Look Before You Sign ... the Pitfalls of Personal Guaranties

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Limited liability protections afforded by various corporate, limited liability, or limited partnership laws normally insulate business owners from personal liability for their business's debts.

However, lenders routinely require a small business owner to sign a personal guaranty as a condition for a commercial loan to the business entity, essentially circumventing the statutory protection against personal liability.

What is a Guaranty?

A guaranty is a contractual agreement in which a person (or an entity) agrees to pay the debts of another. In order to be enforceable, the guaranty must be in writing and signed by the guarantor or some other party legally authorized by the guarantor. The guarantor becomes obligated to repay the borrower's loan, regardless of whether the guarantor is directly involved in the loan transaction between the lender and the borrower.

Lenders require guaranty agreements as a way to ensure the business loan is repaid timely. In addition to having more assets from which to receive payment, lenders also believe that if a business owner puts the owner's own personal assets and income at risk, the owner will be much more likely to treat repayment of the business loan as a priority.

Often times, the guaranty is simply a necessary risk that a business owner must take in order to obtain a business loan. If the borrowing business entity continues to make its loan payments under the terms of the loan, then typically, the guarantor need not worry about the lender enforcing the guaranty even though it usually would have the right to do so. However, if the borrower fails to repay its debt, then the lender will be entitled to enforce the guaranty and seek repayment from the guarantor's personal assets and income.

A guarantor who does not read the terms in a lender's requested guaranty agreement or seek more suitable terms can become directly liable for the borrower's obligation. For example, if the lender tenders a guaranty agreement containing language that provides that the guarantor will be "directly and primarily liable" for the obligation, then the lender does not have to wait for the borrower to default before suing the guarantor for the debt. In essence, this language converts the guarantor into a borrower.

How the lender may proceed, and to what extent the guarantor can be held liable can hinge on several common provisions which may be contained in the guaranty agreement. Any potential guarantor should read a proposed guaranty agreement carefully and understand each contractual provision. Often the terms can be negotiated, even if a business entity is a startup and has limited assets and income.

What is a Continuing Guaranty?

While some guaranties may only subject the guarantor to liability for a single obligation, lenders will often propose a guaranty that will remain in effect for an indefinite time and guaranty all of the borrower's past, current, and future obligations to the lender, as well as any renewals or extensions to those debts.

For example, the proposed guaranty agreement may state that the indebtedness guaranteed includes:

> all of the principal amount outstanding from time to time and at any one or more times, accrued unpaid interest thereon and all collection costs and legal expenses related thereto permitted by law, attorneys' fees arising from any and all debts, liabilities, and obligations of every nature or form, *now existing or hereafter arising or acquired* that borrower individually or collectively or interchangeably with others, owes or will owe lender.

This language makes the guarantor liable for:

- The borrowing entity's unpaid debts to the lender which existed prior to the guaranty and perhaps prior to the time the guarantor obtained an interest in the entity;
- The loan which the borrowing entity is in the process of obtaining from the lender; and,
- Any and all future loans or debts the borrowing entity owes to the lender, including any debts that arise after the guarantor no longer has any interest in the borrowing entity.

While a guaranty of a specific obligation, in contrast, generally terminates once the obligation is satisfied, a continuing guaranty will remain in effect until the guarantor terminates the agreement by providing written notice to the lender. This means that even if all existing obligations have been satisfied, the guarantor will continue to be held liable for any future obligations the borrowing entity incurs from the lender if the guarantor has failed to provide proper notice of the intent to terminate the agreement before any subsequent loan is made or debt incurred. This can prove especially problematic if an owner-guarantor pays off the business's loan that was made during the time the owner-guarantor had an interest in the business, then sells the business, but forgets that the continuing guaranty exists!

Typically, the guarantor must follow the specific instructions contained in a continuing guaranty agreement before a termination is effective. If the continuing guaranty agreement is properly terminated, the termination will only be effective on additional obligations of the borrower which it incurs *after* the termination date. The guarantor will remain liable for the full outstanding balance of all existing debts, including all interest and fees, owed by the borrowing entity to the lender. In order to be truly free of the effects of the continuing guaranty agreement, the guarantor and/or borrower must be prepared to satisfy those existing obligations in full.

Unlimited and Limited Guaranties

An *unlimited* guaranty does not limit a guarantor's obligation to a particular time period or amount. On the other hand, a *limited* guaranty will hold a guarantor liable only up to a specified amount of debt, up to a certain point in time, or only on certain specified loans.

