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M&A ACADEMY:

Impact of the Paycheck Protection Program on M&A Transactions

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A PRIMER ON PPP LOANS AND CURRENT ISSUES

A Primer on PPP Loans and Current Issues

- Paycheck Protection Program passed as part of the CARES Act
- Significant demand for PPP loans
- PPP promulgated as part of SBA's existing Section 7(a) loan program
- Unique features of PPP loans: (1) possibility for loans to be fully forgiven and (2) loans are not secured
- Novel issues in the M&A context

NEGOTIATING THE DEAL – TREATMENT OF OUTSTANDING PPP LOAN BALANCES AND REPAYMENT

To Repay or Not to Repay?

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

- What are the terms of the loan?
- Is lender consent required?
- Is SBA consent required?
- Timing considerations?

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

Is lender consent required?	Is SBA consent required?

• SBA's form Section 7(a) note requires lender consent if borrower:
    • "[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
    • "[r]eorganizes, merges, consolidates, or otherwise changes ownership or business structure"
 	
• Lender may use own form with different consent provisions
	• Change of ownership of borrower in first 12 months after final disbursement or any transfer of the loan and/or release of the Borrower
	
	• "Change of ownership" defined in SBA's Procedural Notice No. 5000-20057 (issued October 2, 2020)
	
	• **"Safe harbor" from SBA approval requirement for certain changes of ownership where PPP loan amount is escrowed with PPP lender and PPP borrower has already filed for forgiveness**

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

- "Change of Ownership" under the recent Procedural Notice:
  - At least 20% of the stock or other ownership interests of PPP borrower are sold or otherwise transferred, whether in one transaction or in multiple transactions since the loan approval;
  - PPP borrower sells or otherwise transfers at least 50% of its assets (measured by fair market value), whether in one or more transactions; or
  - PPP borrower is merged with or into another entity.
- "Safe Harbor" from prior SBA approval requirement for the following "changes of ownership":
  - Sales of 50% or less of the stock of the PPP borrower
  - Other "changes of ownership" where:
    1. PPP borrower has completed and submitted to the PPP lender a forgiveness application, together with required supporting documentation, reflecting its use of all of the PPP loan proceeds;
    2. funds equal to the outstanding balance of the PPP loan are deposited with the PPP lender into an interest-bearing escrow account at the closing of the transaction; and
    3. after the forgiveness process (including any appeals) is completed, the escrow funds are disbursed first to repay any remaining PPP loan balance plus interest

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
  - Certain buyers continue to insist that a PPP loan be repaid at or prior to closing
  - Forgiveness applications may not be timely or feasible
  - SBA's prior approval may be required
- Even with the benefit of the SBA's recent Procedural Notice and the safe harbor thereunder, 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)

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:

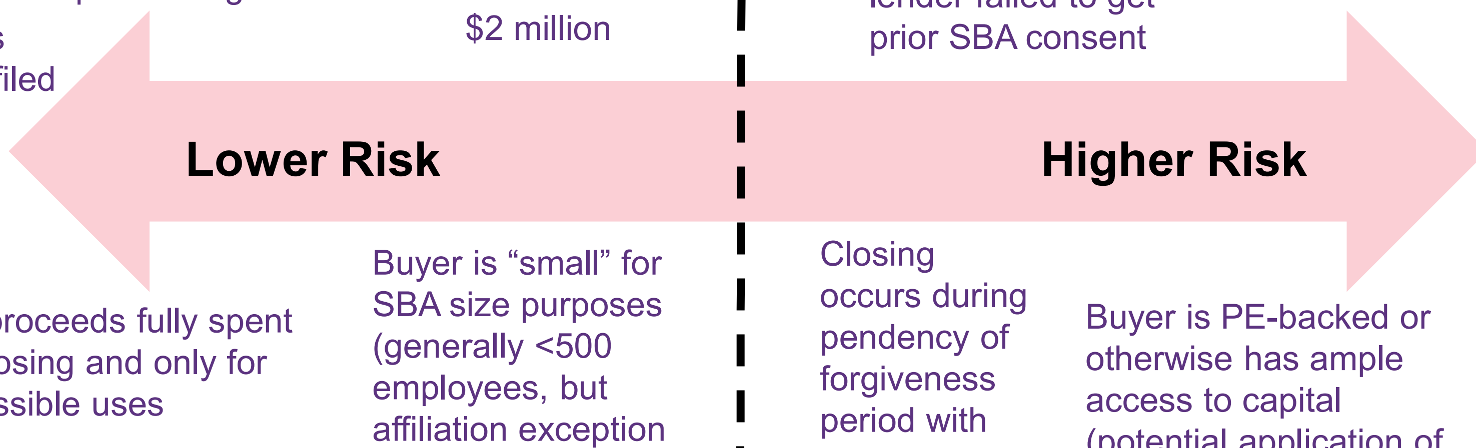
Forgiveness application filed pre-closing

