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All Will Be Forgiven (or Not): What to Consider When Acquiring a Business with a PPP Loan

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Since the enactment of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act") on March 27, 2020, millions of businesses have applied for and received a Paycheck Protection Program (the "PPP") loan from the U.S. Small Business Administration (the "SBA") (for the current terms, laws and rules governing the PPP see our client alert: ***Paycheck Protection Program – Where Are We Now?***). Recipients of PPP loans ("PPP Recipient") that are the subject of a subsequent Sale Transaction[1] will likely be at risk of heightened scrutiny by the SBA and other relevant government agencies, the public, and the press, which may impact eligibility for loan forgiveness and/or result in increased audit risk and potential criminal and/or civil liability and penalty. Critical components of PPP loan forgiveness remain subject to continuing SBA rule revisions and proposed Congressional legislative "fixes," including as to the forgiveness "covered period," forgivable use parameters, and determination of the forgiveness amount. This uncertainty underscores the importance of addressing the issues around and allocating the risks and benefits of PPP loan forgiveness to the parties of the Sale Transaction, especially as it relates to the determination of the amount to be forgiven (whether at the execution of or following the consummation of a Sale Transaction). This alert provides an overview of the issues to consider when allocating such risks and benefits between the PPP Recipient, seller and acquirer, in connection with a Sale Transaction.

I. PPP Specific Risks

1. Affiliation and Loan Eligibility The SBA's affiliation rules impact whether a PPP applicant (or, retrospectively, PPP Recipient) satisfy certain size criteria for loan eligibility by requiring that foreign and domestic affiliates of the applicant or borrower be included in assessing size (e.g., tabulating total employees). Under the affiliation rules applicable to PPP loans, the SBA considers "agreements to merge (including agreements in principle) to have present effect on the power to control a concern [*e.*, PPP applicant or PPP Recipient]."[2] Therefore, a PPP Recipient may be deemed to be affiliated with an acquirer (or prospective acquirer) prior to the closing of a strategic transaction if the PPP Recipient: (i) applied for and received the PPP loan during the executory period following the execution of definitive transaction documents in respect of a Sale Transaction, or (ii) was in negotiations with an acquirer with respect to a Sale Transaction when applying for and receiving the PPP loan. A determination of whether the acquirer is an affiliate of the PPP Recipient under such circumstances is fact specific and will focus on whether there was an "agreement in principle" for the sale of the PPP Recipient.

a. The existence of an executed definitive transaction document or finding an "agreement in principle" would mean that the seller (as parent of the PPP Recipient) and the acquirer, collectively with their respective affiliates, will need to be (or should be) taken into account when assessing whether the PPP Recipient meets the requisite size standards (e.g., employee headcount limitations) for PPP eligibility. This is an important consideration for potential borrowers who are considering applying for a PPP loan while also negotiating or being involved in a Sale Transaction, and for PPP Recipients who may be retrospectively reviewing their eligibility at the time of an application for a PPP loan (to determine whether PPP loans should be returned).

b. Relatedly, there is a maximum cap of $20 million on the total amount of PPP loans that a "single corporate group" can receive. Businesses are part of a single corporate group if they are majority owned, directly or indirectly, by a common parent. The inclusion of a PPP Recipient with a PPP loan in the "single-corporate group" of an acquirer may impact the eligibility of the PPP Recipient and acquirer, together with its other affiliates that have received a PPP loan.

c. Where there is a Sale Transaction, PPP Recipient and acquirer should re-confirm (as should any PPP loan borrowers within their affiliated groups) compliance with both (i) size-based eligibility requirements, including the impact of affiliation under the SBA rules, and (ii) the impact of the $20 million cap for a "single corporate group."

2. Necessity Certification.

a. The PPP Recipient will have certified in its PPP loan application that the "[c]urrent economic uncertainty makes this loan request necessary to support the ongoing operations of the Applicant." The SBA has further reinforced that, in so doing, borrowers must consider other sources of liquidity (the use of which would not be "significantly detrimental" to the borrower). Questions may arise as to (i) whether the PPP loan request was truly necessary to support the ongoing business operations of the PPP Recipient when an impending Sale Transaction may otherwise buoy the PPP Recipient and/or (ii) whether the PPP loan directly or indirectly served an alternate purpose of facilitating a Sale Transaction (which of course is not a permitted use of PPP loan proceeds).

