no right to pursue the third-party guarantor for repayment of the debt and has no remedy for nonpayment.[17]

Typically, Chapter 11 plans provide protection for unsecured creditors by requiring that unsecured debts (such as a Loan) are afforded payments of an amount greater than the amount an unsecured creditor would receive if the company was liquidated.[18] However, similar to the above, the creditor must monitor the Chapter 11 plan to ensure this protection is built into the plan. Sometimes Chapter 11 plans do not contain this protection and the creditor will be deemed to have accepted the Chapter 11 plan if the creditor does not object to the plan prior to its confirmation.

Lastly, to obtain full Loan forgiveness, the borrower must expend the Loan proceeds only for permitted uses, such as payroll and utilities of the business.[19] The lender should ensure that the Chapter 11 plan does not require the borrower to expend proceeds of the Loan to discharge senior debts, which would sacrifice Loan forgiveness.

Conclusion. The intent and language of the CARES act appear to show that Congress intended for borrowers to have ample time to obtain Loan forgiveness or to repay the Loan. The CARES Act provides less clarity as to the

rights, remedies and obligations under the Note and SBA guaranty where the borrower has filed for bankruptcy protection—particularly where the loan proceeds have not yet been fully spent in accordance with the statute. The CARES Act does not expressly prohibit loan forgiveness under these circumstances, but neither does the CARES Act authorize forgiveness. It remains to be seen whether, following a bankruptcy filing, the SBA will seek to block a borrower/debtor from spending the remaining loan proceeds and asserting a claim for forgiveness. Pending clarification from the SBA and/or the bankruptcy court on these points, a lender should appear promptly in its borrower's bankruptcy proceeding and protect and enforce the rights available under its Note. Given the potential forgiveness of the Note, a lender's failure to enforce its rights and remedies could impair the SBA's position and create defenses to the enforceability of the SBA guaranty.

Your regular Locke Lord contact and the authors of this article would be happy to ?help you navigate the CARES Act and the related amendments to the Small Business Act as they relate to the Paycheck Protection Program or otherwise.

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1. *See* Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, 116th Con. (2020) § 1102.
2. *See id*. at § 1102(f)(1).
3. Paycheck Protection Program Flexibility Act of 2020, H.R. 7010, 116th Con. (2020) § 3(b)(1).?
4. There are reports that the legislature is considering automatically forgiving all Loans under a ?certain amount. The exact Loan amount has not been determined but reports indicate it may be $150,000 or $350,000.
5. SBA Form of Promissory Note, §§ 4(H), (I) and (J).
6. SBA Form of Promissory Note, § 5(A).
7. Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, 116th Con. (2020) § 1105(b).
8. SBA Interim Final Rule, 85 Fed. Reg. 23,451 (Apr. 29, 2020).
9. Id.
10. *See* 11 U.S.C. §§ 361, 363.
11. *See* In Re Toojay's Management LLC, et al. Bankruptcy No. 20-14792-EPK, Bankr. Ct. SD Fla. Order of May 1, 2020.
12. Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, 116th Con. (2020) §1102(f)(1).
13. Continuing Small Business Recovery and Paycheck Protection Program Act, S. 4321, 116th Con. (2020) § 116(f)(2)(A).
14. 11 U.S.C. § 362(a).
15. 11 U.S.C. § 362(a).
16. *See* In re Dow Corning Corp., 280 F.3d 648, 657-58 (2002).
17. *See* Id.
18. 11 U.S.C. § 1129(a)(7)(ii).
19. Coronavirus Aid, Relief, and Economic Security Act, H.R. 748, 116th Con. (2020) § 1105(b).

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