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Some Strings Attached: Main Street Lending Program And Private Company M&A

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The Main Street Lending Program, intended to provide credit support to small and medium sized businesses, became operational on July 6, 2020.[i] It includes many borrower-favorable economic terms, including a 5-year term, a low interest rate (capped at LIBOR + 3%), an interest payment deferral of 1 year and a principal payment deferral of 2 years, and a generally borrower-friendly amortization schedule.[ii] However, the Main Street Lending Program possesses certain characteristics that could negatively affect an acquisition, sale or other strategic transaction.

Since making its initial announcement in March of 2020, the Federal Reserve has released a series of documents and Frequently Asked Questions ("FAQs") to shape and clarify the program details. This article discusses several Main Street Loan requirements (around affiliation, dealing with other debt, compensation, dividends/distributions and employee and payroll retention) that require special attention if an M&A transaction of a privately-held company is being conducted or may be on the foreseeable horizon. This article also recommends some basic execution strategies since different approaches to M&A due diligence review and transaction structuring are necessary if the acquiror, the target/seller or both have applied for or received a Main Street Loan.

1. Affiliation Rules; Eligibility and Maximum Loan Size

The Main Street Lending Program adopts the same affiliation rules used for the SBA's Paycheck Protection Program ("PPP"), which generally consider entities that control each other or are under common control (including through ownership of 50% or more of the entity's voting equity interests

(on a fully diluted basis) or a minority investment coupled with certain governance rights) to be affiliates.[iii] Key implications of the affiliation rules are:

- ***Eligibility.*** The Main Street Lending Program considers affiliates of the borrower in determining the borrower's eligibility to participate in the program. In order to qualify, the affiliated group of entities collectively need to have either (i) 2019 annual revenues of $5 billion or less[iv] or (ii) no more than 15,000 employees. Portfolio companies of a private equity fund can qualify for the program only if the borrower, the fund and all of its affiliated portfolio companies collectively pass one of the prongs of the eligibility test.[v] As a result, an existing portfolio company (regardless of size) of a private equity fund may be ineligible to receive a Main Street Loan. However, large private equity funds may acquire a borrower that obtained a Main Street Loan before the acquisition (subject to the next two bullet points) notwithstanding that, on an aggregated basis, the borrower would not be eligible for that loan after the acquisition.

- ***Timing of the M&A Transaction and Agreement in Principle.*** The affiliation rules treat an acquisition as completed if an "agreement in principle" exists for that acquisition. An "agreement in principle" may exist even if the parties have not signed any definitive agreements — even "non-binding" letters of intent or other similar instruments have been determined to be an "agreement in principle."[vi] Therefore, parties to a potential M&A transaction should disclose to each other whether they have obtained or applied for (or intend to apply for) a Main Street Loan early in their discussions and evaluate what impact the potential acquisition and even continued discussions about a potential acquisition may have on their respective Main Street Loan applications.

- ***Single Loan Type; Maximum Loan Size.*** An affiliated group of companies may participate in only one type of Main Street Loan, and may not participate in both a Main Street Loan facility and the Federal Reserve's Primary Market Corporate Credit Facility ("PMCCF"). Further, if a borrower has affiliates who have previously borrowed or have a pending application to borrow a Main Street Loan, the entire affiliated group's outstanding as well as undrawn available debt and EBITDA are used when determining the borrower's maximum loan size.[vii] While the Federal Reserve probably intended for the affiliate calculations to be eligibility tests measured only at the time of the borrower's incurrence of the Main Street Loan, the Borrower Certifications and Covenants includes language that implies this is a covenant and a continuing obligation.[viii] If interpreted as a continuing obligation, an M&A transaction involving an entity that has received a Main Street Loan[ix] raises the following considerations:

    - If both M&A parties received the same type of Main Street Loan, the parties would have to recalculate the maximum loan size applicable to the affiliated group on a consolidated basis to determine whether the aggregate amount of loan proceeds received pursuant to the Main Street program exceeds the permitted maximum loan size (therefore requiring a paydown).

