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# Impact of the Paycheck Protection Program on M&A

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# PPP Primer – Overview/Reminder

- Payroll costs – “at least” 60% of expenditures
  - Gross salary, wage, commission, similar (limited to \$100,000/year)
  - Certain employee benefits – health insurance & retirement benefits paid by employer
  - State & local taxes assessed on compensation (i.e. unemployment)
- Other forgivable “covered” costs – “up to” 40% of expenditures
  - Mortgage interest on real and personal property (no pre-payments or payments of principal generally) (in place before 2/15)
  - Rent/lease payments on real and personal property (agreement in place before 2/15)
  - Utilities – electricity, gas, water, transportation, phone, internet (services started before 2/15)
- Other allowable uses (not forgivable) – included in 40%
  - Interest (on/after 2/15)
  - Interest (nonmortgage liabilities)
  - Rent (lease in force on/after 2/15)
  - Utilities (service began on/after 2/15)



# PPP Primer (cont'd) – Forgiveness Adjustments

- Reduction in headcount
  - Based on change in FTEs (40 hours/week) between base period and covered period\*  
*\*Forgiveness period is the earlier of (a) 24 weeks after the date of origination and (b) December 31, 2020. For loans made before June 5, the original eight-week forgiveness period may be extended to (a) or (b) above, or the borrower may elect to retain the original eight-week forgiveness period.*
  - Safe harbor: December 31 headcount restoration for reductions made between February 15 - April 26, 2020
  - Special rule: worker refuses re-hire – must document
  - NEW safe harbor from loan application: Business in unable to return to same level of business activity as such business was operating at before February 15, due to compliance with certain government guidance or requirements issued during March 1 - December 31, 2020
- Wage reduction
  - Salary/wage reduction applies only to the portion of the decline in employee salary and wages that is not attributable to the FTE reduction
- Document all assumptions based on guidance currently in existence

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# **Negotiating the Deal – Treatment of Outstanding PPP Loan Balances and Repayment**

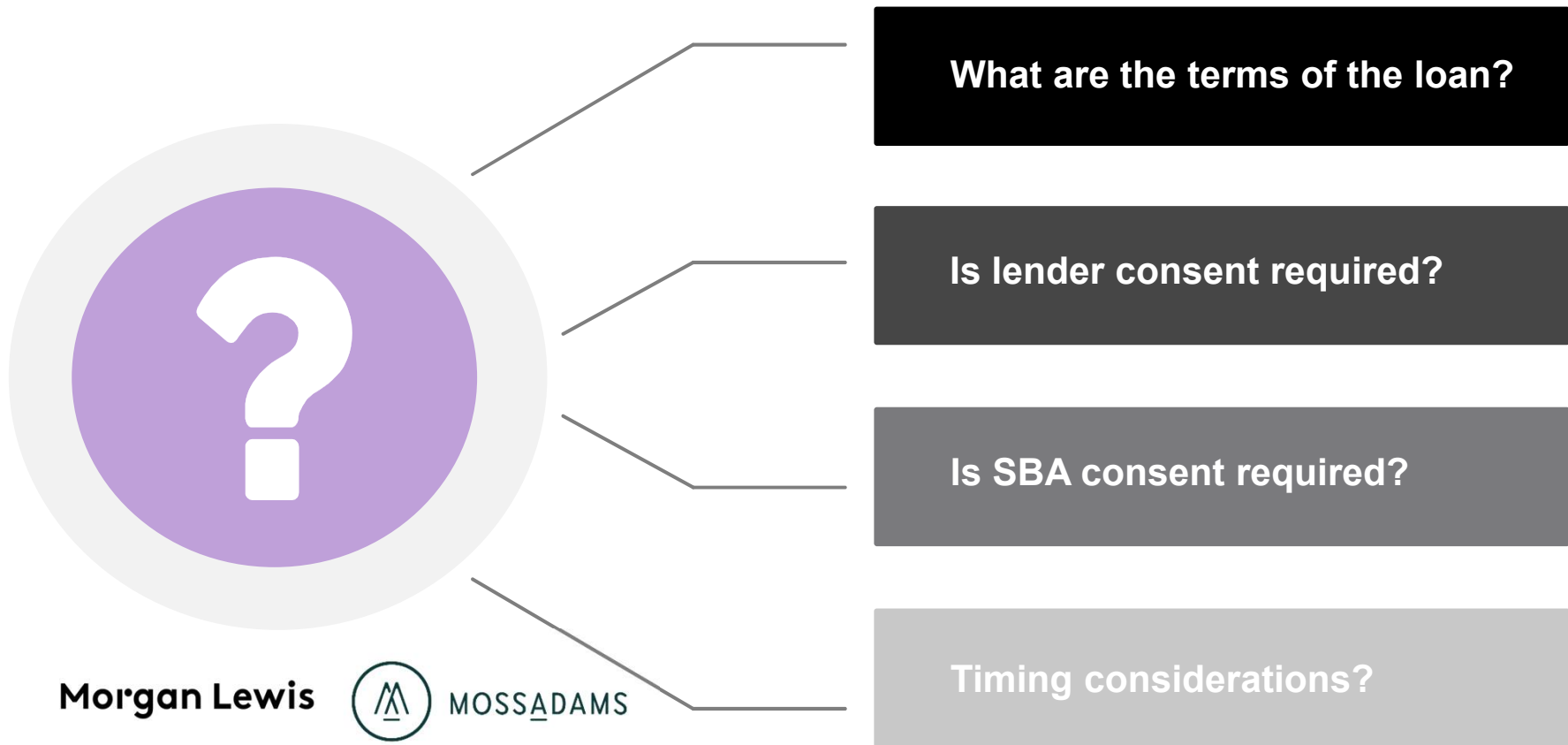
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# To Repay or Not to Repay?

