

Financing Strategies

“Considerations in Buying or Selling a Business in Alabama”
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FINANCING STRATEGIES IN BUSINESS ACQUISITIONS

An essential element of buying or selling a business is obtaining both the capital with which to complete the purchase and the working capital for the business once it is acquired. In the case of a stock acquisition, the corporate entity may come to the Purchaser with working capital sufficient to carry on its business activities, but in the case of an asset purchase, the business will have immediate cash needs that must be met for it to continue its operations. Moreover, even in the case of a stock purchase, the Purchaser may be required to renew or replace existing lines of credit and finance sources and there may be an immediate need for additional working capital to proceed with the business plan of the Purchaser. The equity portion of the financing has already been addressed in our discussion regarding structuring of the acquisition. This segment will focus on issues to consider when planning the debt structure of the acquired business.

I. PLANNING THE DEBT STRUCTURE.

Plans for the funding needs of the business should be made at the earliest possible time, and well in advance of entering into any sort of definitive acquisition agreement. If possible, pro forma financial statements prepared by an accountant or financial advisor should outline the capital needs of the business, both as regards the purchase price and as regards any on-going capital requirements. Those same statements should set forth the anticipated ability of the business to repay its indebtedness. Certain indebtedness, such as indebtedness incurred for the acquisition of the business or to obtain needed equipment and machinery, will typically be amortized over a period of years, while other indebtedness, such as working capital financing, will be obtained on a revolving credit basis, possibly with fluctuating outstanding balances, and with no principal payments due until expiration of the loan term. Use of the loan proceeds may include (i) payment of the purchase price for the business; (ii) replacement of existing debt of the business; (iii) purchase of additional capital assets; or (iv) working capital loans to “carry” critical business assets such as inventory or customer accounts.

II. THE SELLER AS FINANCING SOURCE

- A. Identification of the Terms of Sale. The source of financing for an acquisition should be identified at the very earliest stage of negotiations. Even when the Seller is not the source of financing, the ability of a borrower

to obtain financing for the purchase may be a “deal point”, satisfaction of which must occur in order for the deal to close.

- B. Acquisition Document. Unless the Purchaser is virtually assured of adequate financing from sources other than the Seller, the need to obtain financing should be clearly and unequivocally stated as a condition to closing in the acquisition documentation. This requirement might include not only the borrowing of the purchase price for the business but also obtaining adequate working capital financing after the transaction has closed.
- C. Seller’s Financial Condition. At the outset, the Purchaser should make some estimation of the Seller’s ability to furnish purchase-money financing for the transaction. An obviously distressed business with mounting debts (probably personally guaranteed by the Seller’s shareholders) would not be a candidate for Seller financing
- D. Other Benefits; Setoff Rights. Obtaining Seller financing and including set-off rights in the note or other instrument representing the financing might be an excellent vehicle to secure indemnities given by the Seller to the Purchaser and might provide an extra measure of safety with respect to claims of Seller’s creditors against Purchaser.
- E. Pricing. The use of an above market rate of interest on Seller financing might be a good means to transfer a premium for the business (good will or “blue sky”) from the Purchaser to the Seller. Conversely, a below-market rate of interest might permit the Seller to enjoy a larger immediate capital gain treatment with lesser interest income at a later time.
- F. Underwriting Standards. Seller, who has the incentive of furnishing a portion of the financing for the transaction in order for the transaction to close, is much more lenient with credit terms and requirements of collateral. Also, the Seller, being fully familiar with the nature of the business and the value of its assets, might be more comfortable in lending to that same business.

III. TYPES OF SELLER FINANCING

- A. Unsecured Financing. Seller may furnish unsecured financing in the form of subordinated notes or other debt to facilitate the purchase. While this method usually lasts for a fairly short term period of time (three to five years), long-term funds may be furnished depending on the willingness of the Seller to incur longer-term risk.
- B. Real Estate Financing. Real estate financing may take the form of a long-term loan, secured by the real estate acquired and amortized over a period of ten to fifteen years and possibly with a balloon payment at the end of a five year period. An alternative would be to negotiate a term lease of five to ten years with an option to purchase at the remainder of the term. An above or below market rate on the lease may be used to adjust other items in the purchase price.

- C. Asset-Based Lending. More unusual would be the willingness of a Seller to furnish funds for the working capital needs of the business. Such a credit facility might or might not be secured by assets such as inventory, accounts receivable and other personal property and equipment.
- D. Other Security. Other assets available to secure the Seller financing may include a pledge of the outstanding capital stock of the acquired company, a pledge of general intangibles (patents, trademarks, trade secrets, etc.) or any other assets of the corporation. A pledge of corporate stock, while providing assurance that failure of the Borrower to pay might result in loss of the Company, does not provide significant security. A stock pledge provides no protection against bankruptcy of the business, and foreclosure procedures can be difficult.

