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**ORANGE COUNTY BAR ASSOCIATION**

**COMMERCIAL LAW & BANKRUPTCY**

**SECTION WEBINAR**

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“Flatten the Curve”:  
A Panel Discussion on the “Novel” Issues Impacting Bankruptcy  
Cases Due to the COVID-19 Pandemic



Thursday, May 28, 2020

# The “Novel” Issues Impacting Bankruptcy Cases Due to the COVID-19 Pandemic

May 28, 2020

## PANELISTS

Hon. Scott C. Clarkson  
United States Bankruptcy Judge

Kailey Wright, CIRA  
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## CURRENT STATE OF REMEDIES

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### CURRENT STATE OF REMEDIES - FORECLOSURES

**All foreclosure actions on a mortgage or deed of trust are stayed, and the California state courts may not take any action or issue any decisions or judgments unless necessary for public health and safety.**

**The rule sunsets 90 days after the Governor declares the state of emergency related to the COVID-19 pandemic is lifted.  
(Emergency Rule 2 of Cal. Rules of Court)**

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## CURRENT STATE OF REMEDIES - EVICTIONS

**A California state court may not issue a summons on an unlawful detainer complaint (unless needed to protect public health and safety).**

**The rule sunsets 90 days after the Governor lifts the state of emergency related to the COVID-19 pandemic.  
(Emergency Rule 1 of Cal. Rules of Court)**

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## CURRENT STATE OF REMEDIES - EVICTION MORATORIUMS

### ■ Los Angeles

- ▷ Landlords shall not evict residential and commercial tenants through the Local Emergency Period if the tenants are unable to pay due to circumstances related to the COVID-19 pandemic. (City of Los Angeles Ordinance No. 186585)

### ■ California State Moratorium?

- ▷ Senate Bill 939
- ▷ Bars commercial landlords from evicting tenants for more than a year
- ▷ Makes it easier for tenants to renegotiate or break commercial leases.
- ▷ Excludes publicly traded companies.

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# CURRENT STATE OF REMEDIES – COURTS

## U.S. District Court:

Central District of California will not call jurors for trials until after June 1, 2020.

Emergency time-sensitive matters, e.g., TRO, "as ordered by the assigned judicial officer" to be conducted telephonically.



## Orange County Superior Court:

Courtrooms remain closed through May 26, 2020, except for certain time-sensitive functions, including civil ex partes.

All civil trials scheduled to begin as of March 17, 2020 and forward will be continued 25 weeks.

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## ACCESS TO JUSTICE

- The Bankruptcy Court implemented extraordinary measures for pro se debtors.
- How do self-represented parties file when courts are closed?
- The Court:
  - ▷ Expanded and eased e-filing (immediate fee installments and delayed signatures) and revised drop-box requirements.
  - ▷ Continued to staff help lines.
  - ▷ Met with debtors at the door for over-the-counter filings.
  - ▷ Negotiated free access for telephonic appearances.
  - ▷ Worked closely with pro bono organizations.
  - ▷ Established special Chapter 13 system for post-petition retention.

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## THE BANKRUPTCY COURT IS READY

- The Court is ready for a spike in filings.
  - In 2010, the Central District handled 142,000 filings, as well as the highest percentage and raw number of pro se filings in the country.
- Current Status and Next Steps:
  - Hearings being held telephonically.
  - Zoom?
  - Trials and evidentiary hearings?

## FINANCIAL CONSIDERATIONS IN DETERMINING TO FILE

- Is filing premature?
  - Creditors' collection alternatives are limited (for now).
    - Could explain short term drop in filings.
  - Support packages are available and more could be coming.
- Can the company afford to file bankruptcy?
  - Is Subchapter V an option? The CARES Act increased the debt from \$2,725,625 to **\$7,500,000**.
- Is financing available in this market (other than PPP loans)?
- How can projections be prepared with so much uncertainty?
- What should businesses be doing now to weather the pandemic and be in a position to re-start?

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## Paycheck Protection Program “Loans” in Bankruptcy

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### WHAT IS THE PAYCHECK PROTECTION PROGRAM?

- Stimulus included in the CARES Act for small businesses.
- Originally funded in the amount of \$349 billion.
- Eligible businesses can borrow 250% of average monthly payroll expenses, up to \$10 million, with interest at .5%.
- Term of the loan can be up to 10 years.
- The loan proceeds can be used to pay payroll, rent, utilities, and interest on mortgage obligations.
- There is no personal guaranty or collateral required.
- Repayment of the loans may be deferred for at least six months and up to one year.
- If employers maintain their payroll, the loans may be forgiven.
- Loans are available through June 30, 2020.