Parties must determine whether to repay or not repay a PPP loan at the closing of transaction



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## To Repay or Not to Repay? (cont'd)

Is lender consent required?	Is SBA consent required?
<ul style="list-style-type: none"><li>• SBA's form Section 7(a) note requires lender consent if borrower:<ul style="list-style-type: none"><li>• "[h]as any adverse change in financial condition or business operation that Lender believes may materially affect Borrower's ability to pay this Note" or</li><li>• "[r]eorganizes, merges, consolidates, or otherwise changes ownership or business structure"</li></ul></li><li>• Lender may use own form with different consent provisions</li></ul>	<ul style="list-style-type: none"><li>• Change in ownership of borrower in first 12 months after final disbursement</li><li>• Sales of assets resulting in transfer of loan or release of original borrower</li></ul>

## To Repay or Not to Repay? (cont'd)

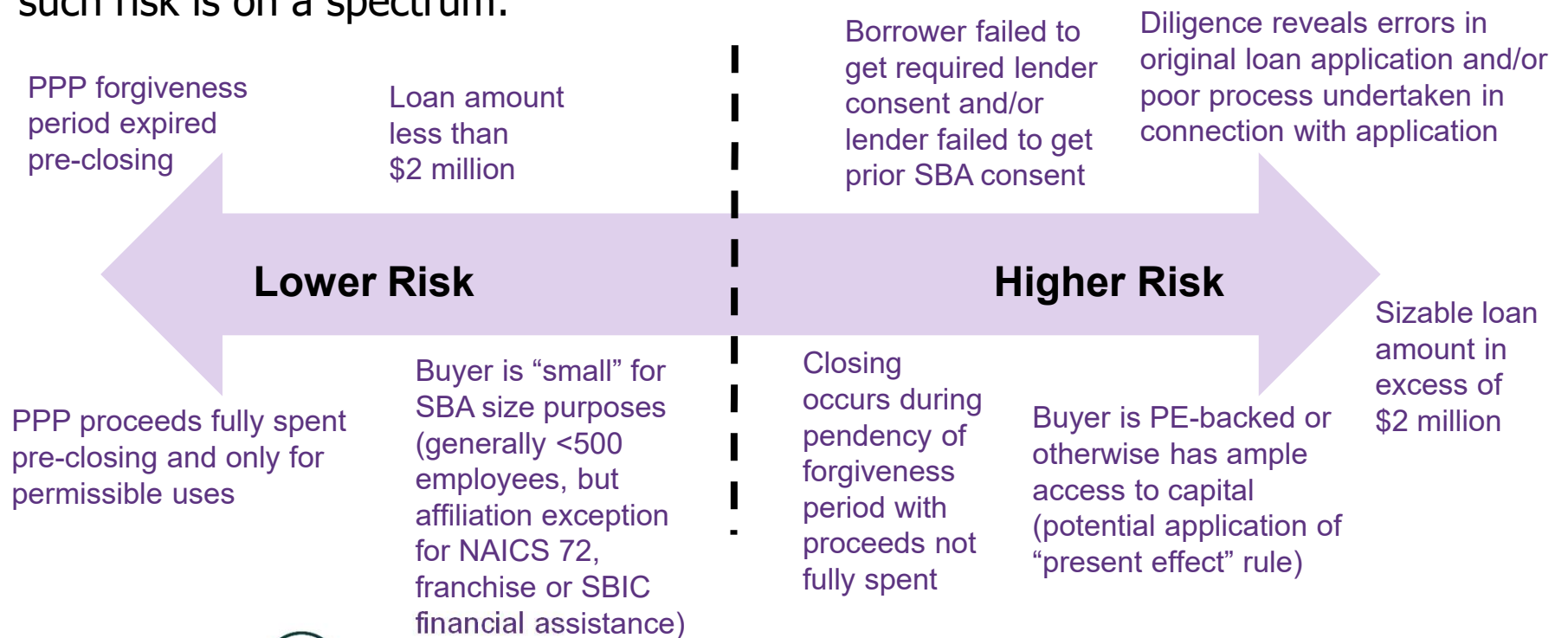
- Market practice to date has varied in respect of PPP-related consent requirements and appetite for accommodation of forgiveness
- In the absence of SBA guidance on treatment of PPP loans in M&A transactions, certain actions taken to accommodate forgiveness will entail some level of risk for each of the transaction parties
- Questions of risk tolerance and potential liability (see risk spectrum below)
- Importance of timing and status of loan
- Risk allocation under definitive transaction documents





## To Repay or Not to Repay? (cont'd)

- Leaving a PPP loan in place to accommodate forgiveness entails some risk, but such risk is on a spectrum:



## Borrower/Seller Perspective

- Should the PPP loan be treated as indebtedness?
  - In a debt-free transaction, indebtedness typically reduces the purchase price
  - Borrower/seller may argue that PPP loan should not reduce purchase price given potential forgiveness
  - Alternatives to preserving value if buyer seeks to repay PPP loan at closing and force sellers to forego benefits of forgiveness application
- When to seek forgiveness?
  - Delaying transaction for forgiveness ensures borrower/seller benefits from forgiveness, but likely jeopardizes transaction timing
  - Options for seeking forgiveness post-transaction (see below)
- Understand consent requirements

# Buyer Perspective

## Benefits of Repayment

- Ensure target company is acquired on a debt-free basis
- Avoid optics and potential scrutiny associated with acquiring a PPP borrower
- Avoid potential headaches of seeking forgiveness
- Significantly reduces risk of audit (including for loans over \$2M)

## Costs of Repayment

- Lose favorable terms of PPP loan (low interest, grace period for payments, unsecured)
- Lose potential benefits of forgiveness



## Buyer Perspective (cont'd)

- What is the timeline for forgiveness?
  - 60-day period for PPP lender to approve forgiveness application
  - 90-day period for SBA to approve and disburse loan forgiveness amount
- Does PPP loan conflict with existing credit facilities or other agreements?
- Consider deal timeline and effect on the eligibility/necessity certifications
  - Based on current guidance there does not appear to be a legal basis for the eligibility and necessity certifications made at the time of application to be re-evaluated to account for M&A activity arising after the date of the original certification (or brought down at the time of forgiveness, if any)
  - Level of scrutiny remains unclear
- Need to evaluate tolerance for potential risks around issues with original eligibility determinations and any PR concerns



## Lender Perspective

- Mixed market practice regarding requiring repayment
- Requiring repayment allows lender to redeploy capital on more market terms and avoid uncertainty regarding PPP loans and forgiveness
- SBA approval requirements
  - Additional considerations/risks for lenders in evaluating SBA approval requirements
  - Substance of SBA requests for approval set forth in 7(a) loan program servicing guidelines
  - Lenders may consider seeking reimbursement from the borrower for any costs and expenses incurred in connection with issuing its consent, including securing any required SBA approval

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# Transaction Structuring and PPP Forgiveness

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# Four Options for Accommodating PPP Forgiveness

## Option 1

Wait to execute on the transaction until the loan is forgiven

## Option 2

Make loan forgiveness a condition to closing in a non-simultaneous sign and close transaction