IV. ISSUES IN SELLER FINANCING

- A. Document Negotiation. The terms and conditions of Seller financing should be negotiated at the time of execution of the acquisition document, and should, if possible, be reflected even at the letter-of-intent stage. The acquisition document should reflect all of the major terms of Seller financing, including repayment terms and a listing of any collateral for the debt.
- B. Timing. Seller financing should be negotiated with the Seller's interest in closing the transaction kept in mind. Sellers typically require fewer restrictive covenants and impose fewer controls on the Purchaser/Borrower. Even where it ultimately appears that the Seller will be unwilling or unable to furnish funds for the acquisition or capital needs of the business, if there is any doubt at all on the part of the Purchaser regarding its ability to obtain those funds, the obtaining of satisfactory financing should be included as a condition to closing.
- C. Restrictions. Because the Seller is intimately familiar with the operations of the business, he may attempt to impose restrictions on the operations of the business designed to insure its financial soundness. Such restrictions are not the norm and should be resisted by the Purchaser.
- D. Personal Guaranties. The Seller will inevitably request the personal guarantee of the principals of the Purchaser. Where a number of shareholders are involved, the guarantee of one might suffice. Where numerous guarantees are required, Purchaser should endeavor to divide the debt by the number of guarantors (or allocate it according to stock ownership) and limit each guarantee to the shareholders' allocable share of debt. In the case of a parent/subsidiary relationship, the guaranty of the parent may be required.
- E. Subordinated Debt. Where Seller financing is only a part of the overall debt package, it may be critical to obtain agreement from the Seller at the time of execution of the acquisition agreement to subordinate its debt to payment of

senior indebtedness to a financial institution. Even where there is no payment subordination, it may be important for the Seller to subordinate its security interest in the purchased assets to the security interest of the bank lender. Absence of such an agreement typically means that no bank will be willing to extend credit to the Purchaser.

- F. Other Considerations. Generally in negotiating the documentation for Seller financing, the Buyer should consider all of the issues that would be relevant to third-party financing. [See discussion below.]

V. ASSET-BASED LOANS FROM FINANCIAL INSTITUTIONS.

- A. The Basic Conflict. Creditor and Borrower will differ markedly in their approaches to lending. Borrower will try to obtain maximum funds (at the lowest cost of funds) with minimum amortization. Creditor's main concern is with repayment. Each lending decision from a Creditor's perspective depends on its analysis of the debtor's character, creditworthiness (ability to repay), and an analysis of the quality of the collateral. Purchasers who have had prior credit difficulties will have difficulty obtaining debt financing for a newly acquired business.
- B. The "Creditworthiness" Issue. Before any loan is made by a competent lender, a credit analyst or other officer will analyze the Borrower's business to determine the likely ability of the Borrower to repay the indebtedness for some time into the future. This same analysis, if shared by the financial institution, can be helpful to the Borrower in making its decision to purchase the business. Where there is an established business relationship, the Borrower should make good use of the analytical skills of his bank officer in determining the terms on which to purchase.
- C. Identification of Lenders. While both banks and financing companies make asset-based loans, banks are more closely regulated in their lending activities and may be less flexible in their approach to asset-based lending. On the other hand, a bank with an established relationship with the Purchaser will likely provide a steadier source of funds for the company at lower rates and with a lesser likelihood of coming down hard on the Purchaser/Borrower in the event of problems with the credit. The Purchaser's first avenue of approach should be a bank with whom it has an established banking relationship. This bank should be able to proceed to analyze the credit without having to investigate the general character and credit-worthiness of the Borrower. The bank furnishing funds for the Seller might also be a source of credit.
- D. Unsecured Financing. As a general rule, unsecured financing for a newly-acquired business would depend entirely on the financial strength of the principals of the business and would be based on personal guarantees of the principals (occasionally with the guarantees secured by collateral). For most newly-acquired businesses, any third-party lender will require security.

