SBA Muddies the Waters by Issuing Complicated Reporting Requirements for Ownership Changes of a PPP Borrower

COVID-19 Resource

The Small Business Administration (SBA) released a Procedural Notice that establishes an approval process for transactions that result in a change in ownership of a paycheck protection program (PPP) borrower. The guidance is relatively clear, but comes very late in the PPP cycle and unnecessarily creates many obstacles and questions. More specifically:

• With an effective date of October 2, the Procedural Notice does not address the many transactions that have already occurred (or those occurring on or already in process after the effective date).

• Given the widespread use of PPP loans, the likelihood that most loans will be substantially forgiven and the overall purpose of helping businesses, the new obstacles created by the SBA for change-of-ownership transactions are unnecessary and counterproductive.
Whether or how the requirements protect the interests of the SBA or the public.

The comprehensive and onerous approval process described in the Procedural Notice applies concepts that may make sense in a traditional SBA 7(a) loan, but do not work in the context of PPP loans, which are not normal and were intended by Congress to become grants so long as recipients spend the proceeds on prescribed costs. The “normal” approval process applied in the abnormal PPP loan context creates unnecessary burdens and confusion that undermines the simulative purpose of PPP loans.

Background

PPP loans have provided a lifeline to many businesses and much needed stimulus to the economy. As described in an August 8 SBA report, there have been more than 5.2 million PPP loans in excess of $525 billion. PPP loans are guaranteed by the U.S. Government and forgivable to the extent the PPP borrower pays or incurs certain costs (payroll costs, mortgage interest, rent or utilities) during the eight-week or 24-week period following origination of the loan. Because loan amounts were based on two and a half months of average 2019 payroll, the extension of the forgiveness period to 24 weeks and allowance of up to 40 percent of the forgiveness to be attributable to non-payroll costs, virtually all borrowers likely will be entitled to substantial (if not full) forgiveness.

As with any program adopted in haste, PPP loans have several issues, including the uncertainty certification when obtaining a loan, the deductibility of costs that result in forgiveness, the SBA’s favorable interpretations of the statutory reductions in forgiveness for reductions in compensation and employees, and the evolving rules for the treatment of employee-owners of a PPP borrower. More information on these issues and others is available under the Tax Benefits, Loans and Other Stimuli section of Lane Powell’s COVID-19 Resource Center.

PPP Loans and M&A Transactions

An M&A target’s lenders generally must approve a material change in ownership of the target or a material sale of the target’s assets unless the lender’s debt is satisfied in the transaction. PPP loan documents generally require lender approval before a change of ownership, without defining what constitutes a change of ownership. In the spring and early summer,
many PPP lenders (particularly community bank lenders) were pretty liberal in granting approval, so long as doing so didn’t seem abusive to the PPP purpose or process and didn’t seem to materially impair credit quality or forgiveness likelihood. Sometime during the summer, the SBA decided that it should take a more active position on the approval process in change-of-ownership transactions.

Following some comments by SBA officials, it became unclear how the approval process should operate. Some banks seemed to continue granting approvals liberally, though some caveated their approvals by making them subject to SBA approval or ratification. Other banks (and some acquirers) required PPP borrowers to create escrow arrangements to secure repayment of the target’s PPP loan. Other banks even suggested that they would not approve the loan absent full repayment (we could never understand why approval would even be necessary in that situation).

Regardless of need or logic, the Procedural Notice now describes the procedures that PPP borrowers and lenders must follow for transactions resulting in a “change of ownership” of a PPP borrower.

**What Constitutes a Change of Ownership?**

Under the Procedural Notice, a change of ownership occurs if:

1. 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;

2. 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

3. A PPP borrower is merged with or into another entity.

Significantly, the definition of a “change of ownership” subject to the Procedural Notice does not appear to include changes in the existing ownership structure resulting from the contribution of additional equity capital. Nevertheless, there remains ambiguity as to whether the Procedural Notice applies to those transactions. Not surprisingly,
therefore, we understand that some lenders (and even some investors) in these common situations are treating the transactions as subject to the Procedural Notice. Because infusing new capital into the (often struggling) borrower’s business in exchange for new equity would invariably decrease credit risk, we encourage the SBA to explicitly state that such transactions are not a change of ownership subject to the Procedural Notice.