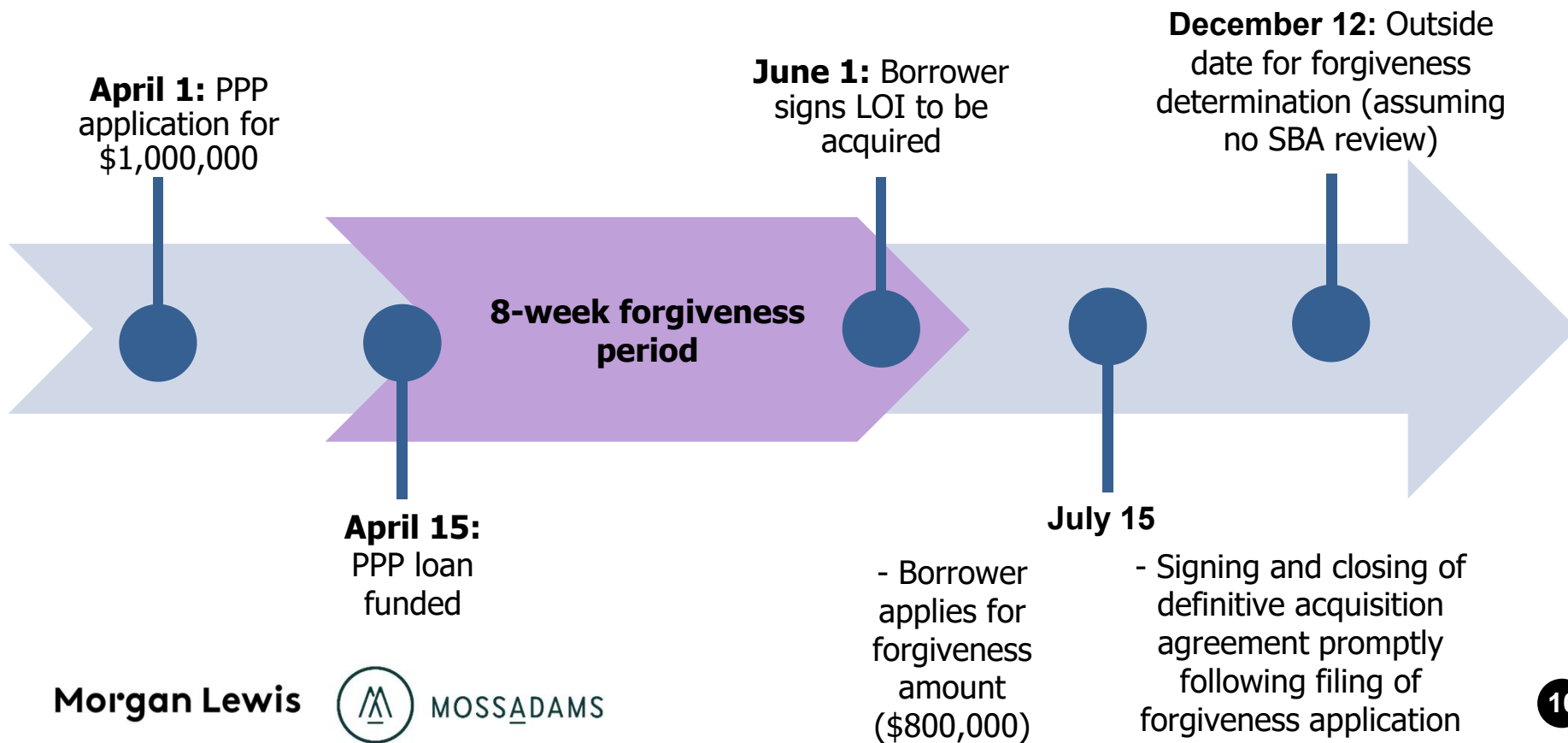
## Option 3

Keep the PPP loan in place post-closing (after obtaining required lender and SBA consent) in order to accommodate a future forgiveness determination

## Option 4

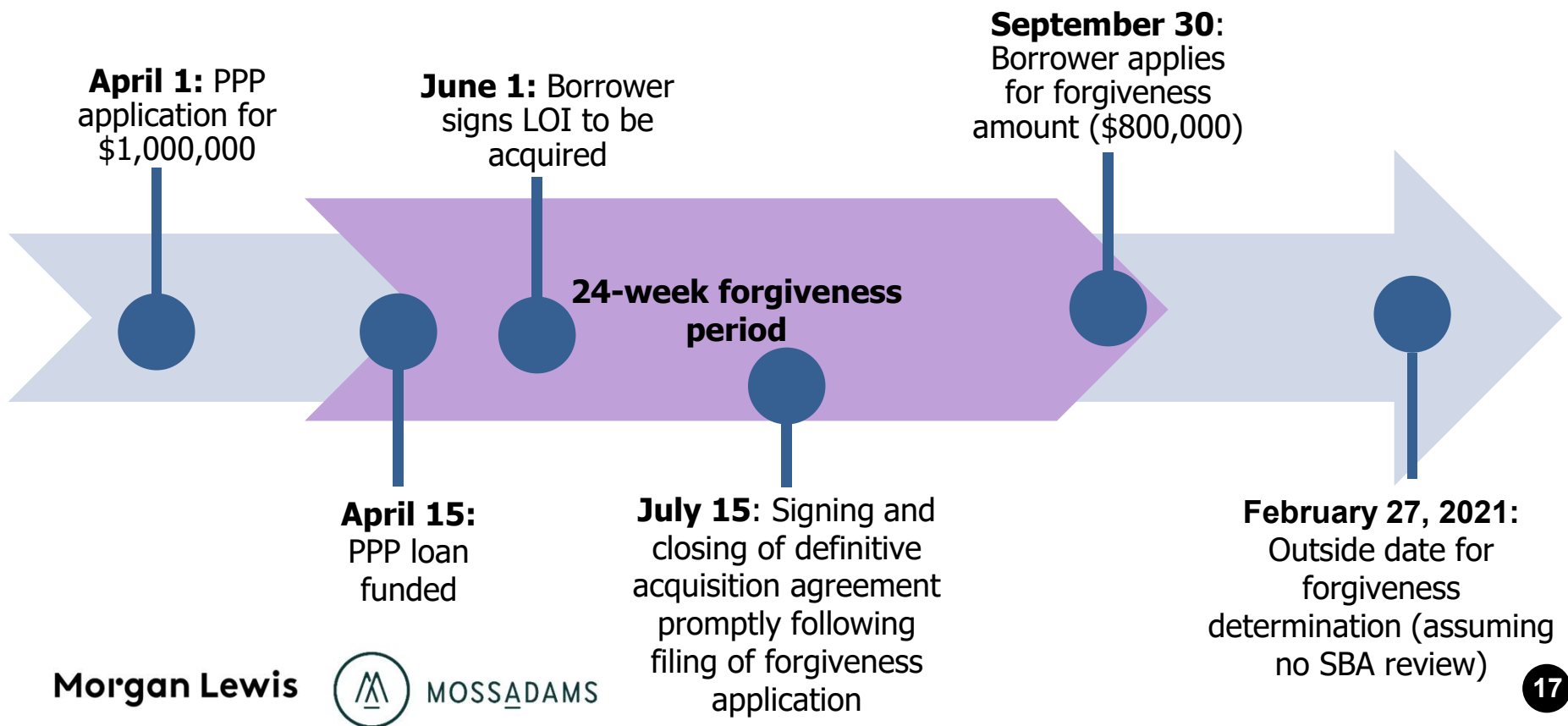
Repay the PPP loan at or prior to closing and allow the seller to recoup a negotiated portion of the indebtedness to account for the potential forgiveness the seller otherwise may have received

# Illustrative Timeline A – Option 3





# Illustrative Timeline B – Option 3



# Treatment of Forgiveness Amount

Baseline: PPP Loan Balance will be treated as indebtedness.

