

October 7, 2020

Buying and Selling PPP Borrowers

Christine Hoke, Adam Tejada, Rick Giovannelli,



AGENDA

- PPP Background and Loan Life Cycle
- Due Diligence Approach
- Purchase Price Considerations
- Lender and SBA Consent Issues
- Stock vs Asset Considerations
- Buyer Financing Issues

- ***Q&A: If you have questions, go ahead and jump in. Use the chat bar NOW or at any time to ask them.***

ERUPTION OF PPP LOANS

- More than 5.2 million US businesses received PPP loans

Loan Size	Loan Count	Net Dollars	% of Count	% of Amount
\$50K and Under	3,574,110	\$62,742,565,653	68.6%	12.0%
>\$50K - \$100K	683,785	\$48,676,961,052	13.1%	9.3%
>\$100K - \$150K	294,557	\$36,058,010,813	5.7%	6.9%
>\$150K - \$350K	377,797	\$84,782,932,509	7.2%	16.1%
>\$350K - \$1M	199,679	\$113,558,427,234	3.8%	21.6%
>\$1M - \$2M	53,218	\$73,887,171,387	1.0%	14.1%
>\$2M - \$5M	24,248	\$72,184,996,045	0.5%	13.7%
>\$5M	4,734	\$33,121,136,431	0.1%	6.3%

*** Overall average loan size is: \$101K.**



PPP BACKGROUND AND DILIGENCE POINTS

PPP loan size, program terms and requirements drive scope of buyer's dive down into diligence



KEY QUESTIONS RE PPP TARGETS

- Size of PPP loan?
 - Is it material?
 - What is the size of the PPP **relative** to the M&A deal value?
 - Is it more than the \$2M audit threshold (incl. any PPP loans to affiliates)?
- TIMING is critical and will drive many issues
- Where is the target in the PPP loan life cycle?
 - When was the loan funded?
 - Is target using an 8 week or 24 week covered period?
 - Has it used all PPP proceeds?
 - Is it still in that covered period?
 - If not, has the borrower applied for forgiveness? Can it?
 - If so, has it received a response from its lender?
 - If so, has it received a response from SBA?

Orange font denotes key diligence items throughout deck



PAYCHECK PROTECTION PROGRAM (PPP)

- **WHAT:** A *potentially* forgivable loan
 - Created under CARES Act
 - Bolted onto existing Small Business Administration (SBA) 7(a) program
- **WHO:** Eligible businesses and nonprofits:
 - “Small businesses”
 - Not more than 500 employees;
 - Met the applicable NAICS standard (revenue or employee); or
 - Met the “alternative size standard”: (<\$5M NI, \$15M TNW).
 - Size includes “affiliates” (BIG issue for PE and VC portfolio companies)
 - Not in impermissible business (lending, RE, sin (running with the devil), etc.)
 - **NEED:** “Current economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant”
- **WHEN:**
 - PPP 1.0: March 27 – June 5, 2020
 - PPP 2.0: June 6 – August 8, 2020

PPP LOAN TERMS

- **Amount:** Up to 2.5X 2019 monthly “payroll costs”
 - Caps: \$10M per borrower
\$20M per “corporate group”
- **Interest:** 1.0%, deferred until forgiveness determination,
 - IF borrower applies within 10 months after covered period
- **Maturity** (of unforgiven amounts):
 - PPP 1.0: 2 years, **unless amended to be 5 years**
 - PPP 2.0: 5 years
- Unsecured, no personal guaranty
 - **BUT!** Recourse to (old AND new) owners if they use funds improperly