- E. Identification of Assets. The first step in approaching third-party financing is a review of available assets. In an asset acquisition, virtually all assets of every description should be considered as a basis for borrowing. Real estate having an established value will support a loan from any number of financial institutions. Other less marketable assets, such as inventory and accounts receivable, will require a sophisticated bank or financing company.
- F. Terms of Lending. Irrespective of the particular assets pledged as collateral, the Borrower/Purchaser will need to fashion loan terms that furnish the needed capital and with repayment terms that meet the anticipated ability of the Borrower/Purchaser to repay. Items to consider in negotiating loan terms are the following:
1. Demand Loans versus Term Loans. While many real estate lenders amortize loans for newly acquired businesses over a period of time, financing based on inventory or receivables is often offered only on a “demand” basis or in one-year increments. In almost all instances, a Borrower would prefer a loan for a fixed term such that the lender cannot “pull the plug” on the business at any time.
 2. Amortized Loans. The term loan amortized over a period of time provides the Borrower/Purchaser with good opportunity for future planning and avoids any surprises with respect to payment terms. This loan provides the greatest risk to the lender because it constitutes a commitment by the lender to proceed with financing over the term of the loan, in the absence of an event of default.
 3. Recent Developments with “Demand” Obligations. While the Borrower must assume for planning purposes that a demand obligation can be called at any time, as a practical matter, the lender may be discouraged from taking immediate action on a demand obligation because of potential lender liability. Recent cases in other jurisdictions suggest that demand obligations, particularly where events of default other than demand are enumerated, require the giving of prior notice or the occurrence of one of the enumerated defaults, before the exercise of remedies. See, e.g., *Reid V. Key Bank of South Maine, Inc.*, 821 F.2d 9 (1st Cir. 1976); and *Shaughnessy v. Mark Twain State Bank*, 715 S.W.2d 944 (Mo. 1986).
 4. Alternatives to the Demand Feature. Even where the Borrower’s needs for funding will extend for a period of five to ten years, the Borrower might be able to obtain one year “revolving” type financing which would be subject to annual renewal (or demand). Where the lender is unwilling to offer anything other than a demand-type credit, Borrower/Purchaser should endeavor to obtain provisions giving it enough time to obtain alternate financing in the event the lender makes demand. Provisions requiring advance notice of sixty to ninety days of the lender’s intention to demand the loan or not renew the credit provide important lead time to the Borrower/Purchaser to obtain alternate financing.

- G. Costs of Borrowing. Most loans to newly-acquired companies will require payment of an up-front or commitment fee to the lender, which will normally be forfeited by the Borrower if the loan fails to close. Borrower should insist on no forfeiture of the commitment fee where failure to close results from action of the Seller. Interest rate pricing will depend heavily on the type of collateral and the period of amortization. For example, real estate loans are often made on the basis of a fixed rate of interest. Working capital loans where the principal balance would be expected to fluctuate upward and downward will necessarily be based on a floating rate of interest normally tied to the bank's prime or base lending rate. More sophisticated loan arrangements might permit a periodic shifting between fixed and floating interest rate. In cases of extraordinarily strong credit-worthiness, below prime financing based on the London Interbank Offered Rate ("LIBOR") may be available. Loan documents frequently provide for an increase in the rate of interest upon the occurrence of an event of default. Other costs of borrowing will include costs of title searches, title insurance, lien searches, and the fees of the bank's and the Borrower's attorney.
- H. Perfection of Collateral Interests. All of our discussions regarding use of real estate and personal property as collateral for loans assume that the Borrower will furnish to the Lender a first-priority, fully-perfected security interest in the collateral. Any factor that complicates the perfection process, such as a retained security interest on the part of the Seller or any outstanding judgments or liens, will make borrowing more difficult.
- I. Bankruptcy Issues. Many practitioners approach the financing of acquisitions with the attitude that the lender and its counsel should attend to matters of perfection of security interests. Where the loan is secured by the personal guaranty of the principal of the business, it is absolutely critical to that owner that the lender's security interest be properly perfected. In the event of a bankruptcy filing, a fully-perfected creditor will be able to realize out of the pledged assets most if not all of the funds it is owed, leaving the owner/guarantor with little exposure. If those assets are not properly pledged and must accordingly be shared with the unsecured creditors of the Borrower, the lender may realize nothing and will then look to the guarantor for repayment of the indebtedness.
- J. Real Estate Loans. Real estate collateral is probably the best understood and frequently the most well-received by a number of financing sources. Borrowing on real estate typically requires a mortgage of the fee simple interest in the property. Loans secured by leasehold interests, except possibly where the lease is an industrial development board financing lease, are rare. Considerations in real estate loans are as follows:
1. Identification and Appraisal of Real Estate. The Borrower can expect the creditor to require a real estate survey and an appraisal by an appraiser selected by the lender as a condition to closing. Regulations issued by the Comptroller of the Currency and other regulatory authorities require appraisals with respect to certain real estate loans. The Borrower can expect to pay these costs. Borrower

should beware loan document provisions that require additional periodic appraisals at Borrower's expense.