    - If both M&A parties received different types of Main Street Loans, one of the loans would have to be repaid.

    - If one of the M&A parties received a PMCCF loan and the other received a Main Street Loan, one of the loans would have to be repaid.

In the absence of further guidance from the Federal Reserve, borrowers should proactively attempt to clarify these issues with their lender in the Main Street Loan documentation.

- ***Significant Operations in the U.S.*** The Main Street borrower must have “significant” operations in the United States. For this purpose, only the borrower and its subsidiaries (and not other affiliates) are counted. Therefore, an acquisition of an otherwise eligible target by a foreign acquiror will not affect the target’s ability to qualify for a Main Street Loan. However, an eligible acquiror currently evaluating a foreign target should analyze whether such acquisition could render the acquiror ineligible for a Main Street Loan. In most cases, the parties should be able to structure the acquisition to address the limitations imposed by this requirement (*g.*, by using a sister holding company to acquire the foreign target).

2. Dealing with Other Debt

For good reason, the debt and lien structure of the target and the post-transaction combined entity tends to attract great attention in M&A deals. The presence of a target or acquiror that has incurred, or plans to incur, a Main Street Loan will add a critical layer of complexity to the M&A analysis. Structuring transactions to comply with these requirements will require careful analyses of existing and potential loan arrangements, and likely will require appropriate intercreditor documentation.

- ***Use of Main Street Proceeds.*** Proceeds of Main Street Priority Loans may be used to refinance existing debt, but that is not the case for Main Street New Loans or Expanded Loans. If the borrower is entering into a Main Street New Loan or Expanded Loan and plans to pay down existing debt, the borrower must find an alternative (i.e., non-Main Street) source of funds to pay off that existing debt.

- ***Payment, Priority and Collateral Sharing Rules.*** Payments by a borrower on other debt (whether existing or new debt such as acquisition financing) will be subject to the Main Street Lending Program requirements, which only allow principal and interest payments that are “mandatory and due” on their scheduled dates or upon the occurrence of an event that automatically triggers mandatory prepayments. The borrower’s other debt will also be subject to the applicable payment and lien priority and collateral sharing requirements of the Main Street Lending Program. For Main Street New Loans, the Main Street lender is not required to share in, or to secure the Main Street Loan with, collateral that secures the borrower’s existing (or future) non-Main Street debt, but the Main Street Loan may not be contractually subordinated in terms of payment priority to any of the borrower’s other debt. In the case of Main Street Priority Loans and Expanded Loans, the Main Street Loan must be on a senior or pari passu basis in terms of collateral and payment priority with the borrower’s other debt (except for “mortgage debt”, which is generally defined as (i) debt secured by real property or (ii) limited recourse equipment financings, including capital or finance leases).

3. Compensation and Dividend Restrictions

The dividend and employee compensation restrictions, which the Main Street Lending Program expressly incorporates from the Title IV of the CARES Act, have caused many borrower companies

to carefully consider whether they want to participate in the program at all.[x] Critically, the restrictions remain in effect for so long as the applicable Main Street Loan remains outstanding and then for an additional 12 months thereafter (the “tail period”). The following discussion describes the restrictions and resulting concerns.

- ***Compensation Restriction.*** A Main Street borrower’s highly compensated employees will be subject to ceilings on their compensation and severance pay.[xi] A Main Street borrower that is likely to be an acquiror should consider whether these compensation restrictions create a drag on its ability to attract, and to retain and integrate, valuable employees that will hamper its M&A strategy (such as limitations on the ability to pay success, retention, change in control or severance amounts to employees) as compared to its competitors for deals.[xii] Conversely, a Main Street borrower that may be a target/seller should consider whether having a Main Street Loan makes it less attractive because of an acquiror’s reluctance to become subject to these restrictions.