Similarly, many businesses will not survive the COVID-induced economic trauma even if they used all or substantially all of their PPP loan proceeds for qualified purposes. Those businesses are closing and need to liquidate, procedurally or effectively. It is unclear whether a liquidation that transfers 50 percent or more of its assets to its creditors or owners in liquidation constitutes a change of ownership subject to these rules. Telling these businesses they need to escrow the full amount of their PPP loans prior to such transfers seems like the triumph of hope over reason.

Additionally, the drafters of the Procedural Notice do not seem to appreciate that parties could avoid causing a transaction to constitute a change in ownership under these rules simply through non-substantive changes to transaction structure. For example: corporate shareholders of a PPP borrower might recapitalize the company to add participating voting preferred stock and then sell that stock instead of common; so long as the preferred has a liquidation preference, such a transaction would seemingly avoid qualifying as a change of ownership.

Finally, although transfers of preferred stock would seem to fall outside the definitional prerequisites for a change of ownership transaction, there is no similar express exception for transfers of preferred interests in LLCs or other similar entities taxed as partnerships, even though the logic (if any) for an exception in the corporate context would seem to be equally applicable if the PPP borrower is structured as a tax partnership.

**Notice and Documentation**

The Procedural Notice requires the PPP borrower to notify the PPP lender in writing in advance of, and to provide the PPP lender with the documents that will effectuate the change in ownership.

The PPP borrower is supposed to provide this notification before the closing of the transaction, but the consequences of failing to do so are unclear. The obvious question is whether failure to do so impairs
entitlement to forgiveness if such notice is not provided or prior-approval not requested. After all, a loan is simply a contract, and the breach of a contract generally triggers liability only for consequential damages (absent some special provision on liquidated damages or acceleration of responsibilities). Accordingly, failure to obtain advance approval should expose the PPP borrower to no more than consequential damages to the lender or SBA, e.g., liability for failure to repay non-forgivable portions of the loan. Changes of ownership in PPP borrowers that fail to comply with the Procedural Notice thus should only create damages to the lender/SBA to the extent the PPP is not otherwise forgivable.

After full forgiveness is final, no approval is necessary for a change of ownership. Until then, some changes of ownership can be approved by the lender whereas others also must be approved by the SBA.

**Situations Where Ownership Change Does Not Require Any Approval**

The Procedural Notice confirms that there “are no restrictions on a change in ownership” if (a) the PPP loan has been repaid in full or (b) the PPP borrower has completed the loan forgiveness process, including remittance by the SBA to the PPP lender of the forgiven portion of the PPP loan and repayment of any unforgiven balance.\(^1\)

**Note:** No PPP loans have been forgiven yet, so this exception is relatively narrow. Indeed, because most banks only recently started accepting PPP loan forgiveness applications, there are very few (if any) businesses that have even completed the forgiveness process. This exclusion will become more important if lenders and the SBA start to expeditiously process forgiveness applications.

**Situations Where Ownership Change Requires Only Lender Approval**

The Procedural Notice provides that the lender *may* approve the transaction without SBA approval if certain requirements are met. The specific requirement depends on the type of transaction:
1. **Sale or other transfer of common stock or other ownership interest or merger.** The PPP lender alone may approve the transaction without the prior approval of SBA if either:

   a) The sale or other transfer is of 50 percent or less of the common stock or other ownership interest of the PPP borrower; or

   b) The PPP borrower completes a forgiveness application reflecting its use of all of the PPP loan proceeds and submits it, together with any required supporting documentation, to the PPP lender, and an interest-bearing escrow account controlled by the PPP lender is established with funds equal to the outstanding balance of the PPP loan. After the forgiveness process (including any appeal of SBA’s decision) is completed, the escrow funds must be disbursed first to repay any remaining PPP loan balance plus interest.

   With respect to these transactions, we note the following:

   • For purposes of applying the 50 percent threshold, the PPP borrower must aggregate all transfers occurring since the date of PPP loan approval. But there does not seem to be any express prohibition against the use of puts and/or calls to fix the economics of a future transaction without actually triggering the 50 percent threshold. Incorporating by reference the rules of Internal Revenue Code sections 382 and 1092 would have prevented such an easy end-run around the threshold.

