The Personal Costs of Commercial Lending

Written By Tyler J. Russell (tjr@wardandsmith.com)
December 7, 2010

When negotiating a commercial loan for your business, it is important to understand the personal liability you may incur in the process. Business owners often fail to realize the personal liability inherent in guaranty agreements that are typically required in commercial deals. Lenders use guaranty agreements to hedge the risk that your business will default on its loans. Prepare yourself for the fact that it is almost certain that you will be required to execute a personal guaranty of your business loans, but be aware of various terms of the guaranty agreement that you may negotiate to limit your liability and protect your personal assets.

The Basics of Guaranty Agreements

Guaranty agreements are contracts that impose a legal duty on one person (called the "guarantor") to answer for a debt incurred by some other person or entity (referred to in this article as the "principal debtor"). Guaranties create an obligation to repay if the principal debtor fails to fulfill his, her, or its obligations when due. The guarantor may incur varying levels of personal liability based upon the type of guaranty agreement entered and the actual terms of the guaranty.

Different terms and provisions can impose varied levels of personal liability upon a guarantor. The following sections outline the basic variations of guaranty agreements and briefly review some potential provisions that may be helpful in limiting your liability.

Know Who You Owe

A guaranty can be either "general" or "special." A general guaranty exists when the language of the guaranty allows it to be enforced against the guarantor by anyone who has acted in reliance upon it by contracting with the principal debtor. For example, if your guaranty agreement does not specifically state the parties who are entitled to enforce it, any individual or entity that extends credit to the principal debtor based, in whole or in part, upon the existence of your guaranty may enforce it against you. If your guaranty agreement identifies the specific persons or entity who may rely upon it (which likely will be the case if the lender is an institution such as a bank, insurance company, or investment fund), it will be a "special" guaranty and only the lenders identified in the agreement may enforce it against you.

By specifically limiting the lenders who are entitled to rely upon and enforce your guaranty, you can protect yourself from unexpected liability because you will know exactly to whom you may be liable. This may reduce your costs in defending later legal actions and eliminate your risk of incurring additional liability beyond what you originally contemplated. If only certain parties can rely upon your guaranty, other lenders will be put on notice that your guaranty does not extend to similar obligations arising between them and the principal debtor.

Be Last in Line to Repay

A guaranty also can be a guaranty of "payment" or a guaranty of "collection." In a guaranty of payment, the guarantor makes an absolute promise to pay the guaranteed debt at its maturity if the principal debtor fails to do so. If the principal debtor defaults, the guarantor is liable to the lender without the lender being required to seek any other remedy or source of repayment. A guaranty of collection, on the other hand, requires the lender to first exhaust its legal remedies against the principal debtor and any collateral securing the debt. If the debt cannot be recovered from the principal debtor or the collateral, the lender then, and only then, may seek recovery from the guarantor.

As a result, if you can limit your guaranty to one of collection, you will be obligated to pay the lender only if it is unable to recover first from the principal debtor or the collateral. Otherwise, you may be required to pay the lender and then spend your own resources seeking repayment from the principal debtor or the collateral. If the principal debtor has become insolvent, bankrupt, or cannot otherwise pay its debts, you may expend considerable time and money seeking reimbursement that may never materialize.

Keep Your Exposure to a Minimum

A guaranty may be "continuing" or "restricted," and it may be "conditional" or "unconditional." A guaranty is continuing when it applies to a series of transactions or extensions of credit, some of which may be in the future and not even contemplated when the guaranty is executed, and is restricted when applicable only to a single transaction. Proposed guaranty agreements can be misleading in this regard because they will specifically, and often prominently, identify a specific debt, and then have language elsewhere that the guarantor also guarantees "any other debt of [principal debtor] to Lender."

Continuing guaranties are very dangerous unless you have the discipline to remember to revoke them when the specific debt for which your guaranty was created has been paid off. Otherwise, you may be surprised to find yourself "on the hook" for an obligation arising years in the future, when you no longer may have a relationship with the principal debtor.

A guaranty is conditional when some act in addition to default by the principal debtor must occur before the guarantor is required to pay the debt. Unconditional guaranties are enforceable immediately upon default.

A guaranty also can be "unlimited" or "limited." An unlimited guaranty means the guarantor is liable for payment of the entire balance of the debt or, if your guaranty is a continuing one, the entire balance of future debts as well.

The limit in a limited guaranty may be a dollar amount that is less than the full balance of the debt guaranteed, or may be a certain percentage of the debt. For example, if there are four guarantors of a debt and the guaranties are unlimited, then the lender is entitled to collect 100% of the defaulted debt from any one of the four guarantors. The unlucky guarantor then is left with pursuing the other guarantors for "contribution." If the other guarantors have no assets, the unlucky guarantor is out 100%. However, if the four guarantors (or only one of them, for that matter) are successful in limiting each of their guaranties to 25% of the debt, that is all the lender can collect from any guarantor without regard to whether the lender can get a nickel from the others. Also, you may be able to exclude the lender's costs in collecting the debt, such as attorneys' fees and other expenses, from your personal liability.

Finally, negotiate conditions upon which your liability as guarantor may be fully or partially released. For example, the lender may allow a scheduled reduction in liability if the principal debtor meets a certain debt-to-equity ratio, net worth, or other specified financial targets. Be creative in generating offers that comparably reduce your liability as targets are met and the lender's risk decreases.

Conclusion

While it may be difficult to avoid having to guarantee a commercial loan to your business, you should negotiate terms that will limit your personal liability arising from that loan. There are numerous options to shield your exposure upon a default, and you and your advisors should be creative in seeking limits on your exposure. The earlier in the process you seek to negotiate these terms, the better chance you stand of limiting your liability and protecting your personal interests.

For further information regarding the issues described above, please contact Tyler J. Russell.

--
This article is not intended to give, and should not be relied upon for, legal advice in any particular circumstance or fact situation. No action should be taken in reliance upon the information contained in this article without obtaining the advice of an attorney.

We are your established legal network with offices in Asheville, Greenville, New Bern, Raleigh, and Wilmington, NC.