

READING

GUARANTEES AND SUBORDINATION AGREEMENTS

Guarantees

A guarantee, another type of loan support, is a legal document obligating a third party, or *guarantor*, to repay the debt if the borrower defaults. A guarantee should never be the primary source of repayment for a commercial loan, nor a substitute for a business borrower's acceptable financial status. It is only as good as the guarantor's willingness and capacity to repay the debt if required. Consequently, when obtaining a guarantee, a business banker must conduct sufficient analysis to assure the guarantor meets basic standards of creditworthiness, as another business, or as a person that owns the borrowing business. The most common types of guarantees are personal, corporate, and government agency guarantees.

Personal guarantees

It is the general policy of most banks that loans to closely held businesses should be endorsed or guaranteed by the owners. In loans made to a sole proprietorship, the owner is automatically obligated to support the business. The general partners of a partnership also have personal liability, as does the general partner of a limited partnership. Therefore, personal guarantees are required to obligate the limited partners of a limited partnership, as well as any owners of C corporations, S corporations, limited liability companies (LLCs), or other entities in which the owner's and business's financial interests are legally separate. By signing a guarantee, the owner, as guarantor, promises to repay the commercial loan if the business fails to repay.

In general, business bankers prefer a personal guarantee from the business owner that has the following four key provisions:

- **Unlimited**—Covers all of the all the indebtedness incurred by one borrower to one bank, with no cap in the dollar amount, including future increases in debt plus allowable collection or legal fees in a problem situation
- **Unconditional**—Any guarantor can be called upon for repayment for any valid reason or event of default, not just lack of loan repayment
- **Joint and several**—If multiple guarantors, then no requirement for lender to take actions on a pro-rata basis. Lender can call on guarantors in any order or amount. This is established even when a business has one owner, because additional owners can be added later in the lending relationship
- **Continuing**—Includes any renewals and extensions of this credit and others extended from the same bank, beyond the original guarantee document

Bringing a third party into the lending arrangement adds to a loan's documentation, monitoring, and record-keeping requirements. A business banker's responsibilities include keeping the guarantor apprised of any significant changes in the borrower's financial status, the terms of the debt, or the status of collateral. Conversely, the business banker is required to update and monitor the financial status of the guarantor.

- More than financial support

Aside from serving as a secondary source of repayment, guarantees are a useful loan support tool in several other respects. In some instances, involving a third party serves as added pressure on the borrower to repay the debt. For example, in a loan default by a general partnership, a creditor first liquidates the assets of the general partnership before the assets of the individual partners can be pursued. However, if each partner provides a guarantee, the liabilities of the general partnership and partners rank equally, thus ensuring that each partner's interests coincide with those of the partnership.

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In other instances, even where the total available financial support of the guarantors is not material as a source of repayment compared to the size of the business, the requirement of personal guarantees places the owners in a position of personal risk in the event the business should fail, giving the bank some additional financial protection, but more importantly, discouraging the owners from allowing the business to over-expand and/or take excessive risk. Further, the personal risk to the guarantors should encourage them to assist the bank with their knowledge of the business and industry, which can be critical to successfully selling any collateral and dealing with other creditors in order to minimize loss to the bank.

Secured personal guarantee

Unsecured guarantees are most common, and are backed only by the guarantor's written promise to repay the loan in the event of default. Although this written promise is as legally binding as the borrower's pledge to repay the loan, in reality it is difficult to collect from guarantors who may not hold the same sense of obligation for the debt as the borrower. For this reason, some banks require secured guarantees.

A secured guarantee, like a secured loan, is backed by collateral, which is evaluated in terms of its liquidity, dependability of value, marketability and controllability. Even though a guarantor may have significant asset holdings to pledge, indebtedness or other claims against those assets may affect the guarantor's ability to use the assets to repay the loan.

Situations when guarantees may be modified

Beyond occasional use of secured guarantees, in certain other isolated situations, a lender will consider a personal guarantee that is modified and does not have all four of the provisions outlined above. The following are two of the more common modifications that are considered:

Limited or specific guarantee with a specific limit as to credit instrument being guaranteed, or a specific limit as to the amount (a dollar amount or percentage of debt) that is being guaranteed. For commercial loans to businesses with several owners, the percentage can be based on each guarantor's ownership of the business. Further, the lender usually will require these limited guarantees to "overlap." Most commonly, this is achieved by having three owners guarantee one-half of the debt each, by having four owners guarantee one-third of the debt, and so on. This approach provides 100 percent coverage of the debt in terms of guarantees; if one of the guarantors becomes a non-factor either due to extreme financial weakness or bankruptcy, death, severe illness or other issues. For businesses with more than five owners, overlap can be achieved by having each owner guarantee the loan at a percentage that is inflated by a factor of 1.20 times or 1.25 times. Certain owners not actively involved in management may be allowed to have a guarantee set at 1.00 times their ownership.