   • All relevant parties must comply with some onerous documentation requirements (discussed in greater detail below).

   • The transaction parties seem to need to affirm ongoing liability of the borrower even though such liability would seem to exist by operation of law under any variation of this type of transaction.

2. **Sale of 50 percent or more of the PPP borrower’s assets.** The PPP lender alone may approve the transaction without the prior approval of SBA if an interest-bearing escrow account controlled by the PPP lender is established with funds equal to the outstanding balance of the PPP loan. After the forgiveness process (including any appeal of SBA’s decision) is
completed, the escrow funds must be disbursed first to repay any remaining PPP loan balance plus interest.

The escrow arrangement under either of these provisions is “interesting” for at least three reasons. First, many PPP borrowers will have long since spent their PPP proceeds and will not be able to fully fund the escrow arrangement. Accordingly, a portion of the purchase price presumably will be used to fund the escrow. Second, requiring an interest-bearing account seems unnecessary given the current low-interest-rate environment and the very short-term nature of this escrow. Third, there is no logical reason for precluding SBA approval only if the borrower’s application demonstrates use of all of the PPP loan, because the purpose for the escrow is to support repayment of any unforgiven amounts (including amounts unforgiven because of lack of use). Is a borrower that used only 96 percent of their PPP funds really such a greater credit risk that only the SBA can make the approval decision? Further, why not allow alternative security arrangements, like a standby letter of credit or pledge of a compensating balance in a cash account?

No doubt, PPP lenders will help facilitate the creation of these escrow accounts, but that will undoubtedly cost the borrower time and money while also sequestering capital that could be better spent supporting our economy. It is unclear why the SBA requires an escrow even if (or to the extent) the lender has reviewed the forgiveness application and approved the loan for forgiveness. M&A transactions regularly involve a target with outstanding contingent liabilities. For these transactions, the parties often use methods other than an escrow account (e.g., holdback, indemnification, installment notes, purchase price adjustment, etc.) to protect the buyer from contingent liabilities such as PPP loans that might not be forgiven. Escrow accounts reflect only one of the many ways to protect both borrower and lender, and it seems like “overkill” for a liability that generally will be forgiven.

**Situations Where Ownership Change Requires SBA Approval**

All other changes in ownership require SBA approval, without any indication of the standards the SBA will apply when determining whether to approve the ownership change. Because the PPP promissory note between the borrower and lender contemplates that only the lender need
approve the change of ownership, the SBA seems to be overreaching here without any appreciation for the impact of delaying transactions pending receipt of SBA approval.

To obtain SBA approval, the PPP lender must submit a request to the appropriate SBA Loan Servicing Center. The request must include:

1. **The reason the PPP borrower does not satisfy the conditions for no restrictions described above (repayment in full or completion of the forgiveness process).** We believe that the expectation of forgiveness explains the lack of repayment and general delays in the forgiveness process (e.g., time to complete application, the 60 days the PPP lender has to review the application and the 90 days the SBA has to review the application) explains why the forgiveness process has not been completed. Still, we find it concerning that the SBA would require providing a reason when the reason appears obvious.

2. **The details of the requested transaction.** The Procedural Notice does not provide guidance for the level of detail required. For example, it would have been helpful if the SBA confirmed that the PPP lender could satisfy this requirement by submitting a copy of the documents that will effectuate the change in ownership received from the PPP borrower. However, the requirement in 4 below, to provide the purchase and sale agreement, may mean that the documents that will actually effectuate the change in ownership are not sufficient to explain the transaction. Further, every change of ownership transaction is now subject to a condition precedent to closing while awaiting SBA approval. We predict many businesses will run out of cash waiting for the SBA to bless their survival.

3. **A copy of the executed PPP loan note.**

4. **Any letter of intent and the purchase or sale agreement setting forth the responsibilities of the PPP borrower, seller (if different from the PPP borrower) and buyer.** The Procedural Notice appears to refer to a specific document (purchase or sale agreement). With respect to the PPP borrower notification requirement, the Procedural Guidance uses a broader phrase: “proposed agreements or other documents that will
effectuate” the change in ownership. It is unclear whether the documents need to be in final form or how the file would be supplemented if they continue to evolve pending SBA approval.

