



Personal Guaranties Build Character

Personal guarantees seem to be a simple and easy way to achieve financing for your business, but when the guaranty involves millions of dollars, the implications should be carefully considered.

by Mark D. Working

If ever there were a daunting legal document, the bank's standard personal guaranty form would qualify. Based on even a minor technical default, it permits the lender to turn to the guarantor and demand repayment of the loan. When the guaranty covers millions of dollars of business borrowings, the personal implications to the guarantor can be alarming. The personal stock portfolio, children's inheritance, family home, and even the retirement nest egg, can be at risk. Even if signing on the bottom line is a necessity to obtain business financing, the potential downside demands your attention.

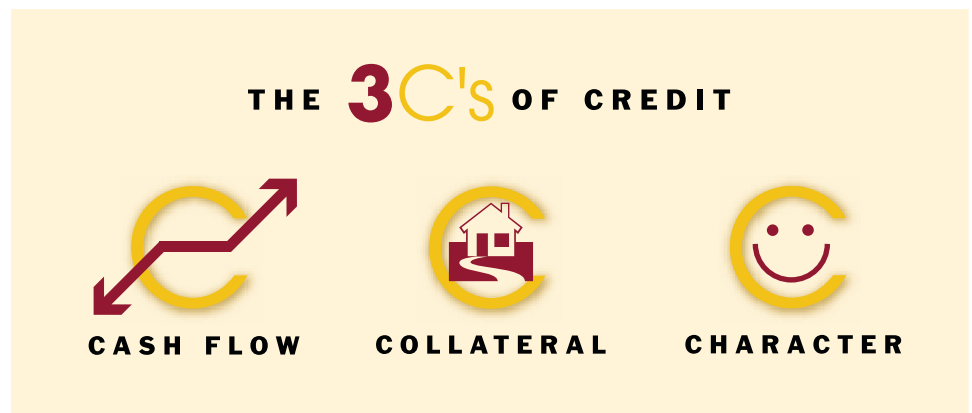
And, that usually is the point. Although in some cases, the guaranty is designed to provide additional financial support, more often than not, the primary purpose is to align the interests of the owner/manager with those of the bank.

THE THIRD "C", CHARACTER

Early in one's career, the "the three C's of credit"—Cash Flow, Collateral, and Character—are drilled into the heads of most bankers. The risks associated with sustaining adequate cash flow entails quantitative and qualitative analyses of the business plan, the industry, the competitive environment, and a variety of other internal and external variables. Collateral adequacy boils down to an assessment of the value of the business assets under distressed circumstances, when cash flow is insufficient to repay the loan.

Character assessments are invariably subjective in nature. The objective is to determine whether the business owner will attend to the business if something goes wrong. This becomes especially important when the borrower's difficulties extinguish the owner's economic interest in the business. This is because realization of cash flow and collateral values are substantially dependent on innumerable managerial, logistical, and operational variables. The attitude of management is a significant factor influencing the practical reality of collecting a loan when the business is in distress.

Bankers know from experience that when



the owner is personally "on the hook," the odds are that management's attention to the job at hand—loan repayment—will be enhanced. By putting at-risk assets outside the business, the bank assures the guarantor's continued economic interest in the outcome.

IS THERE NO ALTERNATIVE TO THE BORROWER?

Competition, or the fear of it, is the only reliable lever for either deflecting the requirement for a guaranty or winning the release of an existing guaranty. Nevertheless, a lender's fixation with personal guaranties generally softens, as the perception of the

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business as an independent stand-alone entity strengthens and/or the challenge of collection is reduced.

