



by Robert Goff

### **Be careful when signing guarantee agreements**

Business owners are sometimes required to personally guarantee their business's payment of debt and performance of contracts.

When an owner signs a guarantee, he is promising that the owner will use his personal funds to repay the money, or perform the contract, if the business doesn't do so.

Although business owners should generally avoid signing business obligations in their individual capacity, a bank or contracting party may insist upon a personal guarantee in order to close a deal. True, a personal guarantee is a serious legal risk. But business owners take risks. It's what they do. It is important though for a business owner to understand, price and minimize the legal risk when signing a personal guarantee.

A guarantee is a promise that if someone else (the obligor) doesn't do something, another person (the guarantor) will do it. For instance, an owner of a business, the guarantor, promises the bank that he will repay a loan if his business, the obligor, doesn't repay it.

Before signing a guarantee, business owners should read it carefully to determine the following:

1. Is there a cap on the guarantor's personal liability? Is the guarantor comfortable with the cap? Can the cap be increased by forces outside of the guarantor's control?
2. How is the guarantee terminated? Does the guarantee terminate after a specific period of time, or is it up to the guarantor to terminate it by sending notice?
3. How much effort does the bank or contracting party have to use to force the obligor to repay the debt or perform the contract before the guarantor must pay or perform?

The starting point in understanding and minimizing the legal risk of a guarantee is to determine the guarantor's maximum liability.

This can be straightforward as in the case of a loan guarantor who is the sole owner-operator of a small business. The guarantee or the loan documents will state the guarantor's liability under the guarantee.

If the loan is a line of credit, the guarantee or the loan documents will provide the maximum amount of the guarantor's liability. Business owners should note that the maximum amount provided in loan documents is exclusive of interest, late fees and collection costs. The guarantor will be liable for such amounts in addition to the maximum amount provided in the loan documents. The legal risk is straightforward in the case of a sole owner-operator because he should always know the total amount of principal and interest owed under the loan documents.

Understanding the legal risk of a guarantee becomes more difficult when the guarantor does not have control of the obligor or there are multiple guarantors.

A guarantor should use extreme caution before guaranteeing the debt or obligation of an obligor not controlled by the guarantor. Consider a line of credit loan to a business guaranteed by an owner of 20 percent of the business.

First, it is especially important for the guarantor to understand the maximum amount that can be loaned under the line of credit. Although the owners may initially only contemplate using a small portion of the line of credit, the guarantors will be personally liable up to the maximum amount provided in the loan documents, plus interest, fees, and collection costs. A guarantor who owns a minority interest in a business can-not be certain that the business will not borrow the maximum amount permitted under the loan documents.

Second, the guarantor who does not control the business should understand that he may be forced to pay the entire amount of the loan even if the business has sufficient assets to repay the loan or other owners signed guarantees. Many guarantees waive the necessity of first attempting to collect from the obligor or attempting to collect from any other guarantors. If the guarantor is an easier collection target, he may have to pay the full amount of the loan first. Then he is faced with the obligation to recover his losses from the business and any other guarantors.

While financial guarantees must state the maximum liability of the guaranty — excluding interest, fees, and costs of collection — other guarantees are not required to provide a maximum liability. Such guarantees require even more caution and understanding.

Consider facts similar to one case in Kentucky: Two construction companies seek a performance bond on a major project. The insurance company agrees to provide the bond if the owners of each company will personally guarantee repayment to the insurance company in the event the insurance company must make payment on the bond.

The construction companies and their owners all signed an agreement stating that the guarantees would cover all bonds issued to either company in the future.

A guarantor could only terminate his guarantee by providing notice to the insurance agreement. The construction companies finished the project without issue and each went on its own way.

Neither guarantor terminated his guarantee. One of the construction companies started another project without the other company and applied for a bond from the same insurance company.

The insurance company dusted off the old guarantee agreements and issued the bond. When the construction company failed to complete the project, the insurance company succeeded in collecting from the guarantor whose company wasn't even involved in the project. If the guarantor had understood his legal risk, and sought to minimize it, he would have terminated the guarantee upon completion of the first project.

Business owners should try to avoid personal guarantees. If a business owner has to sign one it is important for him to understand, price and minimize the legal risk.

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