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# Insights

## Three Minute Update: How Seller Financing Can Get a Deal across the Finish Line

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Ideally, sellers of a business will never have to worry about covering a financing shortfall to get their deal closed. However, with the increase in interest rates over the last few years, structural issues with requirements of the primary lending source and the overall tightening of capital markets, third party financing often falls short of covering the full negotiated value of a sale.

To close this gap and get their deal across the finish line, buyers and sellers will turn to alternative financing sources. Several other alternatives might be available, but often, seller financing provides the most efficient and expeditious alternative. Here we will look at the most common elements of seller financing, provide some examples of how seller financing can work, and identify some of the pros and cons for both sides of the transaction.

**What is Seller Financing?**

"Seller financing" refers to a buyer paying a portion of the purchase price (usually from 10%-30%) in installment payments directly to a seller over a defined period of time post-closing. In the purchase agreement, a seller will negotiate the terms of the financing the seller will provide.  To protect its interests, the seller almost always requires that the buyer execute a promissory note in favor of the seller (aka a "seller note"). Other seller financing documentation might be needed if not addressed in the purchase agreement, such as security agreements and guarantees.

The seller note will contain traditional terms and structures found in most commercial notes, with most terms being fully negotiated. The primary terms of a seller financing package include the principal amount being financed, the maturity date of the seller financing, interest rate, payment cycle (such as monthly, quarterly or annual payments and mandatory prepayments), collateral to secure the financing, oversight and information rights of the seller, events of default, and if applicable, subordinate ranking to an existing loan.

If third party lending is involved, the seller note will almost always be subordinated to the lead lenders. The terms of subordination will also need to be negotiated, such as payment rights, shared oversight between the senior lender and the seller, and standstill obligations of the seller that provide the senior lenders nearly full control of the pursuit of remedies in the event of defaults or bankruptcy.

The rate of interest required by a seller will typically exceed the rates available from the primary lender to reflect the incremental risk assumed by the seller as a subordinated debtholder. In the current interest rate environment these rates can reach as high as 10%. The average term length of a seller note is highly negotiable but usually ranges from three to seven years.

Seller financing can play a role in small and large transactions but most often occurs in smaller transactions involving middle-market and lower-market transactions. Sometimes, a buyer will propose seller financing at the outset in the letter of intent. In other situations, seller financing will be identified as an alternative path when a buyer has exhausted its available cash and is unable to obtain additional funds at all or on terms that make the deal feasible. Sellers will sometimes include a willingness to consider seller financing in the materials used to market the business.

Because of the additional risk that a seller assumes through seller financing, a seller typically has good leverage with the buyer when negotiating the terms of a seller financing package. In contrast, a seller will usually have little leverage negotiating with the lead lending sources.

**Example:** The "Seller" owns 100% of a widget manufacturer and wants to sell the business. The Seller has identified a potential "Buyer", which currently owns a similar business and has plans to expand operations through an acquisition program. The Seller and the Buyer execute a letter of intent with a purchase price of $4 million, and the Buyer contemplates financing all of the purchase price with a bank loan. The Buyer plans to use the cash flow from the acquired business to pay back the loan.

Unfortunately, the bank does not agree with the valuation for the business and will only lend the Buyer $3.5 million. Moreover, the Buyer already has a line of credit with the bank and is currently paying down a separate debt related to prior business operations.

Despite the bad news from the bank, the Buyer remains confident that the synergies and expansion that will ensue after acquiring the Seller's business make it appropriate to still pursue the transaction. Without financing for the remaining $500,000, however, the Buyer will have to walk away from the deal.

To get this deal across the finish line, the Seller agrees to finance the remaining $500,000 to cover the Buyer's shortfall in financing. The Buyer will borrow $3.5 million from the bank and execute a seller note for the remaining $500,000. The bank issues the loan to the Buyer at a 5% interest rate with a term length of 7 years. Pursuant to the seller note, the Buyer will pay back the $500,000 at a 9% interest rate and in installments over a period of four years. The parties negotiate that the Buyer will pay on a straight-line amortization schedule as follows:

| Year | Year 1 | Year 2 | Year 3 | Year 4 | Total |
|---|---|---|---|---|---|
| Principal | 500,000 | 375,000 | 250,000 | 125,000 | |
| Principal Paid | 125,000 | 125,000 | 125,000 | 125,000 | 500,000 |
| Interest Earned/Paid | 45,000 | 33,750 | 22,500 | 11,250 | 112,500 |
| Total Payment | 170,000 | 158,750 | 147,500 | 136,250 | 612,500 |

Because of seller financing, the parties were able to successfully close the deal.

