



Personal Guarantees From A to Z

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General Background



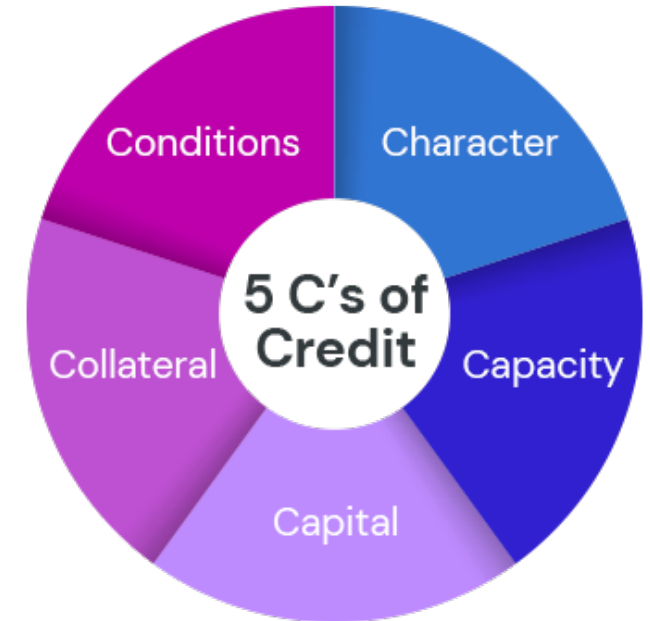
Who do you count on to pay the credit extended?

What conclusion did your credit underwriting reach as to the ability to pay?



The Five C's of Credit:

- Capacity
- Capital
- Collateral
- Conditions
- Character



Should you be considering having the party with the most ability to pay act as the primary obligor, rather than as the guarantor?

Do you want personal guarantees or business guarantees?



Historically, Guarantors were given the benefit of every doubt under the common law

Enforcement of Guaranties was disfavored, in the sense that courts upheld a variety of defenses raised by Guarantors to avoid having to perform on their Guaranties



Defenses to Guarantees

- a. Failure to properly create the Guaranty contract



Defenses to Guarantees

- b. Failure of the Creditor to pursue the primary obligor (*i.e.*, the Debtor) or to pursue collateral



Defenses to Guarantees

- c. Actions by the Creditor following delivery of the Guaranty that increased the risk to the Guarantor of having to pay. These could be:
 - i. Actions that affirmatively increased the risk to the Guarantor
 - ii. Loan administration decisions
 - iii. Failures to make proper disclosures



Defenses to Guarantees

d. Bankruptcy / insolvency related defenses



Automatic Stay in a Bankruptcy

- a. This protects the Debtor from efforts by creditors to collect their debts
- b. Does not automatically apply to a Guarantor that is a separate legal entity, but may be extended to Guarantors if the financial strength of the Guarantor is deemed essential to a successful reorganization
- c. Guaranties should waive any defenses arising from the bankruptcy or insolvency of the Debtor
 - i. After all, this is specifically a risk that the Creditor has required a Guaranty to protect against



Voidable Transfers

- Preferential transfers
- Transfers for less than adequate consideration



Voidable Transfers

- a. These are transfers where the Debtor has attempted to reduce the debt, but due to the timing or lack of consideration, the payment or transfer is reversed



Voidable Transfers

- b. Had the payment been effective, exposure to the Guarantor would have been reduced accordingly



Voidable Transfers

- c. Potentially, if the payment was payment in full, the Guaranty may have been released



Voidable Transfers

- d. To protect against these situations, Guaranties should contain a provision whereby the Guarantor agrees that if any such payment must be disgorged by the Creditor, then the Guarantor's liability to the Creditor will continue to be effective or be reinstated, as if the disgorged payment had not been made



How Do Creditors Respond?

