

# NAVIGATING PPP LOANS IN M&A TRANSACTIONS

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The Coronavirus Aid, Relief, and Economic Security (CARES) Act, among other economic stimulus measures, provides targeted relief to small businesses through its Paycheck Protection Program (PPP). The PPP and other government loan programs implemented in response to the coronavirus (COVID-19) pandemic have a variety of implications on pending and potential mergers and acquisitions (M&A) transactions. This White Paper provides an overview of the factors stakeholders in a transaction should consider in structuring, negotiating, and executing a deal involving a PPP loan, including the following:

- The effect of a transaction on PPP eligibility
- Areas of focus for a buyer in evaluating a target borrower's compliance with PPP loan terms
- Practical considerations for how to treat an outstanding PPP loan balance in a transaction
- Issues regarding PPP loan forgiveness arising from a transaction

[Read our LawFlash on the PPP for an overview of the program.](#) While this White Paper focuses on the PPP and the considerations around an outstanding loan issued under the PPP in the context of an M&A transaction, similar considerations may arise with respect to other governmental relief loan programs.

## **EFFECT OF M&A TRANSACTIONS ON PPP ELIGIBILITY**

The parties to a given M&A transaction will need to consider the effect of the transaction on a PPP borrower's eligibility under the terms of the PPP—regardless of whether such borrower is the proposed buyer or seller in the transaction. Although eligibility is a more pronounced issue in situations where an applicant will be seeking a PPP loan during or subsequent to an M&A process, there are important risk allocation considerations in the context of a deal in which a PPP loan is already outstanding at the time of the transaction (discussed further below in “Negotiating the Deal—Treatment of Outstanding PPP Loan Balances & Protecting Against Relevant Risks”).

[For a more fulsome discussion of the eligibility requirements to consider when applying for a PPP loan, read our LawFlash on the PPP generally.](#)

### **Potential Treatment of Buyers as Affiliates for Purposes of Size Eligibility**

As part of a PPP application, the applicant must certify as to its eligibility to receive a PPP loan, including with respect to its size. This certification is based on facts as they exist at the time the application is accepted for processing by the US Small Business Administration (SBA).

In the context of a sale transaction, if the potential target company (or one of its subsidiaries) is considering or in the process of applying for a PPP loan, careful thought should be given to the application of the SBA's affiliation rules to the target's relationship with the proposed buyer given that the buyer may be deemed affiliated with the applicant—even before the deal is closed—and this affiliation may cause the applicant to be ineligible for the loan. In addition, buyers should consider the implications of these affiliation rules on their own eligibility under the PPP as a result of the transaction.

As a general matter, any buyer that acquires “control” of a PPP loan applicant—whether through majority ownership of voting securities or “negative control” giving the buyer a veto right over board or stockholder actions or certain operational day-to-day activities of the applicant—will be treated as an affiliate of the applicant. Accordingly, such buyer will need to aggregate its and its affiliates' employees and annual receipts (or net worth/net income under the SBA's alternative size standard) with the number of employees or annual receipts of the applicant in order to assess whether the applicant exceeds the size standard for loan eligibility.

[For more information, read our LawFlash on the affiliation rules generally and particular considerations for private equity and venture capital owned small businesses.](#)

## “Present Effect” Rule

As noted above, the required eligibility certification in a PPP loan application is made based on facts as of the time the application is accepted for processing by the SBA. Thus, at first glance, a buyer may believe that it would not be treated as an affiliate of a potential target company if the closing of the transaction does not occur prior to the time the PPP loan application is filed. However, additional analysis may be needed in light of the SBA’s “present effect” rule. The present effect rule (codified under 13 CFR § 121.301(f)(2)) provides in part that under certain circumstances, an acquisition agreement (including an agreement in principle) is given present effect in determining whether the buyer has power to control a target company.

The issue of whether an “agreement in principle” exists is determined “not by the caption on the document, or a partial quotation from the document, or a self-serving characterization of the document, but by the substance of the entire document itself.”<sup>1</sup> Whether an agreement in principle exists is a highly factual analysis that takes into account the status and disposition of the negotiations between the parties and the likelihood that the deal will be completed.

The SBA has taken the position that, in certain circumstances, a signed letter of intent should be treated as an agreement in principle and be given present effect notwithstanding the absence of a signed definitive agreement. A review of relevant case law reveals the following guideposts to take into account in undertaking this analysis:<sup>2</sup>

Likely to be given present effect as agreements in principle:<sup>3</sup>

- Agreements that include a specific price and other definite terms
- Proposals signed by the relevant parties that are only subject to confirmatory due diligence
- Offers that include exclusivity restrictions that are acknowledged and agreed to by the selling parties

Not likely to be given present effect as agreements in principle:

- Mere agreements to negotiate or continue negotiating
- Agreements that are impossible or unlikely, speculative, or based upon material assumptions
- Nonbinding, tentative proposals that contain clear language as to the parties’ ability to withdraw from the transaction
- Agreements that do not include a definitive price (or contain a mere range of price points)
- Offers subject to numerous conditions, including extensive financial and legal due diligence
- Unilateral indications of interests that have not been accepted by the other party

## Impact on Necessity Certification

Since the passage of the CARES Act, the SBA has released additional guidance on the factors to consider in making the certification required as part of the PPP application that “the uncertainty of current economic conditions makes necessary the loan request to support the ongoing operations of the eligible recipient.”<sup>4</sup> In particular, the SBA has stated that borrowers must take into account “their current business activity and their ability to access other sources of liquidity sufficient to support their ongoing operations in a manner that is not significantly detrimental to the business.”<sup>5</sup>

The guidance further notes that it is unlikely that a public company with substantial market value and access to capital markets will be able to make the required certification in good faith, and such a company should be prepared to demonstrate to the SBA, upon request, the basis for its certification. On

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April 28, 2020, the SBA indicated that the same guidance on access to liquidity applies to private companies applying for PPP loans.

