Five Things to Consider if a Buyer is Financing the Purchase of Your Business

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Transactions for the purchase and sale of businesses are rarely all cash deals. No matter the transaction structure, the use of financing to consummate the purchase creates a new dimension and layers of complexity requiring additional scrutiny and analysis by a discerning seller (or its principals). This article highlights some of the key considerations in such instances.

1. If the seller is financing all or part of the acquisition, the seller should act like a banker. Financing to fund business purchases can be provided by the seller, its owners, an unaffiliated third party such as a bank, or any combination of the foregoing. Motivations for a seller providing financing can vary (no available third party lender, an investment opportunity, deferral of taxes), but in the end, if the seller is going defer immediate receipt of the purchase price to make a loan for all or a portion of the purchase price, the seller should approach the financing as a separate transaction and take care to underwrite the buyer, its principals and the new business. Ideally the loan transaction would be documented like a “bank loan” (i.e., with a loan agreement containing representations, warranties and covenants, a promissory note and other security documents) and would be secured by collateral and provide for full recourse against the buyer and its principals, as direct borrowers or guarantors. Of course, these terms will be determined by the underlying transaction specifics and fundamentals (e.g., market forces, negotiating leverage of the parties and the circumstances surrounding the sale, etc.).

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When circumstances warrant, a buyer may try to impose a right of set off against a seller-loan for alleged breaches of the purchase agreement, whether or not addressed in the documentation. Thus, sellers should recognize that seller financing creates potential defenses to repayment not typically present in typical bank funded commercial loan transactions.

2. If the seller is financing all or part of the acquisition and a bank is financing the acquisition, the bank typically gets repaid first. In transactions where the buyer is seeking both third party financing (e.g., a bank) and financing from the seller, the bank will usually require that the seller "subordinate" its right to be repaid as a condition to the bank funding the loan at the transaction's closing. The experienced or well-represented bank will require that the seller-lender enter into a subordination agreement pursuant to which the seller-lender agrees to limitations on the seller-lender's right to be repaid and that in a liquidation the seller-lender will not receive any payments until the bank has been repaid in full. Often times these agreements limit the borrower to interest-only payments on the seller-loan and require that the seller-lender not take enforcement action against the borrower or guarantors until the bank has had ample opportunity to do so. The greater portion of the purchase price funded by the bank the more likely the bank will seek to control and limit repayment of the seller loan. Incidentally, earnouts are often viewed by banks as a form of seller financing that need to be formally subordinated.

3. A third party lender will likely need to underwrite and diligence the seller's business in order to make a loan to the buyer. On these occasions lender becomes a second set of eyes from a diligence perspective, and can be more sophisticated than their buyer-borrower thus potentially raising new and additional issues and increasing transaction costs. Assuming proper protections are in place (i.e., agreements limiting disclosure, etc.), a seller should not object to a third party lender reviewing due diligence materials and making inquiries. Such diligence and inquiries should generally be conducted "behind the scenes" with requests and requirements routed through the buyer and its counsel (except in the case of the subordination agreement referenced in no. 2 above which is most efficiently handled between the seller and the third party lender).

4. The seller has a vested interest in determining the strength of the third party lender's commitment to lend. If a transaction cannot be consummated absent funding of the purchase price via third party financing, the seller should inquire and confirm the third party lender's commitment to fund the buyer in the transaction. Well represented lenders are reticent to provide binding and irrevocable commitments to fund transactions and often work off of indications of interest or non-binding, unsigned term sheets. In transactions involving serial-acquirers with repeat-business funding sources, initial financing terms might be determined via phone calls and emails. If leverage exists, a seller should push a financing buyer to obtain a binding, signed commitment letter from a well-capitalized lending source. While banks will not typically issue a commitment letter that provides an airtight and unbreakable promise to lend, the bank should be willing to bind itself to make the loan within certain customary parameters absent a material change in circumstances. Requiring, or favoring a bid with a potential buyer who has a binding commitment in these circumstances helps to avoid wasted time and resources pursuing a transaction that lacks the capital required to close.

5. If the seller is acquiring an interest in the buyer as a part of the transaction (i.e., rolling equity) the terms of the third party financing probably matter. The terms of the acquisition financing will invariably create limitations on the business, both operational and strategic. A seller not formerly constrained by loan covenants might be surprised on the breadth of controls that will be binding on the business post-closing. For example, the loan documents might limit or prohibit dividends, distributions to the business's owners, earnout payments, or in some cases, employment bonuses. In certain transactions the third party lender might plan to have the seller be a guarantor of the acquisition financing and other indebtedness of the buyer to the lender. As such, it is imperative that the seller understand the structure and approach of the third party lender as early as possible in the sale process.

In conclusion, the involvement of financing in purchase and sale transactions invites new considerations for the seller and adds elements of risk not present when the purchase price is paid in cash. In such transactions, sellers should have counsel well-versed in both purchase and sale transactions and commercial loan transactions as a part of their deal team to address these issues and others.