Faced by a continually-growing myriad of defenses that, if established would make their Guaranties worthless, Creditors began to build waivers of those defenses into their Guaranties

Eventually, the principle developed in the common law courts that waivers of potential defenses to the enforcement of a Guaranty (subject to a few exceptions) would be given effect.



Use of Waivers

- a. Thus, the key to creating a solid, enforceable Guaranty is to include waivers of the various defenses that a Guarantor might seek to raise once the credit goes bad
- b. We will turn to a discussion of the various common law defenses and how to waive them



Failure to Properly Create the Guaranty Contract



Guaranties as Contracts

1. General contract rules apply to the creation of a Guaranty, with some qualifications
2. A contract of Guaranty must be in writing
 - a. This has been the rule since the English Statute of Frauds in 1677
 - b. Arizona's Statute of Frauds is found at A.R.S. §44-101



3. When obtaining a Guaranty from an entity such as a corporation or limited liability company (“LLC”), proper authorization is necessary and should be established

- a. Confirm that the Guaranty has been executed by a proper officer of the entity with actual or apparent authority to bind them
- b. If the magnitude of the credit justifies it, we recommend a basic form of resolution authorizing the Guaranty be obtained



4. As with other contracts, demonstrating that a “meeting of the minds” has occurred and that “consideration” has been given and received is also essential
 - a. “Consideration” is what benefit the Guarantor received from the extension of credit to the Debtor
 - i. Guaranty should recite this benefit, which typically derives from the Guarantor’s ownership position in the Debtor
 - b. We’ll discuss some special issues involving “consideration” later in the context of inter-company Guaranties



Failure of the Creditor to Pursue the Primary Obligor (*i.e.*, the Debtor) or to Pursue Collateral



Enforcement of a Guaranty

1. A Guaranty should provide that the Creditor can pursue the Guarantor without first having to:
 - a. Commence legal action against or otherwise pursue the Debtor
 - b. Foreclose upon or otherwise seek to enforce the Creditor's rights against any collateral that may exist



2. Such a Guaranty should state that it is “absolute” (meaning the Guarantor agrees that it has primary liability just as if it was the Debtor) and “continuing” (meaning that the Creditor can extend new credit to the Debtor from time to time, and that all such new credit will be covered by the Guaranty)

- a. A.R.S. §44-142 provides that judgment will not be rendered against a surety unless the Creditor has also sued and obtained judgment against the primary obligor
- b. This statute can and should be waived
- c. Restatement of the Law of Surety and the common law provide that the obligations of a surety can be no greater than the Debtor’s



Actions by the Creditor Following
Delivery of the Guaranty that
Increased the Risk to the Guarantor
of Having to Pay



Common Defenses

1. These are by far the most common defenses a Creditor can expect a Guarantor to raise, and the list is still growing
2. As noted above, these fall into several categories
3. Actions that affirmatively increased the risk to the Guarantor



- a. Changes in the terms of the credit that increase the risk of a Debtor default
 - i. Increasing the size of the debt
 - ii. Increasing the rate of interest
 - iii. Changing the payment terms to make them more burdensome
 - iv. Changing the non-monetary terms (e.g., financial covenants) to make them more burdensome



- b. Changes in the terms of the credit that increase the risk the Guaranty will be called
 - i. Extending the maturity of a troubled credit without Guarantor consent
 - 1. If the Debtor eventually defaults, the Guarantor will claim that the deficiency would have been smaller if the default had been allowed to occur at the originally stated maturity date
 - ii. Release of other Guarantors or other parties liable to repay the credit
 - 1. Obviously, the fewer responsible parties, the less merry for them once the demand for payment is made



- iii. Release of collateral without a commensurate reduction in the amount of the debt
- iv. Failure by the Creditor to properly perfect its interest in any collateral taken
 - 1. The Guarantor will argue that it relied upon the fact the debt was secured in evaluating its overall risk of having to perform on the Guaranty



4. Loan administration decisions
 - a. Basically, any modification of the debt that results in a material alteration in the terms of the credit
 - i. Guarantors and their counsel have historically been extraordinarily creative in arguing why a particular modification to the terms of the credit increased the risk to the Guarantor of being called upon to perform