b. There is likely to be increased risk where the PPP Recipient either (i) executed definitive transaction documents, or (ii) was in negotiations with a potential acquirer, in each case, with respect to a Sale Transaction, and subsequently or simultaneously made the necessity certification, applied for and received the PPP loan. In the scenario described in clause (ii), the risk will in part depend on how far along the parties were in negotiations and the certainty of executing definitive transaction documents and consummating the Sale Transaction. There will also be risk where the PPP Recipient began negotiations with a potential acquirer after applying for and receiving a PPP loan.

c. The PPP Recipient should carefully and thoroughly document its decision-making process for applying for the PPP loan and use of the PPP loan proceeds to support its certification that the PPP loan was necessary to support its ongoing business operations and address any potential claims of false certifications under the False Claims Act or criminal claims of fraud by the SBA, Treasury or the various federal, state and local authorities that will be scrutinizing PPP loan borrowing.[3] Loan forgiveness applications by borrowers that, together with their affiliates, have borrowed $2 million or more will be audited by the SBA, which will provide an immediate basis for such scrutiny.[4]

3. Use of PPP Loan Proceeds.

a. In general, 75% of the PPP loan proceeds must be used for payroll costs, and the remainder may be used for: (i) payments of interest on any mortgage; (ii) rent; (iii) utilities; and (iv) interest on any other debt obligations incurred before February 15, 2020.[5]

b. Through the use of audits, the government may analyze whether the loan proceeds made available to a PPP Recipient were used for legitimate purposes, particularly in the context of an application for loan forgiveness. The PPP Recipient should properly document its use of the PPP loan proceeds to address any potential questions around making false certification and/or supporting the PPP Recipient's request for loan forgiveness, and avoid or address any claims that the loans were not necessary to support the ongoing business or that the PPP loans were used to facilitate a sale of the PPP Recipient's business.

c. In considering a Sale Transaction in respect of a PPP Recipient, the acquirer should carefully diligence with its advisors such PPP Recipient's application for the PPP loan, and the use of the PPP loan proceeds by such PPP Recipient.

4. Discrepancies between the PPP Loan Application and the Definitive Transaction Documents.

a. As part of the PPP loan application, the PPP Recipient will need to provide financial statements, payroll and tax records, corporate organization structure charts, and other information.

b. In an audit, the government may request copies of information made available to the acquirer to determine whether there are any discrepancies or inconsistences between what was relied on by the acquirer and certified by the PPP Recipient in its PPP loan application.

c. The PPP Recipient should properly document its use of the PPP loan proceeds and be prepared to explain any discrepancies or inconsistencies to address any claims of making a false certification. Clearly, a financial projection provided to the acquirer that shows the PPP Recipient doing (or expected to do) well could be problematic if at or close to such time the PPP Recipient is claiming it has a need for funds to support its business.

5. Audit Risks. The government has indicated that any PPP Recipient, together with its affiliates, that received more than $2 million will be audited. The government will also audit other PPP Recipients "as appropriate." This is especially true for a PPP Recipient that applies for loan forgiveness. We believe that there is an increased likelihood that a PPP Recipient that is the subject of a Sale Transaction following its receipt of PPP loan proceeds will be scrutinized and audited by the government with respect to its application for and use of the PPP loan proceeds. An audit will require the PPP Recipient and other parties to the Sale Transaction to expend resources to address the audit, including time, and costs and expenses of lawyers and accountants, and may also result in criminal and/or civil liability and penalties in addition to the repayment in full of the PPP loan, plus interest. Further, due to the affiliation relationship created by a definitive transaction document (discussed above), affiliates of both seller and acquirer may be pushed above the $2 million threshold and become subject to SBA audit when they might have otherwise avoided that process.

II. Allocation of Risks and Benefits

Given the potential benefits of loan forgiveness and the lag in timing with respect to the use of loan proceeds, an application for forgiveness and a forgiveness determination, [6] the possibility that a loan is not forgiven (or is only partially forgiven), and other risks associated with borrowing a PPP loan (*e.g.*, SBA review of forgiveness application), seller and the acquirer will need to properly allocate these benefits and risks. This may impact certain sections of the applicable Sale Transaction definitive transaction documents, including the following:

1. Purchase Price Adjustment. Depending on how the purchase price is determined, an acquirer may consider negotiating for an adjustment to the purchase price for any loan amount not forgiven, including interest. In a cash free, debt free transaction with a purchase price adjustment mechanism, the PPP loan may need to be a separate component for adjustment (and not a line item under "Indebtedness") taking into account the potential prolonged period that may be required to determine whether the PPP loan will be forgiven. The acquirer should also consider requesting a separate escrow in respect of the PPP loan.