Conditional or contingency guarantee—This structure weakens the preferred unconditional guarantee provision by requiring specific events or actions to occur before the bank can seek relief from the guarantor. Most common is a "collection" or "deficiency" guarantee where the bank must first exhaust all efforts to sell and liquidate all collateral, then seek relief from the guarantor. Another condition can involve establishing the order in which the bank seeks relief from guarantors, or can require pro-rata action by the bank, which negates the desired joint and several provisions. Similarly, a contingency guarantee can create a special circumstance that activates the guarantee, which otherwise lies dormant until the event occurs.

Most banks require that any guarantee arrangement that does not meet the full unconditional, unlimited, joint and several, and continuing provisions must be clearly indicated and represented to the credit approver(s) in the loan package.

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Most banks do not require personal guarantees in the following commercial lending situations, where ownership is broadly disbursed such that there is no single person or small group of persons that can totally influence the entity, or no person actually owns the entity, etc.:

- Publicly-traded companies
- Government bodies
- Not-for-profit entities

Additionally, many banks exclude from guarantee requirements any loans that are backed 100 percent by marketable, liquid collateral, and loans to mature businesses with very large tangible net worth, very strong financial ratios, strong cash flow and very favorable industry trends.

Corporate guarantee

A corporate guarantee results when a business obligates itself to pay the debt of a third party who may default. A business usually guarantees the debts of small or recently formed subsidiaries or certain executive officers. In the case of the subsidiary, a corporate guarantee offers a secondary source of repayment and ensures that the parent company has an incentive to staff, finance, and take all necessary steps to operate the subsidiary profitably. To ensure validity, a corporate guaranty should have stockholder approval or be backed by a legal opinion.

Government agency guarantees

In certain business lending situations, guarantees can be obtained from government agencies. When a loan is guaranteed by a federal or state agency, the bank is promised all or part of the principal and interest if the borrower defaults on the loan. With such guarantees, the bank structures and monitors the loan to abide by the requirements of the guarantor.

The Small Business Administration (SBA) and the United States Department of Agriculture (USDA) guarantee loans to small businesses and rural businesses, respectively, and thus make borrowing possible for many businesses that otherwise could not obtain a loan. State agencies also guarantee loans to assist businesses in obtaining the financing they need. States often use loan guarantees as a tool to stimulate business development or to attract business from other locations, thus creating jobs for their citizens. Similarly, states guarantee loans as a way of advancing socially worthwhile causes, such as assisting minority-owned enterprises.

When the SBA or USDA guarantees a loan, a bank may be able to make the loan on slightly more favorable terms than otherwise possible. The underlying loan should meet most of the bank's lending criteria, but may have slightly weak collateral position, or its owners may not have extensive management experience. Because the SBA and USDA require certain, basic lending standards to be met, its programs are not an opportunity to make financing available to weak or poorly managed businesses. Various SBA programs and underwriting requirements can be found at <http://www.sba.gov>. Information about the USDA's business and industry B&I Guaranteed Loan Program can be found at http://www.rurdev.usda.gov/bcp_gar.html.

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Guarantees and subordination agreements are similar in that they deal with third parties. As a condition of lending to a prospective borrower, a bank may require a subordination agreement, so that debt to an existing creditor (a third party) becomes junior to or subordinate to the bank's debt. A subordination agreement is an agreement between two creditors of a borrower in which one creditor grants to the other a priority position in the credit relationship. This priority position can be for debt repayment, for instance, where the secondary (or junior) creditors' obligations are repaid only after holders of the primary (or senior) debt obligations are paid, or only if certain financial ratios of the borrower are maintained.

A subordination agreement can also create a priority claim to the borrower's assets and order of repayment in the event of default or liquidation. A security interest in collateral can be subordinated as well. That is, the bank's claims to the proceeds from the sale of collateral can have preference over a subordinated creditor.

Any number of lending terms and conditions can be addressed in a subordination agreement, so it is critical to obtain the actual document and understand its provisions.

Most lenders use the subordinated debt category, for financial spreading purposes, only for debts subordinated to the lender and under acceptable conditions. If the debt is from the officers or owners of the business, and adequately subordinated, some banks add the amount to total equity when calculating tangible net worth. For example, a bank may, as a condition of extending credit to a business, specify that any loans from the owners be subordinated to the bank's loans. Payments on the owner loans are prohibited as specified in the subordination agreement. Also, in liquidation, the bank will be repaid in full before any payment is made on the subordinated debt.

In lending to a privately held company, it is often required that any owner debts be subordinated, because the company's owners have the ability to pre-pay these loans, regardless of the written commitment in place between the owners and the business. To effectively freeze these loan amounts, the original note(s) signed by the business are held by the bank, along with a subordination agreement establishing when and how these loans can be repaid.