PERSONAL GUARANTIES: WHAT EVERY SMALL BUSINESS OWNER NEEDS TO KNOW

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When dealing with a personal guaranty, the name of the game is mitigation.

AN OFTEN-OVERLOOKED PARADOX of owning a small business is that—after going to great lengths to create an entity and maintain a separate and distinct corporate existence in order to shield oneself from personal liability—a small business owner, pursuant to a personal guaranty, may find himself or herself personally liable for what is often the largest obligation of the company. This is, in part, due to current Small Business Administration guidelines, which stipulate that if a small business borrows money, the lender will generally require each owner with 20 percent or more equity in the business to execute a personal guaranty. Nearly all commercial lenders follow this guideline. Thus, as a business owner, there is virtually no way to avoid this obligation.

A *personal guaranty* requires the business owner to put up personal assets as collateral for a loan to the business. Therefore, if the loan defaults, the lender can go after the business owner directly and seek the business owner's personal investments, bank accounts or home.

That said, when dealing with a personal guaranty, the name of the game is mitigation. A prudent business owner can effectively minimize his or her risk under a personal guaranty in large part by understanding the negotiation position of the lender. The requirement of a personal guaranty generally arises in two instances: (i) at the point of acquiring a business through seller financing; or (ii) upon entering into a commercial credit facility. The opportunities to mitigate liability will be determined almost entirely along this divide.

SELLER-FINANCED ACQUISITIONS

Generally, a business owner is in a much stronger position to negotiate in a seller-financed acquisition. In this instance, it is vital that the small business owner realize there are actually two types of personal guaranties: (i) guaranties of payment; and (ii) guaranties of collection.

Under a guaranty of payment, upon default, the lender can pursue the guarantor or the original debtor. Thus, in the event of default, the lender can seek payment directly from the business owner as guarantor—without having to first go after the business. However, under a guaranty of collection, the lender must first exhaust its remedies against the business before seeking to collect the debt from the small business owner as guarantor. In other words, the lender cannot seek payment from the small business owner as guarantor unless the lender has reduced its claim against the business to a judgment, and the judgment has been returned unsatisfied or the business has become insolvent. Obviously, a guaranty of collection is much more favorable to the small business owner, as it adds an additional layer of protection.

To obtain a guaranty of collection rather than payment, the small business owner must understand how each is drafted. A guaranty of payment is the default, and is generally indicated by the following language: "...this is a guaranty of payment and not of collection." Thus, to ensure that a personal guaranty is one of collection instead of payment, the small business owner must make sure it contains express language to that effect.

COMMERCIAL LENDERS

On the other hand, a guaranty of collection is not available when negotiating with a commercial lender. A commercial lender will always require a guaranty of payment under which each business owner having given a guaranty is jointly and *severally* liable (each is liable for the entire debt) and the lender is under no obligation to seek prior enforcement against the business itself.

Commercial lenders often include rather onerous language, such as confessions of judgment or the ability to declare default "if the Lender deems itself insecure, in good faith believing that the prospect of payment or performance of this Note or any of the indebtedness of Borrower to Lender is impaired." Nonetheless, even in the face of such one-sided language, there is some room to negotiate and mitigate risk. In general, a guarantor can temper a personal guaranty to a commercial lender in three ways: (i) limit the guaranty; (ii) seek a sliding guaranty to be reduced as the debt is paid off; or (iii) enter into a contribution agreement with the other guarantors (if any).

A PERSONAL GUARANTY REQUIRES THE BUSINESS OWNER TO PUT UP PERSONAL ASSETS AS COLLATERAL FOR A LOAN TO THE BUSINESS.

The initial draft of a personal guaranty proposed by a commercial lender will generally quantify the guaranty as "unlimited" and "unconditional," and include provisions requiring the payment of "all costs and fees, including attorneys' fees, interest and other expenses" incurred by the lender in enforcing the guaranty. Despite this generally proposed language, guarantors are often able to negotiate a hard cap, either tied to the amount of principal and interest then outstanding, or even a fixed dollar amount.

Second, the small business owner as guarantor could seek a sliding guaranty, in which a certain percentage of the personal guaranty falls off as the underlying obligation is paid off. Other similar options include reducing the personal guaranty as certain financial metrics (such as debt-to-equity ratio) improve.

Finally, if multiple owners are each required to give a personal guaranty, in the event of default, each owner would be liable for the entire debt, regardless of their ownership percentage. For example, if Debby owns 25 percent of Company A and John owns 75 percent of Company A, and Company A defaults on a $100,000 loan, the lender could seek the entire $100,000 from the company, Debby or John. As this presents an inequitable result for Debby due to her minority ownership, Debby and John may enter into a contribution agreement amongst themselves. For instance, in the foregoing example, John and Debby would enter into a contribution agreement under which each would "unconditionally reimburse, in proportion with each owner's membership interest percentage, within 10 days of notice, the other Guarantor, if such Guarantor pays or is obligated to pay all or any of the loan obligations." Thus, if Debby paid the entire $100,000 obligation, under the contribution agreement, John would be obligated to reimburse $75,000 to Debby.

In summary, while a personal guaranty may be unavoidable, a prudent small business owner can take active steps to mitigate the risks he or she may face. iBi