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APA challenges to the PPP loan program thwarted by courts and Congress; but a narrow path remains for borrowers

By Morgan C. Nighan, Carolyn G. Nussbaum, Eric M. Ferrante, and Richard M. Price

Last week, the United States Court of Appeals for the Second Circuit upheld loan eligibility restrictions imposed by the U.S. Small Business Administration (the "SBA") on certain borrowers under the Paycheck Protection Program ("PPP"). The SBA's regulation precludes businesses in certain industries from participating in PPP. The Second Circuit rejected claims that such restrictions run afoul of the Administrative Procedure Act (the "APA") and the First and Fifth Amendments to the U.S. Constitution.

Borrowers outside of the Second Circuit may still be able to challenge the application of the SBA's eligibility restrictions to loans taken prior to August 8, 2020. However, borrowers who took loans under the PPP program pursuant to the Economic Aid Act will have a harder time challenging the application of this regulation because Congress expressly incorporated it into the law.

Overview

Pharaohs GC, Inc. ("Pharaohs"), a "gentleman's club" that features nude dancing, was forced to close in response to the COVID-19 pandemic following New York Governor Andrew Cuomo's order, in March 2020, that required the closure of most "non-essential" businesses in the state. As the pandemic raged across the country, Congress passed the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"), creating the PPP, and authorizing the SBA to guarantee loans to small businesses affected by the pandemic.[1] Pursuant to the CARES Act, 15 U.S.C. § 9012, the SBA Administrator promulgated several interim final rules to administer the PPP program. The first of these rules imported the restrictions on participation in section 7(a) loans—the SBA's primary program for providing financial assistance to small businesses—into the eligibility requirements for PPP loans. 85 Fed. Reg. at 20,812 (incorporating 13 C.F.R. § 120.110 restrictions on eligibility for certain "types of businesses"). As a result, businesses that "[p]resent live performances of a prurient sexual nature" (the "prurience restriction"), like Pharaohs, were precluded from accessing PPP loans. 13 C.F.R. § 120.110.

[1] Pub. L. No. 116-136, § 1102, 134 Stat. 281, 286-94 (2020) (codified at 15 U.S.C. § 636(a)).

When Pharaohs' lender informed it that its PPP loan application would be rejected because of the "prurience restriction," Pharaohs sued the SBA in the United States District Court for the Western District of New York, seeking a preliminary injunction restraining the SBA from imposing the "prurience restriction" on PPP loan applicants. Pharaohs made two distinct arguments in seeking a preliminary injunction against the SBA: (1) the regulatory "prurience restriction" is unlawful under the APA, 5 U.S.C. § 706(2)(C), because it is an inconsistent limitation with the statutory CARES Act's express direction that "any business concern . . . shall be eligible" for a PPP loan; and (2) the restriction is an impermissible burden on nude dancing, a protected form of expression. The District Court denied Pharaohs' request for injunctive relief, concluding that Pharaohs had failed to establish that either of its arguments had a substantial likelihood of success on the merits. On March 4, 2021, the Second Circuit affirmed.

Discussion and implications

The Second Circuit's APA analysis

The Second Circuit first rejected Pharaohs' argument that the regulatory "prurience restriction" violates the APA because it is inconsistent with the CARES Act's express statutory eligibility requirements. In doing so, the court found that the SBA was authorized to adopt eligibility restrictions, pointing to the CARES Act's language that "the [SBA] may guarantee [PPP] loans under the same terms, conditions, and processes" as a section 7(a) loan "except as otherwise provided." *Pharaohs GC, Inc. v. Small Business Administration,* No. 20-2170-cv, 2021 U.S. App. LEXIS 6297, at *8 (2d Cir. Mar. 4, 2021) (citing 15 U.S.C. § 636(a)(36)(B)). This language, the court explained, "unambiguously gives the Administrator discretion to adopt the longstanding [restrictions on eligibility] of the 7(a) program." *Pharaohs,* at *9-10. Thus, the court concluded that when the CARES Act language is read in the broader context of the existing section 7(a) loan program—which Congress was presumed to know when drafting legislation—Pharaohs' interpretation that "any business concern" must mean "*every* business concern" is untenable. *Id.* at *10 (emphasis added).

The Second Circuit further explained that Pharaohs' interpretation could not be accepted because the CARES Act specifically lifts SBA regulations requiring collateral and personal guarantees by waiving the usual section 7(a) requirement that borrowers not be able to obtain credit elsewhere. *Id.* at *11. The court observed that, if the SBA did not have the authority to exclude businesses from the PPP, these provisions of the CARES Act would be "superfluous." Likewise, while nonprofits are ineligible for section 7(a) loans, the CARES Act expressly authorized charitable entities to participate in the PPP. *Id.* at *11-12. Congress did not, however, express a similar intention with respect to other limitations on participation in the section 7(a) program, "strongly suggest[ing] that Congress deliberately chose not to change the [SBA's] statutory discretion to exclude businesses, other than those it expressly identified in the CARES Act." *Id.* at *12.

In short, the Second Circuit concluded that the CARES Act language providing that "any business" with less than 500 employees is eligible for a PPP loan "must be understood as simply raising the employee threshold defining eligibility for small business relief to 500 and including a few other kinds of employers in the [PPP] Program, like nonprofit organizations and sole proprietors." *Id.* at *12-13. Thus, under the Second Circuit's analysis, the CARES Act "does not require the [SBA] to make eligible *all* businesses below that threshold"; instead, the SBA may impose all of the same eligibility requirements as apply to the traditional section 7(a) program except those expressly eliminated for PPP purposes in the CARES Act. *Id.* at *13 (emphasis in original).