It is common knowledge that companies with a large shareholder base are less frequently subject to personal financial guaranties. Likewise, borrowing arrangements of larger companies usually are not supported by personal guaranties. In both cases, the shared characteristic is less reliance on the owner(s)/management and/or a small nucleus

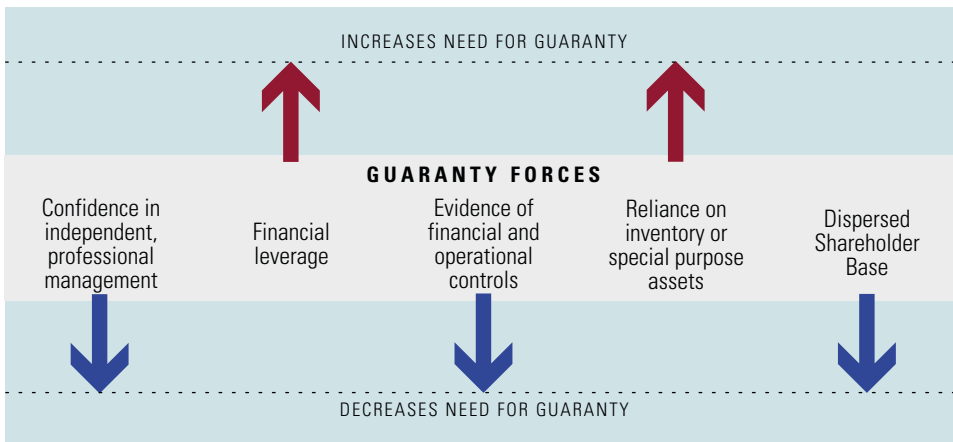
of key people to manage the day-to-day functions of the business. Professional management, coupled with confidence in the firm's internal controls and systems, helps moderate the lender's perception of risk. In a sense, a competent, committed management team is the financial equivalent of an ISO 9000 designation. As management risk is mitigated, lenders will make underwriting decisions on the first two of the three "Cs".

The nature and liquidity of collateral has a bearing on the need for an outside guaranty. For example, significant reliance on inventory or other special-purpose assets heightens the concerns of lenders. Most experienced commercial bankers know that they are ill-equipped to realize the full value of these types of assets. Asset-based lenders, on the other hand, often have greater confidence in the value of the collateral. Although their money may cost a bit more, a guaranty might be avoided.

There is no definitive formula or bright line that defines when a guaranty is to be required. It's a subjective judgment. But, the pendulum swings in favor of the borrower as certain risk factors are minimized. The following table illustrates some of the concerns that are often relevant.

SUPPORT FOR ADDITIONAL BORROWING

At times, a company may need more credit than a lender can justify. An extra increment of financial support may be required. A personal guaranty from a well-heeled shareholder



- A first-loss guaranty (which requires the bank to exhaust collection efforts against the business assets before turning to the guarantor);
- A limited guaranty that ties or caps the amount of the additional support to a specific risk or potential shortfall;
- A net worth guaranty which requires guarantors to replenish losses with new equity or subordinated debt;
- Borrow the money personally and invest the proceeds in the company through subordinated loans and/or additional equity; or
- Negotiate specific performance thresholds or milestones that trigger the reduction or elimination of the guaranty.

MORAL OF THE STORY

Making loans to a company represents a business opportunity for both parties, but there is an inherent conflict of interest between the two. Lenders have legitimate risk issues that need to be addressed. On the other hand, business owners should limit the amount of outside capital invested in the business. From both sides, it's a risk and reward tradeoff.

The only way to arrive at a reasonable solution to this controversial issue is to quantify the amount and nature of the support required, investigate all possible alternatives to provide support with appropriate limits, and use market competition to test the reasonableness of borrowing terms. ♦

can bridge the gap. We sometimes get the sense that borrowers view guarantees as a free way to obtain more credit. After all, the possibility of failure is remote and the guaranty is assumed to cost nothing. It's an expedient way to get credit.

A personal guaranty is far from free. The difference between the amounts that can be borrowed with and without a personal guaranty is the equivalent of an equity investment. In essence, the guarantor is "investing" his personal assets in the business by putting them at risk. For that investment, an economically minded guarantor should expect the same level of return as an actual equity invest-

tor. Since an equity investor would require a return in the range of 20-25%, the guaranty is hardly free.

The truth is that lenders rarely conduct a quantitative analysis of the need for guarantor support. Therefore, a discussion should be pursued in order to craft the financial support in the manner most appropriate for the situation. The effort should be to define the amount of support needed and the appropriate mechanism to provide a stop-loss on further support. Possible alternatives to consider include:

- A pledge of additional internal or external collateral;



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