

Promises, Promises

Navigating the World of Personal Guarantees

By ADAM J. BASCH, Esq.

Due to the difficult financial situation of many companies and their customers, depending upon which side of the issue you are on, it is more important than ever to attempt to minimize or maximize the amount of corporate debt that is personally guaranteed when obtaining credit. Should a company dissolve or become defunct, a creditor's only recourse may be via a personal guarantee.

A personal guarantee is a promise by a person (guarantor), usually a shareholder, to become personally liable for the debt of a corporation. If the corporation cannot pay its debts, and its assets are not worth enough to cover the debt, the guarantor risks his personal assets being attached and seized by the creditor of the corporation. This exposure can also occur when a company refuses to pay its debt. Once the corporation defaults on its obligation to a creditor, the creditor may choose to enforce the guarantee, rather than filing a lawsuit for payment.

Although shareholders are the owners of the corporation, the corporation itself is recognized as an independent entity under most laws. As such, although a person may be a majority shareholder or a sole shareholder, the corporate structure does provide a level of liability protection. Typically, the corporation enters into all legally binding contracts and agreements, whether it is for purchasing goods and services or financing arrangements. In the event that one of these contracts should be breached, the liability belongs to the corporation. However, if the shareholder executes a personal guarantee, he will be jointly and severally liable for the corpora-

tion's obligation.

As a general rule, creditors cannot seize a shareholder's personal assets to pay business debts unless that shareholder specifically gives up his protection. Unfortunately, most small-business owners are forced to give up

seek to obtain financing from a lending institution. From the perspective of the borrower, while it is always best to attempt to negotiate the credit facility without executing a personal guarantee, this is usually a required condition in order to obtain financing.

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their right to limit their personal liability when entering into credit facilities. Many creditors require personal guarantees from the shareholders of a corporation before they will loan money or extend credit to the corporation. In addition, it is becoming more commonplace for landlords to require a personal guarantee before they lease commercial property to a corporation.

It wasn't too long ago that the corporate form was reserved for the General Electrics and Ford Motor Companies of the world. Today, however, businesses that were formerly run as sole proprietorships are taking advantage of corporate-entity advantages. The majority of the readers of this article are either the owners of closely held corporations themselves, or deal with closely held corporations every day. As such, if you have not had to navigate the world of personal guarantees, it is likely, well, guaranteed that you will in the future.

The shareholders of most corporations are required to execute personal guarantees when they

However, each shareholder may still be able to limit their liability via a limited personal guarantee. For example, if a corporation has three shareholders, and they all sign personal guarantees, they are each liable for the whole debt. Some lending institutions will allow shareholders to execute limited personal guarantees, which only require each shareholder to be liable for their respective interest in the corporation. In the preceding example, each shareholder would be responsible for only one-third of the debt.

Most borrowers determine which bank they borrow from based almost exclusively upon the lowest interest rate. If a bank will extend credit without the execution of a personal guarantee, this may be a circumstance in which it is worth paying a higher interest rate. This decision, however, must be made on a case-by-case basis.

In addition to personal guarantees becoming commonplace in the banking industry, there has been an emergence of personal

guarantees in business-to-business relationships as well. Most businesses purchase goods, supplies, and/or materials via credit facilities with other businesses. As a general rule of thumb, if you allow another entity to gain possession of your goods on credit, it is fiscally prudent to always obtain the security of a personal guarantee.

While it is impossible to run a business without taking some risks, you must always consider the possibility that this debt will go unpaid and you will have to seek legal recourse. With the modern trend of under-funded corporations and the vast majority of a corporation's income being held personally by the corporation's principals, if you need to sue and are successful, your judgment may go unsatisfied. Something to keep in the back of your mind is that a favorable legal judgment is merely a piece of paper. What is important is to be able to collect on that judgment.

Hopefully, the economic situation will improve, and the need to resort to personal guarantees will decrease. However, in the near future, you can almost guarantee the need to obtain and agree to provide personal guarantees for your business. ♦

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