2. Environmental Assessment. Any real estate lender will expect a Phase I environmental report for which the Borrower will be expected to pay. Any environmental complication will make the loan unattractive to the Lender.
 3. Lien Searches. Title to the real estate and by derivation, the priority of the creditor's lien on the real estate, will be guaranteed by a title insurance policy issued on a form approved by the American Land Title Association. Title insurance costs can be high, depending on the amount of the loan, and the Purchaser might well be able to require the Seller to pay all or a portion of the title insurance cost by including in the acquisition agreement the obligation of the Seller to furnish a title commitment. The Seller typically has the obligation to furnish proof that the real estate is free and clear of all liens and requiring the Seller to fund the cost of title insurance issuance is not unreasonable.
- K. Inventory Financing. Borrowing based on collateral in inventory is a frequent means for businesses to finance the cost of producing that inventory and working capital. Lenders generally look to inventory as working capital financing and will not amortize inventory financing over any term longer than a one-year period.
1. Creation of the Security Interest. While laws of the particular jurisdiction in which you are working should be consulted, security interests in most types of inventory in Alabama are perfected by the filing of a U.C.C.-1 Financing Statement in the office of the Secretary of State. Where the Borrower does not own the real estate on which the inventory is located, a landlord lien waiver should be obtained to eliminate priming by a landlord lien of the security interest of the creditor.
 2. Identification of Acceptable Inventory. Inventory financing is customarily based solely on the value of completed inventory, with lenders being reluctant to lend on the value of work in process or raw materials. Because of the requirements of filing of U.C.C. financing statements in order to perfect a collateral position in most inventory, Borrower is restricted in the locations at which collateral may be placed. Consigned inventory is excluded, as is inventory represented by warehouse receipts. Lenders will customarily endeavor to include a provision to the effect that any other inventory deemed ineligible by the lender will be excluded from the borrowing base. Because of difficulties in perfection of security interests and difficulties in liquidation, inventory located in a foreign country will almost always be excluded from the borrowing base.
 3. Fluctuating Borrowing Base. Because the Purchaser in operating the business will be constantly producing and selling inventory, the

inventory levels will change constantly, and lender will need to verify, either through reports by the Borrower or through direct verification by the lender, inventory levels at any point in time.

4. Lending Risk. In undertaking inventory financing, the lender takes on several types of risk that are not present with real estate financing. Collateral value may fluctuate more rapidly than with other types of collateral, liquidation costs can be substantial, and the market for the inventory may be thin or nonexistent. Also, lenders anticipate delay in disposing of inventory. To compensate for this risk, lenders typically discount the collateral value, with an industry norm frequently being 50%, so that funds that could be advanced based on the value of inventory would be equal to 50% of the cost of the inventory.
5. Miscellaneous Factors. Inventory financing may be complicated by the very nature of the inventory. For example, motor vehicles may require franchisor cooperation to liquidate and state motor vehicle statutes may complicate perfection of the lender's collateral position. Other inventory, such as drugs and pharmaceuticals, may require special licenses for disposition. Copyright and licensing issues may also complicate disposition of inventory and might motivate the lender to require a pledge of intellectual property and other intangible assets to accompany a pledge of inventory. The value to the lender of the inventory depends on the ability to dispose of it efficiently, hopefully in an established market. Any factor which limits or hinders the ability to dispose of the inventory quickly will diminish inventory as a collateral source and will either result in a further discount by the lender of the value of inventory for borrowing purposes or eliminate the availability of inventory financing altogether.
6. Role of the Guarantor. The ability of the lender to dispose of the inventory may require the expertise of one or more key employees of the Borrower. This is an additional reason for the lender to require personal guarantees because those guarantees provide the incentive for the guarantors to do everything possible to see to it that the lender is paid from the proceeds of the inventory. A performance guaranty [see discussion below] might be an alternative to the unlimited guarantee that is frequently exacted by the lender.
7. Non-traditional Sources of Inventory Financing. A number of means of using inventory for meeting the working capital needs of the newly-acquired business are available that do not use traditional lending arrangements. These include the following:
 - a. Consignment and Sale on Approval. Inventory may be acquired on consignment such that title remains in the supplier until such time as the inventory is sold. Sale on approval also involves the retention of title by the supplier until the sale is consummated.

