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Knowing the Risks of a Personal Guaranty

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With the current state of the economy, management of risk is becoming increasingly important. Many tools can be used to manage risk, and one receiving renewed attention is the personal guaranty. It is often required in connection with a loan, real property or equipment lease and sometimes required by vendors or suppliers.

A guaranty is a promise to pay the debt of another. This obligation is separate and independent from the obligation of the borrower. A guaranty is typically requested when the lender is concerned that the borrower lacks the financial ability or business expertise to pay the debt. Before agreeing to give a personal guaranty, people should consider the following:

If you are a business owner, a personal guaranty blurs the line between business and personal assets. Are you prepared to subject your personal assets to business risk? Also, a guaranty typically guarantees the entire amount of the debt, even though you may own less than all of the ownership interest in the business. A non-owner may also be asked to give a guaranty, perhaps to help a friend or relative launch or expand a business. As a non-owner, are you familiar enough with the business plan or management to understand the amount of risk you are assuming?

Can you repay the entire obligation if the business fails? As a small business owner, you could exhaust your savings in an attempt to save the business, only to be forced into bankruptcy after the business closes because you have a personal obligation to service the debt. If a non-owner, you may be forced to cover the entire amount of the debt of the failed business out of your personal assets.

Like any contract, a personal guaranty is negotiable. Lenders may not be as open to negotiation as they were in the past, but you should try to limit the terms of the guaranty as much as possible and understand your obligations. The guaranty should be limited to the original amount of the obligation and exclude any future debt. It should be limited to the initial term (and exclude any extensions or renewals) and should exclude other amounts such as costs of collection, attorney's fees and default interest.

A guaranty may be unavoidable. If required, you should consider and understand the risks and try to negotiate as favorable terms as possible.