2. Indemnification. If an adjustment for any unforgiven PPP loan amount is not included in the purchase price adjustment section, an acquirer may consider including a specific indemnity to that effect. Even if the parties agree to an adjustment to the purchase price in respect of the loan amount, plus interest, using the purchase price mechanics, an acquirer may consider requesting a specific indemnity in respect of costs and expenses of an audit and/or litigation, and any criminal and/or civil liabilities and penalties that may result.

In the event the acquirer purchases a buy-side representation and warranty insurance policy, the acquirer should consider whether the PPP loan falls within any COVID-19 related exclusions from such policy. In the event that breaches of PPP-related representations and warranties are not covered by a representation and warranty insurance policy, an acquirer may seek a specific indemnity (which may give rise to typical negotiations regarding the application of baskets and/or caps to such specific indemnities).

3. Covenants.

a. Use of Loan Proceeds:

i. If any PPP loan proceeds remain unused at the time of signing (but pre-closing), the acquirer may consider negotiating interim operating covenants for the PPP Recipient to use the PPP loan proceeds for forgiveness-eligible purposes to maximize the prospects of loan forgiveness and minimize potential liabilities related to ineligible uses of such funds.

ii. Similarly, a seller may consider negotiating post-closing covenants that the PPP loan proceeds be used following the consummation of the Sale Transaction by the acquirer for forgiveness-eligible purposes.

b. Other Actions Affecting Scrutiny/Forgiveness:

i. The acquirer may consider negotiating interim operating covenants for the PPP Recipient not to take any actions or make any communications, or fail to take any necessary action or make any necessary communications, that will increase the likelihood of increased scrutiny or liability with respect to the PPP loan or may adversely affect the likelihood of forgiveness.

ii. Similarly, a seller may consider negotiating post-closing covenants for the PPP Recipient not to take any actions or make any communications, or fail to take any necessary action or make any necessary communication, that will increase the liability of the seller under the definitive transaction documents or may adversely affect the likelihood of forgiveness.

c. Party Controlling the Submission of Loan Forgiveness Application. The seller may consider negotiating a covenant allowing the seller to control the PPP loan forgiveness application process, especially if it is entitled to benefit from any loan forgiveness or has any related post-closing liabilities under the definitive transaction documents. If acquirer agrees, it should consider requesting a consent requirement, or at a minimum consultation rights, prior to the submission of the loan forgiveness application. Conversely, if acquirer controls the loan forgiveness application, seller should ask for review/consent rights, especially if it affects the purchase price adjustment or it bears the risks of any resulting liability under the applicable definitive transaction document.

Given the inherent complexity of the situation, acquirer and seller may negotiate to share in the benefits and the risks of any PPP loan forgiveness to align their interests.

d. Party Controlling and Assuming the Defense of an Audit. Similarly, parties should consider including covenants concerning the control of any audit process. The non-controlling party should request customary rights in respect of audits and other actions assumed by the controlling party, including the right to separate counsel and participation and restrictions on settlement.

e. Taxes. PPP loans may also have a tax impact on the PPP Recipient that the parties to a Sale Transaction should consider, including (i) who benefits from the Employee Retention Credit if a PPP loan is returned and the (post-closing) PPP Recipient becomes eligible to utilize such tax credit[7] and (ii) who benefits from the deductibility of expenses for which PPP loans are used should the IRS reverse course on its recent guidance prohibiting deductions for such expenses (in light of public and Congressional pressure)[8].

f. Financing. If the Sale Transaction has a financing component, the financing provisions of the definitive transaction document and the commitment papers and definitive debt documents should be drafted in a way that accommodates the PPP loan and the forgiveness or, if necessary, servicing and repayment of the PPP loan

4. Representations and Warranties. An acquirer may consider negotiating representations and warranties in respect of the PPP loan application, and representations and warranties that align with the certifications made in the PPP loan application, including with respect to the PPP Recipient's eligibility for the PPP loan, need for the loan, and appropriate use of the loan proceeds pursuant to the laws in effect at the time of its use. Separately, a seller may consider negotiating a ring-fencing provision whereby the acquirer acknowledges the certifications made in the PPP loan application and agrees that such certifications will not be construed to amount to a breach of any other representation and warranty in the applicable definitive transaction document (particularly those that speak to the financial health of the PPP Recipient). In conjunction with drafting its representations and warranties (and fulfilling related disclosure requirements), a seller should consider whether its application for and receipt of a PPP loan violated any covenants or obligations under its existing debt facilities and how best to communicate such issues to the acquirer.