A common use of a limited guaranty involves a small business entity that has more than one owner. Negotiations with the lender may result in each owner-guarantor's liability being limited to a percentage of the borrower's obligations equal to, or greater than, each guarantor's percentage of ownership interest in the business, but not the full amount. In some cases, however, a lender may insist that the total amount of guarantor liability exceed 100% so that the lender will have a cushion if one or more of the owner-guarantors have insufficient assets to ante up the owner's entire share. Alternatively, a limitation can be as simple as a limitation of "no more than" a specific amount, which is less than the entire amount of the debt owed. Obviously, the relative bargaining power of the borrower and the owner-guarantor(s) will determine the result of the negotiation, but it is more common than it should be that the owner-guarantor just signs what it is in the initial loan documents without asking for less burdensome terms.

Joint and Several Liability

It can be easier for a business to obtain a loan if multiple individuals are prepared to guaranty the debts of the business. For example, all four owners of a small startup business may agree to give unlimited guaranties to a lender. However, that does not mean that each guarantor is only liable for their pro-rata share (in our example, 25%) of the overall debt. Most guaranties contain "joint and several" liability provisions, and even if the guaranties are silent on the matter, North Carolina law imposes joint and several liability on guarantors. That means that unless the guarantors are liable for a specified amount under a limited guaranty, the lender can hold each individual guarantor liable for the full amount of the borrower's obligation. Moreover, the lender can choose to sue only one or any number less than all of the guarantors for that full amount, leaving the guarantors to fight amongst themselves to ensure the debt is apportioned fairly.

For example, if a co-guarantor declares bankruptcy, is released from liability by the lender, or simply disappears, the remaining guarantors (or those that the lender chooses to sue) will each remain fully liable for the entire amount of the guaranteed debt. In the event that one guarantor pays, or is forced to pay, the debt in full, that guarantor can seek a claim for "contribution" against their co-guarantors in order to recover those guarantors' portion of the debt. But no guarantor can force the lender to look to another guarantor for part payment.

The Obligation of Contribution

When two or more individuals guaranty a borrower's obligation and one or more pays, or is forced to pay, more than their relative share, the guarantor who pays more has the remedy of an action for contribution. This action is based on the law recognizing an implied promise by each guarantor to contribute their fair share to the payment of the guaranteed debt in order to meet their common obligation. Just because the lender chooses to sue only one or less than all of the guarantors, the remaining guarantors are not excused from paying their share of the debt. Contribution allows the co-guarantors who had to pay more than their fair share to sue to recover from those that did not.

Guaranty of Payment vs. Guaranty of Collection

Guaranty agreements commonly provide that the guaranty is for "payment" and not simply a guaranty of "collection." If the agreement states that it is a "guaranty of payment," then the lender can seek recovery of the debt directly from the guarantor without first pursuing the borrower. On the other hand, if the agreement states that it is a "guaranty of collection," then the lender must exhaust the lender's remedies against the borrower before the lender can seek recovery from the guarantor. Due to the flexibility that a guaranty of payment grants the lender, almost all guaranties tendered by lenders specifically state that they are of "payment." It would be rare for a lender to agree to a guaranty of collection only, but, depending on the facts and circumstances, a savvy guarantor of a loan to a prosperous business might be able to negotiate this term.

Lender's Right to Set-Off

If a guaranty agreement provides the lender with a right to "set-off," it means that the lender can "take" funds from the guarantor's account (except for certain IRS or trust accounts), without prior notice, to satisfy the borrower's past due debt.

For example, a guaranty agreement may state that:

> Lender reserves a right of set-off in all of guarantor's accounts with lender including all accounts guarantor may open in the future. Guarantor authorizes lender, to the extent permitted by applicable law, to hold these funds if there is a default and apply the funds in these accounts to pay what guarantor owes under the terms of this guaranty.

By signing a guaranty agreement with such language, the guarantor is granting the lender permission to withdraw personal funds from the guarantor's account(s) as credit against the obligation of a defaulting borrower.

Death of a Guarantor

Most guaranties survive the death of the guarantor, and any liability will become part of the guarantor's estate. As stated earlier, the only way to avoid liability is by paying the obligation(s) in full, or obtaining a release from the lender. Typically, a lender will not release an estate from liability, unless the lender agrees to allow another party acceptable to the lender to take the deceased guarantor's place. It's possible to negotiate a release, or release and replacement, upon death provision in a guaranty agreement if certain factors exist, but such provisions are usually very detailed and require the assistance of an attorney or other professional to draft them.

Conclusion

Before you sign any guaranty agreement, be sure to read all of the terms carefully. Guaranty agreements can easily bind you to more debt than you intended. Prior to signing, you should always obtain independent legal advice from a licensed attorney who will make sure your intentions are adequately reflected or that, at least, you understand your risks before you sign. Otherwise, you may find yourself taking on much more than you anticipated.

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