The ABCs of seller financing

Protecting yourself when you're ready to sell

Time to think like a banker. You have built up equity in your business assets or paid down the mortgage on your investment real estate and decide to sell. You identify a buyer who requests that you provide some or all of the financing. Should you do it? How can you protect yourself should you agree?

When selling off investment real estate, major business assets or the business itself, you want cash at closing. You want the buyer to address its financing needs through banks, investors or other third party sources of capital. Occasions do arise when the buyer wants or needs seller financing to proceed with the purchase.

"Traditional bank lenders are experts at underwriting loans, studying the borrower and its credit worthiness, examining the collateral, and analyzing the sources of repayment," says Brian Moore, a Roetzel & Andress LPA partner and Real Estate Group co-practice manager. "Traditional bank lenders evaluate the risk of the loan; a seller considering seller financing should do the same."

Smart Business interviewed Moore about the differences between seller and conventional bank financing and other pertinent issues.

Brian J. Moore
Partner, Real Estate Group co-practice manager
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When do buyers seek seller financing?

A buyer may seek seller financing if it cannot qualify for conventional bank financing due to a problematic credit history (or lack of one) or when assets being purchased are not suited to conventional lending. Real estate with potential or real environmental problems or a restaurant with collateral or equipment with dubious collateral value are examples where a bank may refuse to lend.

A buyer may qualify for some conventional bank financing, but not the full amount of the transaction. A bank may lend only $700,000 on a $1 million sale. Seller financing might be used to defer payment on the shortfall.

A buyer may request seller financing to obtain more favorable loan terms or to avoid providing guaranties or eliminate loan expenses.

If the buyer is concerned about undisclosed claims, it may request seller financing to maintain some post-closing leverage with the seller. If an undisclosed claim against a business is asserted after closing, the buyer could set off or take a credit against monies due the seller.

While each circumstance is different, most times it is a combination of these reasons.

How is seller financing different from conventional bank financing?

With good legal counsel and a good accountant, seller financing should not be any different from a risk assessment and loan documentation perspective. When a seller is asked to 'be the bank' for the transaction, the wise seller will act like a bank.

A buyer might want the seller to approach this on a simpler basis, perceiving seller financing as easier than conventional bank financing. This is a misconception unless the seller is overly eager to complete the deal.

How does a seller successfully act like a bank?

Follow the example of a prudent bank lender. Evaluate the risk, structure the deal wisely, document the financing to manage that credit risk, and refuse to provide the loan when the risks are beyond the seller's risk tolerance.

The seller needs to evaluate the buyer and its history as a borrower. If the buyer has a poor or no credit history, the buyer should look for qualified guarantors or the seller should consider other additional collateral.

The seller should evaluate the buyer's cash flow situation to be comfortable that, collateral and guarantees aside, there will be a reliable source of cash available to make payments.

Once the evaluation is complete, the seller must determine its risk tolerance. All loans entail some level of risk. Collecting loans by foreclosures, repossession and sales and other court action can be very expensive and uncertain. However, if a seller declines seller financing, the deal may be lost.

If the seller decides to proceed, loan documents should be drafted by an attorney experienced in the preparation of loan documents for sophisticated lenders.

Are there special considerations in cases where the seller only provides some of the financing?

If the buyer obtains bank financing in part and requests some level of seller financing, the seller will need to anticipate the three-way relationship this creates. In most cases, the bank will insist seller financing be subordinate to the bank financing liens and mortgages. The seller must agree that the bank receives its loan repayment and proceeds of collateral in a default scenario before the seller receives anything.

In a default scenario, the seller loses a great deal of control. Good legal counsel is an absolute necessity in this situation.

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