Borrowers/sellers, on the one hand, and buyers, on the other hand, should take the following considerations into account with respect to this updated guidance.

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## *Borrower/Seller Perspective*

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As a general matter, in connection with its necessity certification, a PPP borrower should consider its ability to access other sources of liquidity, including new liquidity through a corporate transaction in the near term. Applicants already considering a potential sell-side transaction at the time of their PPP application will need to take into account the potential liquidity resulting from such a transaction and the likely terms of securing such liquidity. This is especially true if a feature of the transaction is an injection from the buyer of liquidity or working capital that will affect the applicant's balance sheet.

Sellers also need to consider how any cash payments to be disbursed in connection with the transaction will be perceived. For example, if cash consideration to be received by an applicant is reduced due to cash sale bonuses being diverted toward company executives, there is increased risk of scrutiny if the company then applies for a PPP loan certifying that the loan is necessary to support ongoing operations.

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## *Buyer Perspective*

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Buyers seeking to acquire a target company that is applying for a PPP loan will need to consider the ability of the target to make the necessity certification—both before and after the transaction closes. Access to liquidity and capital from the buyer and its affiliates will need to be assessed in determining whether the applicant can make the necessity certification.

It is important to note that the necessity certification is made as of the time of the application for the loan and that the form application for PPP loan forgiveness does not contain a reaffirmation or “bring-down” of the necessity certification.<sup>6</sup> Rather, the SBA’s interim rules on loan forgiveness reference that the SBA will determine borrower eligibility for forgiveness “based on the provisions of the CARES Act, the rules and guidance available at the time of the borrower’s PPP loan application, and the terms of the borrower’s loan application.”<sup>7</sup>

Accordingly, while the acquisition of a PPP borrower after the loan has already been issued gives rise to a variety of practical considerations (see discussion below under “Negotiating the Deal—Treatment of Outstanding PPP Loan Balances & Protecting Against Relevant Risks”) and also commands a consideration of the potential optics and any publicity concerns with investing in a PPP borrower, based on the guidance promulgated to date, there does not appear to be a legal basis for the necessity certification made at the time of application to be reevaluated to account for M&A activity arising after the date of the original certification.

Nevertheless, a buyer should remain vigilant given that it is currently unclear how the guidance issued to date would be applied in an enforcement action involving this set of facts. As discussed below, a buyer should seek to protect itself from potential liability it might otherwise assume through M&A for an improper certification by a borrower and should also give careful thought as to any concerns from a publicity perspective.

**Note on Other Potential PPP Borrowers:** If an applicant for a PPP loan is historically active in M&A or is otherwise considering making a potential acquisition, such applicant will need to consider whether it is able to make the required certification given the ongoing or potential use of available liquidity for M&A activity.

## **NEGOTIATING THE DEAL—TREATMENT OF OUTSTANDING PPP LOAN BALANCES & PROTECTING AGAINST RELEVANT RISKS**

The favorable terms of a PPP loan—especially its loan forgiveness feature—together with the nature of the PPP as a government relief program create unique incentives and options for the treatment of the loan in a pending M&A transaction as compared to ordinary funded indebtedness. For those transactions that involve a target company (or a subsidiary thereof) that has already received a PPP loan,<sup>8</sup> the parties need to first consider whether to repay the PPP loan in connection with the closing (or whether the PPP lender will require repayment) or to keep the PPP loan outstanding post-closing. In the event the parties seek to keep the loan in place, and any required lender consent is obtained, there are a number of implications and considerations regarding deal economics and risk allocation.

### **To Repay or Not to Repay**

The critical decision of whether or not to repay a PPP loan at the closing of a transaction requires an analysis of the terms of the loan to determine what the PPP lender may require. The form of note the SBA has issued for its section 7(a) program, which is the program under which the PPP was promulgated, has been utilized as the standard form of note documenting PPP loans. This form provides that a borrower will be in default under the note if it “[r]eorganizes, merges, consolidates, or otherwise changes ownership or business structure without Lender’s prior written consent.”<sup>9</sup>

Moreover, SBA loan servicing guidelines provide that any proposed change in the ownership of a borrower in the first 12 months after final disbursement requires prior SBA approval.<sup>10</sup> Although there is no express prohibition or consent requirement in the form of note for sales of assets, the reference to a change in “business structure” in such form could be construed to include asset sales.<sup>11</sup> Pursuant to section 7(a) program lending guidelines, a lender would need to seek SBA consent for any assumption of the loan resulting in the release of the original borrower. Therefore, if the PPP loan was included in the asset sale and the buyer wanted to assume the loan and release the seller, SBA consent would likely be needed.<sup>12</sup>

Parties need to be mindful that not all PPP lenders have utilized the SBA form of note to document PPP loans and instead are requiring applicants to complete the applicable lender’s own forms (which may entail an entirely distinct form of note, or modified version of or supplement to the SBA form of note, and in some cases a separate loan agreement). Accordingly, diligence should be done to confirm the nature of any change of control restrictions under the loan documents governing a particular PPP loan. The discussion throughout this White Paper assumes that lender requirements in the event of a change of control generally align with the terms of the SBA form note.

As a general matter, it is likely that lender consent (and, in turn, SBA approval) will be required to the extent the parties will seek to have the event of default waived and keep the loan in place post-closing.<sup>13</sup> Alternatively, the parties may desire (or a lender may require) that the PPP loan be repaid in connection with the closing of a given transaction (whether before closing by the borrower or out of the proceeds to be paid by the buyer in the transaction).