- b. Bill and Hold. Under this procedure, inventory remains in the possession of the supplier and the inventory is delivered to the final customer by the supplier.
 - c. Warehousing. Field warehousing is an arrangement whereby the lender's agent retains actual possession of the inventory at a warehouse site controlled by the lender. This procedure results in extremely tight control by the lender of the inventory but can only be useful in a small number of situations.
 - d. Floor Planning. Floor Planning is a type of inventory financing prevalent in the automobile industry where the inventory financing is furnished by the manufacturer itself who then maintains title to the goods until they are paid for.
- L. Accounts Receivable Financing. Accounts receivable financing can take several forms, the most common of which are (i) the revolving line of credit backed by receivable security and (ii) factoring (the outright sale) of accounts receivable. As regards the use of a revolving line of credit, banks and other financial institutions differ widely in the level of controls they impose on the Borrower.
- 1. Three Party Transactions. Unlike inventory and real property lending, lending based on receivables involves not only the lender and the Borrower but also the Borrower's customers. Communication between the lender and the Borrower's customers might be required by the terms of the financing documents (e.g. to verify outstanding account balances) but ought, from the Borrower's perspective, be kept at a minimum in order to avoid concerns on the part of the Borrower's customers regarding the Borrower's financial condition.
 - 2. "Eligible Accounts". Since the lender will be lending based on the value of the outstanding accounts receivable, the lender will inevitably establish criteria which accounts must meet in order to be part of the borrowing base. These include the following:
 - a. Legitimacy of the Account. Accounts owed by subsidiaries and affiliates are often excluded, as are accounts arising out of anything other than the regular conduct by Borrower of its business, and accounts where the account debtor is also the creditor of Borrower (and where accordingly, the account debtor might have rights of setoff).
 - b. Nature of the Account Debtor. Where more than a given percentage of outstanding accounts (say, 25%) are owed by a single debtor, all accounts from that debtor might be excluded on the basis of the lender's unwillingness to have so much of its credit risk tied to a single customer of

Borrower. The lender might establish credit limits for the various account debtors and exclude accounts from those debtors considered risky. Accounts owed by the United States and its agencies are generally excluded because of the need to use different perfection methods in dealing with these accounts (the Assignment of Claims Act). Accounts owed by foreign debtors are also excluded unless separate arrangements are made for the perfection of those accounts.

- c. Payment History. Accounts are frequently excluded from the borrowing base if they are not promptly paid (a typical provision being that any account not paid within sixty days is automatically excluded from the borrowing base). Also excluded are accounts with respect to which Borrower has granted a payment extension.
 - d. Credit Concerns. Accounts of entities involved in bankruptcy proceedings are generally excluded, as are accounts subject to a claim or lien on the part of any other party, and accounts which are subject to demand or challenge of any sort.
 - e. Notes and Instruments. Accounts represented by notes and instruments are typically excluded for the obvious reason that perfection methods are different in the case of negotiable notes (possession being a condition to perfection).
 - f. Consignment Sales. Accounts which arise from a sale to the account debtor on a bill-and-hold, guaranteed sale, sale-or-return, sale-on-approval, consignment or any other repurchase or return basis are excluded because of the tentative nature of the account.
3. Lender's Discretion. In addition to the criteria set forth above, lenders typically also include a provision in receivable loan financing documentation which gives them the latitude to establish new and different criteria for eligible accounts at any point and which permit them to exclude the accounts of any account debt from the borrowing base at any time in the exercise of their sole discretion. Where the loan is a demand obligation, such a provision may not substantially alter the relationship of the Borrower and the lender, but where a term loan is involved, this sort of discretionary power may give the lender a means, absent demand, of making the lending relationship sufficiently uncomfortable as to encourage the Borrower to take the credit elsewhere.
 4. Borrowing Formula. Once the level of eligible accounts is determined, a percentage formula, ranging from 70% to 90% will be applied to the accounts to determine their loan value and the corresponding amount that lender will advance based on those accounts. This formula reflects the lender's assessment of the risk of bankruptcy or other financial difficulty of Borrower and the success

likely to be realized by the lender in collecting the Borrower's accounts after such an event.

5. Levels of Control. As is the case with inventory financing, the borrowing base with receivables financing fluctuates almost daily. Lenders desiring a strong degree of control over the accounts might require submittal of a daily list of invoices and, in a manner similar to tightly controlled inventory financing, require the payment of all proceeds of the accounts into a post office box or "lock box" over which the lender has sole control. Payment by account debtors of an account will reduce the borrowing base by the amount of the payment. The borrowing base will increase again as the Borrower generates new accounts receivable. This sort of fluctuation creates the possibility that the loan may become "overadvanced", which would result in the need for an immediate payment of principal to the lender. Borrowers who are not sophisticated ought to exercise extreme caution in administering a revolving credit based on receivables.
6. Financing Costs. In addition to the usual interest charges, some financial institutions engaged in receivables financing require the maintenance of compensating balances. More frequent is the imposition of fees representing the "float days" that a Borrower enjoys as a result of the immediate crediting of payments to its account. Many lenders extend to accounts receivable borrowers immediate credit for payments made by account debtors and deposited in the lock box or other controlled account. This credit occurs notwithstanding the fact that under normal bank collection practices the funds might not be good and collected funds for a period of days. Float fees might represent two to five days' interest charged against the account reflecting the costs of giving the Borrower immediate credit. This charge increases the cost of borrowing by Borrower and inasmuch as many institutions have not yet instituted such a policy, Borrower should do its best to avoid such fees.
7. Exercise of Remedies; Notification of Account Debtors. In a very tightly controlled line of credit, at the time of making the loan, Borrower and the lender will give written notice to all of Borrower's account debtors to make payment of invoices directly to the lock box controlled by the lender. In the event of default by Borrower in its obligations, lender is thus already in control of the accounts and need take no further action to continue receiving the payments. On less tightly controlled credits, account debtors might be notified to make payments to the lender only upon the occurrence of an event of default. The terms and conditions upon which account debtors may be notified is of critical importance to many borrowers and ought to be addressed specifically in the loan documents.
8. Factoring Arrangements as an Alternative. A different approach to receivables financing is the use of factoring arrangements. In

