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Better Than All Cash

BY: DOUG ROBBINS

One of the most common expressions we hear from business owners when discussing the sale of their business is **"I want an all cash transaction!"** On a very rare occasion, we have seen a purchaser come forth with all cash and purchase a business outright, but usually there is a portion of the purchase price in those cases that is placed into an escrow account (held by a lawyer in trust) for a period of time, varying from 3 months to 1 year.

It is critical to understand why seller financing is still required for most smaller transactions, the most popular reason being that the seller wants to sell shares to take advantage of the capital gains tax exemptions available to small business owners in Canada.

However, when a purchaser acquires the shares of a company, they also inherit all liabilities of the business. Sure, we have accountant prepared financial statements which are supposed to cover all financial aspects of a business, but then again to save costs, most small businesses opt for a **"notice to reader statement"** in which the accountant clearly states they have not completed an audit nor a review and as such, they have relied on information given to them by the owner to prepare those statements. The net result is that notice to reader statements do not provide much comfort to a purchaser acquiring shares.

Then there is always the possibility of unrecorded liabilities showing up or contingent liabilities appearing such as a tax audit, which then become the responsibility of the purchaser.

The solution to the issue of the owner selling shares for the tax advantage, is the purchaser needs some comfort that there is recourse if undisclosed liabilities should appear.

Therefore, seller financing will provide that comfort. A note, an issuance of special shares, a management consulting contract, a royalty program or some other form of deferred payment to the seller, that is large enough to cover any liability, and can be withheld if liabilities should appear.

There are a number of other factors a seller should take into consideration when negotiating:

- A purchase price premium, for as much as 15 to 25%, as compared to an all-cash transaction.
- The seller should realize a higher interest on the note from the buyer than would be earned on bonds or G.I.Cs.

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- The take back financing is usually secured against the assets of the business, and depending on who the purchaser is, there may be personal guarantees or outside collateral security posted.
- If the business fails, the assets are more valuable to someone who is familiar with the operation and could liquidate in an orderly fashion, or who would be willing to step back in and operate it with a view to perhaps selling it again to someone else.
- The seller is more aware and understanding of the cyclical nature of the business (than an outside financier or bank) and can take this into consideration when structuring the financing, including considering payments over a longer period. We have seen structures wherein the principal payments only occur in high cash flow months (think of a ski resort).
- The purchaser who is providing a higher percentage of the purchase price with their own equity is more selective in what business they consider buying and the price they are willing to pay.

Another consideration may be to retain some of the assets and then lease them to the purchaser. This is a form of seller financing that can provide a steady income stream to the seller and provide a sense of security. We recommend serious consideration be given to this approach if there is real estate owned by the business.

Management consulting agreements, can be an excellent way to finance a portion of the purchase price. One of our most recommended structures is a 5-year contract, working 3 months full time at the outset, followed by 3 months part time, followed by 4½ years for consultation, usually about a day a month. Oftentimes these contracts expand to include becoming a company ambassador representing the company at trade shows/conventions and special promotions. The advantages of this structure can benefit both the purchaser and the seller. The purchaser can expense these costs, and not carry this debt on their balance sheet. The seller now has a steady stream of income and can live on this consulting contract and not on his capital. It has the added benefit to the seller that they are not leaving his business 'cold turkey'.

A seller with a continuing financial interest in the business has a vested interested with the ongoing success of the business, and this is usually considered to be a positive sign in the eyes of the purchaser, that they are acquiring a good business.

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