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Debt-Free Deals with "Free Debt" – Practical Solutions for Sellers with PPP Loans in M&A

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The majority of middle-market M&A has followed a similar structure for quite some time: while ensuring normalized working capital, the seller sweeps “Cash” and pays off all “Debt” at closing. The nuance, of course, lies in the definitions of “Cash” and “Debt.” “Cash” is usually a straightforward definition and excludes restricted cash, as well as checks and wires in transit. On the other hand, the definition of “Debt” usually takes up one-half to three-quarters of a page and, with limited exception, occupies a good portion of a deal's issues lists and negotiations. Treatment of deferred revenue, capital leases, accrued bonuses, and a myriad of other debt and “debt-like” instruments are inevitably fought over throughout the deal. However, the portion of the “Debt” definition that was not controversial and did not garner much attention, until recently, was the provision that covered borrowed money from banks. The lawyers, bankers, and principals all agreed that “debt-free” meant the bank loan would be paid off at closing. Unfortunately, the treatment of PPP loans at closing has complicated that once simple construct.

At the risk of stating the obvious, PPP loans create several uncertainties for those trying to close deals before the PPP loan has been forgiven:

- is a change of control of the seller a default under the PPP loan docs (the answer is usually yes);
- will the bank be willing to consent to the change of control (the answer is decidedly maybe, but collateral will likely be required by the bank to even start the conversations);
- will the buyer be willing to bear any risk or exposure with respect to the PPP loan (does the seller have a patented vaccine for COVID-19?).

Of course, there are other logistical and drafting issues that will need to be addressed, but if the target closing date is prior to the PPP forgiveness, counsel for both sides will need to solve for these issues. And, absent significant negotiating leverage, as a threshold matter the seller should be prepared to stand behind any risk that the PPP loan will not be forgiven.

With that in mind, the seller and its advisors should consider the following steps at the outset of any M&A process:

- if the company is being sold in an auction process, the lawyers, bankers, and principals for the seller should consider adding a question in the appropriate process letter about how the buyer

intends to treat the PPP loan;

- if the sale is not a part of an auction, the lawyers, bankers and principals for the seller should raise the treatment of the PPP loan with the prospective buyer as early as possible in the process (in addition to the obvious reasons, there is a significant benefit to both sides socializing this with their respective banks and financing sources (see the next bullets));
- the appropriate executive with the seller should talk with the bank as soon as possible to figure out what requirements the bank will mandate in order to consent to a change of control (as noted above, the seller should assume that a cash collateral account equal to the face amount of the PPP loan will be required in order for the bank to be willing to come to the table); assuming a bank is willing to consent to the transaction, the seller's chances will be significantly better if the bank does not feel pressured to make a quick decision;
- to the extent the buyer is borrowing funds for the acquisition (or otherwise has a credit facility in place), the seller should push for the buyer to engage in early discussions to ensure that the buyer's financing sources and/or the buyer's credit facility will accept one or all of the foregoing approaches.

Additionally, counsel for both parties should consider the following risk allocation measures:

- a line item indemnity for losses related to the PPP loan;
- a separate escrow for losses related to the PPP loan (note that such an escrow may not be necessary if the cash collateral account mentioned above is put into place);
- tying the release of the working capital escrow to the forgiveness of the PPP loan.

Finally, to the extent there are excess funds from the PPP loan still available prior to closing, the seller should consider whether such funds should be paid back to the bank (thereby reducing the amount of post-closing exposure) or used for appropriate pre-closing payments to employees.

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