contrast to traditional receivables financing where the accounts remain the property of the Borrower subject to the lender's security interest, factoring involves the outright sale of accounts to a finance source. The lender charges a commission or discount for the purchase, and frequently has recourse back against the Borrower for accounts which are not ultimately collected. Reserves against uncollectible accounts are often maintained. In factoring arrangements, the lender normally exercises much greater supervision over each of Borrower's sales activities and may itself either check credit or impose credit controls with respect to each transaction giving rise to a receivable.

- M. Control of Proceeds in Receivables and Inventory Financing. Depending on the creditworthiness of the Borrower, the lender may impose tight restrictions on the proceeds from inventory sales and proceeds of receivables. Use of a "lock box" arrangement whereby all invoices of Borrower are forwarded to a post office box controlled by the lender is not unusual. While lock box systems would appear to limit Borrower's flexibility in dealing with its proceeds, these arrangements, coupled with a well-designed cash management system offered by lender, can actually improve Borrower's ability to manage its cash position.
- N. Conflicts Among Creditors. Because the sale of inventory frequently results in the creation of an account receivable, which in turn is identifiable proceeds in which the inventory lender has an interest, conflicts inherently arise when different creditors have pledges of the inventory and the accounts. Also third parties may obtain purchase money security interests in inventory under certain circumstances that will prime out the lender holding a blanket lien on the inventory. Most agreements flatly prohibit or place strict limits on the Borrower's use of purchase money financing. As regards the conflict between the holder of a security interest in the accounts and the holder of a security interest in the receivables, the only way to resolve that conflict practically is the execution of an intercreditor agreement between the two creditors to say "who gets what". As a practical matter, very few lenders are willing to get involved in financing where the inventory and receivables are split, and most working capital borrowing which is asset-based will involve granting a security interest in both inventory and receivables to the same entity.
- O. Other Collateral. In addition to the personal guaranties discussed below, the lender will frequently require the assignment of a life insurance policy on the life of the principal shareholder or key executive officer. Other collateral pledged as security for the loan might be Borrower's patents, trade secrets and copyrights, certain contract rights, and Borrower's general intangibles. Each of these types of collateral raises special questions of perfection that make them of limited value to most lenders.
- P. Loan Documentation. Credits based on real estate collateral are typically accompanied by fewer financial covenants and other restrictions on the part of the lender. Accounts receivable and inventory financing will generally involve more complex documentation with more opportunities for conduct of

the Borrower or its business to result in termination of the credit. The following issues arise to one degree or another in the documentation of all kinds of financing:

- a. The Commitment of the Lender to Continue Lending; Conditions to Lending. Term loans generally constitute a commitment of the lender to leave the funds in the Borrower's hands throughout the term of the loan in the absence of the occurrence of a stated default. Loan documentation might include a number of "outs" where the lender may have discretion to restrict the amount of funds available to the Borrower or terminate the credit altogether. Many loan agreements contain numerous conditions not only on the initial obligation to lend (such as title insurance, certified resolutions of the Borrower, evidence of casualty insurance), but also conditions on the obligation to advance funds from time to time during the term of the loan. The Borrower should examine these carefully to insure that there are no areas with potential for pitfalls as the credit goes forward.
- b. Environmental Issues. Virtually all lending, but particularly lending based on real estate collateral will contain strong environmental indemnities. These indemnities may extend indefinitely, even after repayment of the loan.
- c. Periodic Reporting. Most loan documentation requires the submittal of periodic financing reports on the part of the Borrower. Short term financing might require monthly reports, while long-term real estate financing may not include financial reporting at all. The Borrower should be sensitive to the requirements for audited financial statements, which might impose additional costs on the Borrower during the term of the loan. Many lenders are satisfied with accountant reviewed financial statements rather than audited statements, particularly where the lender has an established relationship with the borrower or where the lender has performed its own audit and review of the Borrower's business. It is routine for financial statement requirements to include a representation that the statements are prepared in accordance with GAAP. Any unusual accounting practices or changes in accounting procedures or practices should be brought to the attention of the lender.
- d. Withdrawal of Funds. Where the principal balance of the loan fluctuates (as would be the case with accounts receivable or inventory financing), withdrawal of funds might require submittal of a requisition or borrower's report.
- e. Opinions of Counsel. Lenders are increasingly requiring the issuance of legal opinions by Borrower's counsel in

connection with loan transactions. Such opinions are properly addressed to corporate matters, such as the due incorporation and good standing of the Borrower and the proper authorization of the borrowing, but many go further to require that Borrower's counsel verify the absence of liens on real and personal property. Extensive legal opinion requirements can increase Borrower's cost of borrowing.

