Client Alert

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SBA's "October Surprise" Forces PPP Borrowers and Lenders to Complete Loan Forgiveness and Establish Escrow Accounts to Circumvent SBA Prior Approval for Most "Change of Ownership" Deals

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In a significant development for the mergers and acquisitions ("M&A") community, the U.S. Small Business Administration ("SBA") issued a "Procedural Notice" which affects the requirement for companies involved in the buying or selling of a company with a Paycheck Protection Program ("PPP") loan – the requirement of the PPP Lender to obtain SBA "prior approval" for a change of ownership. This requirement was causing significant deal delays and even forcing companies to return PPP funds in order to meet deal closing deadlines. Recognizing the havoc that this requirement was causing in M&A transactions generally, SBA changed, but did not eliminate, the requirement. Beginning on October 2, 2020, as long as companies with PPP loans meet certain specified conditions discussed below with respect to filing for PPP loan forgiveness and placing PPP funds in escrow pending the forgiveness process, PPP Lenders need not obtain SBA prior approval – this applies to most change of ownership transactions.

As a starting point, SBA makes clear that prior to the closing of any change of ownership transaction, the PPP borrower must not only notify the PPP Lender in writing about the contemplated transaction but also provide the PPP lender with a copy of the documents that will effectuate the proposed transaction.

SBA offers its own definition of "change of ownership" as follows:

I. At least 20 percent of the common stock or other ownership interest of a PPP borrower (including a publicly traded entity) is sold or otherwise transferred, whether in one or more transactions, including to an affiliate of an existing owner of the entity[1];
II. The PPP borrower sells or otherwise transfers at least 50 percent of its assets (measured by fair market value), whether in one or more transactions; or
III. a PPP borrower is merged into another entity.

SBA offers its own definition of "change of ownership" as follows:

I. Repaid the Note in full; or
II. Completed the loan forgiveness process; and
    i. SBA has remitted funds to the PPP lender in full; or
    ii. the PPP borrower has repaid any remaining balance on the PPP loan.

Where the PPP Note has not been satisfied prior to closing the sale or transfer, SBA introduced its new conditions which must be met in order to avoid needing SBA's prior approval before closing the sale or transfer.

1 To determine a change of ownership, all sales and other transfers occurring since the date of approval of the PPP loan are aggregated whereas for publicly traded borrowers, only sales or other transfers that result in one person or one entity holding or owning at least 20% of the common stock or other ownership interest of the borrower are aggregated.

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A PPP Lender may approve the change of ownership without SBA's prior approval for a change of ownership structured (i) as a sale or other transfer of common stock or other ownership interest; or (ii) as a merger; or (iii) as an asset sale if:

- The PPP borrower completes a forgiveness application and submits it (with any required supporting documentation) to the PPP Lender; and
- The PPP borrower establishes an interest-bearing escrow account controlled by the PPP Lender, containing funds equal to the outstanding balance of the PPP loan; and
- After the forgiveness process (including any appeals) is completed, the escrow funds are used to repay any remaining PPP loan balance including interest.

Where the change of ownership is structured (i) as a sale or other transfer of common stock or other ownership interest; or (ii) as a merger, a PPP Lender may also approve the change of ownership without SBA's prior approval and without completing the forgiveness application and setting up the escrow account described above if the sale or other transfer is of 50% or less of the common stock or other ownership interest of the PPP borrower.

SBA makes clear, however, that for all sales or other transfers of common stock or other ownership interest or mergers, whether or not the sale requires SBA's prior approval, the PPP borrower and/or successor entity to the PPP borrower, remain subject to all obligations under the PPP loan. If the new owners use PPP funds for unauthorized purposes, SBA will have recourse against those new owners for unauthorized use of PPP funds. This means that regardless of any change of ownership, the PPP borrower remains responsible for:

I. Performance of all obligations under the PPP loan;
II. Certifications made in connection with the PPP loan application, including the certification of economic necessity; and
III. Compliance with all other applicable PPP requirements.

How SBA's Changes Affect PPP Lenders

At present, only 1% of the more than 5.2 million PPP loans have been sent by PPP Lenders to SBA. Thus, one has to wonder whether PPP Lenders can handle SBA's two new additional requirements which clearly burden them by (1) forcing them to start the PPP loan forgiveness process (something many PPP Lenders have not done while hoping that Congress will pass blanket PPP loan forgiveness legislation which would account for 86% of all PPP loans); and (2) obliging them to establish escrow accounts for many of their customers. It's more than likely however, that PPP Lenders will applaud these new requirements despite the added burdens because they add significant protection for the PPP Lenders to be reimbursed by PPP borrowers involved in change of ownership transactions described above after the loan forgiveness process is completed. Effective October 2, 2020, where such a PPP borrower's loan forgiveness application is denied – or a part of it is denied -- the PPP Lender is already holding funds equal to the outstanding balance of the PPP loan in escrow. Those escrowed funds will be "disbursed first to repay any remaining PPP loans balance plus interest."

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How SBA's Changes Affect PPP Borrowers Involved in Change of Ownership Transactions

PPP borrowers involved in change of ownership transactions may see these new requirements as yet two more hurdles to jump before closing a deal – or else risk having SBA find that the company is in violation of its PPP loan terms. PPP borrowers with loans above $2 million, however, may welcome this roadmap since they can expect to be audited and, therefore, these two new requirements tell them exactly how to close a deal without obtaining SBA prior approval without jeopardizing their audit. For the PPP borrowers with loans under $2 million, there is less to like since they weren't expecting to be audited. Now, proceeding to closing without meeting these requirements could trigger an audit for those PPP borrowers for failure to meet all of the terms of the PPP loan.

Finally, it's worth noting that although SBA changed the requirements for PPP Lenders to obtain SBA prior approval for most change of ownership deals by adding two new requirements, SBA expressly reiterated its rights and remedies available under the law to pursue PPP borrowers and their successor entities for fraud, false statements and/or unauthorized uses of PPP loan funds. Since one of the principal purposes of PPP loan insurance is to insure the accuracy of the borrower's economic necessity certification, this coverage may be more relevant than ever to parties involved in M&A transactions. And, while PPP loan insurance was not available to PPP borrowers which closed a transaction without first obtaining SBA's prior approval that may have now changed. PPP loan insurers are digesting this new development and considering whether they can cover PPP borrowers that have applied for loan forgiveness and escrowed the required funds pending forgiveness.

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