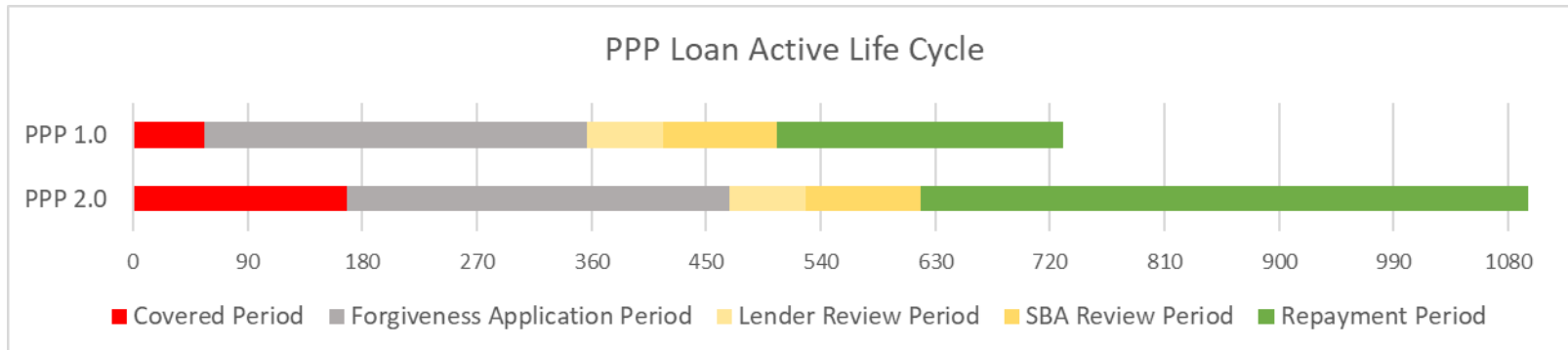
PPP USE OF PROCEEDS & FORGIVENESS

- PPP proceeds may only be used for:
 - At least 60% must be used for “payroll costs”
 - Rent, utilities, interest on “mortgage loans” incurred before Feb 15
 - Interest on non-mortgage debt incurred before Feb 15
 - **But!** Non-mortgage debt payments do not count toward forgiveness.
- PPP loan is forgivable to the extent of:
 - Forgivable uses of proceeds during the “covered period”
 - PPP 1.0: 8 weeks, with a borrower option to extend to 24 weeks (or 12/31/20, if earlier)
 - PPP 2.0: Ends earlier of 24 weeks from loan disbursement or 12/31/20
 - **BUT!** Forgiveness reduced if during covered period, borrower reduces:
 - FTE levels
 - Salary or hourly wage levels
- Key diligence docs: PPP loan & forgiveness apps, loan docs, records.

FORGIVENESS PROCESS & TIMING

- Borrower submits forgiveness application to lender
 - Can submit prior to expiration of covered period, BUT!
 - FTE & salary/wage reduction measures apply to whole covered period
 - Not clear how FTE and salary/wage reductions survive / continue
 - Deadline: final maturity of loan, BUT!
 - Loan payments start 10 months after covered period, if no app.
- **Lender** must send decision to SBA within **60 days**
- **SBA** has **90 days** to review & **will review all loans >\$2M of original principal**
 - “And other loans as appropriate”
 - Borrowers **self report** if they **& affiliates** received loans > \$2M
 - **Original principal** (can't prepay to \$1.99M to avoid review)
- Appeal process

PPP “ACTIVE” LIFE CYCLE



- **Covered Period:**
 - PPP1.0: 8 weeks*
 - PPP 2.0: 24 weeks (or 12/31/20)
 - Determines forgiveness amount:
 - Use of proceeds,
 - FTE, salary/wage levels
- **Forgiveness Application Period:**
 - 10 months after covered period
 - (Actually extends through maturity)
 - Most borrowers applying faster
- **Lender Review Period:**
 - 60 days
 - Tending to be much shorter
- **SBA Review Period:**
 - 90 days
 - No clarity yet on actual timing
- **Repayment Period** (unforgiven amounts)
 - PPP 1.0: 2 years*
 - PPP 2.0: 5 years