PPP forgiveness period expired pre-closing

PPP proceeds fully spent pre-closing and only for permissible uses

Loan amount less than $2 million

Buyer is "small" for SBA size purposes (generally <500 employees, but affiliation exception for NAICS 72, franchise or SBIC financial assistance)



Closing occurs during pendency of forgiveness period with proceeds not fully spent

Borrower failed to get required lender consent and/or lender failed to get prior SBA consent

Buyer is PE-backed or otherwise has ample access to capital (potential application of "present effect" rule)

Diligence reveals errors in original loan application and/or poor process undertaken in connection with application

Sizable loan amount in excess of $2 million

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 and engage with PPP lender early

Buyer Perspective

Benefits of Repayment	Costs 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 • Eliminates the automatic audit for loans over $2M	• 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
- SBA approval requirements
  - Additional considerations/risks for lenders in evaluating SBA approval requirements
  - Substance of SBA requests for approval and other procedures to follow clarified in SBA's recent Procedural Notice
  - 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

TRANSACTION STRUCTURING AND PPP FORGIVENESS

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

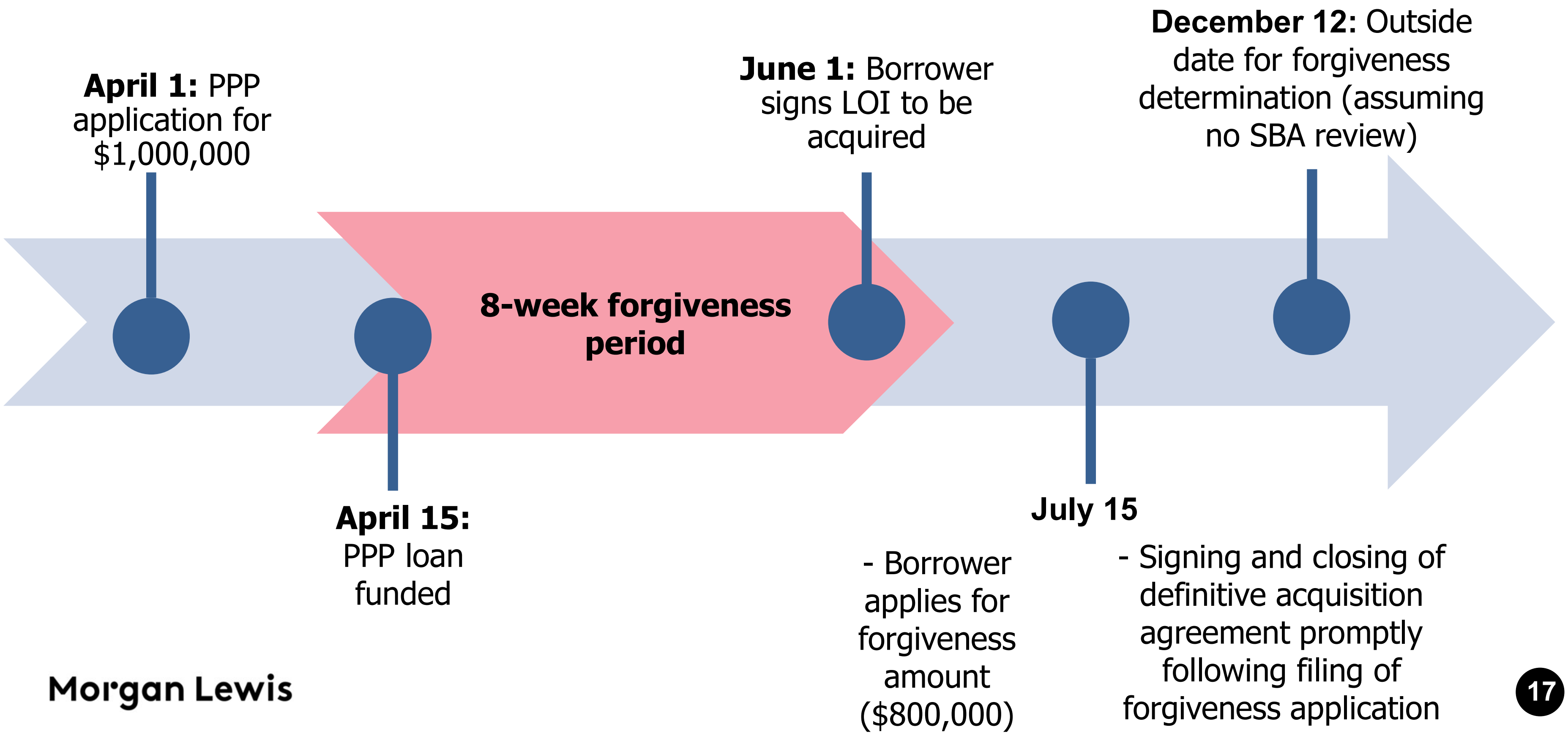
Option 3

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

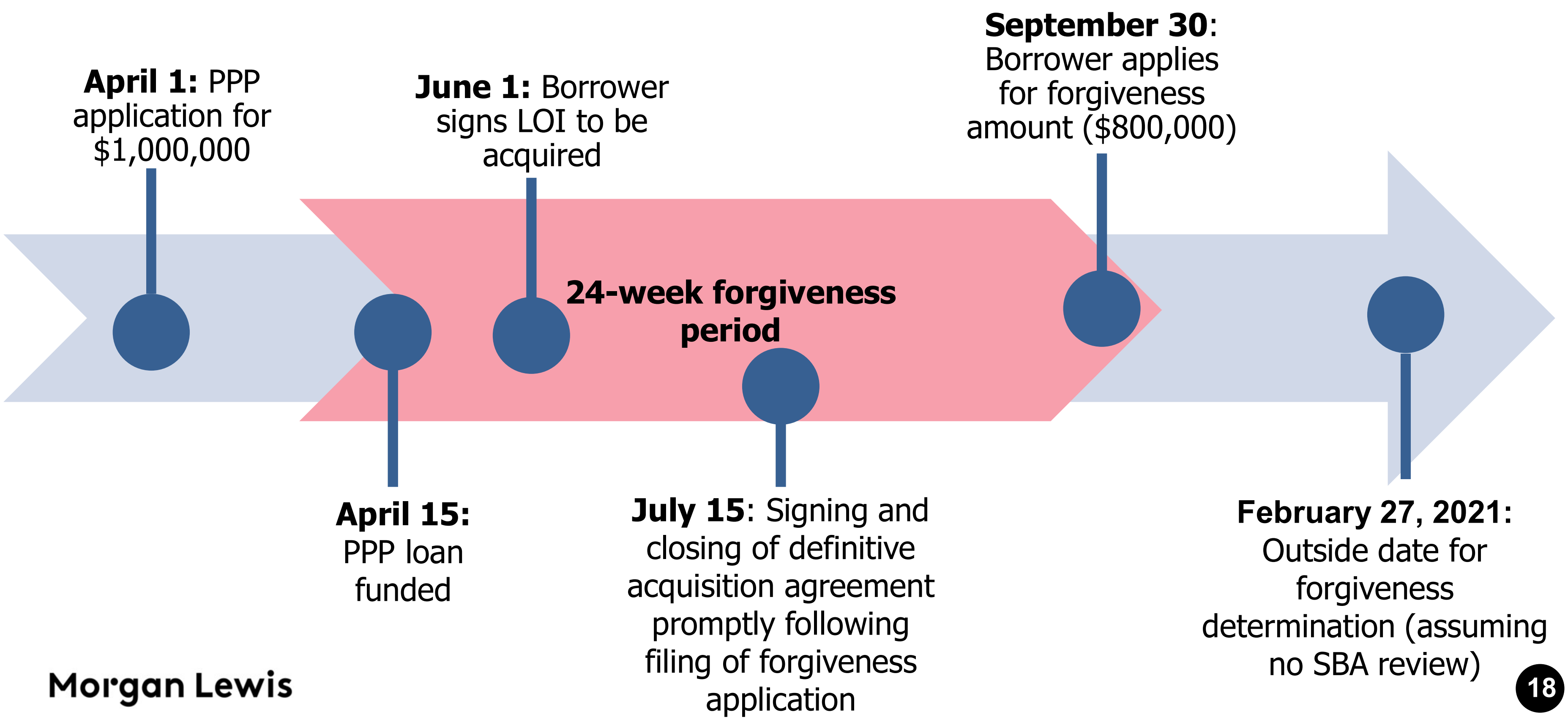
Option 4

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



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Treatment of Forgiveness Amount Pursuant to Procedural Notice

