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THE LEGAL EDGE

When personal guarantees come back to haunt you

ball and chain

Many years ago, my friend Bill pursued his dream of starting a national chain of bicycle superstores. Like all of us, he didn't know what he didn't know. So when his first landlord required that Bill personally guarantee the lease, Bill just signed away.

That first store thrived. Bill added another and it did well, too. So he opened another and another and another. Finally strapped for cash, Bill took on investors who poured money into the business and helped run the company. Together, they expanded the chain beyond the mid-Atlantic, venturing into the Southeast.

Still, Bill's personal guarantee of that initial lease lived on. For well over a decade, this obligation was as non-threatening as an unfed Gremlin.

When you personally guarantee a lease, you're on the hook for all rent due under the lease for as long as it remains in effect. If the tenant renews the term of the lease for another five or 10 years, the ordinary unlimited guarantee goes along for the ride. This may surprise you, but you're automatically on the hook for the new term. Likewise, if the tenant expands the store by adding the empty space next door, your guarantee applies to the rent for both spaces.

The standard guarantee is virtually indestructible and expands to burden you with new obligations. Once you sign, that guarantee remains in effect until the underlying obligation – here, a lease – is fully satisfied and expires, however many years later. The key to managing any personal guarantee is limiting your obligations right from the beginning.

GUARANTEE PRE-NUPS

There are a lot of ways to limit your exposure. No landlord is going to volunteer this info, but there are two widely accepted ways to reduce your exposure under a lease guarantee: the rolling guarantee and the burn-off guarantee.

When pressed, some landlords will allow a rolling guarantee. Under this guarantee, your exposure is limited to a maximum amount – for example, $100,000. But you're always liable for up to this amount if the tenant breaches the lease. Whether the tenant defaults in the first year or many years later, you're on the hook for up to $100,000. You earn no leniency if the tenant faithfully pays the rent for years. You're always exposed to the risk of paying this guaranteed amount.

Usually, you are better off with a guarantee that reduces or burns off over time, hence, the moniker "burn-off guarantee." Under this type of limited guarantee, you might initially be liable for up to $200,000, but this amount declines, for example, by $50,000 every year. After four years, the tenant could blow up the building and you owe nothing (just an exaggeration to make a point, not a suggestion).

Because most entrepreneurs don't abandon their businesses in the early years, even if their companies are struggling, a burn-off guarantee is almost always better. After a few years, you're on the hook for little or nothing, versus a rolling guarantee that remains in effect until the lease expires.

There are many other ways to limit a lease guarantee and plenty of other deals that you may be asked to guarantee. Sticking with leases, you could negotiate for the right to be released entirely if you can find a creditworthy substitute. For example, if you sell your business, you could have the purchaser replace you on the guarantee.

A GUARANTEE FOR EVERY OCCASION

You may be asked to guarantee other business deals that are less flexible or require different strategies for limiting your exposure. Typically, guarantees of bank loans are the toughest to negotiate. Lenders want their money back. They're usually in no mood to bargain over guarantees.

Still, if you know enough to ask, you can limit your personal exposure on a bank loan. Insist on the right to terminate your guarantee, by notifying the bank. Once terminated, your guarantee won't cover any new loans to the borrower. You'll still be liable for everything that was lent before your notice. But you won't be liable for new loans, such

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as draws on a line of credit that occur after your termination notice. Also, make it clear in the paperwork that when the borrower makes payments, the money is applied to the earliest loans. This will reduce your exposure. If you ever terminate your guaranty, the borrower's payments will be credited to the earlier loans that you have guaranteed.

All of these limitations let you stem the bleeding if things ultimately go bad with the borrower. But you should also have a side agreement with your partners that require them to reimburse you for their share of the loan if you're the only guarantor or if the bank chooses just to sue you and not your partners.

If you're selling your business and you have to guarantee certain promises you make as part of the sale, you can also limit your obligations. You might insist that the buyer assert any claims within a relatively short time period, such as six or 12 months after the closing. After that, the buyer loses the right to sue you. With sufficient bargaining power, you can also cap the dollar amount of your guarantee. Likewise, you might limit your guarantee so that you are only on the hook for particularly bad conduct, such as any fraud in connection with the sale.

Depending on the nature of the deal and how eager the other side is to do business with you, there are numerous ways to limit any guarantee. The key is to remember that you can limit your exposure. Then make it a priority in the negotiations.

THE GREMLIN BITES

That's where my friend Bill screwed up. He didn't even think about limiting his guarantee of that first lease. In fact, he didn't think much at all about that guarantee until it was way too late.

After Bill took on the investors and expanded the business, a recession hit the economy, and the company, hard. The investors poured more money into the business, but they also took control. When the company continued to struggle, the investors booted Bill and then started closing a bunch of stores. Bill moved on, or so he thought. Years later, he got a certified letter from that first landlord – the one that insisted on Bill's unlimited guarantee of the lease. The investors had walked away from this lease and left behind unpaid rent totaling well into six figures. The landlord wanted that money and was ready to sue Bill for it. Much to his surprise, Bill was still on the hook. Someone had given water and food to that Gremlin-like guarantee and now it was ready to rip into Bill.

If he had thought about it, Bill likely could have limited that guarantee so that it burned off years earlier. Or he could have insisted upon the right to substitute another guarantor for himself and then made the investors take over that obligation. At the very least, he could have bargained with the investors so that they would share in the payment of the guaranteed amount. But Bill didn't even consider limiting his guarantee until it came back to bite him. CEO

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