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Vendor funding of business sales

a substitute for bank borrowing?

The market for company sales is slowly picking up after five long years of slow activity. A measure of confidence is back as the Euro crisis fades from the headlines. There is pent-up demand from sellers and buyers. Investors with cash are looking for a return, and equity markets are booming when other investments look unattractive. Companies are looking for a strategy that takes them beyond the defensive mindset of recession.

The major obstacle to mergers and acquisition activity remains the lack of funding from the banks. There is no likelihood of that changing, so parties to deals are looking for other ways to finance deals. Top of the list is vendor funding, by deferring payment of the price.

Vendor funding can be attractive. It allows deals to be done with little or no dependence on outside parties, and it may allow the seller to maximise the price through an earn-out arrangement, so that the price depends on the results achieved by the new owners. It can have tax attractions, by allowing the seller to spread his gain over several years.

Deferred deals do have some serious drawbacks, which are often not appreciated by the parties at the outset. They include:

- The seller can end up paying himself out of his own money. He gives away the upside (future growth) but retains all the risk. If the only source of payment is the earnings of the company, why sell? Why not keep the company and the earnings?
 - Credit risk: the deferred price is often unsecured, so that it will not get paid if either the buyer or the company goes bust. Sellers often ask for security, but often there is none of any value to be had: any assets in the company are likely to be charged to the bank, and any seller debt is likely to be postponed to the bank to the point of making the second charge almost valueless. On the other hand, if the company charges its assets to the seller it may find itself unable to borrow. There may be big, expensive arguments between the seller and the bank about priority of security and whether the seller is allowed o enforce his security.

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- Sellers sometimes try to get the company or business back if the buyer does not pay, but that rarely works either. By the time the buyer defaults, the company is usually in a worthless state, and the right to recover it might well be unenforceable if an insolvency is involved.
 - Buyers usually will not give personal guarantees. If they are not risking enough of their own money, they may have little incentive to make the business succeed and pay out the seller, especially if things star falling behind plan. The seller may find he gets his business back by default.
 - The seller may be pressurised into renegotiating of the deal partway through, if there is a risk that he will not recover the full amount he is owed.
 - Tax structuring is delicate: the seller does not want to pay tax on money he may not receive, but also wants to protect his entrepreneur's relief.
- A variable price increases the risk of the deal to both parties. Each will be suspicious of the other's involvement in the business as they try to manage conflicting priorities. Sellers will want some control to protect what is owed to them, and to keep the business largely unchanged so that its performance can be measured; buyers will want freedom to manage the business, including making major changes such as selling or merging.

With the risk increased all round, expert legal advice is essential. I have been handling corporate deals for 30 years with a specialisation in earn-outs and deferred deals. I know the practical realities as well as the legal theory. Call me to discuss your project.

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