Negotiating Loan Guaranties

By Kenneth Neale

It always pays to read the fine print.

In the current lending environment, small business owners are often required to provide personal guaranties in order to obtain loans, even if they are secured by real property or other assets.

In its basic form, a guaranty is an independent agreement by a person or entity to pay the debt or perform an obligation of another (usually your business) in the event of a default by the borrowing party. Effectively, guaranties equate to personal liability for the business owner. Thus, individuals should take special care in negotiating a guaranty. It is best to negotiate the terms up front when applying for a loan in order to avoid surprises later.

Two of the most common forms of guaranty found in commercial loan transactions are the full guaranty of payment and performance and the non-recourse carve-out guaranty. The latter is more limited, but it is not without risk. Business owners need to be wary of the many carve-outs or exceptions to a non-recourse loan. In some cases, the non-recourse status of the loan can evaporate entirely, making the guarantor liable for the full amount of the loan.

Full Guaranty

A full guaranty of payment and performance would allow a lender to require payment or performance of a loan obligation by the guarantor upon default by the borrower. It usually does not require the lender to first exhaust its remedies against the borrower or any collateral before seeking performance from the guarantor. You should do your best to avoid having to provide such a guaranty, but if it cannot be avoided, you should consider negotiating the following points:

Carefully review the loan documents to minimize the chance that the borrower will be in default for non-monetary obligations. A non-monetary obligation could be, for example, a prohibition on transferring or agreeing to transfer any interest in the borrower entity, such as a stock transfer if the borrower is a corporation. A breach of a non-monetary obligation could result in the loan becoming due and payable in full. Make sure that the loan covenants are reasonable and achievable, given the circumstances of the business. As long as the borrower is not in default, there is no liability under the guaranty.

If there is more than one guarantor, which is often the case when there are several owners of a business, a lender will want the guaranty to be joint and severally, meaning that each guarantor is liable for 100% of the loan and the lender could choose to collect from some or all of the guarantors up to the full amount of the liability. Consider negotiating for the guaranty to be several, meaning that each guarantor is only responsible for a specified percentage of the loan (usually corresponding to that guarantor's ownership interest in borrower).

You should try to negotiate a monetary cap on liability under the guaranty. A full guaranty does not just involve a guaranty of the loan amount, but also of interest, including default interest, late payment fees and attorney's fees. Sometimes a lender will accept a flat monetary cap on the liability of the guarantor. A lender may also permit the cap to reduce over time provided the loan remains in good standing.

You may be able to negotiate that the guaranty disappears if the borrower meets certain well-defined milestones relating to better financial performance or an increase in collateral value (and therefore the loan-to-value ratio). The lender may require that the guaranty spring back into existence if those milestones are not maintained, however.

Non-Recourse Carve-out Guaranty

Many real estate and other secured term loans are, with certain exceptions, non-recourse to borrower, meaning that in the event of a default the lender's remedies are limited to foreclosing on the real estate or other collateral securing the loan. These loans invariably have carve-outs to their non-recourse nature, which typically must be guaranteed by the principals. The carve-outs generally have two components: partial recourse carve-outs and full recourse carve-outs.

Partial Recourse Carve-Outs

These carve-outs protect the lender to the extent it suffers harm due to certain "bad acts" of the borrower. These bad acts are not all the same and have grown in number and scope over the years. While it is fair to say there is no standard list of exceptions, the typical carve-outs are for fraud, misappropriation of funds (including rents, condemnation proceeds, insurance proceeds, and security deposits), waste, and the failure to maintain insurance or pay taxes.

What to Watch For

•Carefully review the list of carve-outs to make sure they cover truly bad acts.

•Avoid carve-outs for negligent acts or for the failure to pay taxes or other expenses where funds are not available to do so (if this cannot be avoided, you should pay taxes, insurance and other operating expenses before paying the loan).

•Make sure that the language clearly limits the guaranty obligation to the harm suffered by the lender due to the particular bad act.

Full-Recourse Carve-Outs

Full recourse carve-out provisions are particularly risky because they act as a switch converting a non-recourse loan to a full-recourse loan, thus turning the guaranty into a full guaranty. The events which typically lead to this result are bankruptcy; violations of the due-on-sale or encumbrance provisions of the deed of trust or security agreement and, particularly for real estate-secured loans, failing to comply with separateness (or single-purpose entity) covenants contained in the loan documents. Recent court decisions in this area have generally upheld these provisions, even in situations where the lender arguably was not harmed.

What to Negotiate

The carve-outs for bankruptcy and breach of the due-on-sale or encumbrance provisions should be limited to voluntary actions. An involuntary bankruptcy or an involuntary lien (such as a mechanic's or judgment lien) should not transform the loan to a recourse loan.

Incidental transfers of collateral should be exempted. Due on sale provisions often cover all collateral, including personal property. The sale of small amounts of personal property should not be cause for recourse liability, particularly if the sales proceeds are used in the borrower's business.

Separateness covenants are often very broadly worded and easy to violate. Violations could include, for example, incurring additional indebtedness, failing to keep a separate address and phone number for the business, or amending governing documents without the lender's consent. You should first try to narrow these covenants as much as possible so that they are not so easily breached. You should also attempt to negotiate materiality and cure periods for any violations.

Guaranties should be taken seriously as they could lead to substantial personal liability. A borrower should think about interpretation and enforcement of the guaranty as part of the planning and negotiation process. Are there any ambiguities in the language that need to be cleared up? Are there limits that can be negotiated to cap the guarantor's liability?

The best way to negotiate a guaranty is to raise issues early on in the loan application process. It is also useful to have lending alternatives. A lender may be more flexible if it knows that it has competition for your business.

The current economic climate presents many challenges for businesses, but opportunities for savvy borrowers to take advantage of very favorable interest rates. ◆

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