



October 2020

ALERT
Paycheck Protection Program Borrower Beware:
SBA Procedural Notice 5000-20057

Many small businesses have received forgivable loans from banks and other financial institutions under the popular, if chaotically implemented, Paycheck Protection Program (PPP) of the Small Business Administration (SBA). Many of these borrowers are entering the forgiveness phase of their PPP lifecycle.

Buyers and sellers of businesses that have PPP loans outstanding need to be aware that the existence of the PPP loan may trigger third party notification, escrow and / or prior approval obligations.

As background, PPP loans are generally subject to the regulatory requirements that apply to SBA “7(a) loans.” One such requirement is that a 7(a) lender obtain SBA prior approval of any change in ownership of a 7(a) borrower within the first 12 months after final disbursement of the loan.

SBA recently issued SBA Procedural Notice 5000-20057, effective October 2, 2020 (the Notice), which outlines the rules to which PPP lenders and borrowers must adhere when a borrower is contemplating a change of ownership transaction.

Definition of Change of Ownership

The Notice defines a “change of ownership” to mean any of the following:

- at least 20 percent of the common stock or other ownership interest of a PPP borrower is sold or otherwise transferred, whether in one or more transactions, including to an affiliate or an existing owner of the entity;
- 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
- a PPP borrower is merged with or into another entity.

In determining whether these percentage ownership thresholds are met, all sales and other transfers occurring since the date of the approval of a borrower’s PPP loan must be aggregated.

In the absence of further SBA guidance, this broad definition of change of ownership could apply in some unexpected circumstances, such as:

- an additional equity investment in a PPP borrower,
- a PPP borrower buys out an existing investor,
- a transfer of interests in a PPP borrower for estate planning purposes, or
- a transfer of interests in a PPP borrower between husband and wife.

PPP Borrower Must Notify Lender of Any Change of Ownership Transaction

Prior to the closing of any change of ownership transaction, a PPP borrower must notify its lender in writing of the contemplated transaction and provide the lender with copies of the documents in connection with the proposed transaction.

Lender's Notice Requirement

For all sales or other transfers of common stock or other ownership interests or mergers, whether or not the transaction falls within the Notice's definition of change of ownership or requires SBA's prior approval, the Notice requires the lender to submit to SBA certain information about the new ownership of the borrower. Specifically, the lender must notify the appropriate SBA Loan Servicing Center, within 5 business days of completion of the transaction, of the:

- identity of the new owner or owners of the common stock or other ownership interest;
- new owner's or owners' ownership percentage or percentages;
- tax identification number or numbers of any owner or owners holding 20 percent or more of the equity in the borrower's business; and
- location of, and the amount of funds in, the escrow account under the control of the PPP lender, if an escrow account is required, as described below.

PPP borrowers contemplating any such transaction or merger must be prepared to provide this information to their lender in time for the lender to comply with its SBA notice obligation.

Change of Ownership Transactions That Do Not Require SBA Prior Approval

The SBA Notice does not restrict a PPP borrower's change of ownership if, prior to closing of change of ownership transaction, the borrower has:

- fully repaid its PPP loan, or
- completed its loan forgiveness application, and either:
 - SBA has remitted funds to the lender in full satisfaction of the PPP note, or
 - the borrower has repaid any remaining balance on its PPP loan.

The other way that a PPP borrower can avoid SBA prior approval is to use the PPP forgiveness application and escrow deposit alternative under the following heading.

Two Alternatives for 50% Change of Ownership Transactions and Mergers

If a change of ownership of a PPP borrower involves:

- a sale or transfer of more than 50% of its equity interests in the borrower;
- a merger of the borrower with another entity; or
- a sale or other transfer of 50% or more of its assets, based on fair market value,

then the borrower has two alternatives:

- The borrower can:
 - complete its PPP loan forgiveness application reflecting its use of all PPP funds and submit it, together with any required supporting documentation, to its PPP lender, and
 - establish an interest-bearing escrow account controlled by its lender with funds equal to its outstanding PPP loan balance. After completion of the forgiveness process, the escrow funds will first be used to repay any remaining PPP loan balance, plus interest, and any remaining escrow funds will go to the borrower.

or

- The borrower's lender can submit a request for SBA prior approval of the change of ownership transaction. To obtain SBA's prior approval of a transaction, the lender must submit the request to the appropriate SBA Loan Servicing Center, including the following:
 - the reason the borrower cannot either fully repay its PPP loan or satisfy the escrow condition described in the preceding alternative;
 - the details of the requested transaction;
 - a copy of its executed PPP loan note;
 - any letter of intent and the purchase or sale agreement setting forth the responsibilities of the PPP borrower / seller and buyer;
 - disclosure of whether the buyer has an existing PPP loan and, if so, the SBA loan number; and
 - a list of all owners of 20% or more of the purchasing entity.

SBA may require additional risk mitigation measures as a condition to its prior approval of a transaction. If the transaction involves a sale of 50% or more of the assets of a PPP borrower, SBA's approval of the transaction will be conditioned on the buyer's assumption of all of the seller's PPP loan obligations in the purchase agreement or a separate assumption agreement, which must be submitted to SBA.

SBA has 60 days following its receipt of the request to approve or deny the request.

Both Buyer and Target Have PPP Loans

The Notice also addresses transactions involving any sale of equity (whether or not constituting a change of ownership within the meaning of the Notice) or merger where both the buyer / new owner and the target or successor in a merger have separate PPP loans. In such a situation, following the consummation of the transaction:

- in the case of a purchase or other transfer of common stock or other ownership interest, the PPP borrower and the new owners or owners are responsible for segregating and delineating PPP funds and expenses and providing documentation to demonstrate compliance with PPP requirements by each PPP borrower; and
- in the case of a merger, the successor is responsible for segregating and delineating PPP funds and expenses and providing documentation to demonstrate compliance with PPP requirements with respect to both PPP loans.

Practical Suggestions for PPP Loan-Affected Buyers and Sellers

The entire PPP process has been chaotic and unpredictable with vague and constantly changing rules, and we expect implementation of the directives in the Notice to be no different. That being said, we can make a few preliminary, high-level observations.

Because SBA did not prescribe a particular form of PPP loan note, all PPP borrowers contemplating a business transaction, whether or not the transaction would constitute a change of ownership under the Notice, should review their form of PPP loan note to determine whether the transaction would trigger lender notice and consent.

To avoid the uncertainty and relatively long timeframe entailed with seeking SBA prior approval, PPP borrowers contemplating a change of ownership transaction while their PPP loan is outstanding may be compelled to use the forgiveness application and escrow deposit alternative described above, assuming they have sufficient funds to satisfy the escrow requirement.

Alternatively, PPP borrowers contemplating such a transaction that is likely to require SBA approval should seek such approval as early in the transaction process as possible to avoid significant delays in closing the transaction.

Buyers and sellers in purchases and sales of businesses that have PPP loans outstanding will want to do due diligence on compliance with the Notice and in some cases seek additional representations and covenants in the transaction agreements.

Anyone contemplating an equity purchase or sale or merger where both the buyer and the target have PPP loans outstanding must strictly adhere to the segregation rules, described under “Buyer and Target PPP Loans” above, for each separate PPP loan following the closing to preserve the PPP borrowers’ abilities to obtain full PPP loan forgiveness.

If you are contemplating a business transaction, whether as a buyer or seller, that involves an outstanding PPP loan, and you have any questions about the notification and SBA prior approval

rules in the Notice, and how these rules may impact your proposed transaction, please feel free to contact:

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