Below is a summary of the factors to consider in evaluating whether the parties to a given transaction should seek such consent or have the loan repaid in full, as well as certain considerations for lenders when faced with such a request for consent.

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## *Borrower/Seller Perspective*

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While sellers may seek to exclude an outstanding PPP loan from a typical definition of indebtedness under the rationale that the loan amount should not operate to reduce purchase price on account of the expected forgiveness, buyers will likely insist on treating PPP loan balances as reductions to the purchase price akin to other indebtedness. Sellers should in turn, to the extent possible, seek to preserve the potential forgiveness amount or otherwise be compensated for the portion of the loan actually forgiven.

As discussed further below under “Purchase Price Plumbing—Options for Handling PPP Forgiveness,” the parties may agree to delay the deal timeline in order for forgiveness to be obtained prior to closing or, at minimum, allow for the borrower to submit the forgiveness application prior to closing. However, delays in the timeline will entail some degree of risk for sellers in that the buyer may walk away from the deal or the business may suffer a material adverse event that puts closing at risk. Moreover, deal dynamics and buyer leverage may be such that the seller is unable to avoid having the PPP loan repaid in full at closing, thereby losing out on the economic benefit attributable to potential forgiveness of the loan.<sup>14</sup>

PPP borrowers will need to understand the terms of their individual loans to determine whether consent is required in connection with a change of control. To the extent lender consent is required, the borrower will need to engage with its lender early in the process to confirm whether or not the lender will consent within the contemplated transaction timeline.

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## *Buyer Perspective*

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Assuming the parties negotiate a debt-free transaction, as noted above, buyers will tend to favor repayment of any PPP loan at or prior to closing and treat such loans similar to other indebtedness for the purpose of acquiring the target company on a debt-free basis. Under this default position, the seller will not receive any potential benefit tied to loan forgiveness.

In addition, certain buyers may insist on repayment of a PPP loan prior to or at closing in order to disassociate themselves from the PPP. For example, notwithstanding that the economic necessity certification is not brought down at the time of closing or upon submission of the forgiveness application, certain buyers (including private equity- or venture capital-backed buyers and public companies) may prefer to avoid the optics and potential negative press that may be associated with the acquisition of a PPP borrower. Buyers should also be vigilant regarding the potential liabilities arising from the acquisition of a PPP borrower. For further discussion on key diligence areas and options for allocating potential risks, see “Due Diligence & Risk Identification,” “Additional Seller Representations,” and “Indemnification & Risk Allocation” below.

While some buyers may be willing to extend the deal timeline to allow for forgiveness of the loan prior to closing, recent SBA guidance on PPP loan forgiveness references a 90-day period for the SBA to approve and disburse the loan forgiveness amount (subject to any additional time if the SBA elects to review a forgiveness application).<sup>15</sup> This 90-day period is in addition to the 60-day period a PPP lender has to approve the forgiveness application prior to submission to the SBA. Accordingly, *loan forgiveness could take up to 150 days or longer* following the submission of a forgiveness application.<sup>16</sup>

While the parties would certainly push the PPP lender for a much shorter timeframe, this 150-day period will likely have a chilling effect on seller arguments to delay closing until after the loan is forgiven. Moreover, Congress is actively considering modifications to the PPP, including an extension of the eight-week forgiveness period to potentially as much as 24 weeks, which extension would likely make buyers less likely to agree to delay a closing to accommodate loan forgiveness.

Even where a PPP loan is not forgiven (or forgiveness is not expected), there may be some subset of buyers that are amenable to keeping the loan in place in order to take advantage of the favorable terms of the PPP loan (e.g., low interest, grace period for payments, unsecured).

Certain buyers may consider negotiating with sellers in order to receive some portion of the value received as a result of a favorable forgiveness determination. This approach is more likely where a buyer's valuation assumes that the loan will be forgiven.

If a PPP loan will remain outstanding post-closing, buyers will need to ensure that their existing credit facilities (as well as any new facilities or agreements with lenders or third party financing sources being utilized in order to fund some portion of the deal consideration) are not breached and do not otherwise impose restrictions on the ability to take on such PPP loan within the buyer's structure. For a further discussion of considerations from the perspective of buyer's financing sources, see "Financing Considerations & Lender Insights" below.

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### *Lender Perspective*

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A PPP lender will likely be the ultimate authority in determining whether a PPP loan will need to be repaid in full in connection with a transaction. We are monitoring market practice for trends in lender practice on this front. On the one hand, lenders may be disinclined to consent to leave a PPP loan in place post-closing, and as such may require repayment of the loan. On the other hand, there is a countervailing perspective in the market that, notwithstanding the provisions of the form of note, lenders should not require repayment in light of the SBA guarantees backstopping PPP loans and the intent of the program to provide forgivable loans.

Understandably, while the PPP provided lenders the opportunity to expeditiously deploy capital given the SBA guarantees backstopping the loans, when faced with a change of control transaction and the uncertainty around forgiveness applications, lenders may be inclined to avail themselves of the opportunity to recoup the funds and redeploy capital with more typical market terms (and lenders will already have earned the processing fees to be paid by the government regardless of whether the loans remain outstanding or are repaid in full).

There may be some instances where a lender is more inclined to consent to a transaction and keep a PPP loan in place, especially in situations where the new buyer presents a more creditworthy owner of the borrower, debtor demand is lacking for such lender, or the transaction involves a particularly important relationship for the lender.

### **Purchase Price Plumbing—Options for Handling PPP Forgiveness**

If a buyer's valuation of a target company hinges on the forgiveness of an outstanding PPP loan, or a buyer otherwise is amenable to leaving an outstanding PPP loan in place post transaction, there are a number of timing considerations and options for the contractual treatment of the forgiveness amount.



