Avery Commercial Lawyers

A GUIDE TO VENDOR FINANCE IN BUSINESS SALES

The provision of vendor finance in the context of a business sale transaction presents potential risks and opportunities for buyers and sellers.

Vendor finance occurs when a seller agrees to fund (usually a part of) the purchase price to sell its business. An initial amount will be paid by the buyer at settlement, with the balance, plus interest, repaid over an agreed period.

When is vendor finance appropriate?

A seller may agree to provide vendor finance in circumstances where a purchaser is having difficulty obtaining bank finance to fund the purchase of the business.

Whilst such arrangements are usually not preferred by sellers, it can sometimes be the difference between a seller being able to sell its business or not at its desired price.

What are the risks to a seller?

There are risks to a seller if a buyer defaults under the arrangement. However, a seller can seek to minimize (not eliminate) its risk by ensuring that:

- the arrangement is correctly documented by a lawyer
- the repayment terms and interest rate are commercially appropriate
- there is sufficient security to support the loan if the buyer defaults
- the level of finance is not so great to reduce the buyer's level of commitment to the business

What terms are usually agreed?

The parties will usually agree to the following terms:

- the amount to be borrowed (e.g. $50,000 - $100,000)
- the agreed interest rate (usually between 7% - 12% per annum)
- the repayment schedule (e.g. monthly in advance)
- the term of the loan (e.g. 12 to 24 months)
- type of loan (e.g. interest only or reducing principal and interest)
- the provision of agreed management and financial reports
- details regarding the provision of security

The terms will either be contained in the contract of sale, or documented in a separate loan/security agreement.

What security should be sought by a vendor?

A seller needs to ensure that adequate security is taken in the event of default by a buyer. This might include:

- a mortgage over specific assets of the business (e.g. chattel mortgage)
- a charge over the assets of the buyer's company (also known as a registered security agreement).
- A mortgage over the lease or other freehold owned by the buyer

A well advised seller would also ensure that personal guarantees are provided by the buyer and/or its directors.

However, it is important to ensure that any potential form of security has sufficient equity in the event that it needs to be relied on by the seller.

In certain circumstances, a seller might also require a buyer to:

- enter into a deed of priority to limit the right of any other third party lender
- require the buyer to provide a statement of assets and liabilities certified by its accountant
- limit the right of the buyer to distribute profits until the seller has been repaid in full
- grant powers of attorney (e.g. to allow the seller to take back control of certain business licences in the event of default)

One of the principal rights of a secured creditor under a company charge (registered security agreement) is the capacity to appoint a receiver to the company in the event of a default.

The receiver's role is to collect and sell enough of the charged assets to repay the debt owed (this may include selling specific assets or the business entirely), and pay out the money collected in the order required by law. The receiver's primary duty is to the company's secured creditor.

If director's guarantees have been obtained, a seller would also have the option of being able to sue the directors personally. However, a personal guarantee is only going to be of benefit if the guarantor has sufficient assets upon which to rely.

A seller should discuss any proposed arrangement with their accountant and lawyer to ensure that the security is adequate. A seller should also keep in mind that:

- the business assets may depreciate in value (particularly if the business is poorly run); and
- a guarantor may dispose of valuable personal assets

Whilst there are risks in any vendor finance arrangement, the risks need to be balanced against the potential benefits to all parties concerned.

If you would like more information on the legal aspects of vendor finance arrangements, please feel free to contact me to discuss.

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Matthew is an experienced commercial and property lawyer who regularly advises clients in relation to the purchase and sale of businesses. He is a member of the Law Institute of Victoria (LIV) and an associate member of the Australian Institute of Business Brokers (AIBB).