5. **Disclosure of whether the buyer has an existing PPP loan and, if so, the SBA loan number.** In a typical M&A transaction, buyers do not provide details about their outstanding loans and it is unclear why this information could or should impact the approval process. Does the fact that the buyer has a PPP loan mean it is more or less likely that the SBA will approve the change of ownership? This requirement likely will raise concerns for some buyers/investors who may believe their financial condition is of no concern to others.

6. **A list of all owners of 20 percent or more of the purchasing entity.** In a typical M&A transaction, buyers do not provide the names of all 20 percent or more owners. PPP loan applicants had to list all 20 percent owners, but that was for qualification of the loan, so this demand seems like the government just wants more information for the sake of having more information. Still, it is unclear how this information impacts the approval process. This requirement likely will raise concerns for some buyers/investors.

Pursuant to the Procedural Notice, the SBA may require additional information. The Procedural Notice has two additional requirements for SBA approval of changes in ownership resulting from a sale of 50 percent or more of the PPP borrower’s assets:

1. **The purchaser must assume all of the PPP borrower’s PPP loan obligations.**

2. **This assumption must be reflected in either the purchase or sale agreement or a separate assumption agreement.** If the buyer and seller use a separate assumption agreement, the agreement must (also) be submitted to the SBA.

**Note:** We have been concerned that transferee liability or fraudulent conveyance rules would apply to changes of ownership resulting from asset sales. These requirements for asset sales ensure that the buyer has liability.
The Procedural Notice provides that the SBA will provide a determination within 60 calendar days of receipt of a complete request. We expect that many buyers and sellers will balk at the prospect of waiting 60 days for SBA approval, especially for emergency transactions involving distressed sellers.

**Additional Requirements for Sale of Ownership Interest or Merger (But Not Asset Sales)**

The Procedural Notice contains special rules for “a sale or other transfer of common stock or other ownership interest in the PPP borrower, or a merger of the PPP borrower with or into another entity.” The rules apply regardless of whether the sale requires SBA approval.

1. The PPP borrower (or surviving entity in a merger) remains subject to all PPP loan obligations. This should not come as a surprise to anyone and results by operation of law anyway.

2. If the new owner(s) uses PPP funds for unauthorized purposes, the SBA will have recourse against the owner(s) for the unauthorized use. This provision seems strange and un-administrable because cash is fungible. For example, assume a PPP borrower receives a PPP loan for $1 million and also has $3 million of cash from operations. If the borrower spends $1 million on qualifying PPP costs (e.g., payroll and rent) and the balance on a new boat, could the SBA argue that only one fourth of the PPP proceeds were used for qualifying purposes because only one fourth of the cash was so used? Further, by now PPP borrowers will generally be at or near the end of their 24-week periods, so they likely have already used all PPP funds and are entitled to full forgiveness, so we are not sure of the extent to which this will have operative effect.

3. Within five business days of the completion of the transaction, the PPP lender must notify the appropriate SBA Loan Servicing Center of:

   1. The identity of the new owner(s) of the common stock or other ownership interest.
2. The ownership percentage of the new owner(s).

3. The tax identification number(s) of any owner(s) holding 20 percent or more of the equity of the business.

4. The location of, and the amount of funds in, any escrow account under the control of the PPP lender.

1 It is unclear if this “no restrictions” provision overrides the notification requirement. Presumably, the PPP borrower has no obligation to notify the PPP lender after the PPP loan has been fully satisfied.

2 For reasons that befuddle us, in the case of escrow accounts created in connection with the sale of 50 percent or more of the borrower’s assets (but not for escrow accounts created in connection with sales of less than 50 percent equity), the PPP lender must notify the appropriate SBA Loan Servicing Center of the location of, and the amount of funds in, the escrow account within five business days of completion of the transaction.

3 The Procedural Notice describes this provision as applying to any sale or other transfer of common stock or other ownership interest or merger and does not explicitly limit these rules to changes in ownership. Given the context, we believe that these rules should only apply to such a change in ownership. Based solely on the text, however, they arguably could apply to other common situations, including an investment of new equity or a liquidation and possibly even to sales of less than 20 percent of the common stock.