**Pros and Cons of Seller Financing**

Both sellers and buyers can benefit from seller financing, but both sides will also face additional downsides.

- **Seller Pros**
  - **Higher Returns and Tax Benefits** – Sellers often receive more money for the business when offering seller financing. Sometimes, a seller may be able to negotiate a higher purchase price because of the additional risk it takes by financing a portion of the purchase price. Also, a seller note will almost always carry an interest rate, and that rate may be better than a seller could achieve by investing the funds had the seller received those amounts at closing. The seller note rate almost always exceeds the rate paid on a traditional bank loan. In the example above, the Seller note had a 9% interest rate compared to the bank's 5% interest rate, and in total, the Seller received an additional $112,500 because of seller financing. Seller financing can also help achieve some tax planning objectives through installment treatment of the payments. Using installment payments may provide tax benefits by spreading recognition of gains over the period of the seller note. Sometimes, a seller's marginal tax rate will be lower in later years than the year the deal closed, also providing a positive tax benefit.
  - **Deeper Buyer Pool** – The availability of seller financing can increase the number of viable buyers, leading to a more competitive process, with that competition expected to improve the economics of the proposals.
  - **Helps the Deal Close** – Seller financing increases the likelihood that a deal will close. In the example above, the Seller and the Buyer would not have been able to close the deal without seller financing. Seller financing can also improve the speed to close, particularly if no other lending will be involved.

- **Seller Cons**
  - **Increased Risk** – A seller assumes more risk because it only receives payment for a portion of the purchase price at closing. Payment of the remaining portion through installments carries the risk that these payments may never be made or will be delayed beyond the agreed up payment terms. A buyer's payment for the remaining portion of the purchase prices may be contingent on the financial success of the business

after the acquisition closes. This risk, however, can support a seller's leverage to negotiate for a higher purchase price and interest rate under a seller note, hence the 9% interest rate in the example above.

- **Subordination** – Seller financing will almost always be subordinated to bank financing. In the example above, the seller note will be subordinate to the bank's loan and any other existing debt the Buyer may have with the bank. The Seller may be able to negotiate payments under the seller note if the Buyer is not in default with the bank. Sometimes, though, the seller note will be fully subordinated, and payment will have to wait until the Buyer pays back the bank in full before payments on the seller note can be made. This adds to the Seller's risk in the transaction. Also, negotiating subordination terms when bank financing will also be involved often increases the time and expense to get to closing.

- **Buyer Pros**
  - **Less cash at closing** – Since the seller financing covers a portion of the purchase price, a buyer can bring less cash to the closing table. In the example above, if not for the seller financing, the Buyer would have had to pay an additional $500,000 at closing.
  - **Helps the Deal Close** – If a buyer cannot find enough financing or is unwilling to pay a certain price, a seller note can help bridge the gap and allow a buyer to acquire a business that buyer could not otherwise purchase.

- **Buyer Cons**
  - **Increased Debt Obligation** – Since a seller note is additional debt and typically carries a higher interest rate, a buyer will pay more money for the business. With more debt, the buyer will likely have less financial flexibility. A buyer's cash flow becomes restrained and must be allocated to pay back the debt. This may result in a buyer having to forgo or delay a new business opportunity.
  - **Security Interest in Assets** – Often, a seller will require that it be given a security interest in the assets of the buyer, including those in the business. Moreover, these arrangements will include a process to collect payment and seize a buyer's assets if the buyer defaults under the seller note and does not timely cure such default. These arrangements may also complicate the process for a buyer obtain additional financings needed to support its business objectives.

**Comparison to Other Alternatives**

Other alternatives that sellers may be asked to consider include earnouts and equity rollovers. While a full discussion of these fall beyond the framework of this alert, some differences standout. Seller financing fixes the amount that will be paid to the seller. Earnouts reflect contingent payments that are made only if the negotiated milestones are achieved, usually with some maximum value over a limited timeframe. Rollovers can provide upside value beyond the negotiated price based on increases in the value of the business at the time of monetization of the equity in the ongoing business.

**Conclusion**

Seller financing can help get a deal across the finish line. Understanding the pros and cons for a buyer and a seller is key when negotiating the terms of the seller financing. If you are considering selling your business and need assistance developing a plan or want to learn more about seller financing and other alternatives, please contact **Robert A. Greising** or **Travis D. Lovett** or any member of our **Business, Acquisitions, & Securities Practice**.

*The authors acknowledge the contributions of Griffin O'Gara, one of our summer associates, in drafting this Alert.*