**Assumes no amendment of PPP 1.0 loans to 24-week covered period or 5-year maturity*

TAX BENEFITS OF DELAYING APPLICATION FOR FORGIVENESS

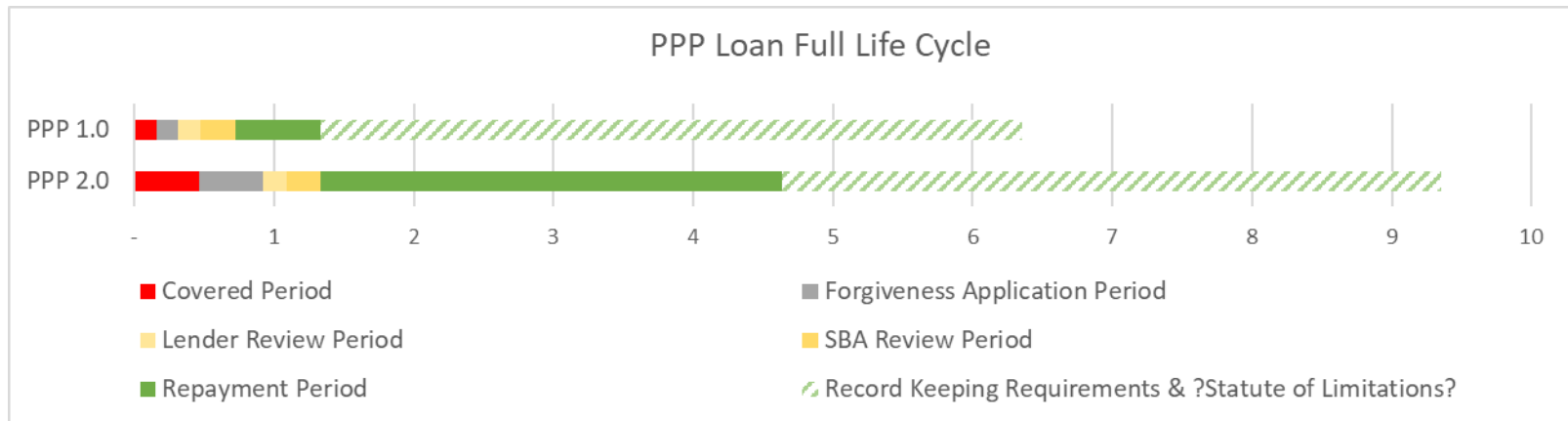
- PPP loan forgiveness is tax-free. However, in IRS Notice 2020-32, the IRS stated that that expenses associated with forgiven PPP loan are not deductible.
 - There is a push to change the IRS stated position.
- Taxpayers may still benefit from expense deduction even if such expenses are ultimately not deductible.
 - If taxpayer has not applied for or received a determination that a PPP loan is forgiven in 2020, it arguably should/could deduct the underlying expenses on its 2020 tax return
 - Corporate taxpayer in an NOL position can carryback 2020 NOLs for 5-years under the CARES Act. Current US federal corporate tax rate is 21%, prior to 2018 it was 35%.
 - If loan is forgiven in 2021, even if the IRS' position is correct, arguably taxpayer should be required to recapture the 2020 expenses under the so-called "tax benefit doctrine" into income in 2021 rather than amend a 2020 return. For corporate taxpayers that paid US federal income tax during CARES Act carryback period when corporate tax rates were 35%, this may result in a tax arbitrage.
 - Each tax-year stands on its own, so as long as taxpayer files 2020 tax return before receiving forgiveness determination, taxpayer arguably should be able to take this position. However, co-author of notice has been quoted as saying taxpayer should not take the deduction if it reasonably believes PPP loan will be forgiven
 - Corporate taxpayers that may benefit from this position should file 2020 tax returns/NOL carryback as soon as possible. If loan forgiveness (and potentially application for loan forgiveness) is determined prior to the 2020 tax return being filed, corporate taxpayer may have a weaker position and should consider any financial statement impacts of the position.



HOW LONG DO WE NEED TO WORRY ABOUT THIS?

