

BUYING OR SELLING A BUSINESS

COLLATERAL SECURITY

By Gianfranco A. Pietrafesa

In a typical deal, the parties may agree on paying a portion of the purchase price at closing in cash with the balance being paid over a period of years with interest, with the buyer making a promissory note in favor of the seller. However, the parties often do not discuss the collateral to secure the buyer's payment and performance under the promissory note. The reasons for this failure run from being naïve about the need for collateral to the seller feeling uncomfortable asking the buyer to provide collateral.

Nonetheless, a seller needs something more than a buyer's promise to make payments under a promissory note. A seller needs collateral. This article summarizes some of the more common types of collateral in deals involving the sale and purchase of a business. For illustrative purposes, this article will deal with the sale of a corporation.

Security Interest in Assets

A seller may obtain a security interest in the assets of the buyer. In general terms, if the buyer fails to make payment under the promissory note, a security interest gives the seller the right to seize and dispose of the assets to satisfy the buyer's debt under the promissory note. In an asset deal, the seller will receive a security interest in the assets that it sold to the buyer. In a stock deal, the seller will receive a security interest in the assets of the business being sold. However, a seller may sometimes also receive a security interest in other assets that the

buyer already owns. Unfortunately, a seller's security interest may be subordinate to the security interest of the buyer's lender providing financing for the purchase of the business or a line of credit to fund its operations.

Stock Pledge

A seller may receive a buyer's pledge of its shares of stock in a corporation. In an asset deal, a corporate buyer will pledge the shares of stock of the corporation that purchased the assets. In a stock deal, the buyer will pledge the shares of stock of the corporation that it acquired in the deal. However, a stock pledge may not be an option if the buyer has already promised to pledge its shares of stock to the lender providing financing.

Personal Guaranty

A buyer may receive the personal guaranty of a third party. For example, if the buyer making the promissory note is a corporation, its shareholders will guaranty the note. This type of guaranty is usually a guaranty of payment, which allows the seller to immediately sue the guarantor without having to first sue the buyer. Although uncommon, the personal guarantor may be required to provide collateral to secure the guaranty, such as a mortgage on a residence or a pledge of other securities.

Conclusion

This article summarizes some common types of collateral security. There are subtle legal and practical issues when dealing with

collateral security. The buyer and seller must consult with their lawyers when dealing with collateral security since such matters implicate legal as well as business issues.

For more information on collateral security, or on buying or selling a business, please contact Franco at gpietralesa@archerlaw.com or 201-498-8559.



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