- ***Dividend Restriction*****.** After the Main Street program was first announced, the initial term sheets released by the Federal Reserve indicated that only a “common stock” dividend would be prohibited (consistent with the statutory language of the CARES Act). However, the Federal Reserve has since modified and clarified this restriction as it applies to the Main Street program in a number of important respect. According to current Federal Reserve guidance, the restriction:

    - prohibits any distributions with respect to “common stock equivalents” of the borrower;

    - prohibits any dividends or distributions with respect to preferred stock or any other equity interests that provides for mandatory or preferential dividends (unless such preferred equity interests and the obligation to pay dividends or distributions existed as of March 27, 2020);[xiii] and

    - permits distributions by an S-corporation or another “pass through” entity to the extent reasonably required to cover an owner’s income taxes resulting from ownership of such S-corporation or other “pass through” entity.[xiv]

Similar to the compensation restrictions, a borrower that is either a potential acquiror or potential target needs to consider how the dividend restrictions may impact their contemplated transaction. The most notable concerns in an M&A context are:

- Any M&A transaction that otherwise might have contemplated post-closing dividends or distributions to shareholders would need to incorporate other mechanisms to provide near-term liquidity to the shareholders (*g*., interest to accommodate for deferred distributions, redeemable preferred equity or an exchange offer of liquid stock). For example, a company with a Main Street Loan selling all or substantially all of its assets would be prohibited from distributing cash received in a transaction to its shareholders until the end of the tail period (subject to the limited exceptions described above). We expect most prospective sellers with a Main Street Loan to insist on a stock sale or similar structure to avoid the dividend limitation.

- These dividend restrictions would prohibit an acquiror from closing a traditional

dividend recap transaction, even where the source of the dividend is not a Main Street Loan. However, the parties may be able to structure an alternative transaction to achieve similar effect, *g*., where the proceeds of a non-Main Street loan are used to redeem equity (assuming that the acquiror and its parent companies are not publicly traded).[xv]

  - If the parties expect a borrower to provide regularly scheduled distributions, such arrangements would need to be structured in the form of another payment instrument such as subordinated debt, a management agreement or other contractual arrangements.

  - If the parties expect the borrower to compensate one or more of its owners for services, care should be taken to structure the payment as a contractual obligation. While the Main Street guidance does not address whether guaranteed payments from a partnership to its service partners could be recharacterized as a prohibited distribution, we think that guaranteed payments should be permitted so long as they constitute fair market compensation for services actually provided and do not mimic a capital distribution (*g*., if such payment is made pro rata to all partners regardless of their service or contribution).

As the parties to an M&A transaction explore alternative structures to accommodate the Main Street Lending Program's dividend restrictions, careful tax planning is essential to ensure the most efficient, or at least predictable, tax outcomes. In addition, the borrower's organizational documents and loan documents should be carefully reviewed to determine whether consents must be obtained before accepting the Main Street Loan, as the dividend restrictions may conflicts with the requirements of such documents.

- ***No Application to Affiliates; Non-Circumvention*.** It is worth noting that, by their terms, neither the compensation restrictions nor the dividend restrictions apply to any affiliates of the Main Street borrower. However, in an M&A transaction where the acquiror has received a Main Street Loan, such restrictions may attach to the target company to the extent the lender requires the target company to become a co-borrower or guarantor (in which case these restrictions would apply directly) or otherwise contractually requires the target company to be subject to these restrictions. In addition, given the evolving landscape surrounding the CARES Act, we generally caution parties against establishing unusual affiliate arrangements that might appear to directly circumvent the applicable Main Street covenants, such as moving the executive team to a parent holding company in order to avoid the compensation restriction, or structuring debt or equity instruments or other affiliate arrangements that are "off market".

- ***Timing the Main Street Loan Payoff*.** Where the sale of a borrower is being contemplated, serious considerations should be given to repaying the Main Street Loan at least 12 months in advance of the sale to minimize the effect of the compensation and dividend restrictions on the sale process and valuation.