*PPP loan risks do **not** end when the loan is forgiven
(and might not end when it is repaid).
You might still hear about it later.*

PPP FULL RISK SURVIVAL LIFESPAN



- **Covered Period:**
 - PPP 1.0: 8 weeks*
 - PPP 2.0: 24 weeks (or 12/31/20)
- **Forgiveness Application Period:**
 - 10 months after covered period
 - Most borrowers applying faster
- **Lender Review Period:** 60 days
- **SBA Review Period:** 90 days
- **Repayment Period** (unforgiven amounts)
 - PPP 1.0: 2 years*
 - PPP 2.0: 5 years
- **Survival Period: ~6 years**
 - After loan is forgiven and/or repaid
 - Borrowers must **retain records**
 - 6 years
 - From date of repayment or forgiveness
 - SBA retains right to review
 - False Claims Act SOL: 6 years
 - Probably from date of loan application
 - But borrowers **re-make certification** in forgiveness application

**Assumes no amendment of PPP 1.0 loans to 24-week covered period or 5-year maturity*



PURCHASE PRICE CONSIDERATIONS

Best of both worlds?

*In a “**debt-free**, cash-free” purchase price,
Seller doesn’t want to treat PPP loan as “**debt.**”*

PPP PURCHASE PRICE CONSIDERATIONS

- If PPP = **debt**, seller bears payoff amount
 - Repaid at closing, or
 - Retained by seller as an “excluded liability”
 - Requires lender, **and now SBA**, consent.
 - PPP loans are unsecured.
- If **not 100% debt**, who bears payoff and risk?
 - Repaid at closing, but buyer bears (as additional purchase price)
 - Assumed* by buyer, w/o reduction of seller proceeds.
 - Buyer bears cost and risk of forgiveness
 - Assumed* by buyer, w/ PPP loan balance in escrow
 - Seller bears cost and risk of forgiveness

*Assumed in an asset deal, or simply left in place in an equity deal.

TIMING DRIVES TREATMENT AND DOCS

Whether outstanding PPP loans will be “debt” and reduce purchase price may depend on where the PPP borrower is in the life cycle of the loan:

Timing of Signing:	Concerns	Treatment in Documents
<ul style="list-style-type: none"> ▪ “Covered Period” 	<ul style="list-style-type: none"> • Amount of forgivable loan is not determinable • Sellers may want credit for known forgivable amount (or more) • Operations <i>after</i> closing affect forgiveness <ul style="list-style-type: none"> • Seller wants control over <ul style="list-style-type: none"> • operations & • forgiveness process • Need Lender & SBA consent 	<ul style="list-style-type: none"> • <u>~Earnout provisions:</u> <ul style="list-style-type: none"> • Must buyer maximize forgiveness? • Use of proceeds • Maintaining or increasing FTE and/or salaries/wages • Will buyer agree to comply with other PPP requirements? • <u>~Third-party-claim provisions</u> <ul style="list-style-type: none"> • Control and cost of forgiveness process probably follows risk • Allocation of risk of claims

TIMING DRIVES TREATMENT AND DOCS

Whether outstanding PPP loans will be “debt” and reduce purchase price may depend on where the PPP borrower is in the life cycle of the loan:

Timing of Signing:	Concerns	Treatment in Documents
<ul style="list-style-type: none"> • Forgiveness Application Period 	<ul style="list-style-type: none"> • Maximum forgivable amount can be calculated • Sellers likely to resist repaying PPP “debt” • Need Lender & SBA consent 	<ul style="list-style-type: none"> • Best to have borrower apply pre-signing (or pre-closing) if possible • If not, Seller may want covenant that buyer will file for forgiveness • ~Third-party-claim provisions • Allocation of risk of claims
<ul style="list-style-type: none"> • Lender Review Period • SBA Review Period 	<ul style="list-style-type: none"> • Same as forgiveness period • Need Lender consent • May need SBA consent 	<ul style="list-style-type: none"> • ~Third-party-claim provisions • Allocation of risk of claims
<ul style="list-style-type: none"> • Repayment Period 	<ul style="list-style-type: none"> • Forgiveness amount has been finally determined • Full outstanding balance treated as debt and repaid at closing 	

