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Managing Risk: Personal Guaranties in Commercial Transactions

Commercial lenders routinely require one or more owners or managers of a business to personally guaranty payment of business debt. A personal guaranty is not a substitute for borrower creditworthiness; the business remains the primary source of repayment. The guaranty is a contract separate from the underlying obligation that requires the guarantor to perform only in the event the business defaults. A personal guaranty provides the lender with additional security for the loan. It also ensures that management has as much of a financial stake in the business as the lender.

In Minnesota, to be enforceable, a guaranty must be in writing, be signed by the guarantor, and express the consideration for it (typically the extension of credit). As with most contracts, the devil is in the details. Although Minnesota courts routinely uphold clear and unambiguous guaranties, they will construe drafting ambiguities against the lender.

When evaluating a personal guaranty, either as a lender or a guarantor, the following should be considered:

Is the guaranty one of payment or collection?

Under a guaranty of payment, a default by the borrower triggers the guarantor's obligation to pay. Upon default, the lender may accelerate amounts due and demand payment from the guarantor without first (or ever) attempting to collect against the borrower or enforce any security agreement with respect to collateral.

In contrast, a guaranty of collection obligates the guarantor only to the extent the lender has been unsuccessful at diligent efforts to exhaust other remedies. Such a guaranty tends to invite a dispute over what constitutes "diligent efforts."

What constitutes default on the underlying obligation?

The loan documents should define what constitutes default based on clear, precise contractual duties, such as the failure to make payments when due or the failure to comply with specific loan covenants or reporting obligations. Where the borrower has multiple obligations to the lender, the loan documents may provide that default on any one obligation constitutes default on the guarantied debt. Such a cross-default provision permits the lender to act promptly to protect its interests at the first sign that the borrower is experiencing financial difficulties.

The underlying loan documents may give the borrower the right to cure a default. While the right to cure, when exercised, may protect the guarantor from liability, the loan documents may include a limitation on the number of defaults that may be cured prior to acceleration. Such a provision prevents a borrower from repeatedly defaulting and then curing, driving up the cost to service the loan and effectively preventing the lender from taking steps to enforce the guaranty.

What is the extent of the guaranty?

A guaranty may be limited to a single debt or a specific amount or may be unlimited. A guaranty may extend to all the borrower's indebtedness to the lender, whether then existing or incurred at some time in the future. The lender may require that the guaranty extend to any extension, renewal, or replacement

Managing Risk: Personal Guaranties in Commercial Transactions continues on page 7

of the debt. Such a requirement, coupled with an absolute and unconditional payment guaranty, frees the lender to restructure the debt without compromising its ability to enforce the guaranty.

How long is the guaranty enforceable?

Minnesota courts will limit enforcement of a guaranty of indefinite duration to a reasonable amount of time, unless the guaranty permits the guarantor to revoke his or her guaranty prospectively. In that case, the guaranty remains in force indefinitely unless and until the guarantor exercises that right. The lender may structure the loan documents to provide that revocation by a guarantor constitutes default. In that case, upon revocation, the lender is positioned to reevaluate the credit and, at its option, take steps to enforce the guaranty.

How does enforcement work among multiple guarantors?

One or more individuals or entities may guaranty the same debt. A guarantor who pays more than his or her fair share of the debt has an equitable right of contribution from co-guarantors under Minnesota law. If the guarantors agreed to be jointly and severally liable for the debt, the lender can avoid becoming embroiled in contribution disputes among co-guarantors. Joint and several liability also permits the lender to target its collection efforts against the guarantor or guarantors with the greatest ability to pay.

Does the guarantor have any defenses to enforcement of the guaranty?

Unless otherwise agreed, a guarantor may raise any defense that the borrower has to payment of the underlying obligation, except for incapacity and bankruptcy. The guarantor also may defend against enforcement of his or her guaranty on the grounds that the lender has acted or failed to act without the guarantor's consent, such as released collateral, failed to enforce a security interest in collateral, or changed payment terms, thereby materially increasing the guarantor's risk.

However, a guarantor can, and often does, bargain away his or her defenses to induce the lender to extend credit. Minnesota courts routinely uphold waivers of all guarantor defenses except for actual payment. A comprehensive waiver frees the lender to restructure the debt without notice to or consent by the guarantor, even to the extent of releasing co-guarantors from liability.

Who pays for legal expenses?

Minnesota law generally requires each party to a dispute to bear its own legal expenses, unless otherwise agreed or authorized under statute. An unlimited guaranty may obligate the guarantor to reimburse the lender for attorney fees and other costs of collection incurred to collect amounts due, as long as such fees and costs are reasonable and the loan documents provide for it.

The risk inherent in any loan transaction varies depending on the circumstances. An attorney can help structure a guaranty to meet the parties' needs.