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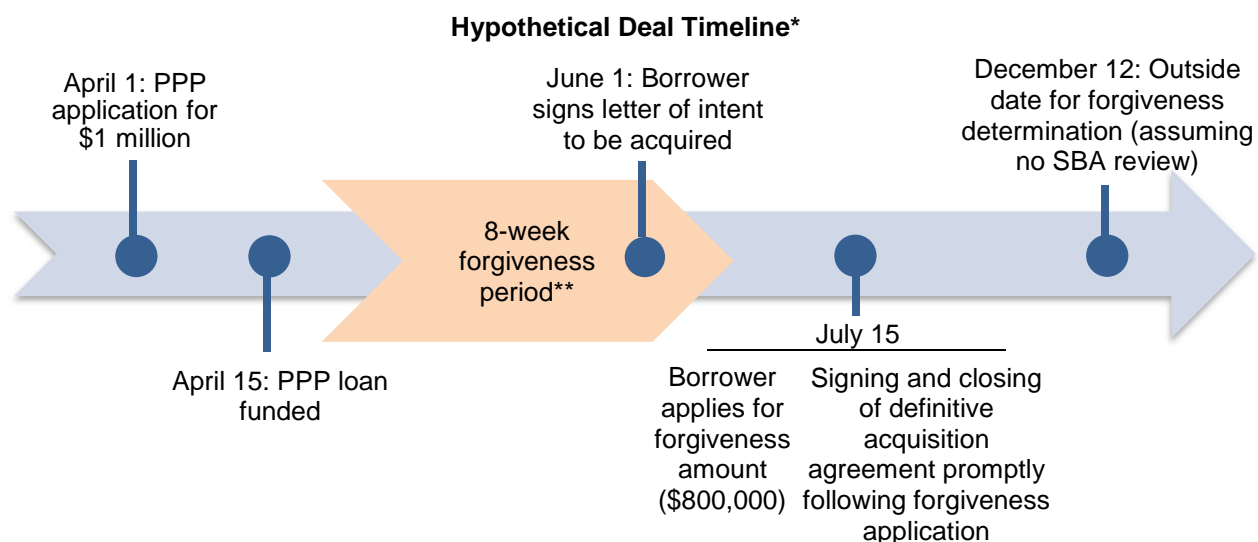
**Note on Asset Sales:** This discussion assumes that the PPP borrower will be acquired through a sale of equity or a merger, as opposed to the acquisition of a business by way of an asset sale. As discussed above under “To Repay or Not to Repay,” in the asset sale context, if a PPP loan will stay with the seller-borrower and remain outstanding after the sale, the borrower will need to consider its ability to comply with the limitations on the use of PPP proceeds—e.g., the loan proceeds can only be utilized for permitted uses, and 75% of the proceeds must be used for payroll costs. If the borrower is selling substantially all of its assets and the borrower’s employees will be transferred as part of the transaction, it is unlikely that the borrower will be able to comply with these requirements.

The ability of a PPP borrower to seek forgiveness should not be negatively impacted if its business is acquired by way of an asset sale structure following the end of its eight-week (or possibly longer, as noted above) forgiveness period. Assuming the borrower has obtained lender consent or a waiver, if required, and assuming the borrower satisfied the use of proceeds requirements during the relevant period and is not otherwise in breach, it should be able to apply for and receive forgiveness in accordance with applicable PPP rules and guidance.

For transactions in which the parties agree to accommodate some form of value adjustment relating to a pending or future PPP loan forgiveness application, the parties may take one of the following approaches:

- **Option A:** Wait to execute on the transaction until the loan is forgiven.
- **Option B:** Make forgiveness a condition in a non-simultaneous sign-and-close transaction.
- **Option C:** If the parties do not want to delay the deal timeline for loan forgiveness, keep the PPP loan in place post-closing (after seeking and obtaining any required consent or waiver from the PPP lender and the SBA) in order to accommodate a future forgiveness determination and adjust the purchase price accordingly.<sup>17</sup>

As noted above, given the possibility that a forgiveness determination may not be made until 150 days (or possibly longer if the SBA elects to review the forgiveness application) following the submission of a forgiveness application, Options A and B are less likely to be pursued.<sup>18</sup> Set forth below is an illustrative deal timeline for a hypothetical transaction described by Option C in which (1) a simultaneous sign-and-close transaction to acquire a PPP borrower is effected prior to the PPP loan being forgiven, and (2) the parties agree to keep the PPP loan in place post-closing to accommodate such forgiveness.



*\*This hypothetical assumes an eight-week forgiveness period consistent with the SBA guidance to date on the PPP. Note that the Congress is actively considering modifications to the PPP including an extension of this eight-week period.*



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In the above hypothetical transaction (and for “Option C” transactions generally), there are a number of alternative approaches for the treatment of the PPP loan balance and potential forgiveness amount in the purchase price mechanics at closing and post-closing:

- **Covenant to Remit Forgiveness:** PPP loan balance is treated as indebtedness, reducing the purchase price payable at closing by \$1 million. Buyer agrees to pay the forgiveness amount (\$800,000) if and when the borrower receives a favorable forgiveness determination, and only up to the amount actually forgiven (i.e., no additional payment to seller if the forgiveness application is rejected).
- **Escrow Forgiveness Amount:** PPP loan balance is treated as indebtedness, reducing the purchase price payable at closing by \$1 million. Buyer places maximum potential forgiveness amount (\$800,000) in a third-party escrow account to be released to seller if and when the borrower receives a favorable forgiveness determination, and only up to the amount actually forgiven (i.e., escrow amount released to buyer to the extent any portion of the loan is not forgiven).
- **Credit for Forgiveness at Close and Adjust Post-Closing:** After performing diligence and achieving adequate comfort, buyer gives seller credit for the expected forgiveness benefit (\$800,000) (perhaps subject to some discount factoring in the risk of denial) at closing, resulting in a net reduction to the purchase price on account of the PPP loan of \$200,000 (\$1 million loan balance net of the forgiveness amount). Upon the forgiveness determination, the acquisition agreement provides for a post-closing adjustment mechanic to “true up” the forgiveness benefit under which buyer may be able to recoup value to the extent the maximum forgiveness amount is not approved.<sup>19</sup>