ALLOCATION OF RISK IN DEAL DOCS

- Reps should cover key areas of material risk & diligence
 - RWI not covering PPP reps
 - Emerging “PPP insurance” product
 - Are PPP reps “fundamental”?
- Many buyers seeking special indemnity for:
 - PPP reps and/or
 - All PPP (*and CARES Act?*) risks
- Who bears risk of changes to PPP-related laws?
 - Closing conditions
 - Reps
 - MAE definition (“*changes in laws...*”)

MARKET APPROACH: CONTINGENT ESCROW

- Special PPP escrow:
 - Original PPP principal amount, **plus accrued interest** through:
 - At least closing date
 - Some cushion for expected forgiveness determination?
 - Additional cushion for expenses of obtaining forgiveness?
- Unforgiven amount **plus accrued interest** paid directly to PPP lender
 - New SBA safe harbor guidance (*Oct. 2*):
 - PPP lender must “control” this escrow account
 - Immediate repayment; buyer can’t amortize balance
- Buyer reimbursed for costs?
- Balance released to Seller (*forgiven principal & unused interest, cost amounts*)
- Seller generally bearing risk of PPP claims
- *EVOLVING Issues:*
 - *Is PPP escrow available for PPP-specific indemnity claims?*
 - *If so, is it retained beyond forgiveness determination? If so, for how long?*

OTHER COMMON APPROACHES

- **Split-the-difference:**
 - Loan is repaid at closing and parties share burden
 - Buyer pays a portion as additional purchase price
 - Seller reduces proceeds to cover the remaining loan amount
 - Approach likely to burn off as SBA Review Periods fade away
 - Works best when PPP loan is small relative to deal size

- **“Your loan, your problem”**
 - Buyer insists on an asset deal
 - Seller retains loan as an excluded liability
 - Seller bears full risk of forgiveness and compliance
 - Not possible during covered period
 - NOTE: New SBA Guidance makes this more challenging

- Driven by buyer concerns re **reputational risk** as much as legal risk



LENDER & SBA CONSENT REQUIREMENTS

Where have all the good times gone?

Current market practice may be obsolete as new SBA guidance provides clarity but also new obstacles.

LENDER & SBA CONSENT PROCESS

- SBA 7(a) SOP (servicing manuals) require SBA lenders to get SBA approval for:
 - Borrower asset sales
 - Borrower changes of ownership w/in first loan year
- PPP loans are 7(a) loans
- What lenders have been doing:
 - June-July: many consented without SBA approval (*oops*)
 - August-Sept: Most requested SBA consent
- What SBA has been doing:
 - Slow to respond, but
 - Consenting upon receipt of buyer information and loan escrow

NEW SBA PROCEDURAL GUIDANCE (10/2)

- **SBA consent required for most M&A deals unless:**
 - PPP borrower has **utilized all PPP proceeds**; and
 - PPP borrower **has submitted** a forgiveness application to lender; and
 - The parties establish an “interest-bearing” **escrow account**:
 - **equal to the outstanding PPP loan balance**
 - in an account “in the control of” the PPP lender.
 - Upon final forgiveness determination, escrowed funds must be applied:
 - First to the PPP lender re repay any unforgiven amount **plus interest**
 - Then, to seller or as parties have otherwise agreed.
 - Asset buyer **need *NOT* assume** PPP loan if in the above safe harbor
 - PPP lender to notify SBA of location & amount of required escrow w/in 5 business days of closing*

- *Safe harbor is unavailable to borrowers:*
 - *Still using PPP proceeds*
 - *Whose lenders have not opened their forgiveness portal*

NEW SBA PROCEDURAL GUIDANCE

- Unchained: No restrictions if PPP Loan fully discharged “prior to closing”
 - Via final forgiveness, repayment or a combination of the two
 - If PPP loan is being paid at closing, ensure that it is wired before sale proceeds

- Covered “changes of ownership”:
 - “Sales and other transfers” of “at least 20% of the **common stock or other ownership**” of PPP borrower,
 - Including transfers to affiliates or existing owners
 - Lenders may consent without SBA consent if transfers aggregate 50% or less
 - Public companies: only if 1 SH acquires 20% or more
 - Sales of more than 50% (by FMV) of **the assets** of the PPP borrower
 - In each case % captures one or more sales in the aggregate since the date of **approval** of the PPP loan.

