



Melissa's Monthly Memo

Three Things to Know About a Personal Guaranty

With the state of the economy, business people are much more sensitive to risk. There are many tools that can be used to manage risk, but one receiving renewed attention is the personal guaranty.

A personal guaranty is nothing more than the commitment of a third party (the guarantor) to assume the obligations of one party (the debtor) to a contract. A guaranty is required when a creditor is concerned that a debtor lacks financial strength or business experience. A typical small business scenario would be as follows: Because of minimal financial assets and lack of operating history, our brand new small business (the debtor) is thought to be a poor risk by a commercial property owner (the creditor). The risk-averse landlord asks the owner of the business to personally guarantee the lease. Anxious to start the new business, she agrees.

What has just occurred? The landlord has just transferred risk from himself to the owner of his new tenant. If the store fails, the business owner may have to cover the cost of the lease, not from the business' cash reserves, but from her own pocket. The single most important thing to know about personal guaranties: they bring substantially more risk to the person giving the guaranty.

Does this mean she should have refused the deal? Not necessarily. If her business plan is sound, her customer base is solid and her personal finances are strong, this might be a very reasonable risk for her to take. Of course, personal guaranties are negotiable. Perhaps she could have tried to limit the guaranty to just the first year of the lease. Read the document and understand what your obligations are and what protections you might be waiving. So the second key point to remember: understand what you are signing and look to negotiate the terms.

Our final point to remember is that personal guaranties can work both ways. Remember our hypothetical commercial property owner? He's a small businessman, too, and he used the personal guaranty to reduce his risk. So while small business owners often find themselves asked to make guaranties, they can also use this tool to their advantage.

Personal guaranties can be found in many small business scenarios. It may be required by a contractor looking at an expensive bill of materials. Or used by a parent or friend looking to help launch a start-up company, or even a vendor looking to help a good customer survive a tough market. However they might be used, just remember: They can transfer significant risks, they are negotiable, and they could be a tool for you too!

Until next month.

Melissa Sayer is a partner with Nordman, Cormany, Hair & Compton LLP in Oxnard. She lives on a ranch just outside Santa Paula, with her family and their avocados, lemons, goats and chickens.