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## PPP “LOANS” IN BANKRUPTCY

- **What are the issues?**
- May the SBA and private lenders categorically deny the PPP loan application of a business because it is a debtor in a pending bankruptcy case?
- Can the Bankruptcy Courts order the SBA or a private bank to make a loan or consider a PPP application notwithstanding a pending bankruptcy?



## PPP APPLICATION QUESTION NO. 1

*If questions (1) or (2) below are answered “Yes,” the loan will not be approved.*

Question	Yes	No
1. Is the Applicant or any owner of the Applicant presently suspended, debarred, proposed for debarment, declared ineligible, voluntarily excluded from participation in this transaction by any Federal department or agency, <b><u>or presently involved in any bankruptcy?</u></b>	<input type="checkbox"/>	<input type="checkbox"/>



## DEBTORS VS. THE SBA

- Debtors in cases across the nation have sued the SBA in Bankruptcy Court for TROs requiring the SBA and the private lenders to consider their PPP applications.
  - ▶ **There is s case in the Central District:** *NAI Capital, Inc. v. Carranza (In re NAI Capital, Inc.)*, Adv. Case No. 1:20-ap-01051-DS (Bankr. C.D. Cal. May 20, 2020)
    - ▶ On May 20, 2020, Judge Saltzman denied the debtor's request for TRO.
- There are decisions on both sides and the landscape changes daily.

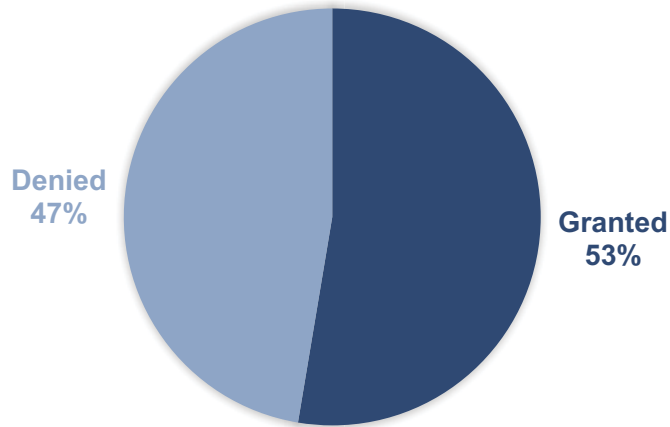
## SUMMARY OF RULINGS TO DATE

Debtor	TRO Granted	TRO Denied
Abe's Boat Rentals		✓
Americore Holdings, LLC	✓	
Areway Acquisition, Inc. and Yourway Coatings, LLC		✓
Asteria Education, Inc.		✓
Breda, LLC		✓
Calais Regional Hospital	✓	
Cosi, Inc.		✓
Hartshorne Holdings, LLC et al.	✓	
Hidalgo County Emergency Service Foundation*	✓	
J-H-J, Inc. et al.		✓
KP Engineering, LP et al.	✓	
NAI Capital, Inc.		✓
Organic Power, LL	✓	
Penobscot Valley Hospital	✓	
PPV, Inc.		✓
Roman Catholic Church of the Archdiocese of Santa Fe	✓	
Springfield Hospital, Inc.	✓	
Trudy's Texas Star, Inc.		✓
Weather King Heating & Air, Inc.	✓	

\*On May 11, 2020, the District Court ordered a stay of the injunction pending the SBA's appeal.



## SUMMARY OF COURT RULINGS ON TRO'S



\*There are approximately 7 pending cases

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## DOES THE CARES ACT EXCLUDE DEBTORS?

- **No, not expressly.**
- The PPP Loan provisions are codified in 15 USC § 636(36).
- Section 636 does **not** expressly exclude debtors in bankruptcy from the businesses eligible for a PPP loan.
- *Compare with In re Roman Catholic Church of Archdiocese of Santa Fe, 2020 WL 2096113, at \*6 (Bankr. D.N.M. May 1, 2020) (stating that the CARES Act's "direct loans to mid-sized businesses specifically excludes bankruptcy debtors.")*.

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## RELEVANT PROVISIONS OF CARES ACT

### What are the specified eligibility requirements for a PPP Loan?

- ▶ Be in operation as of February 15, 2020.
- ▶ Be a small business – employ not more than 500 employees (for whom the borrower has paid salaries and payroll taxes). See 15 USC § 636(36)(D); see also 15 U.S.C.A. § 636(36)(F)(ii)(II).