**Buyer Covenant to Remit Forgiveness:** Buyer agrees to pay to seller the forgiveness amount if and when the borrower receives a favorable forgiveness determination.

**Escrow Forgiveness Amount:** Buyer places the maximum potential forgiveness amount in a third party escrow account to be released to seller if and when the borrower receives a favorable forgiveness determination.

**Credit for Forgiveness at Close and Adjust Post-Closing:** Buyer gives seller credit for the expected forgiveness benefit, potentially discounted for the risk of denial and/or tax adjustments. If and when the PPP loan is forgiven, such amount is paid to Buyer. Acquisition agreement provides for post-closing adjustment to true-up the forgiveness benefit if the maximum forgiveness amount is not approved.

*Pro-Buyer*

*Pro-Seller*

## Considerations in Asset Sales

- Is lender consent required under the terms of the PPP note?
- Interplay of SBA consent requirements under lender guidelines
- Have the PPP loan proceeds already been utilized?
  - If PPP loan proceeds are utilized prior to the asset sale, the seller/borrower's eligibility for forgiveness should not be impacted
  - If a borrower seeks to sell substantially all of its assets and transfer its employees and exclude the loan from the sale in order to seek forgiveness, but has not utilized all of the PPP loan proceeds at the time of the sale, then it is unlikely that the borrower will be able to utilize the loan proceeds for permitted uses following the asset sale



# Effect of PPP Loans on Net Working Capital/EBITDA

- Net Working Capital
  - How to define normalized net working capital?
  - Trailing twelve-month average will not be representative of normalized without adjustments
- EBITDA Considerations
  - Accounting for PPP loan and forgiveness
- Tax Considerations

# Net Working Capital

- How to define normalized net working capital (“NWC”) considering both COVID-19 and PPP loan?
  - Traditional trailing twelve month NWC average may not reflect normalize NWC
  - Consider Covid-19 impact on business trends and NWC accounts (e.g., delayed collections and deferred payments)
  - Treatment of deferral of payroll taxes under CARES act
  - Treatment of deferral of rent and other
  - Consider use of PPP loan proceed impact on NWC (e.g., settlement of past due AP)
  - Normalized operation level: Pre-COVID versus new normal
  - Perform detailed analysis of customer receivable – any customer(s) in Chapter 11? Risks?
  - Incorporate forecast to close date and post-close in determining normalized NWC
  - Other CARES act provision impact on NWC (and net debt)
  - Treat as part of debt
  - Other



# EBITDA Considerations

## How did PPP loan impact EBITDA?

- Review the accounting of PPP loan and forgiveness
  - Any impact on EBITDA (e.g., forgiveness portion recorded as reduction of payroll)?
- Consider financial trends. Use of proceeds?
  - Were proceeds used to invest in business?
  - Did the proceeds used for investment result in non-recurring items (e.g., Acquisition of customers)
  - Did the proceeds used result in recurring activities?
- Consider normalizing EBITDA for the temporary impact of COVID-19

# CARES Act and PPP Tax Considerations

- Loan forgiveness / Cancellation of Debt ("COD")
  - Not taxable for federal income tax purposes
  - Potentially taxable for state income tax purposes
- Employer portion of Social Security tax deferral
  - Available until loan forgiveness application is approved
  - Consider impact on net working capital and closing adjustments
- Payroll tax credits
  - Employee retention credit (not available w/ PPP)
  - Paid family leave credit (no double dipping w/ PPP forgiveness)
  - Paid sick leave credit (no double dipping w/ PPP forgiveness)
- Federal Income Tax Key Provisions: Revisit all elections made on 2018 & 2019 filed returns
  - Excess business losses and net operating losses
  - Qualified improvement property and interest expense limitation



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# **Due Diligence, Risk Identification and Risk Mitigation**

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## PPP-Focused Due Diligence

- Understand the nature and extent of CARES Act Federal Funding Programs assistance
- Consider additional scrutiny for PPP loans over \$2 million.
- Was the borrower eligible?
  - Confirm understanding of eligibility for and use of PPP funds with management and any third party consultants (and review third party consultant reports, if any)
  - Review process for determining and documenting the economic need of PPP Loan funds received, and relating document retention policy, therein
  - Document any identified deficiencies in documentation or document retention policy

## PPP-Focused Due Diligence (cont'd)

- Was the loan amount and any expected forgiveness amount properly calculated?
  - Review process for calculating the PPP Loan amount applied for and any forgiveness amount based on standards established by the CARES Act and the PPP regulations
  - Quantify risks and exposure identified in reviewing PPP loan amount and forgiveness calculation
- Has the loan been properly administered since its issuance?
- Have any directors, officers, or other employees been debarred or otherwise prohibited from engaging in any government contracting activities?
- Bolstering “Compliance with Laws” representations and any representations pertaining to Indebtedness

**NOTE: All under backdrop of potential False Claims Act enforcement (criminal penalties for false statements and/or civil liabilities such as treble damages)**



# Other Due Diligence Considerations in Response to COVID

What other areas of focus during diligence should be considered?

