

Personal Guarantees: How Helpful Are They?

A personal guarantee may aid in collection of outstanding receivables — if certain key elements are in place.

By Murray S. Lubitz, Esq.



It is a prudent credit manager that attempts to obtain personal guarantees from the principals of an incorporated entity to which credit is being extended. In today's volatile marketplace, the existence of a personal guarantee may provide the only viable basis of collecting outstanding receivables from a corporate obligor experiencing financial difficulty.

However, in the final analysis, the effectiveness of a personal guarantee is directly dependent upon the financial capability of the guarantor.

Are There Different Kinds of Personal Guarantees?

Guarantees can be classified as being either guarantees of payment or collection, and the distinction is important to recognize. A guarantee of payment is a far more effective tool, as it allows a creditor to proceed directly against the guarantor without the necessity of taking any action against the primary obligor.

Conversely, in the case of a guarantee of collection, a creditor must first proceed directly against the primary obligor — and only if the debt cannot be collected after the exercise of due diligence can collection commence against the guarantor. Most jurisdictions have defined due diligence as the commencement of legal proceedings against the corporate guarantor — and the result being the obtainment of an uncollectible money judgment. Therefore, when drafting a personal guarantee, a creditor should specify that the guarantee is one of payment.

When Should the Guarantee be Obtained?

Personal guarantees of corporate obligations are generally obtained at either the inception of the business relationship between the supplier and the purchaser or at a subsequent time when the creditor has lost confidence in the customer's ability to repay a debt incurred in the business relationship.

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What are the key elements of a solid guarantee?

Whether obtained at the inception of the business relationship or not, there are some general rules to follow in drafting and execution of a personal guarantee:

- The guarantee should be a guarantee of payment and should specifically refer to past, present or future indebtedness.
- It should be a continuing guarantee and remain in effect until written notice of an election to terminate is given.
- The signature of the guarantor should be notarized to insure against any future questions regarding the genuineness of the signature. There should be no designation of title or corporate capacity.
- A provision for the recovery of collection expenses and attorneys fees should be inserted.
- No prior notice or other condition precedent should exist before action can be taken against the guarantor.
- The guarantee should bind the successors and assigns of the individual guarantors.
- The social security number and residence (street address, not a P.O. Box) of the guarantor should be included.
- The guarantee should be dated and all blanks filled in.

In conjunction with the execution of a personal guarantee, the well-informed credit

manager will also attempt to obtain a personal financial statement from the guarantor. One benefit is that it allows an immediate evaluation of the financial capability of the guarantor, and if it is deemed insufficient, additional guarantees or other remedial action can be taken.

Furthermore, in the event collection activity is eventually activated against the guarantor, the financial statement will serve a variety of useful purposes, including a disclosure of the guarantor's assets.

When The Guarantee Is Obtained After The Business Relationship Is Established

Special problems may arise when the guarantee is signed subsequent to the inception of the business relationship. In the typical situation, this will occur when the creditor determines that a customer has far exceeded its credit line and appears unable to liquidate the debt. A dialogue between the creditor and the customer takes place, resulting in the execution of a personal guarantee by the customer's principals.

Although this guarantee may be entirely valid on its face, the unsuspecting credit manager may ultimately discover that the guarantee is legally unenforceable for a variety of reasons, the most prevalent being lack of consideration and statute of limitations.

For the purposes of this article, consideration may be defined as value. In order for a personal guarantee of a corporate obligation to be binding, value or consideration must be received. Future extension of credit by the supplier to the purchaser is the most obvious example of consideration.

In addition, the waiver or postponement of a legal right by the creditor, such as the institution of suit to collect an overdue account or the filing of a mechanics lien, will also be construed as consideration by the courts in most jurisdictions. The gray area is the situation where, after execution of a personal guarantee, the creditor refuses to sell to the customer on either a credit or cash basis — and furthermore takes immediate legal action against both the primary obligor and guarantor. This may result in the guarantee being interpreted as a gratuitous document and not legally binding upon the guarantor due to the lack of consideration.

Another problem that may surface in conjunction with subsequently executed personal guarantees is the statute of limitations. As you are aware, the statute of limitations that applies to actions commenced to recover damages for goods sold and delivered is four years [Uniform Commercial Code Sec. 2-725 (1)].

The execution of a personal guarantee subsequent to the inception of a debt may lull the uninformed into believing that the statute of limitations has been waived or extended. Unfortunately, this is simply not the case. The personal guarantee does not generally give rise to an independent legal right, and the ability to enforce a guarantee is directly dependent upon the validity of the underlying corporate indebtedness.

Therefore, if the statute of limitations would act as a defense to the collection of a debt from a corporate obligor, it would also prevent imposition of legal liability upon the guarantor. As a result, a careful monitoring of the aging of accounts receivable is advisable, even when personal guarantees are in existence.

What Is The Bottom Line Advantage to Having a Personal Guarantee?

A personal guarantee creates a greater potential source of recovery for the collection of outstanding receivables. The guarantee, as an effective tool of collection, can be maximized when proper attention in drafting, execution and monitoring is exercised.

The credit manager who is able to obtain personal guarantees from the principals of his incorporated customers has established a greater security and financial advantage in the protection and minimization of future debt liability. ●



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Lubitz also served as the 103rd president of the Commercial Law League of America and currently serves as its treasurer. He has lectured before many professional organizations — including the New York State Bar Association and the Equipment Lessors Association — and was a featured speaker at a National Collection and Credit Risk Conference. He has also authored numerous articles dealing with various aspects of commercial law and may be reached at ztibul@aol.com.