- Unanswered questions:
 - Applicable to indirect ownership (e.g., sale of holdco equity)?
 - Primary issuances?
 - Outstanding vs. fully-diluted equity?
 - Voting vs. non-voting?

OTHER REQUIREMENTS

- Stock deals (even if lender or SBA consent is not required)
 - Borrower remains subject to all PPP requirements
 - New owners subject to recourse if proceeds misused on their watch
 - Buyers with PPP loans must ensure :
 - Proceeds of each PPP loan are segregated and
 - Segregated usage is properly documented.
 - *Presumably would apply to an **asset buyer** with its own PPP too?*

- Asset deals – ***only** if SBA consent is required*
 - Buyer **must assume** all PPP obligations
 - APA or separate assumption agreement must
 - expressly provide for assumption
 - be submitted to SBA

- If SBA consent required: “SBA may require **additional risk mitigation measures** as a condition of its approval of the transaction.”
 - *Probably not much more than escrow of full loan amount plus interest?*

REQUIRED SUBMISSIONS TO SBA

- If SBA consent is needed:
 - the reason that the PPP borrower “**cannot**”
 - **fully satisfy** the PPP note, or
 - or escrow funds
 - details of the transaction
 - a copy of the executed PPP Note
 - LOI **and purchase agreement** “setting forth responsibilities of parties”
 - whether buyer has an existing PPP loan and, if so, SBA loan number; and
 - a list of all owners of 20 percent or more of the purchasing entity

- For **all** stock transfers & mergers, even if SBA consent is not required (*even if less than 20%?*)*
 - Identity of the new equity owners
 - New owners’ ownership percentage
 - EINS for any owner(s) of at least 20% of the “equity”

*Must be provided w/in 5 business days of closing

FREEDOM OF INFORMATION ACT (FOIA)

- Info submitted to lender or SBA is subject to disclosure under FOIA
- Exception: confidential commercial information
- PPP borrowers and buyers should:
 - Request confidential treatment for all materials submitted in connection with PPP:
 - PPP loan forgiveness application & responses to SBA requests
 - Change of control requests
 - Mark such materials as confidential
 - BUT! No assurance it will be treated as confidential



STRUCTURAL CONSIDERATIONS

Beat it:

*Back to the drawing board on stock vs asset deals
in light of new SBA guidance*



EQUITY ACQUISITION CONSIDERATIONS

- **PPP borrowers & certain affiliates cannot use the Employee Retention Tax Credit (“ERTC”)**
 - Restriction applies even if the PPP loan is repaid or forgiven.
 - Key issue when large ERTC user buying small PPP borrower
 - Applies to controlled group treated as a single employer
- PPP loan may remain outstanding after closing
 - Subject to lender and SBA approval
- “Your loan, my problem”
 - Risk of PPP Borrower’s non-compliance runs with the entity.
 - Non-compliance liabilities remain even if PPP loan is repaid or forgiven.
- **Reputational & legal risk to buyer is heightened**

ASSET ACQUISITION CONSIDERATIONS

- Current market practice:
 - PPP loan & risks are excluded liabilities and retained by seller
 - Buyer thus remains eligible to claim the ERTC
 - Lower reputational & legal risk to buyer

- SBA Guidance: Buyer must **assume PPP loan** unless in consent safe harbor
 - ***Exactly the opposite of what buyers want***
 - ERTC not available to parties that have “received” PPP loan proceeds.
 - Not contemplated in statute, but assumption should not be deemed “receipt” of PPP proceeds
 - Liability assumption may not jeopardize ERTC from a technical and policy perspective.
 - Assumption was not possible during covered period if PPP loan not repaid
 - Seller FTE levels reduced by transferred EEs → reduces forgiveness
 - Impact of new SBA guidance? If buyer **assumes** PPP obligations:
 - Does it step fully into seller’s shoes re forgiveness?
 - Covered period continues uninterrupted on buyer’s watch?
 - FTE counts carry over to buyer?
 - Impact of buyer’s legacy expenses, FTE etc. on forgiveness?

