# Considerations for Businesses with Outstanding PPP Loans in M&A Transactions

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On October 2, 2020, the U.S. Small Business Administration (the "SBA") issued Procedural Notice (5000-20057), titled "*Paycheck Protection Program Loans and Changes of Ownership*" (the "Notice"). The Notice sets forth the steps that must be taken when the recipient of a Paycheck Protection Program ("PPP") loan intends to engage in a transaction considered by the Notice to be a change of ownership.

Although continuing to leave some questions unanswered, the Notice provided much-needed guidance to PPP borrowers and lenders, acquirers and M&A practitioners at a critical time for M&A activity. This article provides a refresher of the Notice, as originally summarized in a Lathrop GPM legal alert on October 14, 2020 by Business Transactions Practice Group members Bill Klein and Daryn McBeth, and considerations for PPP borrowers that are considering or in the process of a change of ownership.

**Overview of SBA Procedural Notice (5000-20057)**

Under the Notice, a "change of ownership" occurs when: (1) at least 20% of the common stock or other ownership interest of a PPP borrower (the "Borrower"), including a publicly traded entity, is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity; (2) the Borrower sells or otherwise transfers at least 50% of its assets, measured by fair market value, whether in one or more transactions; or (3) a Borrower is merged with or into another entity.

The procedures to be followed upon a change of ownership differ depending upon the status of the PPP loan (the "Loan") and the type of ownership change, as follows:

1. **The Loan is fully satisfied**. The SBA does not impose any restrictions on a change of ownership if, prior to closing the sale or transfer, the Borrower has:
    1. Repaid the Loan in full; or
    2. Completed the loan forgiveness process in accordance with PPP requirements and (i) the SBA has remitted funds to the PPP lender (the "Lender") in full satisfaction of the Loan or (ii) the Borrower has repaid any remaining balance on the Loan.

2. **The Loan is not fully satisfied**. If the Loan is not fully satisfied prior to the closing of the change of ownership:

1. Instances in which SBA prior approval is not required. The Lender may approve the change of ownership, and the SBA's prior approval is not required, if the following conditions are met:
    1. *Change of ownership is structured as a sale or other transfer of common stock or other ownership interest or as a merger*. An individual or entity may sell or otherwise transfer common stock or other ownership interests in a Borrower without the SBA's prior approval only if:
        1. The sale or other transfer is of 50% or less of the common stock or other ownership interest of the Borrower (aggregating all sales and other transfers occurring since the approval date of the Loan); or
        2. The Borrower completes a forgiveness application reflecting its use of all of the Loan proceeds and submits it, together with any required supporting documentation, to the Lender, and an interest-bearing escrow account controlled by the Lender is established with funds equal to the outstanding balance of the Loan. After the forgiveness process, including any appeal of the SBA's decision, is completed, the escrowed funds must be disbursed first to repay any remaining Loan balance, plus interest.
    2. *Change of ownership is structured as an asset sale*. A Borrower may sell 50% or more of its assets, measured by fair market value, without the prior approval of the SBA, only if the Borrower completes a forgiveness application reflecting its use of all of the Loan proceeds and submits it, together with any required supporting documentation, to the Lender, and an interest-bearing escrow account controlled by the Lender is established with funds equal to the outstanding balance of the Loan. After the forgiveness process, including any appeal of the SBA's decision, is completed, the escrowed funds must be disbursed first to repay any remaining Loan balance, plus interest.
2. Instances in which SBA prior approval is required. If a Borrower's change of ownership does not meet the conditions of paragraph 2.a. above, then the Lender cannot unilaterally approve the change of ownership, and prior SBA approval of the change of ownership is required. The Lender is responsible for submitting the request to the appropriate SBA Loan Servicing Center, and the SBA has 60 calendar days from receipt of a complete request to review and provide a determination. This article is focused on Borrowers that are able to satisfy the conditions of paragraph 2.a. above. For a complete list of requirements applicable to transactions requiring prior SBA approval, please see the Notice.

The foregoing is only a summary of certain provisions of the Notice. For the complete text of the Notice, visit: https://www.sba.gov/sites/default/files/2020-10/5000-20057-508.pdf.

**M&A Considerations for Borrowers in Light of SBA Procedural Notice (5000-20057)**

While the treatment of Loans in a change of ownership may evolve as additional guidance is issued by the SBA, what follows is a high-level summary of considerations for Borrowers that are considering, or are in the process of, a change of ownership for which prior Lender approval is required.

