Seller notes and SBA loans

Today's Lenders Look at Seller Notes Differently

By Steve Mariani

How many times have you heard "The SBA requires a seller promissory note"? Well we want to clear up all the confusion on required seller notes. In short, there's no such rule (anymore). You may find that shocking as many people have been led to believe it is required by the SBA. Here is what the SBA rule stated up until 2010.

In addition, a lender should require as much seller-financing as possible with the seller-financing having a subordinate lien to the SBA-guaranteed loan on the business assets. A rule of thumb for the amount of seller-financing that should be required is the amount being borrowed by the buyer to finance the acquisition of intangible assets such as goodwill.

Since the 2010 revision of the SBA SOP this has been removed and now it is the lenders discretion to require a seller note or not. With the lending markets heating back up in 2019 we see seller notes slowly disappearing as many lenders do not want to lose a borrower or loan due to the fact that they internally require the seller to financing part of the acquisition.

Diamond Financial has always discouraged seller notes as we see no advantage to the borrower and here's why:

1) The seller typically only wants to hold a note for 3 to 5 years which decreases the annual cash flow to the buyer due to the higher payments. Typical SBA loan terms are 10 years.
2) The seller feels he has a right to review the financials of the business and has some type of interest in the operation moving forward. This creates many different concerns between the buyer and seller post-closing.
3) The buyer gives up negotiating advantages when determining the selling price of the business. Typically, the buyer gets a better price for an all cash transaction and the seller no longer waits to collect his funds.

As a major broker advocate, we also see the sellers, when including a seller financing note, require the broker to either negotiate their fee or assist in the financing of that seller note. Again, both of which we are strongly against.

With all the above said there are times we support and even suggest seller notes and here are the scenarios we feel them to be appropriate:

1) To assist in bridging a down payment (equity) gap or shortfall. (as of 2018 this note must be on full stand by for the full loan term to be considered "equity")
2) To reduce the annual debt service to allow the lender coverage ratios to become acceptable when securing an approval.
3) To allow an aggressively growing business to sell for slightly higher than would normally be sold for.

Earn outs have been against SBA rules for many years now, but we feel there are times when this is the most appropriate method for faster growing companies. In these cases, based on specific criteria, we do support "Forgivable" seller notes. Not to be confused with a standard seller note. A forgivable note is one that includes milestones or revenue targets that would allow a portion of the note to be "forgiven" if the business does not reach those preset goals. I'm not going into the details in this writing but wanted you to know that these are an option in certain specific transactions.

When you really explore seller notes as a financing option, it is not typically beneficial to the transaction and if it can be avoided, is usually in the buyers best interest to do so. Don’t let conservative SBA lenders convince you otherwise.

AskDiamond@easysba.com is always available for specific questions regarding this or other SBA rules.