REGENTS BANK

An Entrepreneur's Guide to Personal Guarantees
By Dan Yates

A closely held company is one that is owned by a relatively limited number of people, often entirely by one family or individual. Majority owners of closely held companies have considerable discretion when it comes to how they elect to manage their company's profit and loss statement as well as the company's capital structure as reflected on the business balance sheet. These decisions may be motivated by tax or other personal considerations.

This discretion can take the form of substantial "above market" owner salaries, bonuses, and dividends and subsequently some of these funds can find their way back into the business in the form of a shareholder loan to the company.

Traditionally the majority of banks that extend loans to closely held companies require the owners of the business to sign a personal guarantee, which is a contractual promise the owner makes to personally repay the business loan should the company default on its obligation to repay the bank.

Personal guarantees concern some business owners because they can negate the protection from creditors that they sought to gain by incorporating their businesses. A firm line no longer separates the assets of the business and the individual when a personal guarantee is executed. In fact, if a business owner defaults on a loan, the bank can rely upon the business owner's personal assets as a source of repayment.

From a banker's perspective, personal guarantee requirements are centered on certain basic points of business reality. One is the simple fact that business owners enjoy the benefits of significant personal discretion when it comes to the flow of funds between the business and the owner. It is not uncommon to blur these lines when the owner needs or desires to take funds out of the company for personal reasons.

Typically in evaluating a loan for approval, bankers seek to identify at least three sources of repayment. The primary source of repayment is generally how the bank will get paid in the normal course of events if the business plan succeeds as advertised. The secondary (i.e. fallback) source of repayment is any collateral that has been pledged for a loan. (i.e. collateral is typically evaluated in liquidation terms as in a fire sale, not in terms of its value to a going concern). The tertiary source of repayment, if needed, is generally the owner's personal net worth, which bankers look to cover any shortfall should the primary and secondary sources of repayment fail to pay off the bank loan.

It is not a foregone conclusion that a closely held business owner must provide a financier with a personal guarantee in order to get a loan. From a negotiation perspective, to entice a bank to waive a personal guarantee requirement, the owner would be well advised to demonstrate to the banker, why a personal guarantee is not necessary to assure the bank's loan will be repaid in the normal course of business and/or from the secondary repayment sources.

Getting the personal guarantee requirement waived is usually only possible if your banker knows for certain that your company has a strong track record of profitability and liquidity or if the pledged collateral value is of a quality and nature that the chances of the bank not getting repaid are minimal.

A cynic might say, that any company that can qualify for a personal guarantee waiver probably does not really need a loan but there are numerous examples in the business community where highly successful companies may have a credit line in place, without guarantees, for the purpose of serving as an emergency backup plan.

"The borrowing entity that gets a financial guarantee waived is usually a larger company with excellent financial strength," said Monte Schwartz, chief credit officer with Regents Bank. "This company usually has low leverage, a strong capital position and a good earnings history."

Schwartz adds that a nonprofit entity that cannot provide personal guarantees may seek a cash secured loan or can borrow against their brokerage account of stocks and bonds.

Negotiating a line of credit without a personal guarantee may provide the business owner with a false sense of security. In these situations, if the business should subsequently fall upon difficult times, the bank of record is typically going to require a personal guarantee at that time, to continue with the financing arrangement, or call the loan.

When a credit facility has been obtained without personal guarantees, most bankers will implement loan covenants that will be far stricter than they might otherwise be, if the guarantee had been offered. In addition, if during the course of the financing arrangement, loan covenants are violated, a banker may have less flexibility in working with the company to "right the ship" during repayment negotiations than if that customer had previously signed a personal guarantee.

"A strong guarantee from the owner could relax the loan covenants, creating a more liberal structure on the credit," said Jim Dowd, chief credit officer at Mellon First Business Bank. "It's a trade off."

Consider the personal guarantee waiver request from your banker's perspective. "Banks are lending you their depositor clients' money, not their own capital," says Robin Paterson, executive vice president and chief credit officer at America Business Bank. "They have a big obligation to make sure that money is lent properly."

A banker may interpret the request to waive the personal guarantee as a lack of confidence from the closely held business owner to make good on his or her company's financial obligation.

"When clients need a bank to stand behind them, they need to be willing to stand behind their bank," said Paterson.

If the business owner has agreed to personally guarantee the debts of their business, the banker has a strong motivation to work with the business owner, to help make the business healthy again because they know that it's in everyone's mutual interest. When a personal guarantee is off the table and has been waived, there can be a presumption that the business owner might elect to walk or file bankruptcy rather than stick it out, if significant personal finances are also on the line and at risk.

While a full and complete waiver of a personal guarantee is generally a challenging negotiation to prevail upon for most small business owners, a compromise may be possible as some bankers might be willing to craft a limited guarantee where the dollar amount of the guarantee is less than the full business loan commitment.

Bankers may also be open to waiving a personal guarantee down the road if certain milestones are met, including reducing the leverage in the business either from infusing additional equity into the business or from significant retention of profits that accumulate over time.

If you do decide to execute a personal guarantee document with a bank, you should have a business lawyer review the document to help make sure that you understand all of your obligations under such an agreement, which vary from state to state.

Above all else, be honest with your banker. A good banker can be a valued business ally who can give you sound advice about the best financial decisions for you and your business. A banker who has a sophisticated understanding of your business can help you determine whether taking a loan is the right decision for you and how that loan can be structured to bring you maximum success.

After all, your success is your banker's success. If you don't feel like your banker thinks this is true, you might want to search for a new banker.

Dan Yates is president & CEO of Regents Bank, a San Diego based community business bank dedicated to serving small to mid-size businesses as well as those individuals who appreciate truly exceptional service.