KEY TAKEAWAYS

- Deals now more likely to follow one of two paths:
 - ***I'll Wait.*** Defer until target fully uses PPP proceeds, applies for forgiveness
 - ***Right Now.*** Close sooner, but buyer requires PPP loan to be repaid at close
 - Still an open business question to be negotiated as to who bears cost of payoff

- Use of SBA consent process likely disfavored
 - Requires buyer to assume all primary PPP risk in both stock & asset deals
 - RWI not available, but PPP insurance?
 - Buyers could require seller indemnity, with escrow backstop
 - Confidentiality concerns re:
 - Buyer ownership
 - Deal terms
 - SBA has 60-day review period
 - Could create extended sign-close gap
 - Notify lender early, communicate regularly and provide info ASAP



JUST OUTSIDE THE SAFE HARBOR: GOOD ENOUGH?

- What to do about already-closed deals that don't meet safe harbor?
 - Approach depends on status and what was done
 - Try to replicate safe harbor requirements after closing?
- Who bears risk of non-compliance with this SBA guidance?
 - **Lenders:**
 - SBA guidance: procedural notice to lenders
 - Lender may risk SBA not honoring guaranty
 - **PPP Borrowers:**
 - SBA guidance is not structured as IFR
 - Unclear if borrower forgiveness is at risk due to unauthorized consent by lender
 - If borrower closes without lender consent
 - Creates a default under most PPP notes
 - Forgiveness application does not require certification re compliance with PPP note
 - BUT! SBA still has flexibility to determine borrower did not meet “**necessary certification**”
 - **Buyers:** probably low risk, but:
 - Tortious interference claim by PPP lender?
 - Aiding & abetting FCA claim by SBA?
 - Merits? You got me. You really got me.



BUYER DEBT FINANCING CONSIDERATIONS

*Look before you Jump:
Leveraged buyers should consider impact
on their own non-PPP credit facilities
before assuming or taking a PPP loan.*

PPP LOANS & BUYER DEBT

- Consider PPP loan in light of existing (or acquisition) debt docs
- Key provisions in buyer debt docs:
 - PPP loans are “debt” (until forgiven):
 - Negative covenants (permitted debt baskets)
 - Financial covenant calculations
 - Key: If baskets are large enough and financial covenants work (for example, PPP debt is immaterial) then you may not want to address with your existing lender, unless:
 - Cross default
 - Unless a change of control consent is obtained from the PPP lender (and SBA), there may be a cross-default to the PPP loan

PPP LOANS & BUYER DEBT

- Typically existing lenders will agree to:
 - (i) a carveout (or stand-alone basket) for PPP debt; and
 - (ii) exclude PPP debt from financial covenant calculations so long as PPP loan is expected to be forgiven
 - If not forgiven (or any portion thereof) then such amounts will be considered debt for financial covenant purposes going forward
- Consider whether there is a need to address cross-default concerns

PPP LOANS & BUYER DEBT

- Concessions typically come with additional lender protections:
 - PPP funds have been/will be used in accordance with the CARES Act
 - Such PPP funds were used to maximize forgiveness (?)
 - Applications for forgiveness will be made promptly
 - Unforgiven amounts immediately repaid (?)
 - Copies and correspondence regarding PPP matters
 - No amendments to PPP documents
 - (or at least not adverse to existing lender)



QUESTIONS?



Rick Giovannelli
Partner
Charlotte
Tel: +1.704.331.7484
rick.giovannelli@klgates.com



Christine Hoke
Partner
Charlotte
Tel: +1.704.331.7495
christine.hoke@klgates.com



Adam Tejada
Partner
New York
Tel: +1.212.536.4888
adam.tejada@klgates.com



K&L GATES

Happy Trails To You
RIP Eddie Van Halen