## 1. Free Cash Flow Versus EBITDA

- EBITDA focus as well as Free Cash Flow (“FCF”)
  - Go beyond typical adjusted EBITDA analysis and expand analyses to assess a business’ free cash flow
  - Example: Deeper analysis of capital expenditures and potential impact on capex deferral

## 2. Short-Term Cash Flow Forecast

- Increase focus on short-term cash flow forecast and consider incorporating sensitivities (e.g., timing of return to new normal).
- Detailed sales forecast build “bottom up” and “sliced” by channel, geography, etc. Incorporate payment terms and historical payment pattern.
- Include the main net working capital accounts on the balance sheet forecast (i.e., AR, Inventories, Prepaids, AP, Accruals, Deferred revenue).

# Other Due Diligence Considerations in Response to COVID (cont'd)

## 3. Customers and Customer Channels Analysis

- Review customer base to identify potential revenue or other concentrations (e.g., location, industry, etc.) that could impact recurring revenue. Consider to classifying risk in low, medium and high to facilitate sensitivity analysis.
- Perform gross margin analysis, if possible.

## 4. Cost Structure Flexibility

- In depth analysis of variable versus fixed cost structure.
- Review ability and speed to scaling up/down. Consider investment requirement to accelerate scale.
- Review variable and fixed cost structure and scale by department and function.

## Recourse

- Treatment of PPP related reps and/or “Compliance with Laws” rep as fundamental (e.g. extended survival, “first dollar” recovery, no cap).
- Consider specific indemnity related to PPP non-compliance (particularly where issues have been found)
- Consider specific indemnity in respect of forgivable amount (depending on whether buyer has “paid” for the value thereof)
- Definition of “Losses”
- Escrow/holdback backstopping forgiveness determinations, if applicable, or indemnity obligations for potential PPP-related liabilities
- **R&W Insurers likely to seek exclusions related to PPP liabilities**

## Covenants

- Covenants related to “forgiveness” element
  - Binding seller during interim period **or** binding buyer post-closing if seller remains “on the hook” for the forgiveness amount (via indemnity or escrowed sale proceeds)
- Control of Audits / Cooperation
  - Six-year audit period for PPP loans – all loans in excess of \$2mm will be audited



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# **Quick Reference Guide: Best Practices for Parties to Pending M&A Deals**

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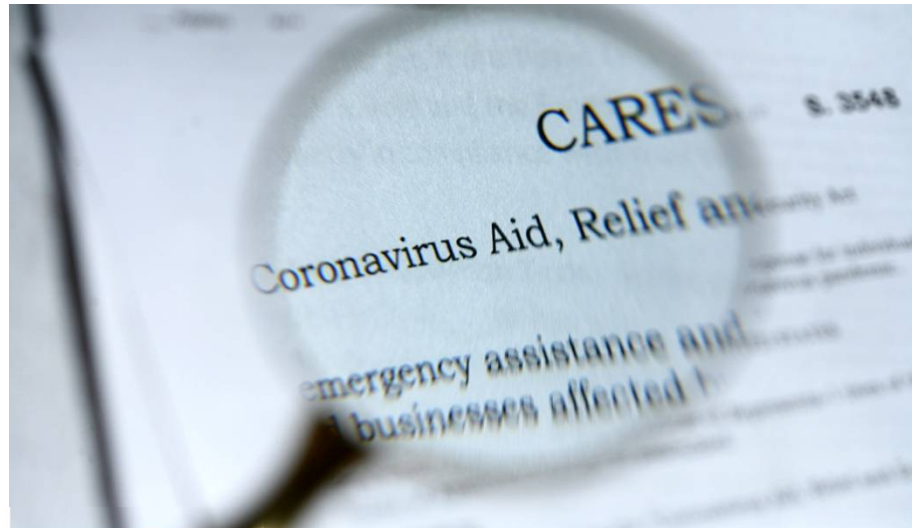


## Best Practices for Parties to Pending M&A Deals Involving PPP Loans

Borrowers/Sellers	Buyers	PPP Lenders
<ul style="list-style-type: none"> <li>• Identify whether lender/SBA consent required</li> <li>• Engage with PPP lender early in process</li> <li>• Anticipate buyer diligence around the analysis undertaken in respect of the PPP loan amount, eligibility &amp; necessity</li> <li>• Prepare clear and comprehensive documentation evidencing expected forgiveness amount</li> <li>• Seek to file forgiveness application ASAP</li> <li>• Confirm eligibility for forgiveness (i.e. not in default under the loan documents)</li> <li>• Consider structuring alternatives to leave PPP loan in place to accommodate forgiveness</li> <li>• Weigh the potential benefit of forgiveness against the potential tax benefits of a particular structure originally contemplated</li> <li>• Resist unnecessary risk allocation and open-ended recourse for PPP matters</li> <li>• For PPP loans that remain outstanding, consider post-closing covenant protection</li> </ul>	<ul style="list-style-type: none"> <li>• Ensure thorough diligence process around borrower's PPP calculations, eligibility &amp; necessity (note probable RWI exclusions)</li> <li>• Understand any required lender/SBA consents</li> <li>• Be mindful of future audit risk (regardless of treatment at closing) as new owner</li> <li>• Undertake risk assessment of assuming loan, accounting for any PR concerns</li> <li>• Push for debt-like treatment and repayment of PPP loan to avoid potential timing delays and administrative headaches</li> <li>• If keeping loan in place to accommodate forgiveness, (i) proceeds should still be reduced by loan amount and (ii) loan amount and interest (and even related administrative expenses) are escrowed or otherwise held back and released upon final forgiveness (or later if protecting against audit risk)</li> <li>• Unless loan is excluded as part of asset deal, seek appropriate contractual protection via PPP-specific reps and indemnification</li> <li>• Take into account terms of existing debt facilities</li> </ul>	<ul style="list-style-type: none"> <li>• Understand proposed transaction structure and whether such transaction triggers a consent requirement of event of default, and whether prior SBA approval is required</li> <li>• If borrower requests lender consent, undertake internal review in accordance with bank procedures</li> <li>• If amenable to issuing consent but prior SBA approval is required, prepare submission seeking SBA approval in accordance with 7(a) loan program servicing guidelines</li> <li>• If borrower seeks to sell business via asset sale and proposes excluding PPP loan and keeping in place to accommodate forgiveness, require loan amount (plus interest) to be escrowed and to restrict post-closing actions to protect against other creditors</li> <li>• Consider seeking reimbursement from borrower for costs and expenses incurred in connection with issuing its consent, including securing any required SBA approval</li> </ul>