- f. Financial Covenants. Particularly in cases where the loan is not payable on demand, the lender might endeavor to obtain the practical benefits of a demand loan by including complex financial covenants, breach of which will constitute default under the agreement. Covenants include maintenance of minimum net worth, debt service coverage, and quick ratio. The Purchaser should recognize these as potential pitfalls and review these requirements carefully with its accountant.
- g. Restrictions on Financial Transactions. It is not unusual for loan documents to place severe restrictions on the ability of the Borrower to borrow funds from any source other than the lender. Such restrictions can include prohibitions on lease purchase transactions and capital spending. Prohibition of dividends and restriction on management salary increases may also be included and may conflict with Borrower's financial plan or conflict with Borrower's agreements with its equity investors.
- h. Representations of Borrower. Representation and warranty sections of loan documents frequently include the following topics:
 - (1) Organization and Qualification
 - (2) Corporate Power and Authorization
 - (3) Enforceability
 - (4) Pending Law Suits and Claims
 - (5) Financial Statements
 - (6) Title to Properties
 - (7) Pension Plans
 - (8) Payment of Taxes
 - (9) Title to the Collateral
 - (10) Place of Business and Location of Collateral

- (11) Changes in Name of Borrower
 - (12) Existing Debt, Insolvency, and Related Financial Difficulties
 - (13) Environmental Matters
- i. Affirmative Covenants. Affirmative covenants customarily given by Borrowers in connection with third-party loans include the following:
- (1) Insurance
 - (2) Payment of Taxes
 - (3) Compliance with Laws
 - (4) Financial Statements
 - (5) Visits and Inspections
 - (6) Maintenance of Properties
 - (7) Erisa Compliance
 - (8) Financial Covenants
- j. Negative Covenants. Negative covenants imposed on Borrowers in loan documentation might include the following:
- (1) Indebtedness
 - (2) Liens
 - (3) Dividends and Distributions
 - (4) Affiliate Transactions
 - (5) Merger or Consolidation
 - (6) Location of Collateral; Destruction of Collateral
 - (7) Capital Expenditures
 - (8) Acquisitions
 - (9) Prepayment of Debt
 - (10) Lease Transactions

(11) Deposit of Funds

- k. Subordination of Debt. Where the purchased business has been capitalized in part with debt to shareholders, officers, or other principals, the lender will frequently require subordination of the indebtedness and subordination of any collateral securing the indebtedness. Separate subordination agreements from each holder of subordinated debt are required and the notes or other instruments representing the indebtedness will be legended to give notice to any holder of the subordination. Subordination will also customarily be required of any portion of the purchase price financed by the Seller.

VI. LESS TRADITIONAL SOURCES OF FINANCE.

- A. Trade Credit. In evaluating its credit needs, particularly as regards working capital, the Purchaser of a new business ought to consider the availability of normal credit terms from its suppliers as a source of liquidity. Some vendors will go further and extend payment over a period of time and retain a security interest in the product sold to secure the obligation. The availability of credit terms might be an important sales tool for the vendor and competition among vendors might result in competitive trade credit rates for the newly acquired business.
- B. Manufacturers and Franchisors. Along those same lines, a manufacturer who furnishes a substantial quantity of goods to a newly acquired business might be willing to engage in asset-based financing to encourage the purchase of its products. Such a structure would involve the retention by the manufacturer of a security interest in the products sold in much the same manner as would a lender or other finance source. In rare cases, manufacturers are willing to issue limited guaranties of their customers' bank obligations.
- C. Seller Guarantees. The Seller in an acquisition transaction can frequently stand to gain a considerable profit from the sale of its business, and that profit would be lost if the potential buyer were unable to obtain needed financing for the purchase. In rare cases, the Seller might be willing to issue its own personal guarantee of a portion of the Purchaser's debt in order to get the deal closed.
- D. Venture Capital. In many cases venture capital may be available to furnish funds for the purchase or for working capital of the business. This source of funds is typically used only where conventional bank financing is unavailable for the reason that the cost of funds is generally higher. Venture capital firms, if not already shareholders in the enterprise, may require equity "kickers" in addition to traditional interest payments in return for their furnishing of funds.

- E. Purchaser's Funds. A portion of the debt financing needs of the newly acquired business might be obtained from the Purchaser's shareholders themselves in the form of subordinated debt. Use of subordinated debt not only furnishes the needed funds but since most banks consider subordinated debt to be the equivalent of equity, it has the added advantage of "dressing up" the balance sheet of the business and making it generally more credit-worthy in the eyes of lending institutions.

