Professional Perspective

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Many businesses received Paycheck Protection Program (PPP) loans backed by the Small Business Administration (SBA) to stay afloat during the Covid-19 crisis. Some of these businesses, however, have been forced to file for bankruptcy protection after receiving the PPP funds. For these businesses, how will their PPP loans be dealt with if some funds remain unused? One bankruptcy case from the United States Bankruptcy Court for the Southern District of New York provides a framework for this issue going forward in what appears to be the first agreement of its kind. In short, the SBA and the lender for a SBA-backed PPP loan agreed to share remaining unused PPP loan funds with other creditors.

Cosmoledo, LLC Bankruptcy

In the Cosmoledo, LLC bankruptcy, the debtors owned and operated sixteen Maison Kayser bakery cafés in New York City. The debtors are comprised of Cosmoledo, a Delaware limited liability company, and multiple New York limited liability companies (LLCs). Each of the New York LLCs have Cosmoledo as their sole member. Between 2016 and 2018, to fund debtors' operations and growth, Cosmoledo entered into a series of notes, payable to Moussechoux, Inc. Later, Cosmoledo and Moussechoux entered into a debt purchase agreement, pursuant to which Cosmoledo exchanged the prior notes for amended notes, and Cosmoledo also issued a new note to Moussechoux. On the same date that the debtors filed for bankruptcy relief, Moussechoux sold and assigned its rights under the notes to MK Debt, LLC, a Delaware limited liability company.

In 2019 and the first quarter of 2020, before the Covid-19 crisis, the debtors implemented a restructuring strategy as a result of unsustainable overhead costs and the poor performance of certain stores. The restructuring generally contemplated a recapitalization, a reorganization of their production facilities, a reduction of store footprint, and revision to their store level management structure.

During the Covid-19 crisis, New York Governor Andrew Cuomo declared a state of emergency that required the debtors to temporarily cease operations. Almost seven hundred employees of Cosmoledo were furloughed at this time. During this time, the debtors planned to reopen and applied for a SBA-backed PPP loan. The debtors received their requested PPP loan, but ultimately determined that certain factors, including the loss of in-store dining revenue and continued overhead, would make the debtors' business unlikely to repay its obligations in the ordinary course of its operations. Later, the debtors filed for bankruptcy in order to sell their assets. Before filing for bankruptcy, the debtors had used only some of the PPP funds.

After filing for bankruptcy, the debtors filed a motion to repay the PPP loan. The debtors' bank accounts contained sufficient funds to repay the PPP loan. Because the debtors had made the strategic decision to not reopen or rehire their workforce, the debtors had almost no payroll costs that would be authorized by the PPP loan. As a result of the possibility that the federal government could hold the debtors legally liable for knowingly using the PPP funds for unauthorized purposes, the debtors could not spend the PPP loan in the ordinary course without potential exposure to liability. Further, the debtors faced uncertainty with the future of the PPP program.

After Congress enacted the PPP program, it changed key provisions such as those relating to the maturity of PPP loans, deferral of PPP loan payments, and forgiveness of PPP loans. Congress could further change the program's provisions again at any time. In short, the debtors could no longer use the PPP loan for its specific purpose and sought to repay it before any potential changes to the debtors' liability because of congressional action. The unsecured creditors committee (UCC), however, raised informal objections, arguing that the PPP loan is an unsecured loan and should be treated the same as all other unsecured claims rather than being repaid in full.

To resolve the dispute and avoid costly litigation regarding the repayment of the PPP funds and the treatment of the unused PPP funds as estate property, the debtors, the UCC, the SBA lender, and the SBA reached an agreement. The agreement is memorialized in the debtors' plan of liquidation.

Under the plan, the unused PPP funds will be available for distribution to creditors. The claims that would constitute "authorized uses" of PPP funds under the CARES Act and SBA guidance, not including those entitled to administrative expense treatment, are classified in Class 3. All other general unsecured claims are classified separately in Class 4. Both classes will share pro rata in the cash remaining in the estate, including the PPP funds, after payment of senior claims, provided that holders of Class 3 claims will receive an aggregate distribution in an amount not less than $3 million.

Conclusion

The alternative to settling the PPP funds issue would be costly and protracted litigation. At the conclusion of such litigation, a court could hold that the PPP loan is an unsecured loan. If that were determined to be the case, the PPP claims would need to receive the same treatment as other unsecured claims. This would be a logical conclusion for a court to draw because the SBA regulations do not place restrictions on the use of PPP loan funds. Those regulations instead affect the ability of the borrower to qualify for forgiveness.

There is no guarantee that the agreement set forth in the Cosmoledo plan will be adopted in every case. The SBA in future cases maintains the discretion to take a different negotiating stance than the one they took in the Cosmoledo case. In addition, parties such as the unsecured creditors committee in other cases might not agree to settle, potentially leading to extensive litigation in the federal courts. Nevertheless, the plan in the Cosmoledo case sets forth a valuable framework for debtors that have unused PPP funds and are seeking to confirm a plan of liquidation without costly and protracted litigation.