### If not the CARES Act, then what excludes debtors from the PPP?

- ▶ A SBA rule.
- ▶ The SBA is required to issue regulations to carry out the CARES Act. See 15 U.S.C. § 9012.

## SBA FOURTH INTERIM FINAL RULE

### Will I be approved for a PPP loan if my business is in bankruptcy?

No. 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. If the **applicant or the owner** of the applicant becomes the debtor in a bankruptcy proceeding after submitting a PPP application but before the loan is disbursed, it is the applicant's obligation to notify the lender and request cancellation of the application. **Failure by the applicant to do so will be regarded as a use of PPP funds for unauthorized purposes.**

The Administrator, in consultation with the Secretary, **determined 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.** In addition, **the Bankruptcy Code does not require any person to make a loan or a financial accommodation to a debtor in bankruptcy.** The Borrower Application Form for PPP loans (SBA Form 2483), which reflects this restriction in the form of a borrower certification, is a loan program requirement. Lenders may rely on an applicant's representation concerning the applicant's or an owner of the applicant's involvement in a bankruptcy proceeding.

**Fourth Interim Final Rule. 85 Fed. Reg. at 23,451.**



## ISSUES CONFRONTING BANKRUPTCY COURTS

Is the SBA immune from suit and can the SBA be enjoined?

Is a proceeding challenging the SBA's bankruptcy exclusion core?

Does the SBA's bankruptcy exclusion violate the Administrative Procedures Act?

Does the SBA's bankruptcy exclusion violate § 525 of the Bankruptcy Code?

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## IS THE SBA IMMUNE FROM SUIT?

- SBA's position - the SBA may be sued, **but "no . . . injunction . . . shall be issued against the [SBA] . . ."** See 15 U.S.C. § 634(b)(1).
- Some courts believe the anti-injunction provision is limited.
  - ▶ Section 634 prevents injunctions that interfere with the "internal workings" of the SBA, and does not bar judicial review of the SBA's actions (the product or end result of the "internal workings"). See *In re Calais Regional Hospital*, 2020 WL 2201947, at \*2 (Bankr. D. Me. May 1, 2020) (relying on *Ulstein Maritime, Ltd. v. United States*, 833 F.2d 1052 (1st Cir. 1987)).
- Section 106 of the Bankruptcy Code abrogates sovereign immunity with respect to §§ 105 and 525.

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## BANKRUPTCY COURT JURISDICTION

- Is the review of the SBA's actions core or non-core?
- Courts that have entered TROs and denied requested for TROs have agreed – **core**. See, e.g., *In re Roman Catholic Church of Archdiocese of Santa Fe*, 2020 WL 2096113, at \*4 (Bankr. D.N.M. May 1, 2020) (core because "it goes to the heart of case administration" and involves whether a governmental unit has violated § 525(a)).

## THE ADMINISTRATIVE PROCEDURES ACT

- The Administrative Procedures Act ("APA") governs judicial review of agency action.
- The APA covers:
  - ▷ **Who can sue** ("[a] person suffering legal wrong because of agency action . . ."). 5 U.S.C. § 702.
  - ▷ **Where can a suit be filed** (court specified by statute for the subject matter or, if none or inadequate, "a court of competent jurisdiction." 5 U.S.C. § 703.
  - ▷ **What type of action is reviewable** (any action; action made reviewable by statute or any final action "for which there is no other adequate remedy.") 5 U.S.C. § 704.
  - ▷ **The remedy available.** The court can **compel** or **set aside** agency action that is, *inter alia*:
    - ▷ "[A]rbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law"; or
    - ▷ "[I]n excess of statutory jurisdiction, authority, or limitations, or short of statutory right[.]" 5 U.S.C. § 706.

## SECTION 525 OF THE CODE

Section 525 is the Code's Anti-Discrimination Provision. It states that:

"[A] governmental unit may not deny . . . 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 . . . ."

11 U.S.C. § 525.



## SECTION 525 DOES NOT APPLY TO LOANS

- Courts seem to uniformly recognize that § 525 does not apply to loans. See, e.g., *Watts v. Pennsylvania Housing Fin. Co.*, 876 F.2d 1090, 1094 (3d Cir. 1989); *Ayes v. U.S. Department of Veterans Affairs*, 473 F.3d 104, 110 (4th Cir. 2006).
- **Question:** Is the PPP loan a "loan"?
  - ▶ The statutory scheme refers to the PPP loan as a loan. See 15 U.S.C. § 636(36); see also 15 U.S.C. § 9005 (discussing forgiveness of the loan).

