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CORPORATE ADVISORY

A guaranty—of a loan or any contract—is designed to make things personal. With a personal or third party guaranty, someone other than the borrower or the contracting party (the primary obligor) can be held liable if there is a default or a breach. Just the fact that someone else has skin in the game may make a default or breach less likely in the first place. But not all guaranties are created equal and there are important issues to scrutinize and negotiate before any guaranty is signed.

For example, there is an important difference between a "guaranty of collection" or a "guaranty of payment." Before you can enforce a guaranty of collection against the guarantor (the person or entity who signed the guaranty), you will usually have to get a judgment against the primary obligor and pursue the primary obligor first to satisfy that judgment, or show that the primary obligor cannot be served with a lawsuit or is unable to pay the judgment. A guaranty of payment is a much more powerful and direct device. It lets you pursue the guarantor in court right from the start, and seek payment directly from the guarantor.

Likewise, the distinction between a "continuing guaranty" or "specific guaranty" is an important one that may result in adverse consequences if overlooked. In a continuing guaranty, the guarantor agrees to cover all the borrower's obligations to the lender, even as new obligations are made, increased or renewed over time. With a specific guaranty, the guarantor is only liable for a single transaction between the lender and the borrower. Either one might be right for your deal, but be sure to consider the options and specify your choice clearly in the guaranty.

After determining which type of guaranty works best for your particular deal, there are other issues to address. For example, a continuing guaranty typically obligates the guarantor for any loans the lender makes to the borrower until the guarantor provides a termination notice to the lender. If you are a lender whose loan-processing pipeline takes 60 days, you want to ask for guaranty termination provisions that take that pipeline into account. You do not want to find yourself in a situation where you are obligated to lend money on a loan that is already in the pipeline, even though the guaranty has been terminated. On the other hand, a guarantor providing a continuing guaranty will probably try to negotiate a cap on its total potential liability, so it does not end up guaranteeing more than it had planned.

Lastly, be sure not to ignore the importance of adequate consideration. The guarantor must receive a benefit for providing the guaranty. Otherwise, the guarantor can argue the guaranty is unenforceable for lack of consideration. In the typical “downstream” guaranty—where the owner of a company guarantees a loan made to her wholly-owned company—the consideration is clear. However, in an “upstream guaranty”—where a subsidiary guarantees a loan made to its parent company—the issue of consideration can open the door for the subsidiary to argue that it did not receive any benefit from the loan. It is therefore important for you to document clearly in the guaranty how the guarantor benefits by providing the guaranty.

Personal and third-party guaranties are useful and powerful business tools. Just be sure you are using the right tool for the job.

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If you would like to discuss any of these issues further or have any questions as to what might be the best type of guaranty for you and why, please contact Mark Hobson, Esq. or Robert Kuntz, Esq. at DEVINE GOODMAN RASCO & WELLS, P.A.