## Effect of PPP on Net Working Capital

Buyers, as part of their accounting and financial due diligence effort to evaluate the working capital needs of a potential target company, should consider the effect of any PPP loan proceeds on working capital balances. To the extent a transaction will include a net working capital adjustment or otherwise seek to “normalize” the working capital of the company at closing to account for any historical swings, the parties could agree to exclude the PPP proceeds from current assets and adjust the target net working capital amount to account for the PPP proceeds.

A potential buyer-favorable approach toward adjusting for receipt of a PPP loan is to reference a “pre-COVID-19” level of net working capital (e.g., 2019 rather than trailing 12 months) as a target level for purposes of any adjustment. We expect this approach in any given transaction to be highly deal- and fact-specific, and subject to significant negotiations.

## Due Diligence & Risk Identification

As M&A activity involving PPP borrowers continues to expand, buyers, lenders, and other stakeholders (e.g., representation and warranty insurers) are continuing to hone their focus on the relevant issues surrounding such loans.

As a threshold matter, buyers need to understand whether a target business has availed itself of a PPP loan. If so, added scrutiny during the diligence process is warranted with respect to compliance with SBA requirements, the terms of the PPP, and False Claims Act (FCA) concerns. These diligence efforts, and the various options for addressing potential areas discussed below, are appropriate even in situations where a PPP loan will be repaid prior to or in connection with closing, given the potential risk of governmental audits and the liability regimes faced by a PPP borrower.

- Buyer diligence exercises should test whether a PPP borrower was in fact eligible to apply for and receive the PPP loan under the CARES Act and applicable SBA rules (including the SBA’s

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- affiliation rules with respect to size, SBA rules regarding ineligible businesses, and the CARES Act necessity criteria) and should test whether the borrower properly analyzed its eligibility.
- Buyers should also test the calculation of the loan amount included on the borrower's PPP application, including the determination of payroll costs and the borrower's employee count.
  - In light of the recent media focus on recipients of PPP loans and potential scrutiny around the need for the PPP funds, buyers should confirm, as part of testing the borrower's analysis in making its necessity certification, whether the borrower had access to other sources of liquidity on terms that were not substantially detrimental to the business.
  - Buyers' diligence should confirm that the borrower has collected and retained documentation and analysis supporting its PPP certifications and claims, including size and necessity, calculation of loan amounts, expenditures of loan funds, and support for its loan forgiveness application, both with respect to expenditures and the calculations used to reduce loan forgiveness based on reductions in full-time equivalent employees and salaries, if any. [For a fulsome discussion of the PPP loan forgiveness requirements, read our LawFlash on the PPP.](#)
  - Confirming the validity of this certification and other certifications made at the time of PPP loan application (and, if applicable, the borrower's forgiveness application) is especially important under the PPP and other programs implemented by the CARES Act. Applicants seeking federal funds under these programs are subject to whistleblower suits, federal audits, and investigations of violations under numerous enforcement regimes, and could face stiff penalties. These could include potential criminal penalties for false statements in connection with the PPP (as authorized by the Inspector General Act of 1978 or under other laws criminalizing false statements or fraudulent schemes) and potential civil liability under the FCA, which imposes both penalties and treble damages for individuals and entities who defraud the government. [For more information, read our LawFlash on the fraud risk and other potential liabilities that may arise when borrowing under the PPP and other CARES Act programs.](#) As part of this exercise, buyers should evaluate the potential risk of a future audit (keeping in mind the SBA's guidance that "[a]ny borrower that, together with its affiliates, received PPP loans with an original principal amount of less than \$2 million will be deemed to have made the required certification concerning the necessity of the loan request in good faith"<sup>20</sup>).
  - Finally, buyers will want to ensure that a PPP borrower utilized the loan proceeds only for permitted uses and, to the extent the parties are structuring the transaction in a manner to preserve the value attributable to forgiveness, otherwise satisfied the PPP loan forgiveness requirements. Buyers should understand any employee attrition and salary reductions since the time of the loan disbursement during the forgiveness period and the resulting impact on the potential forgiveness amount.

**Note on Other Governmental Relief Programs:** Buyers should be sure to understand if the target company has participated in any other governmental relief programs, and scrutinize the borrower's eligibility under and compliance with such programs. Buyers will also need to understand what restrictions they may be subject to when stepping into the shoes of companies participating in these programs (e.g., restrictions on dividends and executive compensation under the Main Street Lending Program). Appropriate representations in the definitive transaction documentation may be warranted to allocate risk regarding compliance with these programs.

## Additional Seller Representations

Buyers should consider supplementing acquisition agreements with additional representations and warranties relating to the PPP loan and any other programs under the CARES Act or other governmental relief programs in which the target company participates. Such representations will not only reinforce a buyer's diligence efforts and force the target company to self-diligence and disclose appropriate instances

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of non-compliance, but will also operate to shift the allocation of risk for any breaches or inaccuracies in such representations and warranties to the seller. These additional representations and warranties should cover, among other items, the following:

- Whether or not the target company has applied for and/or received funds under the PPP or any other governmental relief program
- That the company was eligible to participate in such program(s)
- That the certifications made by the company in applying for such relief were true and correct and made in good faith
- That the company is in compliance with all conditions and other applicable requirements under the terms of such program(s) (including, to the extent that the buyer is bearing the economic burden that forgiveness is not obtained, that proceeds were applied toward the forgivable uses specified in the CARES Act and related guidance)
- Whether any directors, officers, or other employees have been debarred or otherwise prohibited from engaging in any government contracting activities

As discussed further below under “Indemnification & Risk Allocation,” these representations and warranties will be important in transactions pursuant to which a seller is providing post-closing indemnification for breaches of its representations and warranties or where a buyer otherwise will have available recourse for breaches of such representations and warranties under an insurance policy.