- b. Keeping in mind point 3.b.i. above, even modifications that might seem to benefit the Debtor by granting more time, or modifying covenants to make the immediate risk of a default less likely, may be characterized by the Guarantor as only postponing the inevitable, to the Guarantor's ultimate detriment, because the eventual deficiency the Guarantor must pay has only gotten larger



5. Failures to make proper disclosures – Guarantors over the years have argued a right to receive basically any material information concerning the Debtor



- a. Guaranties should include waivers of numerous types of notices that a Guarantor might claim they were entitled to receive
 - i. Notice of acceptance
 - ii. Notice of incurrence of the debt
 - iii. Notice of default
 - iv. Demand for payment
 - v. Notice of acceleration
 - vi. Notice of intent to accelerate
 - vii. Notice of modifications to the terms of the credit



- b. Non-disclosure by the Creditor of material financial information concerning the financial condition of the Debtor
 - i. Guaranties should recite that the Guarantor is familiar with the financial condition of the Debtor, has made its decision on its own, and has not relied on any information received from the Creditor



- ii. Guaranties should also recite that the Guarantor is in a position to continue to be informed about the financial condition of the Debtor, is not relying on the Creditor for any such information, and waives any obligation for the Creditor to disclose material information that comes into Creditor's possession in the future
 - 1. Without such a waiver, Guarantors have been released from their Guaranty if the Creditor failed to disclose material negative financial information in connection with a modification of the credit



Inter-Company Guaranties



Dealing With a Family of Entities

1. These are situations where one or more subsidiaries guaranty the debt of their parent, or where one or more brother-sister entities guaranty the debt of each other. In financings provided to Debtors with numerous subsidiaries, it is common to have all (or all that have any assets) guaranty the full amount of the debt



2. The concern here is one of a fraudulent transfer or fraudulent conveyance, meaning a transfer for “less than reasonably equivalent value”
 - a. For example, the parent controls the decisions of its subsidiaries and can simply obligate them to guaranty its debt, or to guaranty the debt of some brother/sister subsidiaries
 - b. The Guarantor in this situation may not actually realize anything of value from providing the Guaranty
 - c. To the extent possible, a well-drafted Guaranty should attempt to recite and explain why there was a benefit from the credit received by the Guarantor



3. This is a potential defense that cannot be waived, so you simply have to structure around it as best you can
4. Note that a downstream Guaranty, *i.e.*, when the parent guaranties the debt of its subsidiaries, does not present this same issue
 - a. Because the parent can control the transaction, it is presumed to have received consideration through the provision of credit to an entity that it controls



Conclusion



1. Generally speaking, the various common law or statutory defenses to enforcement of a Guaranty may be waived in a well-drafted Guaranty
2. This notwithstanding, most Guarantors are likely to be heavily involved in the businesses of the entities whose debt they guaranty
 - a. As a result, they are likely to be fully or substantially aware of the status of that debt and of any modifications or changes that are being made
3. When possible, if the Guarantor is available to consent to whatever action is being taken, obtaining a consent from the Guarantor is a prudent step



The foregoing is a discussion of general principles applicable to the creation, use and enforcement of contracts of guaranty in commercial transactions and does not constitute legal advice. Legal advice can only be given in a situation involving identified parties and a specific transaction, and with respect to which an attorney-client relationship has been created. Delivery of a copy of this presentation does not create an attorney-client relationship between any recipient hereof and either the authors or Gammage & Burnham, PLC.



A wide-angle landscape photograph of a rugged mountain range. The mountains are composed of layered red sandstone, with prominent peaks and cliffs. The sky is filled with heavy, dark grey clouds, with some light breaking through near the horizon. The foreground shows a valley with green trees and some small buildings. The word "Questions?" is written in a large, white, serif font across the center of the image.

Questions?