

## **SELLER FINANCING BASICS**

### **A Primer for Buyers and Sellers**

by [Glen Cooper](#), CBA

Most business sales are financed, at least in part, by the sellers themselves. Offering seller financing puts the seller in a stronger position to get a better price and a faster sale.

Buyers nearly always need seller financing. Their advisors strongly recommend it. Seller financing acts like a bond for performance to assure that the seller will live up to the promises made to the buyer during the sales process. Seller financing is seen by most buyers as an indication that the seller has faith in the future of the business.

Buyers can expect, however, that sellers who offer seller financing must also act a lot like a bank! A buyer can expect to be asked to secure the loan and sign a personal guaranty.

#### **What is Seller Financing?**

Sellers of small businesses usually allow the buyer to pay some of the purchase price of the business in the form of a promissory note. This is what is known as seller financing.

Seller financing is particularly common when the business is large enough to make a cash sale difficult for the buyer (over \$100,000), but too small for the mid-market venture capitalists (under \$5 million). Seller financing is also common when the business, for any number of reasons, does not appeal to traditional lenders.

A rule of thumb is that sellers will typically finance from 1/3 to 2/3 of the sale price. Many do more than that. It all depends on the situation. Each transaction is unique. The interest rate of the seller note is typically at or below bank prime rates. The term of the seller note is usually similar to that of a bank.

For a service business which sells for \$500,000, for example, the transaction might be structured as \$150,000 down from the buyer and \$350,000 in seller financing. The seller note might run for five to seven years and carry an interest rate of 8% to 10%. Monthly payments are the norm and usually start 30 days from the date of sale unless the payment schedule must be modified to allow for the seasonality of the business revenues. The seller note would also usually have a longer term if real estate were being financed.

When a seller offers seller financing, the price the buyer can afford to pay goes up as the amount of the down payment required by the seller goes down.

#### **Why Would A Seller Offer Financing?**

Sellers are nearly always reluctant to offer seller financing. Like all of us, they fear the unknown. Despite the advantages of playing bank, it is an uncomfortable role for them. They usually come around to seller financing only after some effort has been made to persuade them.

A seller's first encounter on this issue might be with the business broker. In many cases, but not all, the business broker will bring up the issue. Most business brokers agree that sellers need to offer seller financing, but not all are willing to discuss the issue at the beginning of the listing. When the buyer is unknown, the seller's fear of seller financing is greatest. Some brokers prefer to wait until the buyer prospect is known before suggesting the amount and terms of seller financing.

Offering seller financing up-front, however, can attract buyers and speed up the business sale. This is the major issue that usually persuades a seller to offer some type of financing.

Seller financing is seen by buyer prospects as comforting proof that the seller is not afraid of the future of the business. Buyers are more likely to believe a seller's optimistic view of the business' future when seller financing is offered. Some buyers can't or won't look at businesses for sale unless seller financing is a possibility. The more buyer prospects that look at a business, the better the chance a seller has to get an acceptable offer. A seller can also get a better price for a business that has financing in place. As in nearly all buying situations, buyers are often focused on achieving a purchase on terms that allow them to buy with as little 'cash in' as possible, even if the long-run costs are higher.

Seller financing can also lead to a speedier sale. If the seller plays bank, then the deal gets done more quickly. Applying for a bank loan takes a long time for some buyers, and the rejection rate for new acquisition loans is very high - sometimes as much as 80%! Banks also move much slower than sellers, even when they do approve a loan. A seller is more likely to grant a loan request, approve a transaction, and close it as fast as the attorney can get the agreements prepared. Banks take anywhere from thirty to 120 days to approve and close a loan. There is also the possibility that the bankers will give the buyer negative feedback about the business, so that the buyer backs out.

A seller may also see tax advantages and profitability in seller financing, but these alone are not usually compelling reasons to offer seller financing. Capital gains from a small business sale can be reported in installments if seller financing is in place. This stretches out the capital gains tax into future years. Charging interest is also profitable. Sellers, however, are usually not as worried about tax liabilities as they should be until after the sale has taken place. They also usually believe they can get better interest rates from investments than from seller notes.

### **Why Should A Buyer Ask For Seller Financing?**

Buying a business without seller financing is like buying a home without a home owner's warranty. The seller note is a bond for performance. This is the major reason a buyer ought to ask for seller financing.