VII. GUARANTY AGREEMENTS.

Personal guaranty agreements are so common in asset-based financing of all descriptions that most lenders assume as a matter of course that the principal shareholders of the newly-acquired business will furnish such a guaranty in connection with the purchase. Obviously, it would be best to avoid giving personal guaranties at all, but once the decision has been made, there is little to negotiate in terms of a guaranty agreement in order to improve the position of the guarantor. What follows are some thoughts on how to diminish the impact of a personal guaranty in the acquisition of a business.

- A. Nature of the Guaranty. The personal guaranty agreement is typically an open-ended commitment on the part of the guarantor to pay all debts of the business whose debts are being guaranteed. The forms of guaranty used today contain extensive waivers of rights on the part of the guarantor, and are unconditional in nature. While the corporate shield will prevent general creditors from coming against the shareholders in the event of bankruptcy of the business, the personal guaranty eliminates this protection in the case of the holder of the guaranty.
- B. Identity of Guaranteed Indebtedness. While both the Borrower and the lender will proceed with documentation of the loan and execution of the guaranty agreements with the principal purpose of having the guarantor guarantee the specific loan that is being closed, virtually all guaranty agreements contain blanket provisions which have the effect of making the guaranty agreement applicable to all debt of every description of the Borrower to the lender. Such agreements can have the unintended result of guaranteeing all sorts of Borrower debt to the lender and should be avoided in favor of a guaranty agreement which identifies the specific loan guaranteed.
- C. Collateral. The guarantor takes comfort from the fact that in addition to the personal guaranty there is also collateral standing behind the obligation of the business. Most guaranty agreements give the lender the right to release or otherwise dispose of the collateral without diminishing its rights under the guaranty agreement, and most guaranty agreements give the lender the right to proceed directly against the guarantor without making any effort to liquidate the collateral at all. Even where the Guaranty Agreement so provides, case law often acts to restrain arbitrary action by the lender with respect to the collateral.
- D. Exhaustion of Collateral. The discussion in the preceding item assumes that the lender will in fact exhaust its collateral position prior to making any

demand upon the guarantors. Most loan documentation provides no such obligation on the part of the lender, and most lenders are free to try to collect the entire loan amount from the guarantors without making any effort to foreclose on the collateral. It is advisable for the guarantors, where possible, to insist on a provision requiring some effort on the part of the lender to foreclose on the collateral prior to proceeding against the guarantors under their guaranty agreements. The best provision would require foreclosure and sale prior to pursuing the guarantors. A more moderate approach would be to require the lender to endeavor for a period of say, six months, to realize upon the collateral before proceeding against the guarantors.

- E. Expiration of Guaranty Agreements. Most guaranty agreements do not contain an expiration date and continue in full force and effect until the indebtedness is paid in full. In start-up situations, it may be appropriate to request the expiration of a guarantor's obligations after a period of years or after the principal indebtedness is reduced to a certain amount.
- F. Subrogation and Reimbursement. Most bank guaranty agreements provide an express waiver by the Guarantor of any and all rights of subrogation with respect to the business, such that if the Guarantor pays the debt of the business, it will not have the right to pursue the business or assert an interest in the bank's collateral. Where this is a major concern, the Guarantor might have a collateral reimbursement and indemnity agreement with the business wherein the business agrees to reimburse guarantor if it is required to pay any such debt. While such an agreement might be of little use in the bankruptcy context, the guarantor might want to take a subordinate collateral position in certain assets of the business to protect its position.
- G. Multiple Guarantors. While the financial institution will normally require blanket guarantees from multiple shareholders of the business, shareholder should do their best to limit the amount of each guaranty to a pre-determined dollar amount of the indebtedness. Accordingly, where the business is borrowing \$3,000,000 and each of the three principal shareholders are asked to guarantee debt, the shareholders should attempt to have each of their guaranty agreements limited to \$1,000,000 in aggregate value. Contribution and reimbursement agreements are also appropriate among shareholders to avoid the imposition of the entire liability on a single guarantor.
- H. The Performance Guarantee. A severely weakened version of the guaranty agreement that is finding acceptance with some lenders is the performance guaranty. The performance guaranty addresses only one area of the lender's concern, namely the concern that it may need the expertise of the principals of the business in liquidating collateral, and it addresses that concern by providing the obligation on the part of the "performance guarantors" to continue working with the lender (sometimes free of charge) for a stated period (typically three to nine months) for the purpose of helping the lender in liquidating the collateral. Because the performance guaranty imposes no monetary obligation on the guarantor, it is a very attractive alternative to the onerous guaranty agreements that are prevalent in bank financing.