The complication caused by the compensation and dividend restrictions to business operations and the ability to compensate equityholders alone are enough to dampen interest in a seller/target (or if the acquiror has entered into a Main Street Loan, to depress what the acquiror can offer to the

seller/target). But it also is important to understand structural elements of these restrictions that make them unusually inflexible and inhibit a party's ability to address and adopt to real world circumstances.[xvi] Customarily, a borrower may work with its lenders as a matter of contract to obtain amendments, waivers or consents to operating covenants in loan agreements. The compensation and dividend restrictions are set forth in Borrower Certifications and Covenants (which the Federal Reserve has advised is nonnegotiable). That document is to be executed by the borrower and the lender, but is expressly for the benefit not only of the lender, but also the Main Street SPV, the Board of Governors of the Federal Reserve, the Federal Reserve Banks themselves and the Secretary of the Treasury. Obtaining an amendment, modification or waiver to address a variance from all of those players is not practically feasible, especially in any commercially reasonable period of time. But more significantly, the compensation and dividend restrictions are in fact statutory obligations. Any variance would be a violation of law, not just a breach of contract. Therefore, these restrictions stand on very different footing than other Main Street Loan terms that may be varied in accordance with the contracts themselves. As statutory obligations, the restrictions also cannot be avoided or extinguished simply by repaying the Main Street Loan, which is an option in ordinary loan arrangements. A breach raises the possibility of a government enforcement action. Then all of this is exacerbated by the fact that the compensation and dividend restrictions last for 12 months after full loan repayment.[xvii]

4. Employee Retention and Payroll Maintenance Requirements

The borrower is obligated to use commercially reasonable efforts to retain employees and maintain payroll during the Main Street Loan term. While the program does not provide any specific metrics on such requirement, this covenant exposes the borrower (and by extension, an acquiror) to potential scrutiny and second guessing by politicians and the public, which as we have seen with the PPP program, can be influenced by changing political winds.

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Strategies for Approaching an M&A Transaction

An important takeaway from the above discussion is that companies should take a thoughtful approach to borrowing a Main Street Loan because of the complexity it adds, especially to executing M&A transactions. In addition, when considering an M&A transaction in this environment, each side of the transaction should have a clear strategic approach to ferreting out where there may be Main Street (or other COVID relief) considerations and to employing tools to address those considerations. The recommendations discussed below focus on Main Street Loans but a similar approach should be taken with respect to other COVID-related relief.

- The cornerstone of a healthy M&A strategy is thoughtful due diligence. Parties should not assume that representation and warranty insurance (RWI), directors and officers (D&O) or other insurance will be accessible to cover exposures.

- This due diligence begins with directly inquiring upfront what type of Main Street Loan(s) and other COVID-related relief either side or its affiliates has applied for and taken. Parties should not wait to share this basic information, which itself could determine whether one party or the other is even willing to transact.

- If either party has applied for or entered into a Main Street Loan, a close examination should

be conducted to confirm that party's eligibility, including a thorough understanding of employee count[xviii] and 2019 revenues, U.S. operations, the party's affiliate structure, relationships that could cause a prohibited conflict of interest,[xix] and the calculations used to measure compliance with the maximum loan size limitations. The calculations will require knowledge of the debt and EBITDA of the borrower at the time that the Main Street Loan was granted (and of its affiliates who also have applied for or received a Main Street loan). It also would be wise to inquire into the reasons why the Main Street Loan was sought.

- The examination also should extend into how Main Street Loan proceeds were used and the Main Street borrower's then-outstanding debt and liens.

- The Main Street borrower's employee compensation structure, dividend/distribution practice and affiliate payments (including the purpose of those payments) since taking the Main Street Loan should be reviewed for compliance along with its employee retention and payroll maintenance efforts.

This careful due diligence will be critical to manage risk, to determine whether an M&A transaction involving an entity with a Main Street Loan is possible, and ultimately to properly structure the transaction. The following is a description of some specific deal terms and other considerations for such an M&A transaction:

- Representations and warranties should be specially crafted to cover the eligibility and ongoing compliance concerns discussed above, and to reaffirm that the materials submitted in connection with the Main Street Loan application were accurate.

- The parties may wish to alter the customary indemnification scope, time periods and dollar caps to account for the atypical risks that are characteristic of the Main Street Loan structure—such as the fact that a violation of the compensation, dividend and conflict of interest restrictions may be considered violations of law subject to potential government enforcement in addition to contract breach exposure, and that there is a 12 month tail on these Main Street Loan covenants.