- Where parties sought to close a transaction but keep a PPP loan in place post-closing in order to accommodate a future forgiveness determination, market practice varied prior to the issuance of the recent SBA Procedural Notice on changes of ownership in terms of approaches for the treatment of the PPP loan balance and potential forgiveness amount
- Procedural Notice provided a roadmap for effecting such changes of ownership without having to seek prior SBA approval
  - PPP borrower has used all of its PPP loan proceeds and submitted a forgiveness application
  - Funds equal to the outstanding balance of the PPP loan are deposited with the PPP lender into an interest-bearing escrow account at the closing of the transaction and released only upon a final forgiveness determination (including any appeals)

Other Options for Treatment of Forgiveness Amount

****Alternative options where the Procedural Notice "safe harbors" are not satisfied***

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.

Pro-Buyer

Establish Escrow Subject to Forgiveness: Same approach as outlined in the Procedural Notice. Alternatively, the parties might agree to just deposit the maximum potential forgiveness amount, as opposed to the total PPP loan balance, into escrow, or utilize a third party to serve as escrow agent, as opposed to the PPP lender.

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-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, as confirmed by the SBA's recent Procedural Notice
  - 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 (and this scenario will require prior SBA approval)

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
  - Buyer-favorable approach: Target net working capital to reference a "pre-COVID-19" level and exclude the PPP proceeds from current assets
  - Seller-favorable approach: Target net working capital to refer to trailing 12 months (including effects of COVID-19) and include PPP loan proceeds
- EBITDA Considerations
  - Accounting for PPP loan and forgiveness
- Highly deal- and fact-specific


DUE DILIGENCE, RISK IDENTIFICATION AND RISK MITIGATION

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)
  - What, if any, affiliation analysis was performed?
  - Review process for determining and documenting the economic need of PPP Loan funds received, and related document retention policy
  - 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)
- Consider relevant financial due diligence focus (e.g., cash flows, customer retention, cost structure flexibility)

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 all potential PPP-related liabilities

R&W Insurance Implications

- Buyers should be wary of potential exclusions if pursuing a R&W insurance policy
- Blanket exclusions for losses arising from the use of proceeds or availability of forgiveness of all PPP loans
- Subject to level of buyer due diligence, exclusion may be expanded to include all losses arising out of or resulting from any PPP loans

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

BUYSIDE FINANCING CONSIDERATIONS AND LENDER INSIGHTS

Financing Considerations

- Impact of PPP loan on buyer's existing credit facilities
  - Consent of buyer's other lenders may be required for both M&A transaction and assumption of PPP loan
  - Buyer's other lenders may prefer for PPP loan to repaid to avoid time and costs
  - If PPP loan remains outstanding, PPP lender and buyer's other lenders may need to coordinate and enter into an intercreditor agreement
- PPP-specific representations in financing arrangements for M&A transactions

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- Please email Daniel Gieseke at daniel.gieseke@morganlewis.com if you have any questions.

Key Takeaways

Key Takeaways from This Session

- Ensure you understand the PPP loan terms and required consents and notices that will be required in connection with transaction (e.g., does the transaction constitute a change of ownership under the new SBA definition?)
- Treatment of PPP loan amount and related opportunity for forgiveness will be fact-specific and depend on, among other things, the loan status (including the use of proceeds and forgiveness period), transaction timing, and party leverage
- Decision on loan treatment will entail evaluations of risk tolerance
- Ensure appropriate escrow structure is implemented if relying on "safe harbor" from prior SBA approval requirement
- Consider appropriate allocation of risk of PPP-related liabilities, even where the outstanding loan amount is repaid at closing
- See "Quick Reference Guide" below

