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As Seen In **The National Law Review** June 10, 2020

SBA Rulemaking and Guidance Challenged in Federal Lawsuits in Connection with PPP Loan Guidance

The Coronavirus, Aid, Relief, and Economic Security Act (the "CARES Act") was signed into law by the President on March 27, 2020. Title I of the CARES Act, named "Keeping American Workers Employed and Paid" by Congress, appropriated $659 billion for loans guaranteed by the Small Business Administration ("SBA") under the Paycheck Protection Program ("PPP").

Section 1114 of the CARES Act instructs the SBA to issue regulations "to carry out this title and the amendments made by this title" within fifteen days and without regard to the usual notice requirements, which the SBA did in the form of Frequently Asked Questions (the "FAQs"). 15 U.S.C. §§ 9001(1), 9012.

While ostensibly intended to clarify uncertainty in the CARES Act, two recent federal lawsuits challenge certain rulemaking and guidance promulgated by the SBA. The question before the courts is whether such rulemaking and guidance is a lawful interpretation of the CARES Act or, as the plaintiffs argue, amounts to illegal rulemaking.

Agencies are prohibited by the Administrative Procedures Act from taking action "in excess of statutory jurisdiction, authority, or limitations, or short of statutory right." 5 U.S.C. § 706(2)(C). The validity of an agency's interpretation of a statute is reviewed by a court using the two-step framework outlined in the landmark case, *Chevron, U.S.A., Inc. v. Natural Res. Defense Council, Inc.*, 467 U.S. 837 (1984). The first question reviewed in the *Chevron* analysis is, "whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." *Chevron*, 467 U.S. at 842–43.

The plaintiffs argue that certain elements of the SBA guidance did not give effect to the unambiguously expressed intent of Congress and, as a result, are unlawful and unenforceable.

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DV Diamond Club of Flint v. SBA

DV Diamond Club of Flint LLC ("DV Diamond") is a strip club in Flint, Michigan, which feared that it would be denied a PPP loan by lenders as a result of guidance from the SBA that is not consistent with the CARES Act. DV Diamond's initial complaint, dated April 8, 2020, was amended on April 17, 2020 to add forty-one new co-plaintiffs (collectively with DV Diamond, the "Plaintiffs"), each of whic h claims to operate a legal sexual oriented business which meets the eligibility requirements under the CARES Act. The Plaintiffs argue that the CARES Act is unambiguous as to what businesses are eligible for PPP loans and the SBA, therefore, has no right to assert additional eligibility requirements or disqualifiers. *See DV Diamond Club of Flint, LLC v. U.S. SBA*, 20-cv-10899, 2020 U.S. Dist. LEXIS 82213, at *27 (E.D. Mich. May 11, 2020).

The U.S. District Court for the Eastern District of Michigan (the "District Court") issued an injunction in favor of the Plaintiffs, noting that Congress unambiguously stated that the SBA may not exclude from eligibility for a PPP loan guarantee a business that met the CARES Act's size standard for eligibility. *Id*. at *27.

The District Court agreed with the Plaintiffs that, "under step one of *Chevron* that the PPP Ineligibility Rule conflicts with the PPP and is therefore invalid." *Id*. at *42.

"Congress provided temporary paycheck support to all Americans employed by all small businesses that satisfied the two eligibility requirements—even businesses that may have been disfavored during normal times." *Id*. at *4-5.

The Sixth Circuit Court of Appeals denied the SBA's motion for a stay of the injunction, holding that the relevant factors, including the Plaintiff's likelihood success, weighed in favor of the Plaintiff. *DV Diamond Club of Flint, LLC v. SBA*, No. 20-1437, 2020 U.S. App. LEXIS 15822, at *8 (6th Cir. May 15, 2020).

Zumasys, Inc. v. SBA

Zumasys and two affiliated companies (collectively, "Zumasys") received PPP loans but are concerned that they may subsequently be deemed ineligible as a result of "improper, and legally impermissible, underground regulation" promulgated by the SBA. (*Zumasys, Inc. v. U.S. SBA et al.*, Dkt. No. 20-cv-008511, Dkt. 1 (the Zumasys Complaint) ¶ 58.)

Zumasys claims to have acted in reliance on the CARES Act by obtaining—and spending—what they expected to be forgivable PPP funds under the terms of the CARES Act rather than furloughing or terminating their employees. Subsequently, guidance set forth in questions 31 and 37 of the SBA's Frequently Asked Questions, according to Zumasys, might require their loans to be repaid. Zumasys claims that being forced to repay their loans will place them in a worse financial position than had it never sought the PPP funds.

The SBA's "credit elsewhere" test, which requires a borrower to demonstrate that the needed financing is not otherwise available on reasonable terms from non-governmental sources, was expressly excluded as an eligibility requirement to obtain a PPP loan by Congress. Zumasys alleges, however, that the FAQs "purport to re-impose the "credit elsewhere" requirement in contravention of" the CARES Act. (*Id*. ¶ 66.)

As a result, in an argument similar to that made by DV Diamond and its co-plaintiffs, Zumasys asserts that the FAQs "are not in accordance with the law and exceed Defendants' authority under the CARES Act," and asks that the SBA should be enjoined from enforcing them by the court. (*Id*.)

Subsequent to the filing of the Zumasys lawsuit, on May 13, 2020, the SBA issued guidance in question 46 in the FAQs that any borrower that, together with its affiliates, received PPP loans with an original principal amount of less than $2 million will be deemed to have made the required certification concerning the necessity of the loan request in good faith.

While this development, on its face, would seem to alleviate the concerns of Zumasys, a great deal of uncertainty remains for borrowers in connection with the guidance that has been released by the SBA since the passing of the CARES Act into law. Furthermore, there is no guarantee that subsequent guidance from the SBA will not contradict the guidance currently being relied upon, and in FAQ 39 the SBA noted that it will review all loans in excess of $2 million and in subsequent rulemaking it noted that with respect to a PPP Loan of any size, the "SBA may undertake a review at any time in [the] SBA's discretion."

Conclusion

The challenges by DV Diamond, Zumasys and other plaintiffs will hinge on whether or not the applicable courts determine that the guidance issued by the SBA is inconsistent with the unambiguously expressed intent of Congress.

To the extent that borrowers and applicants continue to believe that problematic discrepancies exist between the law and guidance being delivered by the SBA, and the SBA subsequently determines that a borrower is ineligible for a PPP loan or forgiveness of such loan, the courts may in the future be called upon again to apply the *Chevron* analysis to the SBA's actions in connection with the PPP.