- These representations, warranties, covenants and indemnifications may flow in either direction – in favor or sellers, acquirors or both – depending on the source and type of risk. For example, a seller may want indemnification protection if the acquiror's Main Street Loan introduces potential risk to payment of any portion of the purchase price such as an earnout, or the sellers will retain a portion of their equity through a rollover transaction.

- The consequential damages waiver contained in a standard purchase agreement should not exclude potential civil or criminal fines or penalties that may be imposed for violations.

- Both parties are likely to have a vested interest in audits or investigations, especially those conducted by the US government entities. Therefore, indemnification procedures, control over audits and cooperation obligations in the standard purchase agreement should be revisited.

- The parties to an M&A transaction also should consider the effect of potential public disclosure of the Main Street Loan recipients and negative publicity from even an alleged violation of Main Street Loan provisions or an unpopular public reaction to a party having obtained a Main Street Loan.

Our analysis is necessarily limited by the time sensitivities of the current crisis as well as the absence of precedent for some of what is contained here. This analysis represents our best interpretation and recommendations based on where things currently stand.

FOOTNOTES

[i] Sheppard Mullin's chart that summarizes and compares the three types of Main Street Loans can be found here.

[ii] This is as compared to amortization terms commonly seen in senior term loans with commercial banks. Other term loan facilities, including Term Loan B facilities, may have a more borrower-friendly amortization schedule, including bullet payments at maturity or 1% annual amortization, but those facilities are commonly available to a relatively small portion of the market of Main Street eligible businesses.

[iii] Affiliation for the purpose of PPP is determined pursuant to very specific rules set forth in 13 CFR 121.301(f), subject to certain exceptions set forth in 13 CFR §121.103(b) and, for purposes of Main Street, subject to the SBA's further PPP affiliation guidance, including in the form of interim final rules published from time to time in the *Federal Register*. For further discussion regarding PPP's affiliation rules, please see our blog post analyzing the affiliation rules here.

[iv] Revenue for the purpose of eligibility is calculated using revenue figures appearing on 2019 GAAP audited financials and/or the 2019 annual receipts as reported to the IRS (or, if such financials or reports are not available for 2019, the most recent fiscal year for which they are available). While uniform use of either audited financial statements or annual receipts clearly would be preferred, FAQ E.4 and Section 1.D. of the Borrower's Certifications and Covenants can be read to allow the mixing and matching of revenue figures from financial statements and tax returns as available. The penultimate sentence of FAQ E.4 (which is mirrored in Section 1.D of the Borrower Certifications and Covenants) says "If a potential borrower (or its affiliate) does not yet have audited financial statements or annual receipts for 2019, the borrower (or its affiliate) should use its most recent audited financial statements or annual receipts." *[emphasis added]*. The FAQs do not specify a methodology for incorporating GAAP revenues from financial statements of one affiliate with annual receipts from another affiliate. We presume the borrower would certify that it used a rational methodology and we do not read the Main Street guidance as requiring an external audit or certification of the calculation.

[v] See FAQ E.12, Borrower Certifications and Covenants, Section 1.D.

[vi] This is a very fact-specific review of the extent to which the parties are conducting open discussions or have solidified the key terms of the deal such that they are considered to have a present intention to consummate the deal. See 13 C.F.R. § 121.103(d)(1). Compare *Size Appeal of Telecommunications Support Services, Inc.*, SBA No. SIZ-5953 (2018), *Size Appeal of Enhanced Vision Systems, Inc.*, SBA No. SIZ-5978 (2018).

[vii] Under this test, the Main Street Loan(s) of an affiliated group cannot exceed a multiple of 2019 EBITDA—(i) 4x for the Main Street New Loan Facility or (ii) 6x for the Main Street Priority Loan Facility or Main Street Expanded Loan Facility.