# QUESTIONS & ANSWERS

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# Biography



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Andrew P. Rocks counsels clients on a wide variety of business law matters, focusing on public and private mergers and acquisitions (M&A) (including spin-offs and other divestitures, joint ventures, strategic investments, and recapitalizations), private equity, venture capital investments, and general corporate and securities law matters

His clients range from Fortune 500 companies to private equity funds and their portfolio companies to entrepreneurs and emerging businesses across many industries, including technology, retail, consulting, manufacturing, pharmaceutical, healthcare, and energy. Andrew represents many of his clients, including emerging companies and portfolio companies of his private equity clients, through their entire life cycle, guiding these clients through the negotiation and implementation of employment arrangements, incentive equity plans, and other start-up matters, equity and debt financings, corporate restructurings, and sale transactions.

He routinely advises on complicated transaction structures involving pre-transaction restructurings, equity rollover components, the use of representations and warranties insurance, and earnouts, among other things, on behalf of both buy-side and sell-side clients.

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# Biography



Jacquelynne Hamilton is part of a team that focuses on diverse transactions, including mergers and acquisitions, joint ventures, spin-offs, and strategic alliances. Other areas of work include matters involving finance, restructuring, tax, and securities, including public and private equity and debt offerings. Clients range from Fortune 500 companies and investment banks to emerging market companies. While attending law school, Jacquelynne participated in the Entrepreneurship Legal Clinic and served on the board of Lambda Law.

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Andrew Budreika is a Partner in the Finance practice. He advises clients on private equity transactions, domestic and cross-border public and private mergers and acquisitions, debt financings, strategic investments, and other corporate transactions. Andrew also regularly counsels clients on securities law, corporate governance, and other general corporate and finance matters.

Consistent with Morgan Lewis's core principles, Andrew is committed to providing exceptional client service and building long-term strategic relationships with clients focused on communication and collaboration. Andrew seeks first to listen and understand a client's goals and the business context and then to provide insightful, creative, and tailored solutions that enable the client to achieve those goals within the client's defined parameters for success. Andrew endeavors to bring together Morgan Lewis's intellectual and global talent and resources to construct elite legal teams that deliver the best overall results and experience to clients.

Andrew is also passionate about using technology, knowledge management, legal project management, and other innovations in legal practice to provide fast, reliable, and consistent service in a cost-effective and efficient manner.

Andrew has practical experience handling a full spectrum of transactions including buyouts; platform acquisitions; exit transactions; mergers; add-ons and roll-ups; carve-outs and spin-offs; leveraged recapitalizations; and management rollovers and equity incentive structures. He also regularly works on matters involving growth equity, minority, and strategic investments; co-investments; corporate restructurings and reorganizations; and founder liquidity transactions. Additionally, Andrew advises on acquisition financings; syndicated bank loans; investment grade and high-yield bond offerings; asset-based loans; mortgage loan warehousing and repurchase facilities; and capital call lending transactions.

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Matthew Scherneck is a partner in the Finance Practice and serves as the New York office local practice group leader. Matthew advises direct lenders, mezzanine investment funds, and venture capital investors on loans and other investment transactions with a wide range of borrowers across industry classes and of all sizes, types, and structures. Matthew also advises private equity clients and corporate borrowers on domestic and cross-border acquisition financings, out-of-court restructurings and workouts, bankruptcy matters, and real estate financings. Matthew leads transactions spanning diverse industries, including media and telecommunications, Internet and technology, food and beverage, real estate, retail, and healthcare.



## Biography



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Luc is Moss Adams' Transaction Services Practice Leader. Prior to joining Moss Adams, Luc was at Genentech. He has more than 20 years of business experience including 15 in mergers and acquisitions involving transactions ranging in size from several million to \$20 billion dollars. At Genentech, he oversaw the oncology portfolio financial modeling and valuations, including valuations of potential in-licensing and out-licensing drug candidates. Prior to Genentech, he worked in Ernst & Young's transaction advisory service group based in San Francisco, and served as the West Coast technology and life science subject matter expert. Luc led numerous due diligence teams for both corporate and private equity clients including multi-national transactions.

