Neither A Borrower Nor A Lender Be

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This article is not about Shakespeare, nor is it about some Kingdom on the other side of the world. This article is actually about Vendor Finance.

Vendor Finance is becoming more prevalent in this day and age, and the purpose of this article is to question why parties are becoming involved in such arrangements, especially where such parties have not considered the potential down side, if it all goes wrong.

Vendor finance, in its most simple terms, occurs when a vendor and purchaser enter into a transaction for the sale/purchase of certain assets and undertakings, where the purchaser does not have sufficient funds to pay for the assets and undertakings in full. The vendor allows for the sale to be completed, and receives an undertaking from the purchaser to pay the remainder of the purchase price at some later time on terms agreed between the parties.

In the case of the vendor, they may perceive this arrangement as favourable, as they have a binding contract for the purchase of the assets, and presumably a signed loan agreement for the payment of the remainder of the purchase price.

For the purchaser, the agreement would seem favourable as they may not be in a position to meet the entirety of the purchase price up front, however vendor finance allows them to take possession of the assets and come to an arrangement for the payment of the remainder at a later time.

The purchase/sale of assets can sometimes be entered into with rose coloured glasses, after all, who purchases a business thinking that it will not succeed. Therefore, from the purchasers point of view, the option of vendor finance may well be to enticing so as to complete the sale without looking at the matter with a little more diligence.

If one were to sit back and look at the situation rationally, there may actually be a reason why the financier, is not willing to provide enough funding to allow the purchaser to purchase the asset outright (assuming the purchaser has sufficient capital to commit to the project). The reason for this could well be that the purchase price being sought is actually significantly higher then what the underlying asset is worth.

The vendor may be willing to provide vendor finance as they have been trying to sell the asset for some time and have not been successful. This could be reflective of a declining demand for the underlying asset, or that their sale price is to high. By providing vendor finance this may in fact be the key factor to enable a sale agreement to be entered into.

Therefore, in the purchasers “desperation” to acquire the asset, which they have been enticed to complete by the offer of vendor finance (as they do not have sufficient funds at their disposal), they may in fact be purchasing an asset for more than what it is worth. The key to this process for the purchaser (as with any significant asset purchase) is to ensure a proper due diligence is performed prior to entering into the agreement so as to ensure that the purchaser does not pay a premium for the purchase of the asset.

From the vendors point of view, they are entering to a sale agreement for the sale of assets, which they have spent a great deal of funds to acquire in the first place, or have spent a great deal of personal exertion in building up.

Once they have completed the sale agreement, the vendor no longer has any control over the asset. In many cases, if the purchaser was seeking finance from a third party (i.e., a bank), the third party may require a deed of subrogation be entered into such that this additional financier’s security ranks above that of the vendor. Therefore in the event that the purchaser fails to pay the remaining balance to vendor, the vendor has limited recourse to the assets, as there may the claim of a first ranking secured creditor whose debt would be required to be paid prior to that of the vendor.

The most important factor for the vendor to consider prior to entering into vendor finance is to consider that by entering into the agreement, you are in effect lending money to the purchaser.

This matter needs to be considered very carefully, as the vendor needs to ask themselves, when was the last time I lent a significant amount of money to a stranger? Further to the point, why isn't the purchaser's financier willing to lend the purchaser enough funds to purchase the assets in their entirety.

It could well be that the financier does not believe the purchaser has enough asset backing to finance the funds necessary, or they are concerned that the business venture will not generate enough funds to service the loan at the higher sum. If this is the case, and if the financier, who is in the business of lending money to strangers does not believe it is appropriate to lend the funds necessary to complete the sale, then the question the vendor needs to ask themself is, why should I?