## COMPETING RATIONALES

### COURTS GRANTING

- Capricious because the PPP is not a normal loan program. It is a grant to businesses *that are presumed to be in financial distress*.
- The SBA exceeded its statutory authority because the CARES Act addresses the eligibility requirements to obtain a PPP loan and *not* being a debtor in bankruptcy is not one of the requirements.
  - Congress made clear when it wanted to exclude debtors.
- The SBA is violating § 525 because the PPP “is not a loan program at all. It is a grant or support program.” Repayment is not a significant part of the program.

### COURTS DENYING

- Not arbitrary. The SBA has broad authority to administer the loan program and the SBA gave its reasoning in the rule. It may not be fair, but that is not the test.
- The SBA acted within its rights. The PPP loan is included in the existing Section 7(a) small business lending program. See 15 U.S.C. § 636(a)(6). The SBA replaced a case-by-case review with a bright line rule to reconcile the pre-existing requirement that loans be of “sound value” with the obligation to expeditiously process the PPP loan applications.
- The SBA is not violating § 525 because the PPP loan is a not and not a grant similar to a license. The CARES Act calls it a loan. While the PPP loan can be forgiven, it is a loan.

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## ALTERNATIVE APPROACH – DISMISSAL AND REFILE

- The case of *In re Advanced Power Technologies, LLC*, was dismissed without prejudice (on an emergency motion by the debtor to dismiss in order to obtain a PPP loan).
  - ▶ After obtain the PPP loan, the debtor sought reconsideration of the dismissal and the motion was granted.
- The case of *In re Capital Restaurant Group, LLC*, was dismissed with prejudice with a one-year bar to re-filing.
  - ▶ The court required the bar if the debtor proceeded with dismissal.

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## CAN A BUSINESS OBTAIN A LOAN AND THEN FILE?

- It has occurred: The debtor in the *In re TooJay* bankruptcy in Florida filed with a PPP loan.
  - The largest unsecured creditor was the bank that made the \$6.4 million PPP loan.
- **It is too soon to tell.**

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## CAN A BUSINESS OBTAIN A LOAN AND THEN FILE?

- May depend on intent and use of the proceeds.
- The PPP application is expressly focused on **pending** bankruptcies.
- SBA's rationale for excluding debtors and the Fourth Interim Rule suggest that the SBA is focused on two factors: (1) whether the loan will be used for the required purposes; and (2) whether it will be repaid (if not forgiven).

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## CAN A BUSINESS OBTAIN A LOAN AND THEN FILE?

- The SBA could view an application submitted with the intention to file or re-file a bankruptcy case as a bad-faith application. See, e.g., AUSA in the *J-H-J, Inc.* case regarding dismissal and re-filing.
- The Fourth Interim Final Rule expressly states that if applicant or owner becomes a debtor after submitting a PPP application but before the loan is disbursed, must notify the lender and request cancellation of the application. **“Failure by the applicant to do so will be regarded as a use of PPP funds for unauthorized purposes.”**
  - ▶ It is not a stretch for the SBA to take the same position in response to a filing after the loan is funded.

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## USE OF THE PROCEEDS ARE RESTRICTED

- Even if a debtor can obtain a PPP loan and then file, the use of the funds are restricted.
  - ▶ Failure to use a PPP loan for the intended purpose could expose owners to liability and will impact forgiveness.
  - ▶ "Notwithstanding the waiver of the personal guarantee requirement or collateral under subparagraph (J), the Administrator shall have no recourse against any individual shareholder, member, or partner of an eligible recipient of a covered loan for nonpayment of any covered loan, **except to the extent that such shareholder, member, or partner uses the covered loan proceeds for a purpose not authorized under clause (i).**" 15 U.S.C.A. § 636(36)(F)(v) (emphasis added).

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## PANDEMIC PROMPTED STAYS

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### DEBTORS THAT HAVE SOUGHT STAYS

- A handful of debtors in large cases have sought stays of their cases and authority to defer post-petition payments.
  - ▷ *In re Modell's Sporting Goods, Inc.*, Case No. 20-14179 (Bankr. D. N.J.).
  - ▷ *In re True Religion Apparel, Inc.*, Case No. 20-10941 (Bankr. D. Del.).
  - ▷ *In re Pier 1 Imports, Inc.*, Case No. 20-30805 (Bankr. E.D. Va.).
  - ▷ *In re CraftWorks Parent, LLC*, Case No. 20-10475 (Bankr. D. Del.).

