CapitalEyes

A Bank of America Business Capital bi-monthly e-newsletter on leveraged finance.

November 2005

Bank of America Higher Standards

Why Seller Paper May Be A Viable Financing Solution

With the abundance of debt financing options, some sponsors probably need to jog their memories to recall the last deal in which they utilized seller financing. Back in leaner times for the financing markets, it was not uncommon to see seller paper fill the gap in the capital structure after traditional financing sources had been exhausted. Today, seller paper finds its way into deals for a variety of reasons and can take many forms, ranging from a simple, hope-we-get-paid-someday subordinated promissory note to a full high-yield style form, complete with indentures, registration rights agreements and the like. The following describes how seller paper is utilized, and the forms it can take.

When And Why Seller Paper Is Used

Seller paper is used for a variety of reasons, driven by the different contexts and reasons for seller financing.

Financing of Last Resort for Buyer - Seller paper is sometimes used to fill the gap between the targeted purchase price for an acquisition and the amount of financing available from third party financing sources. That gap may exist for a number of reasons. In an environment where financing is scarce, the buyer may need seller paper as a financing source for what would otherwise be the market purchase price for an acquisition. When used in such a context, seller paper tends to take elaborate forms, designed with economic benefits and protections for the seller that either mimic or perhaps even surpass those given to third party financing sources.

Purchase Price of Last Resort for Seller - Conversely, even though financing is available for what would be the market purchase price for an acquisition, the buyer and the seller may wish to "stretch" the purchase price beyond that mark. Seller paper is often structured in such situations to provide the possibility of achieving that "full" purchase price, while minimizing the risks to the buyer and its third party financing sources.

Cheaper Than You Might Think - Even when financing market conditions are generally reasonable, a bump in the markets or special characteristics of a given company or transaction may produce a situation where seller financing on mutually agreeable terms makes more sense marginally for both parties than full utilization of the most expensive tranche of third party financing.

Some Skin In The Game - In situations where the seller will continue to have a significant continuing role in managing the company, seller paper can be used to ensure the seller maintains a continuing interest in the performance of the company. Seller paper can also be structured in situations where significant contingencies are built into the achievement of the full purchase price, or where the buyer has a significant interest in ensuring the fulfillment of indemnity obligations to provide a mechanism for returning economics back to the buyer.

More Headache Than You Might Think - While seller financing can be useful, there are also reasons to think carefully about whether seller paper should be utilized. Unlike third party financing, there are often no "market" terms available to guide the negotiation of terms, and no continuing relationship with the providers of the financing. Negotiations can take unpredictable turns, particularly when thrown into the general mix of the negotiations over the sale of the company. In the longer term, if the relationship with the seller turns sour, or if the seller notes are transferred by the sellers to unfriendly hands, the seller notes may become a device for mischief.

Common Types Of Seller Paper

Seller paper takes many different forms depending on the specifics of the transaction. For illustrative purposes, it may be useful to consider two examples on the opposite extremes of leverage between the buyer and the seller, as well as an example of a structuring alternative.

Deeply Subordinated Promissory Notes - Common where seller paper is used to stretch the purchase price, this form of seller paper is relatively simple, without significant covenant or other protection for the seller beyond the promise to pay. Commonly, this form of seller paper is deeply subordinated to other financing to reduce the risk to third party

financing sources, and comes with significant restrictions of transferability.

- Contractual Subordination - In contexts where leverage has already reached the limits of financeability, third party financing sources will want the seller to agree to a deep form of contractual subordination. In extreme cases, no cash payments of any kind will be permitted during the life of the third party financing. More commonly, cash payments are limited to scheduled payments of interest, with payment blocks imposed during any default under the third party financing. This type of paper typically is not cross-defaulted to the third party financing, and carries with it standstills and other blocks on the taking of remedies.

- Payment-In-Kind - This type of seller paper often provides for payment of all or a portion of interest in kind rather than in cash, to reduce the strain on cash flow.

"True" Subordinated Financing - Where seller paper is utilized as financing of last resort for a major portion of the purchaser price, seller paper commonly takes a more elaborate form. Like true third party financing, such paper often includes a full package of restrictive covenants and other protections for the sellers, and is designed to maximize the sellers' liquidity in terms of transferability (no consents over transfers, registration rights, etc.). In many ways functionally similar to bridge financing, the balance of risks and economics favors the seller, while the buyer will be focused on making sure that the paper can easily be refinanced when third party financing on acceptable terms becomes available.

- Full Covenants and Defaults - This type of paper often carries a full set of restrictive covenants, including restrictions on debt, guarantees, dividends, acquisitions, and asset sales, and comes with a full set of events of default, including cross-acceleration or cross-default to the third party financing.

- Transferability - As is the case with third party providers of bridge financing, liquidity is an important concern to the seller in this context, as it is not in the business of holding debt, and wants to convert the investment into cash as soon as possible. Company consent over transfers is rare in this context, and the sellers often obtain liquidity enhancements such as registration rights.

- Prepayments/Redemptions - This type of paper is typically refinanceable at will, with no call premiums or non-call periods.

Holding Company Notes - When seller paper is placed at the holding company rather than the operating company, the seller's claim is structurally, rather than contractually subordinated, to the claims of third party financing sources. While the decision to place the debt at the holding company may occur for a variety of reasons, some principal consequences from a financing perspective include:

- Structural Subordination - The sellers' claims are separated from
the claims of the third party financing sources such that the need for negotiations between the sellers and the financing sources is minimized. This can be of particular benefit with an unsophisticated seller whose expectations may clash with third party financing sources' desire for deep contractual subordination.

- Access to Operating Company Cash - Significant limitations on the buyer's ability to access the operating company's cash to pay the seller paper are typically placed under the terms of the third party financing at the operating company level. Both the holding company paper and the third party financing at the operating company level need to be carefully designed to match the cash pay obligations at the holding company with the operating company's ability to pay dividends to service the obligations.

- Threat to the Sponsor's Equity - Because holding company paper is not contractually subordinated to any debt, there are no payment blocks or remedies blocks that can act as a buffer between the claimholder and the sponsor's equity. Granting the sellers significant covenant protection or cash pay rights at the holding company level can result in situations where the sellers can immediately become a direct threat to the sponsor's equity. Covenants, defaults, and cross-default provisions need to be carefully designed to ensure that the sponsor's

ability to work with third party financing sources in a downside situation are preserved.

Use As Needed, But Carefully

Seller paper may be a useful tool - sometimes even saving a deal that would otherwise be unworkable from a buyer's or seller's perspective for a variety of reasons. But as with any type of debt financing, the issuance of seller paper is a long-term commitment that can impose significant financial burdens and operating restrictions. Careful thought should be given to whether seller paper is in fact the best financing source in a given situation, and seller paper should be carefully structured to minimize the risk to value and operating flexibility. The time it takes to fully develop seller financing terms early in a proposed transaction can minimize surprises later in the process or after the transaction is completed.

This article was written by Sung S. Pak, associate, Debevoise & Plimpton and originally ran in the Spring 2005 issue of The Debevoise & Plimpton Private Equity Report.

As seen in CapitalEyes, a Bank of America Business Capital e-Newsletter on leveraged finance.

Bank of America Business Capital is one of the largest asset-based lenders serving the United States, Canada and Europe. Contact us at 866.287.4098.

Capital markets and investment banking services are provided by Banc of America Securities LLC, member NYSE/NASD/SIPC, a subsidiary of Bank of America Corporation and an affiliate of Bank of America Business Capital. © 2006 Bank of America Corporation