## Indemnification & Risk Allocation

Buyers should consider whether to supplement the available buyer recourse package in a typical transaction in order to mitigate potential risks regarding compliance with the PPP and any other governmental relief programs, especially in situations where the buyer’s due diligence exercise has raised particular concerns about such issues.

Sellers will likely argue that such mitigation is not necessary and the buyer should simply accept the risk as one that is attendant to acquiring the target as a going concern. Ultimately, the approach taken by the parties will depend on the relative leverage of the parties and the negotiation dynamic more generally. As noted above under “Due Diligence & Risk Identification,” these options should be considered even in situations where a PPP loan will be repaid prior to or in connection with closing, especially where particular concerns have been identified in diligence.

**Note on Representations and Warranties Insurance Considerations:** Given that the potential liabilities of a PPP borrower involve penalties imposed by the government under the backdrop of a new, far-reaching, and rapidly issued set of statutes, regulations, and administrative guidance, it is both difficult to assess the likelihood of such liabilities arising with respect to a given recipient and the magnitude thereof. As such, similar to other such categories of liabilities (e.g., asbestos, pension underfunding), we expect insurers will seek to exclude PPP-related liabilities from coverage under an R&W insurance policy. There are certain avenues available to buyers in order to mitigate risk related to exclusions under such a policy, including (1) evaluating the underlying exposure and deducting some amount from the proposed purchase price (i.e., self-insuring), (2) obtaining a specific indemnity relating to such matters from seller (see discussion below), and (3) obtaining a separate insurance policy relating to such matters (it is unclear whether a standalone product will be made available).

Below is a summary of certain key terms to consider when negotiating indemnity coverage around these issues, together with buyer and seller perspectives with respect to such terms.

- **Treatment of Relevant Representations as Fundamental:** Buyers may consider treating any representations around compliance with the PPP or other government relief

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programs as fundamental such that such representations survive longer than and are not subject to the same limitations on recovery of losses as other general representations. Sellers should carefully consider the extent to which such representations expand the scope of any other general compliance with laws representations in the agreement, which are not typically treated as fundamental absent particular concerns raised during diligence. A potential middle-ground approach would be to accommodate an extended survival period and a higher cap on indemnifiable losses for a breach of any compliance with laws or PPP-specific representations (i.e., treating such representations as “quasi-fundamental”).

- **Specific Indemnity Coverage:** An even more buyer-favorable approach would be to seek direct indemnity coverage for any non-compliance with the terms of a PPP loan or other government relief programs (including any future determination that a borrower was ineligible to participate in such programs) or the inability to secure PPP loan forgiveness due to improper use of proceeds pre-closing or otherwise. Specific indemnity matters generally are not subject to the survival periods and limitations on indemnifiable losses that apply with respect to breaches of representations and warranties because they tend to be negotiated allocations of risk concerning specifically identified issues. Accordingly, sellers should scrutinize proposals that include a specific indemnity and push back in situations where no specific concerns are reasonably supported. For example, if PPP loan forgiveness is not assumed as part of a buyer’s valuation for a business or if the seller will not receive the benefit of any loan forgiveness amount unless and until the loan is forgiven, then a specific indemnity addressing the risk that the PPP loan will not be forgiven is less appropriate from the seller’s perspective.
- **Recoverable Losses:** Buyers should ensure that any indemnifiable losses under an acquisition agreement include any losses suffered by the target company as a result of a given breach or instance of non-compliance, including the amount of any civil or criminal fines or other penalties imposed on the company or its directors, officers, or employees under the FCA or other applicable enforcement regimes, and any fees and expenses incurred by the buyer in connection with asserting and recovering under its indemnification claims. Additionally, buyers should seek to make sure that consequential or special damages are not excluded as recoverable losses.
- **Caps on Damages:** As noted above, rights to indemnification for breaches of fundamental representations or under specific indemnities are generally not subject to the caps on recovery applicable to breaches of representations and warranties generally. The parties to a transaction could agree to treat the applicable subset of representations as “quasi-fundamental” as mentioned above or could agree to a different set of limitations appropriate for the risk covered by a specific indemnity—e.g., a cap on recoverable damages for a specific indemnity covering a failure to receive forgiveness on a PPP loan equal to the maximum forgiveness amount. Of course, the most buyer-favorable approach would be to leave any such indemnification obligations uncapped. However, the particular facts and circumstances of a given transaction may support some reasonable cap on a seller’s post-closing exposure. For example, a target company that is owned by a well-capitalized private equity group and that received a PPP loan in excess of \$2 million is likely to be considered higher risk and command a higher cap on losses than a company that took out a \$500,000 loan and is solely owned by its original founder.

## Covenant Protections

Depending on the timing of a given transaction, the parties should seek certain covenants in the signed acquisition agreement in order to maximize value and/or limit potential claims regarding a PPP loan.