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

Borrowers/Sellers	Buyers	PPP Lenders
• Identify whether lender/SBA consent required • Engage with PPP lender early in process and provide required notice of transaction • Anticipate buyer diligence around the analysis undertaken in respect of the PPP loan amount, eligibility & necessity • Prepare clear documentation evidencing expected forgiveness amount • Confirm eligibility for forgiveness (e.g., not in default under the loan documents) • Seek to file forgiveness application ASAP • Consider structuring alternatives to leave PPP loan in place to accommodate forgiveness and required approvals/timing implications • Weigh the potential benefit of forgiveness against the potential tax benefits of a particular structure originally contemplated • Resist unnecessary risk allocation and open-ended recourse for PPP matters • For PPP loans that remain outstanding, consider post-closing covenant protection	• Ensure thorough diligence process around borrower's PPP calculations, eligibility & necessity (note probable RWI exclusions) • Understand any required lender/SBA consents • Be mindful of future audit risk (regardless of treatment at closing) as new owner • Undertake risk assessment of assuming loan, accounting for any PR concerns • Push for debt-like treatment and repayment of PPP loan to avoid potential timing delays and administrative headaches • 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) • Seek appropriate contractual protection via PPP-specific reps and indemnification • Take into account terms of existing debt facilities	• Understand proposed transaction structure and whether such transaction triggers a consent requirement of event of default, and whether prior SBA approval is required • If borrower requests lender consent, undertake internal review in accordance with bank procedures • 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 and Procedural Notice • 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 • Consider seeking reimbursement from borrower for costs and expenses incurred in connection with issuing its consent, including securing any required SBA approval


Q&A

Biography

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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.

Biography

Matthew Schernecke 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.

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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.

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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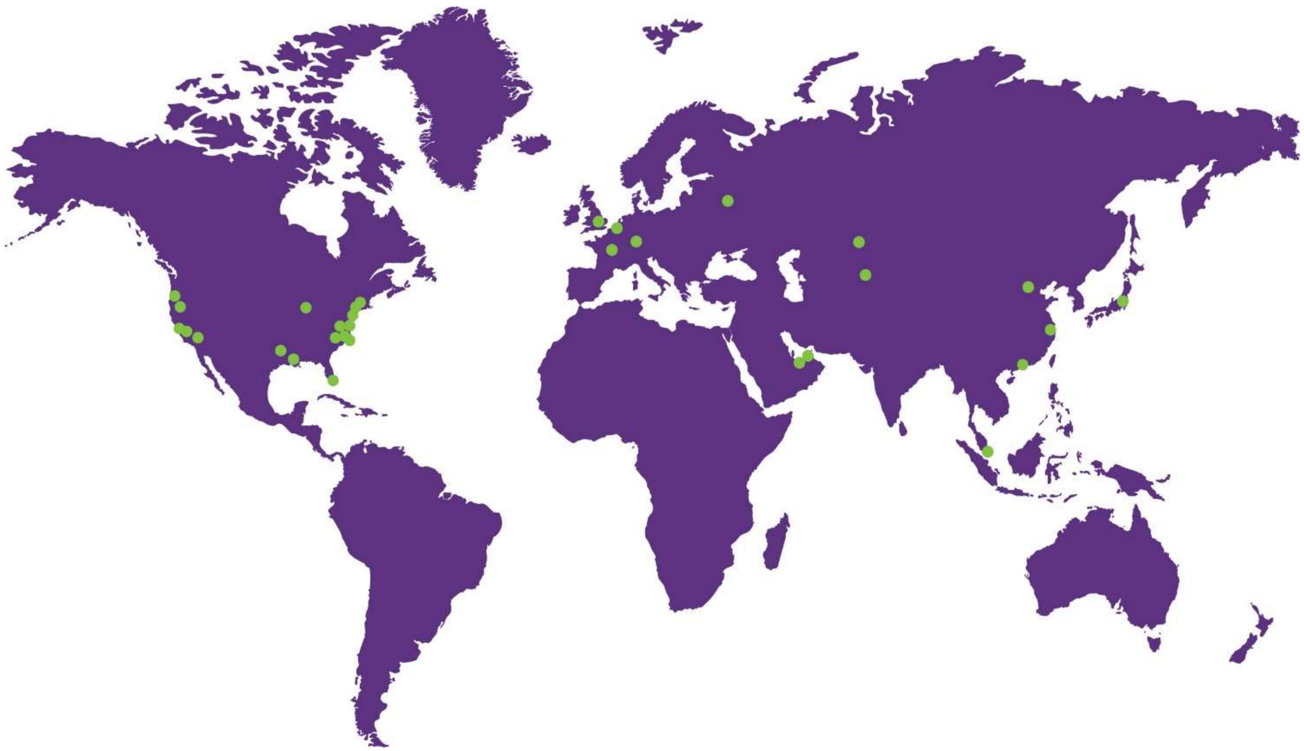

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