Beyond that, sellers have a strong motive to maintain the business goodwill if they have a remaining stake in its future ability to pay back the seller note. Without such an interest, sellers may choose to question the new owner's skills and integrity. After a sale takes place, the seller and buyer frequently disagree about the future of the business. This disagreement is a natural outgrowth of their different positions and can become serious. If a seller note is in place, the seller has a motive to temper any irritation caused by the buyer with forbearance.

Even with a non-compete agreement in place with the seller, the fact that the business owes the seller a major amount of money may change the nature of the seller's attitude. Instead of being indifferent or quarrelsome, a seller who is still owed money is more likely to be solicitous and genuinely helpful.

### **How Is Seller Financing Usually Secured?**

Seller financing can be as creative as sellers and buyers want to make it. Most sellers, however, like to add security provisions in as many forms as possible. This can encompass personal guarantees as well as specific collateral, stock pledges, life and disability insurance policies and even restrictions on how the business is run.

The most common requirement is for a personal guaranty by the buyer and the buyer's spouse. Sellers expect this. If a buyer objects, sellers immediately question their seriousness. A personal guaranty is not a specific lien on any particular buyer asset, but is the guaranty that the buyer is placing all assets at risk as needed to satisfy the loan. If the seller note payments are not made, the seller has to proceed with the long process of formal foreclosure. But, to satisfy the foreclosure, the seller will have access to all buyer assets. The spouse's signature is required to prevent the transfer of assets to the spouse's name to dilute the buyer's net worth.

Specific collateral is the other common source of security. If no bank financing is involved, the seller wants a first mortgage on any real estate and first security agreements on all personal property involved in the sale. Sometimes, the seller will require that the buyer offer additional security in the form of additional mortgages and security agreements on real and personal property that the buyer owns. If a bank is involved, the seller must usually settle for second place in the line of secured creditors behind the bank.

A third type of security is the 'stock pledge.' The buyer is required to form a corporation and give the seller the rights to 'vote the stock' in case of seller note default. This allows the seller a speedier solution than foreclosure. If the terms of the seller note are not met, the seller can vote to require that payments be made and can even vote to replace management of the business. This threat is usually enough to guarantee seller note payments are not missed.

Life and disability insurance policies on key members of the buyer's new management team are less frequently used methods of adding security to a seller-financed transaction. Term life insurance is available at rates which are relatively low, so this is most common. Disability insurance is used less often because it is more expensive. The seller will typically want the business to pay for these policies up to the amount of the seller note. These policies stay in effect until the seller note is paid.

Restrictions on how the business is run are sometimes added. These restrictions can be in the form of requiring that the new owner preserve certain account or employment relationships, that certain operating ratios of the business are maintained, that the new owner's pay is limited, or that other important operating benchmarks are met until the seller note is paid. Most sellers won't use this form of adding to their own security as a creditor. They usually readily identify with buyer objections to any controls placed on the new business owner.

### **How Can Both Buyer and Seller Benefit?**

If you are a buyer or seller and this all seems a bit intimidating to you, take heart! It's just as intimidating for the other party! Don't lose site of the fact that this is just a normal transaction between two parties who must each benefit if a deal is to be struck.

Buyers are just looking for a fair chance to buy a job and a reasonable return on investment. They usually have modest goals about what they need to earn for the job they are buying. They are usually fair about how they define what they need to receive as a return on investment for the business risks they are assuming.

Sellers are mostly just ordinary people who once bought or started a business and now want to sell it. They want to get the most they can, but they have learned to be practical. They are usually persuaded by fairness and reasonableness. If not that, then they are at least eventually persuaded by the reality of what's possible.



If you are a buyer, seller financing can offer you better terms and a friendlier lender. You will be able to buy the business quicker because you won't have to wait a month for the bank's loan committee to meet. There are no loan processing or guarantee fees and, usually, no invasive lender controls or audits.

If you are a seller, I would advise an early commitment to seller financing. It will save you a lot of time. You'll get a better price because you'll see more buyer prospects. There are many more buyers who can afford to take a chance when the admission price is reasonable.

Seller financing, properly understood and employed, can really benefit both buyer and seller.

### **About the Author**

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