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## STAY VARIATIONS AND AUTHORITY

Debtors have sought the following for a period of time (typically, 60 days):

- ▷ Prevent filings by creditors (stay relief, payment of administrative claims, and compel the assumption or rejection of contracts or leases).
- ▷ Encourage or require creditors to meet and confer with the debtor before filing a motion.
- ▷ Establish notice and objection procedures for motions by the debtor, such as, to approve compromises.
- ▷ Extend deadlines in the case.
- ▷ Defer payments of expenses, including rent, that are not included debtor's proposed budget.

The debtors have based their requests on a combination of §§ 105, 305, and 365.

**Takeaway – temporary stays and modified notice and objection procedures are OK, but cannot force creditors to jump through many hoops.**

- ▷ In CraftWorks, the court refused to grant the motion as presented as too burdensome on creditors.

For Pier 1, deferred payment may mean no payment; it's closing all stores.



## KEY BATTLE – CAN COURTS DEFER RENT BEYOND 60 DAYS

- Can a court defer the payment of rent beyond the 60-day period in § 365(d)?
- Section 365(d)(3) states that the debtor "shall" perform all obligations arising under a commercial property lease.
- Section 365(d)(3) states that such requirement may be extended for only the 60-day period following the petition date.
- A suspension of proceedings under §§ 305 or 105 should not affect the debtor's obligation to pay rent per the terms of the lease.



## KEY BATTLE – CAN COURTS DEFER RENT BEYOND 60 DAYS

- But wait, according to the *Pier 1* court, § 365 does not create a separate remedy or a right to compel payment.
  - ▶ The debtor's failure to comply with § 365(d)(3) merely gives rise to an administrative expense claim. See *Pier 1 Imports, Inc.*, 2020 WL 2374539, at \*5 (Bankr. E.D. Va. 2020).
- By preventing the filing of motions to compel payment of an administrative expense claim, the court can effectively delay the payment of rent beyond the 60-day period.



## WHY SEEK A STAY?

- The ability to seek a stay could become important if creditors can collect and revenues have yet to snap back.
- Minimize expenses incurred during the pandemic.
- Can a plan be proposed now?
  - ▶ How would projections be prepared?
- In Subchapter V cases, does the existing pandemic continue to be a matter for which the debtor should not be held justly accountable to extend the plan filing deadline?
- Will debtors be able to pay accumulated deferred obligations?



## FIGHT OF THE FUTURE – DEFERRAL VS. ELIMINATE

- Section 365(d)(3) states that the debtor "shall" perform all obligations arising under a commercial property lease.
- However, the debtor's obligation to comply with a lease is subject to the lease terms and may be subject to statutory and common law defenses.

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## POSSIBLE DEFENSES UNDER NON-BANKRUPTCY LAW

- Force majeure clauses.
- California Code of Civil Procedures 1511(2): Performance is excused "[w]hen it is prevented or delayed by an irresistible, superhuman cause, or by the act of public enemies of this state or of the United States, unless the parties have expressly agreed to the contrary."
- Common law defenses of:
  - ▷ Impossibility;
  - ▷ Impracticability; and
  - ▷ Frustration of purpose.

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## COMMON LAW DEFENSES CAN DISCHARGE PAYMENT

### Restatement (Second) Contracts § 269

- ▶ Impracticability of performance or frustration of purpose that is only temporary suspends the obligor's duty to perform while the impracticability or frustration exists **but does not discharge his duty or prevent it from arising unless his performance after the cessation of the impracticability or frustration would be materially more burdensome than had there been no impracticability or frustration.**



## THE FIGHT IS BREWING

- The debtor in *True Religion* reserved its rights to seek more than the deferral of rent based on the common law defenses and the debtor in *Pier 1* sought to defer its rent obligations based on the common law defenses and on the grounds that the “shelter-in-place” orders amounted to a taking of the leased premises.
- ▶ The court in *Pier 1* made clear that it was not determining the amount of rent the debtors must pay or whether any of the debtors' defenses had merit; rather, the debtors' obligation "to pay rent accrues in accordance with the terms of the applicable lease and state law." See *Pier 1 Imports, Inc.*, 2020 WL 2374539, at \*4 (Bankr. E.D. Va. 2020).