As the laws, rules, regulations, and guidance around the PPP and CARES Act continue to evolve and federal and state governments contemplate further legislation to address the impact of COVID-19 on businesses (as evidenced by H.R. 6800 (the HEROES Act), which passed the House of Representatives this past week[9]), parties should be thoughtful about drafting interim operating covenants and post-closing covenants, particularly as it relates to PPP loan forgiveness. Parties should be cognizant of and include mechanics in the definitive transaction documents that anticipate shifts in the legal landscape around the PPP. These changes will likely impact both loan forgiveness and risk allocation, and having the foresight to plan ahead will enable parties to nimbly respond to and work within the bounds of any future laws, rules, regulations, and guidance.

While Section II discusses the impact of a PPP Recipient's PPP loan on a number of provisions in the definitive transaction documents, there may be other provisions that are affected taking into account the specific facts surrounding the PPP Recipient's application, receipt and use of the PPP loan proceeds. All of the issues discussed above become much more complex if the PPP Recipient is merged with or combined with another existing business of the acquirer following the consummation of a Sale Transaction.

On a final note, notwithstanding the allocation of risks identified in this alert, if the parties are interested in consummating a Sale Transaction, it is important that all parties involved understand and realize that it is in the best interest of each of the parties involved to resolve any potential issues that may arise out of a PPP Recipient's application for any PPP loan, including its receipt and use of such proceeds. The interests of all parties should be aligned to avoid a process involving civil and/or criminal allegations and causes of action, which will require such parties to allocate resources to defend against such allegations and/or causes of action, and may undoubtedly impact the parties' reputations.

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Proskauer's cross-disciplinary, cross-jurisdictional Coronavirus Response Team is focused on supporting and addressing client concerns. We will continue to evaluate the CARES Act, related rules and regulations and any subsequent legislation to provide our clients guidance in real time. Please visit our Coronavirus Resource Center for guidance on risk management measures, practical steps businesses can take and resources to help manage ongoing operations.

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[1] For the purposes of this alert, a "Sale Transaction" includes (i) a merger or consolidation with respect to the PPP Recipient, (ii) a sale or issuance of equity interests that results in the acquirer purchasing from the seller or the PPP Recipient, as applicable, a significant interest in the PPP Recipient, (iii) a sale, lease, transfer, exclusive license or other disposition of all or substantially all of the assets of the PPP Recipient, and (iv) investments, including growth-equity or similar minority stake investments in the PPP Recipient.

[2] 13 C.F.R. §121.301(f)(2) (2019). Note that, in contrast, "[a]greements to open or continue negotiations toward the possibility of a merger or a sale of stock at some later date are not considered 'agreements in principle' and [] are not given present effect." Discussions about the possibility of a future merger or buy-out, by themselves, are not sufficient to find affiliation. *See* U.S. Small Bus. Admin., *Small Business Compliance Guide: Size and Affiliation* (June 2018), *available at* https://www.sba.gov/document/support--affiliation-guide-size-standards.

[3] *See* 18 U.S.C. §§ 1001 (1996) & 3571; 15 U.S.C. § 645(a) (2013); and 18 U.S.C. § 1014 (1996).

[4] *See* the SBA's FAQ for Lenders and Borrowers Questions 37 and 46.

[5] *See* Interim final Rule published on April 15, 2020.

[6] Notably, responding to pressure from the business community, pending legislation in the U.S. House of Representatives (H.R. 6886 (Paycheck Protection Program Flexibility Act of 2020)) proposes to extend the forgiveness "covered period" to 24 weeks, which would further extend the timeframe for use of PPP loan proceeds and application for and approval of forgiveness.

[7] Treasury and the SBA clarified in their Frequently Asked Questions published regarding the PPP (Question 45) that borrowers that repay their PPP loan during a recent safe harbor period (which expired May 18th) become eligible for the Employee Retention Credit under the CARES Act. While it is unclear whether the SBA will extend that construct to PPP loans repaid going forward, a seller will certainly want to benefit from the post-closing company's utilization of such credit if available.

[8] On May 6, 2020, a bi-partisan group of Senators introduced S. 3612 (Small Business Expense Protection Act of 2020) which would clarify that PPP Recipients can deduct eligible expenses that were paid for by PPP loans from their taxes.

[9] As of the date of this alert, neither the HEROES Act nor any other next stage COVID-19 recovery/stimulus legislation has been taken up in the Senate.

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