The Second Circuit's Pharaoh decision creates a conflict with the Sixth Circuit

The Second Circuit's decision in this regard runs counter to an earlier decision from the United States Court of Appeals for the Sixth Circuit in *DV Diamond Club of Flint, LLC v. Small Business Administration,* 960 F.3d 743 (6th Cir. 2020). In that case, decided in May 2020, the Sixth Circuit denied a stay of enforcement of a preliminary injunction enjoining the SBA from applying the "prurience restriction" to a Michigan-based gentleman's club's PPP loan application. There, the Sixth Circuit concluded that the SBA could not establish a likelihood of success on appeal because "Congress made clear that the SBA's longstanding ineligibility rules are inapplicable given the current circumstances" when it specified that "any business concern" was eligible for a PPP loan. *Id.* at 746-47. The Sixth Circuit further concluded that the CARES Act language specifying that the SBA "may guarantee covered loans under the same terms, conditions, and processes" as traditional section 7(a) loans "likely constitutes a catch-all governing procedure otherwise unaffected by the mandate of the CARES Act and the PPP and does not detract from the broad grant of eligibility." *Id.* at 747.

The Second Circuit distinguished *DV Diamond Club* on a procedural point without addressing the substance of the Sixth Circuit's decision. Because the District Court had granted a preliminary injunction, the SBA asked the Sixth Circuit to stay the injunction until the merits of its appeal were decided, it was the SBA that bore the burden in *DV Diamond Club* to show its entitlement to the extraordinary remedy of injunctive relief. *Pharaohs,* 2021 U.S. App. LEXIS 6297 at *13 n.4. In contrast, Pharaohs had the burden to show it was entitled to the injunctive relief it was seeking. *Id.*

Although the *Pharaohs* and *DV Diamond Club* could be interpreted to create a split between the Circuits, it is one that is likely to impact only a small handful of borrowers who received PPP loans prior to August 8, 2020. Those borrowers may still challenge the SBA's application of its ineligibility rule if they receive a denial of loan forgiveness on that basis. However, as we discussed in a prior alert, Congress likely mooted other similar challenges to the SBA's eligibility restrictions as imposed on PPP borrowers who have received loans under the most recent round of PPP funding under the Economic Aid to Hard-Hit Small Businesses, Nonprofits, and Venues Act (the "Economic Aid Act") by expressly incorporating the pre-existing regulations containing them into the Economic Aid Act's statutory language.

The Second Circuit's constitutional analysis

While the Second Circuit's analysis of Pharaohs' constitutional arguments is less likely to apply to a large swath of otherwise ineligible PPP borrowers, it is interesting nonetheless.

First, the court rejected Pharaohs' argument that the "prurience restriction" impermissibly regulates protected speech. In reaching this conclusion, the court explained that the restriction is not subject to strict scrutiny—and instead only must satisfy the more lesser scrutiny of rational-basis review—because nude dancing "involves 'only the barest minimum of protected expression," *id.* at *14-15 (quoting *Doran v. Salem Inn, Inc.*, 422 U.S. 922, 932 (1975)), and because the restriction represented a permissible funding condition that set the scope of a government subsidy as opposed to a funding condition that amounts to a backdoor regulation of speech. *Id.* In other words, the "prurience restriction" represents, according to the Second Circuit, a permissible exercise of Congress's authority to "specify the activities [it] wants to subsidize." *Id.* Thus, Pharaohs was required to demonstrate that the justifications that "might support" the regulation lacked any rational relationship to a legitimate government interest. Pharaohs was unable to meet this requirement.

Second, the court rejected Pharaohs' argument that the "prurience restriction" represented viewpoint-based discrimination because "prurience" is not a viewpoint. Instead, the court explained, "prurience" is a content-based restriction that can be restricted, under the rational-basis standard, so long as the restriction has a rational relationship to a legitimate government interest. *Id.* at *19-21.

Conclusion

The Second Circuit's decision in *Pharaohs* means that potential PPP borrowers in New York, Connecticut, and Vermont that are restricted from eligibility for section 7(a) loans are likely out of luck and will continue to be ineligible for PPP loans. Those restrictions include foreign businesses, "[p]yramid sale distribution plans," "[s]peculative businesses (such as oil wildcatting)," businesses with an associate indicted for a felony or crime of moral turpitude, "[b]usinesses primarily engaged in political or lobbying activities," and, as discussed herein, businesses that "[p]resent live performances of a prurient sexual nature." 13 C.F.R. § 120.110. However, as noted above, the *Pharaohs* decision is unlikely to impact any new PPP borrowers under the Economic Aid Act because Congress made sure to clear up any confusion or basis to argue ambiguity by expressly declaring in the statute that those entities covered by the 13 C.F.R. § 120.110 restrictions are also ineligible for the latest round of PPP funding. A narrow path remains for borrowers outside of the Second Circuit to challenge the application of the eligibility restriction for PPP loans taken prior to August 8, 2020.

For more information on the content of this alert, please contact your Nixon Peabody attorney or:

- Morgan C. Nighan, 617-345-1031, mnighan@nixonpeabody.com
- Carolyn G. Nussbaum, 585-263-1558, cnussbaum@nixonpeabody.com
- Eric M. Ferrante, 585-263-1362, eferrante@nixonpeabody.com
- Richard M. Price, 202-585-8716, rprice@nixonpeabody.com