Contracts BULLETIN
a SMACNA publication

Volume 0, Issue Number 97 June 13, 2007

Contracts Bulletin # 97 – The Personal Side of Personal Guaranties

There is nothing more personal than a personal guaranty.

Business owners often go to great lengths to minimize the risk of personal liability. At a minimum, a prudent business owner will operate his or her business under the protection of a corporation, limited liability company or other form of business entity, buy liability insurance to protect against liability and take steps in the operation of the business to reduce the exposure to personal liability.

But, when it comes to borrowing money or obtaining credit, it is often difficult, if not impossible, to avoid going "personal."

Most of us, if put in our lender's shoes, would want the same thing. Our lender wants to make sure we have every incentive to repay the loan, including (and maybe most importantly) the risk of personal liability. The lender's access to the guarantor's assets can also make collection far easier and more fruitful than collection against a business entity. A lender's hook into the personal assets of the business borrower is an important part of the deal for the lender and, even in good times, it can be difficult to avoid signing a personal guaranty. Once the guaranty is signed, life is never quite the same again. Being personally liable for a business debt brings cold hearted reality to every business dream.

So, with little chance of completely avoiding a personal guaranty, are there any strategies for reducing their reach? The answer is yes, but they require some forethought and planning.

Before we go there, however, there is a bit of comforting information for those business owners who have signed a personal guaranty and own a homestead in joint tenancy with a spouse.

Joint Ownership and a Guaranty

In 2004, the Minnesota Supreme Court decided the case of *Kipp v. Sweno.* The case involved homeowners who obtained a personal judgment against the builder who built their home. After obtaining the judgment, the homeowners sought to foreclose on the builder's home. The builder was married and owned his homestead in joint tenancy with his spouse.

There is a law in Minnesota which protects a homestead against the claims of creditors but only up to $200,000.00 in equity ($500,000.00 if the homestead is used primarily for agricultural purposes). In this case, the creditors claimed that the equity in the builder's homestead exceeded the $200,000.00 limit. The court ordered the sale of the homestead and the builder appealed.

The case raised a number of legal issues, but the issue which carried the day dealt with the fact that the builder owned his homestead in joint tenancy with his spouse. The central question of the case was whether, with a judgment against only the builder, could the creditors foreclose against the couple's homestead and eliminate the interest of the builder's spouse in the homestead?

The Supreme Court said no. The Court carefully analyzed the longstanding policy in Minnesota to protect the homestead and noted that, by allowing this personal judgment to be foreclosed, the joint tenancy between the builder and his spouse would be severed and she would lose her interest in the home even though she was not liable for the debt. This case protects the homestead owned by spouses in joint tenancy from creditors with a judgment against only one of the joint tenants. (It is important to remember that law may be different from state–to–state, so you should consult with your attorney regarding the law that applies to you.)

Two Important Rules When Reviewing Guaranties

1. Less is Not More for Personal Guaranties.

A "red flag" in reviewing any personal guaranty is that short and concise guaranties can often have very broad implications. For example, "John Jones does hereby personally guaranty any and all debts or obligations of ZZZ Corporation." This is a very broad and dangerous guaranty for the guarantor. It contains none of the limits referenced below, and should be a "red flag" that changes are required.

2. The World Belongs to Those Who Ask

There is little downside in requesting a lender make modifications to the guaranty. First, none of the requested modifications listed below are "unreasonable" and a lender should not be put off by such a request. Second, if the lender is inflexible and requires signature of the guaranty in the form presented (even though it has very onerous terms), the guarantor is clearly on notice that the lender intends to be aggressive, and that the guaranty will be taken seriously.

Limiting Guaranties

There are also a few things a business owner can do to limit the reach of a personal guaranty. Here are some ideas:

1. Have More Than One Option.

When looking to borrow, have more than one option. Some banks and other financial institutions, and some trade creditors, may be willing to limit the reach of a personal guaranty when competing for your business.

2. Limit the Exposure/Business Partners.

You may want to ask the lender to limit your exposure under a personal guaranty to your percentage interest in the company. So, for example, if you have three partners and you each own 33.33% interest in the company, ask your lender to limit your liability under a personal guaranty to one–third of any claimed amount. Some lenders will accommodate such a request.