[viii] We base our assumption about the Federal Reserve's intent on the fact that the vast majority of

the provisions addressing these rules are drafted as certifications made as of the date of such certification, rather than as having any continuing effect. See Borrower Certifications and Covenants Instructions and Guidance, Sections 1.D, 1.E, 5.E and 5.F; See also FAQ E.10. But conflicting language exists in the same sections such as Borrower Certifications and Covenants Instructions and Guidance, Sections 1.E ("The Borrower must . . . commit that it will not seek to participate simultaneously in the Main Street Priority Loan Facility, the Main Street Expanded Loan Facility or the Primary Market Corporate Credit Facility . . .") and 5.F ("In no case can an affiliated group's total participation in the Facility exceed the maximum loan size that the affiliated group is eligible to receive on a consolidated basis").

[ix] It is worth clarifying that if either party to an M&A transaction has a pending application for a Main Street Loan (but has not actually received it), the transaction could still render the applying party ineligible if the other party has a Main Street Loan. Under certain scenarios, even execution of a letter of intent could render such party ineligible. See our discussion above re Timing of the M&A Transaction and Agreement in Principle.

[x] See Section 4003(c)(3)(A)(ii) of the Coronavirus Aid, Relief, and Economic Security Act (the "CARES Act").

[xi] No officer/employee whose total compensation was between $425,000 and $3 million in 2019 may (1) receive total compensation during any 12-month period in excess of the 2019 amount or (2) receive severance pay or other termination benefits in excess of 2x the 2019 amount. No officer/employee whose total compensation exceeds $3 million in 2019 may (1) receive total compensation during any 12-month period in excess of $3 million + 50% of the amount above $3 million received in 2019 or (2) receive severance pay or other termination benefits in excess of 2x the maximum total compensation received in 2019. See Section 4004(a) of the CARES Act and Borrower Certification and Covenants Instruction and Guidance, 2.D.

The compensation restrictions also apply to (i) any officer/employee whose employment with the borrower started during 2019 or later, in which case the total compensation is measured for the 12-month period starting from the end of the month in which such officer/employee commenced employment (and if such total compensation exceeds the $425,000 and/or the $3 million threshold, the compensation restriction would apply to such officer/employee for the life of the Main Street Loan + 12 months) and (ii) any existing officer/employee whose compensation first exceeds $425,000 during a 12-month period ending after 2019, in which case the total compensation is measured for the 12-month period starting from the end of the month in which such officer/employee's compensation first exceeded $425,000 (and the compensation restriction would apply to such officer/employee for the life of the Main Street Loan + 12 months). See Borrower Certification and Covenants Instruction and Guidance, 2.D.

FAQ H.12 defines total compensation to include salary, bonuses, awards of stock, and other financial benefits provided by the borrower and its affiliates to the officer/ employee excluding the value of severance pay or other benefits paid in connection with a termination of employment.

[xii] An acquiror taking a Main Street Loan will need to evaluate compensation offered by a target's direct competitors and companies in other industries that may be attractive to this highly sought-after employee talent pool, including whether those other employers also are taking Main Street Loans. If they are not, the acquiror could find itself at a significant disadvantage in a competitive process to acquire the target.

[xiii] See Borrower Certification and Covenants Instruction and Guidance, 2.D.

[xiv] Note, however, that the permission does not appear to cover distributions made by a consolidated corporate subsidiary to the common parent corporation to enable that common parent to pay its consolidated corporate income tax liability.

[xv] The Federal Reserve specifies that the dividend restrictions do not cover repurchases or redemptions. See Borrower Certification and Covenants Instructions and Guidance, 2.D.

[xvi] The same concerns expressed in this paragraph apply to the public company stock buyback restrictions, which are contained in Section 4003(c)(3)(A)(ii) of the CARES Act (along with the compensation and dividend restrictions), and the conflict of interest provisions, which are derived from CARES Act Section 4019.

[xvii] The Main Street SPV or another government agency could bring an enforcement action, and may have varying motivations to do so (such as political pressure or popular sentiment). Main Street borrowers face similar concerns with respect to the conflict of interest requirements under CARES Act Section 4019.

[xviii] FAQ E.3 lays out the employee count methodology.

[xix] See FAQ A.9 and Section 4019 of the CARES Act.

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