- **Covenants to Protect Forgiveness:** In the event the parties agree to keep a PPP loan in place post-closing to accommodate forgiveness, sellers should seek post-closing covenants to ensure buyer will seek forgiveness (perhaps subject to an efforts standard) and to prevent buyer from taking courses of action that may negatively impact forgiveness of PPP loans or

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compliance with loan covenants (including, among other things, complying with the use requirements and other terms of the PPP loan and not taking actions that would reasonably be expected to negatively affect the ability to seek forgiveness). In the event the parties sign a definitive acquisition agreement contemplating a non-simultaneous signing and closing, and there is a likelihood that the PPP borrower will apply for forgiveness during the executory period between signing and closing, buyers should insist on covenants in line with those described above. Buyers should also seek a covenant from the seller that it will cause the PPP borrower to comply with the covenants and other PPP loan terms during the executory period.

- **Control of Audits:** Depending on the treatment of potential damages arising from a future audit relating to eligibility for or compliance with the requirements of the PPP or other governmental relief programs, the parties to a transaction should consider setting forth in the definitive acquisition agreement which party would control any such audit process. Buyers will be particularly sensitive to the handling of these matters given the media scrutiny surrounding these programs and the potential government investigations (and possible criminal and civil liabilities that may arise therefrom) into the receipt of funds thereunder. Given the six-year audit period for PPP loans, an audit could occur after a significant amount of time.
- **Cooperation:** In connection with the audit control rights described above (and depending on which party will hold such control rights), parties should seek a cooperation covenant in connection with any SBA audit or other government investigation or litigation related to a PPP loan to help ensure proper access is granted to relevant books and records and to individuals involved in the application for and administration of the applicable loan. This covenant could accompany a customary cooperation covenant around the PPP loan more generally.

## FINANCING CONSIDERATIONS & LENDER INSIGHTS

### Consents/Waivers

If a buyer intends to utilize acquisition financing to close a transaction, or if a buyer will otherwise finance the transaction but has incumbent financing in place, certain additional considerations should be taken into account.

Depending on the relative sizes of the buyer and target, nature of the transaction (asset deal v. equity deal), overall transaction size, amount and structure of the buyer's acquisition financing and/or any incumbent financing, and financial position of the target company, a buyer's financing source may prefer that the PPP loan be repaid in full at closing in order to avoid (1) any underwriting risk associated with the assumption of a PPP Loan; (2) negotiating the provisions in financing documents necessary to permit, and properly integrate, the PPP financing;<sup>21</sup> and (3) the complexities of negotiating and/or monitoring (a) the forgiveness process and (b) financing cooperation provisions, in each case, as applicable, in the purchase documents, the financing commitment letters and term sheets, or the definitive (or incumbent) financing documents.

### Financing Conditionality

For a transaction involving an executory period between signing and closing with no "financing out" in favor of the buyer (i.e., closing of the acquisition is not conditioned on receipt of acquisition financing), the obligation of a buyer's financing source to fund the transaction is customarily conditioned on, among other things, the accuracy in all material respects of (1) certain specified representations and warranties contained in the definitive financing documents and (2) certain representations and warranties contained in the acquisition agreement as are material to the buyer's financing source to the extent the buyer has the right to decline to consummate the transaction as a result of the inaccuracy of such representations and warranties.

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Given that the focus on these PPP loans is a new issue in the market, financing sources may seek to include among those representations described in (1) above certain PPP-specific representations or other general representations that may address related issues (e.g., compliance with laws) that historically buyers would have success arguing should not be included in such category. In addition, under the representations and warranties described in (2) above, a lender could argue that material issues as to eligibility or improper calculation of the funded loan amount are sufficiently material to the lender group such that it is not required to fund at closing.

Buyers should be mindful of lender posturing on this front as market practice becomes more well-developed and should consider implications of the PPP loan in the process of marrying the representations, including the specific additional representations discussed under "Additional Seller Representations" above (and any related closing conditions), in the acquisition agreement to those in the definitive financing documents as it determines the acceptable level of financing risk.

If the parties determine that closing will occur only upon approval of the forgiveness application by the SBA and the termination of a PPP loan, the commitment period for the acquisition financing will need to be structured accordingly. For example, similar to the antitrust approval context, the parties could agree to built-in extension periods in exchange for a "ticking fee" to be paid to the lender.<sup>22</sup>

## Financing Cooperation

A seller's obligations in the acquisition agreement to cooperate with buyer's efforts to obtain acquisition financing should take into account considerations related to the PPP loan, particularly where the latter is to remain outstanding following closing until such time as it is forgiven. For example, as noted above, the buyer's financing source will need access to the PPP loan documentation in order to ensure that provisions regarding default are properly aligned between the PPP loan documents and the buyer's primary financing documents.

In certain instances, the buyer's financing source and the PPP lender may need to enter into an intercreditor agreement in order to document the relationship between the PPP loans and the buyer's other financing. If the transaction occurs during the eight-week period in which the PPP loan proceeds can be applied toward forgivable expenses, the buyer should ensure that the credit agreement and other documents do not restrict the ability of the PPP borrower to apply any PPP loan proceeds toward such forgivable uses under the applicable guidance.

## CORONAVIRUS COVID-19 TASK FORCE

For our clients, we have formed a multidisciplinary Coronavirus COVID-19 Task Force to help guide you through the broad scope of legal issues brought on by this public health challenge. Find resources on how to cope with the post-pandemic reality on our [NOW. NORMAL. NEXT. page](#) and our [COVID-19 page](#) to help keep you on top of developments as they unfold. If you would like to receive a daily digest of all new updates to the page, please [subscribe](#) now to receive our COVID-19 alerts, and download our biweekly [COVID-19 Legal Issue Compendium](#).



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## About Us

Morgan Lewis is recognized for exceptional client service, legal innovation, and commitment to its communities. Our global depth reaches across North America, Asia, Europe, and the Middle East with the collaboration of more than 2,200 lawyers and specialists who provide elite legal services across industry sectors for multinational corporations to startups around the world. For more information about us, please visit [www.morganlewis.com](http://www.morganlewis.com).