Luc's private equity experience includes working on due diligence engagements for The Carlyle Group, Warburg Pincus, Vista Equity Partners, Norwest Venture Partners, TSG Consumer Partners, etc. He has also advised corporate clients such as Cisco, HP, BMC Software, AMD, Qualcomm, Juniper Networks, SAQ, Alliance Healthcare, Primoris Amgen, Gilead Sciences, Geron Corporation, Cell Therapeutics, and others.

Luc is fluent in French.



## Biography



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Guy has practiced public accounting since 1987. He has advised entrepreneurs, private equity groups, strategic investors, investment bankers, lenders, and other capital providers on merger and acquisition, divestiture, and ESOP transactions ranging from \$10 million to \$1 billion in enterprise value. His clients have included both established and entrepreneurial companies within the manufacturing, transportation, distribution, retail, service, contractor, and real estate industries.

Prior to joining Moss Adams, Guy founded and managed successful advisory and business consulting practices at national, regional, and local CPA firms. He has extensive experience in business planning, mergers and acquisitions, valuation, due diligence, budgeting and forecasting, and deal structuring. Guy is a Certified Public Accountant, Certified Merger & Acquisition Advisor, and a Certified Global Management Accountant. He has also served as an adjunct professor in the Center for Entrepreneurship at California State University, Fullerton.





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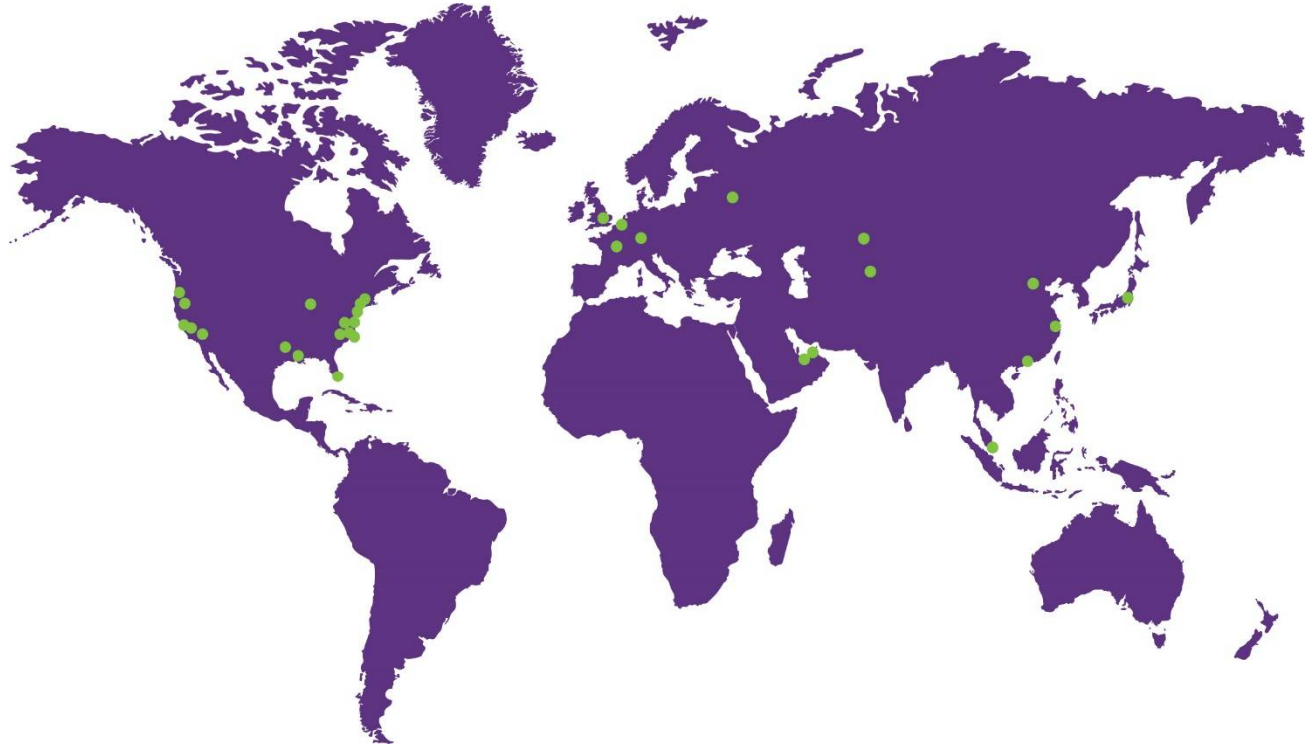
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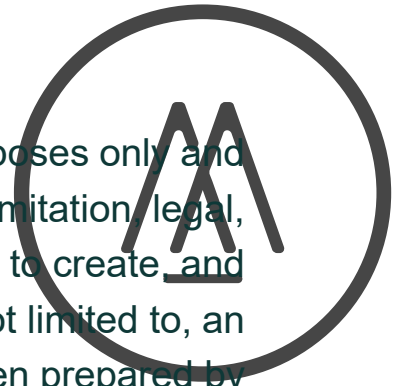
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