- **Involve the Lender early in the transaction process**. Prior to the closing of the change of ownership, the Notice states the Borrower must notify its Lender in writing of the contemplated change of ownership and provide its Lender with a copy of the proposed agreement(s) or other document(s) that will effectuate the proposed change of ownership. Generally speaking, involved parties will prefer to bring the Lender "into the know" early in the transaction process rather than scrambling to address PPP matters immediately prior to closing. Moreover, early involvement of the Lender facilitates additional time for the preparation and negotiation of the PPP Escrow Agreement (the "Escrow Agreement") and compliance with the underlying provisions of the Loan documents, as discussed below.
- **Consider the content of the Escrow Agreement**.
  - *Amount to be escrowed.* The PPP escrow agent (more often than not, this is also the Lender) frequently has a preferred form of Escrow Agreement. The Escrow Agreement will be entered into by the PPP escrow agent, the Lender and the Borrower and will state the amount of funds to be escrowed. Pursuant to the Notice, the escrowed funds must equal the outstanding balance of the Loan. In most cases, however, either the Lender or acquirer wants the escrowed funds to include some amount of interest beyond the closing date. The Borrower typically prefers this as well, because then it does not have to replenish the escrow account if the funds are insufficient. The amount of interest to be escrowed varies and may be anywhere from 60 days post-closing to the entire amount of interest payable on the Loan. However, because the interest rate on Loans is low, the inclusion of interest in the escrowed amount is typically not significant in the overall transaction.
  - *Lender consent.* If not captured in a stand-alone document, the Escrow Agreement should incorporate the Lender's consent to the change of ownership. The consent includes not only the consent contemplated by the Notice, but also any consent that may be required by the underlying Loan documents. Most Loans provide that a change of ownership or certain other changes with respect to the Borrower are a default under the Loan, unless the Lender's prior written consent is obtained.
  - *Release of funds.* The party or parties to whom the escrowed funds are to be released will be stated in the Escrow Agreement. Assuming some or all of the Loan is forgiven, a seller generally prefers that any forgivable amounts remaining in the escrow account be released directly to it, rather than to the buyer. This eliminates the seller waiting on the buyer to receive the funds and then releasing them to the seller.
  - *SBA notification.* Finally, the Escrow Agreement will preferably call out the Lender's obligation under the Notice to provide information about the transaction to the appropriate SBA Loan Servicing Center within five business days of completion. In the case of a change of ownership structured as a sale or other transfer of common stock or other ownership interest or as a merger, the Lender must provide: (i) the identity of the new owner(s) of the common stock or other ownership interest; (ii) the new owner(s)' ownership percentage(s); (iii) the tax identification number(s) for any owner(s) holding 20% or more of the equity in the business; and (iv) the location of, and the amount of funds in, the escrow account under the control of the Lender. In the case of a change of ownership structured as an asset sale, the Lender must provide the location of, and the amount of funds in, the escrow account.
- **Consider the implications of the Loan on the definitive documentation**.

- *Representations and warranties.* A buyer will require certain assurances to be provided with respect to the Loan in the purchase agreement in the form of representations and warranties. Such representations and warranties are likely to address the Borrower's eligibility to receive a Loan, the Borrower's usage of Loan proceeds, the accuracy of any information provided and certifications made in any application, including the Loan forgiveness application, and the Borrower's compliance with the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act"). The scope of these representations and warranties, however, will likely vary depending upon whether the transaction is an equity or asset sale, and in the case of the former, will hold greater significance to a buyer and may therefore be more expansive.
- *Covenants.* The Notice provides that regardless of any change of ownership, the Borrower remains responsible for: (1) performance of all obligations under the Loan; (2) the certifications made in connection with the Loan application, including the certification of economic necessity; (3) compliance with all other applicable PPP requirements; and (4) obtaining, preparing and retaining all required PPP forms and supporting documentation and providing those forms and supporting documentation to the Lender or the SBA upon request. Therefore, particularly in the case of a change of ownership structured as a sale or other transfer of common stock or other ownership interest or as a merger, in which the buyer will control the Borrower post-closing, a seller may want covenants from the buyer in the definitive documentation regarding the operation of the Borrower's business post-closing insofar as it relates to PPP matters. Such covenants may include that until such time as the Loan is either forgiven or paid in full, the buyer will: maintain the Borrower as a separate legal entity; take reasonable steps to comply with the terms and conditions of the Loan, the CARES Act and other applicable laws; refrain from taking any actions intended to result in non-forgiveness of the Loan or a determination of Borrower's ineligibility for the Loan; and take any actions reasonably requested by the seller to result in full forgiveness of the Loan.

  The Borrower might also consider negotiating covenants relating to an SBA audit or review (an "Audit"). At any time while a Loan is outstanding, the SBA may elect to Audit the Borrower with respect thereto. In a situation in which the buyer controls the Borrower post-closing, the seller will generally want to participate in the Audit, and in some cases, may want to assume and control the defense of the Audit and represent the Borrowers' interests before the SBA. Typically, this is at the seller's expense, with the buyer having a right to participate at its own expense and with separate counsel. More specific parameters regarding Audits will be as negotiated among the parties.
- *Indemnification.* Additionally, a buyer may require a specific indemnity for Loan matters. Such an indemnity may read something to the effect of, "*any losses relating to the Loan, the Borrower's application therefor or its receipt thereof, and any PPP audit*," or may be more detailed, such as "*all liabilities sustained or incurred by any buyer indemnified party, directly caused by, relating to, arising out of, resulting from, or attributable to (A) the Borrower's application for and receipt of the Loan, (B) any non-compliance or failure of the Borrower to comply with the terms of the Loan or any other government relief program arising out of or relating to COVID-19 or any COVID-19 measures (including any future determination that the Borrower was ineligible to participate in such programs), (C) any breach by the Borrower of any representation or covenant in any Loan document, and (D) any inability of the Borrower to obtain Loan forgiveness due to the improper use of Loan proceeds or otherwise*." In any event, the language of a PPP-specific indemnity clause should be carefully

reviewed and negotiated by the Borrower's counsel in light of the Loan characteristics and status and the overall transaction terms.

For more information, contact Lindsey Day, Business Transactions Practice Group leader Mark Williamson, or your regular Lathrop GPM contact.