3. Spouse as Business Partner.

Consider whether you want to include your spouse as a co–owner of your business. Banks and other lenders typically want all those with an ownership interest in the business to sign a personal guaranty when the business takes out a loan. (Some banks will waive the personal guaranty requirement if the business partner owns 20% or less in the company.) While there are many factors to consider, limiting a spouse's exposure to business debts is an important goal. In the Kipp v. Sweno case, if both husband and wife were liable, the homestead would have been lost.

4. Limit the Length of the Personal Guaranty.

If you will be reducing the amount of the loan over time, you may want to ask your lender to consider limiting the personal guaranty to the first two or three years of the loan with the thought that your real estate or other assets which secure the loan will, at that point, provide adequate protection for repayment to the lender.

5. Claims Against the Guarantor Should Be the "Last Resort" for the Lender.

The guaranty should contain a provision that the lender must first seek to enforce its claims against the party borrowing the money (i.e. the business entity) before it can seek to enforce claims against the guarantor. This, in many cases, forces the lender to work with the business borrower, rather than allowing the lender to go against the guarantor as the "easy target."

6. Mandatory Deposit Provisions.

Some guaranties require the guarantor secure the guaranty by maintaining an account with a specified minimum amount of funds, or providing other assets of the guarantor for the benefit of the lender. As discussed below, these provisions give the lender a tremendous advantage in collection and should be avoided wherever possible.

7. Avoid Self Renewing or Blanket Personal Guaranties.

Often, when working with suppliers, a business owner may sign a personal guaranty at the start of the relationship without realizing that this personal guaranty will continue indefinitely or renew automatically. I recently reviewed a 12 year old guaranty which a trade creditor was asserting as a basis for personal liability. You may want to put a sunset date on a personal guaranty or negotiate with the trade creditor to eliminate or limit the reach of the personal guaranty after you have established yourself as a reliable borrower.

No Second Chance

After the guaranty is signed, rarely can you change or modify the scope or terms of a guaranty without the consent of the lender. The lender has little incentive to "soften" or lessen the scope of a signed guaranty. The only practical way to renegotiate a guaranty is to demonstrate to the lender that you are going to stop doing business the lender and that the guarantor and the business entity have the ability to take their business elsewhere.

As a recent harsh example of a lender strictly enforcing guaranty, an employee guarantied a long term lease for his company shortly before he retired. Six years later, his partner died and the underlying business went broke. The lessor successfully enforced the guaranty against the retired employee. Efforts to "renegotiate" or "soften" the guaranty did not prove successful and the lessor obtained a judgment in court against the guarantor for the $130,000 the company owed on the lease. This example demonstrates that it is crucial that guarantors carefully read proposed guaranties and request to limit the terms prior to execution.

Collection by the Lender

Lenders are often quick to enforce guaranties against guarantors where they know the guarantor is solvent and offers a comparatively easy opportunity for collection. Likewise, (as discussed above) some guaranties provide that the guarantor must maintain a personal account or other assets with the lender. In this instance, a lender can promptly collect against the guarantor by garnishing a personal account, completely avoiding the costs and expense of litigation.

If a lender proceeds in a court action against a guarantor, the guarantor is entitled to those defenses that exist in any contract. However, guaranties are widely used and enforced. Most courts will not ignore the terms of a guaranty, even when the terms treat a guarantor harshly. That is, courts will enforce guaranties even though the guarantor appears to have received minimal value from providing the guaranty.

A claim that a guarantor that he or she signed a document without reading the guaranty is unlikely to be sympathetically received by most courts. As a general rule, courts do not reform guaranties because they are perceived to be unfair, or because the agreement is "unconscionable" based upon the vastly different bargaining powers of the guarantor and the lender.

A guaranty may be set aside if the guarantor can show that there were fraudulent statements by the lender or fraudulent acts (e.g. the lender told the parties there would be no guaranty and one was inserted in the transaction). A guarantor may also be able to argue that the scope of the guaranty was beyond the terms negotiated. For example, if the guarantor can demonstrate that the guaranty was intended to be limited as to time or amount and a broad guaranty was signed. In such an instance, a court may reform or rewrite the agreement to make it consistent with the promised terms.

Conclusion

Personal guaranties are a reality few business owners can avoid. However, if presented with a guaranty, attempt to limit its scope and impact by requesting the reasonable limitations discussed above.

SMACNA wants the Contracts Bulletin to serve our members. Your feedback or topic suggestions are welcomed by contacting Mike McCullion at 703–995–4027 or mmccullion@smacna.org.
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