<sup>1</sup> Kadix Systems, LLC, SBA No. SIZ-5016 (2008).

<sup>2</sup> See generally *Size Appeal of: WRS Infrastructure and Environment, Inc., Appellant*, SBA No. SIZ-5007 (S.B.A.), 2008 WL 5192390 (October 1, 2008); *Size Appeal of: Telecommunication Support Services, Inc., Appellant*, SBA No. SIZ-5953, 2018 (S.B.A.), 2018 WL 4921530 (August 17, 2018); *Size Appeal of: Enhanced Vision Systems, Inc., Appellant*, SBA No. SIZ-5978, 2018 (S.B.A.), 2018 WL 7200866 (December 13, 2018).

<sup>3</sup> Note that the SBA has considered these factors to be indicia of an “agreement in principle” even where the governing letter of intent is described as non-binding (other than certain terms relating to the negotiations themselves).

<sup>4</sup> 15 USC §636(a)(36)(G)(i)(I).

<sup>5</sup> *Paycheck Protection Loans: Frequently Asked Questions* (May 19, 2020), at Question 31.

<sup>6</sup> Borrowers that submitted their PPP application prior to April 23, 2020, the date Treasury issued its guidance interpreting the necessity certification, should reassess the necessity certification in light of Treasury’s guidance.

<sup>7</sup> *Interim Final Rule – SBA Loan Review Procedures and Related Borrower and Lender Responsibilities*, at Pg. 7.

<sup>8</sup> While this discussion focuses on a situation where a PPP loan is outstanding at the target company or one of its subsidiaries, if a company is sold by a parent company (in a carve-out sale or divestiture or otherwise), the seller will similarly want to consider the use of proceeds from the PPP loan and whether it can continue to meet the requirements under the PPP if one of its operating subsidiaries is no longer part of the organization. In this context, buyers will also want to consider the target company’s reliance, if any, on the PPP proceeds of its parent company in evaluating the working capital needs of the business post-closing.

<sup>9</sup> SBA Form 147 (Version 4.1), at § 4(L).

<sup>10</sup> See *7(a) Loan Servicing and Liquidation* (SOP 50 57 2), at Pg. 23; *Lender and Development Company Loan Programs* (SOP 50 10 5(K)), at Pg. 255; *Servicing and Liquidation Actions 7(a) Matrix*. These guidelines do not expressly address actions that need to be taken for a proposed change in ownership after the first 12 months following disbursement, but certain changes in a borrower’s legal structure require notice to SBA (but not approval). See *Servicing and Liquidation Actions 7(a) Matrix*.

<sup>11</sup> As a practical matter, it is likely not a feasible option to exclude a PPP loan from a sale of substantially all assets and for such loan to remain outstanding to the extent the seller-borrower would only be a “shell” company without assets as a result of such transaction, and thus will not be able to meet the PPP loan permitted use requirements (e.g., the requirement that 75% of loan proceeds be used to cover payroll costs). In limited cases, it may be feasible to leave a PPP loan with a seller-borrower in an asset sale, such as a carve-out transaction not constituting a sale of substantially all assets where the seller-borrower remains a capitalized operating business.

<sup>12</sup> See “*Note on Asset Sales*” above for a further discussion of considerations in the asset sale context.

<sup>13</sup> In certain instances loans may be funded without the borrower signing any form of note or loan agreement. In such circumstances, it is likely that a change of control of the borrower would not result in an event of default or otherwise require lender consent, but the relevant facts and circumstances will need to be evaluated on a case-by-case basis.

<sup>14</sup> The CARES Act and the SBA guidance originally contemplated an eight-week forgiveness period after which a borrower may apply for forgiveness. Congress is actively considering modifications to the PPP including an extension of this eight-week period to potentially a 24-week period. Such an extension would obviously impact the likelihood of an agreement to extend an M&A transaction timeline in order to accommodate loan forgiveness.

<sup>15</sup> *Interim Final Rule - SBA Loan Review Procedures and Related Borrower and Lender Responsibilities*, at Pg. 13.

<sup>16</sup> Borrowers must maintain documentation relating to their PPP loans for six years after the date the loan is forgiven or repaid in full. The SBA Office of Inspector General or its authorized representatives can access these records upon request. Thus, even if the SBA approves the forgiveness application within the 150-day period described above, it maintains the right to review records in connection with the PPP loan for up to six years.

<sup>17</sup> As an alternative to keeping a loan in place in situations where the parties agree that the seller should realize some potential value on account of a likely forgiveness of their PPP loan, but do not want to hold up the deal on account of the forgiveness timing, the parties could repay the loan at closing and agree to some adjustment to the deal value in favor of seller based on the expected forgiveness amount (perhaps with some discount factor).

<sup>18</sup> Option B may be more likely in a transaction that has significant regulatory or other closing conditions or that could take a similar amount of time.

<sup>19</sup> In certain limited circumstances where a seller has strong leverage (e.g., where a buyer is seeking to distinguish itself in an auction), a buyer may agree to assume the risk of the forgiveness determination and give credit for forgiveness at closing without a post-closing true up.

<sup>20</sup> *Paycheck Protection Loans: Frequently Asked Questions* (May 19, 2020), at Question 46.

<sup>21</sup> These provisions may include, among other things, treatment of the PPP loan as financial covenant neutral, no liens on PPP loan assets, no cross-default to the PPP Loan, no subordination of PPP loans, covenants regarding compliance with the CARES Act, and efforts to seek forgiveness and use of proceeds.

<sup>22</sup> The potential extension of the eight-week forgiveness period being considered by Congress and discussed further above will impact any negotiations on this issue.