The truth about seller notes, help or hindrance.

Building success through the sharing of information

By Steve Mariani

February 2022

Today I share my controversial thoughts surrounding seller notes. Throughout my 25 plus years I have conversed with many lenders, borrowers, and brokers over the seller note ramifications and my overall view of these and why I typically vote to remove them from an acquisition transaction.

It always begins with me recalling a conversation with a seasoned broker named Ed. Ed is adamant that businesses should be sold via seller financing whenever possible. He believes a faster closing and smaller commission is to a broker's advantage. I don't disagree with Ed regarding the financing of a small stationary store selling for 150K. The concern is that once we move into larger, goodwill transactions, many other factors need to be accounted for and considered before determining a final financing structure.

As I speak with potential buyers daily, my comments always begin the same way, I am against seller financing and begin to list the reasons why: My first is always in reference to the effects on annual cash flow. Most seller notes we see are on a 3- or 5-year amortization term and payments are greatly increased over an SBA 10-year term. Once I recognize that the buyer has a seller note being considered in their transaction, I explore the actual reasons for such a note. Many times, my buyer says, "It's to have the seller keep an interest and skin in the game". This doesn't and shouldn't provide a buyer with any sense of comfort as he moves toward closing. I always feel that if a seller note brings a buyer a level of confidence in the business, he should step back and better understand what he is NOT comfortable with and how to better understand those operational items prior to closing.

What most buyers don't consider is that almost all seller notes require an unlimited personal guaranty of the buyer. If this buyer discovers blatant fraud during his first week of operation, a judge is the only way to overturn this seller's note. That's not comforting.

Next is another concern that often comes up surrounding seller notes which is the ability to demand ongoing financial statements of the operation, post-closing. The seller is now a financing obligation like another lender and can demand consistent monitoring of the business. Most buyers do not want to share or have the seller that involved in the businesses financials once they take possession.

Noting the above concerns, although many times critical to the transaction, these are NOT my biggest reasons to exclude seller notes from acquisitions. In my opinion, the buyers greatly reduce their negotiating abilities when including some level of seller financing. Many attorneys and accountants advise against them also and even tell the seller to “never expect to be paid”. We see this in many scenarios and do not believe it’s in the best interest of the buyer, seller, or overall transaction.

In short, a transaction which includes no level of seller financing typically has a greater cash flow for the buyer and may save them many dollars during the price negotiation stage of the acquisition. The seller is typically more appreciative of leaving with all his funds and so is the broker handling the sale. A longer term and lower price always benefit all parties and is a recipe for success.

Seller notes can make the deal happen at times and I support them if they do. Above I described transactions where we have no concerns about historical cash flow of the target business and the down payment ability of the buyer. Should either of those not be the case, a seller note can be the difference.

Current market conditions (lenders) demand some level of post-closing liquidity on the buyer’s personal financial statement, meaning that the buyer cannot empty every account they have to inject as down payment. Since the crash of 2010, lenders have repeatedly focused on a buyer having some level of personal funds post-closing known as “post-closing liquidity”. Many times, the buyer believes they have the funds to close but lenders will not allow the emptying of every account and a small sellers note could make up the difference.

The rules have changed. Based on the latest SBA SOP’s, a seller note must be on full standby for the life of the loan if it is being considered equity injection or down payment. This may or may not be a concern depending upon the relationship with the seller and/or the amount of the requested note. A small note on a large transaction may be a no-brainer for either party.

The business has grown and continues to expand but historical cash flow cannot support the current selling price. The difference in annual debt service using a seller note can change everything. By lowering the requested financing amount, it conversely increases a lenders debt service coverage ratio. This sellers note is not required to be on full standby if it is not being considered for injection. That said, it must be on some level of standby until the lender is confident the business can support these additional sellers note payments. Typically, 2 years form the closing is where most lenders will remove the sellers note payment amount from their calculations regarding historical cash flow coverages. This is entirely lenders discretion, and each has their own terms and requirements.

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