

# Of Creditors, Guarantors, and Sureties: Whose Debt Is It Anyway?

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**“This kindness will I show; go with me to a notary; seal me there your single bond, and—in merry sport—if you repay me not on such a day, in such a place, such sum or sums as are expressed in the condition, let the forfeit be nominated for an equal pound Of your fair flesh, to be cut off and taken In what part of your body pleaseth me.”** — *Shylock, The Merchant of Venice, Act I, Scene III.*

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**THE PURPOSE** of this article is to discuss the primary contract law principles relevant to the enforcement of personal guarantes.

Shakespeare’s *Merchant of Venice*—centered on a contract between Shylock, the moneylender, and Antonio, the Merchant of Venice, which allows Shylock to cut off a pound of Antonio’s flesh in the event of default—offers a classic contract law example of a personal guaranty.<sup>1</sup> While creditors today do not secure loans with debtor

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<sup>1</sup> Some argue that the contract is not a personal guarantee as much as it is a Uniform Commercial Code Article 9 secured transaction: Shylock will lend Antonio 3000 ducats, which will be secured by a pound of Antonio’s flesh as collateral. Moreover, under UCC Article 2 the definition of a good is something that is identifiable and movable at the time of formation of the contract. Therefore, Antonio’s flesh can most likely be called a “good” within the meaning of Article 2. In other words, Shylock is the Secured Party, Antonio is the Debtor, and the pound of flesh is the collateral.

flesh, they almost always collateralize the personal assets of the debtor as security for their performance.<sup>2</sup>

In most creditor-debtor relationships, the legal classification of the debtor as “surety,” “absolute guarantor” or “conditional guarantor” carries great significance in terms of both the legal remedies available to the creditor and the extent of debtor liability in the event of default. Accordingly, it is important to understand the precise legal meaning and import of these terms under contract law as they relate to the issue of putting your personal assets at risk.

Personal liability clauses in today’s commercial contracts are drafted in a manner that renders the debtor absolutely and unconditionally liable for the entire loan amount in the event of default. In other words, the language of the clause is broad enough to give the creditor carte blanche to attach and dispose of the defaulting debtor’s business *and* personal assets to satisfy any outstanding loan amount. Take the example of the U.S. Small Business Administration’s (SBA) 7(a) loan program for financing small businesses. The section on Loan Repayment Terms states:<sup>3</sup>

### **Collateral**

The SBA expects every 7(a) loan to be fully secured, but the SBA will not decline a request to guarantee a loan if the only unfavorable factor is insufficient collateral, provided all available collateral is offered. This means every SBA loan is to be secured by all available assets (*both business and personal*) until the recovery value

equals the loan amount or until *all assets have been pledged* (to the extent that they are reasonably available). *Personal guarantees are required* from all owners of 20 percent or more of the equity of the business, and lenders can *require personal guarantees* of owners with less than 20 percent ownership. *Liens on personal assets of the principals may be required.* (Emphasis added)

While the precise extent of debtor liability is a matter of negotiation between the parties, most commercial contracts tend to contain terms similar to the one above in that the entire personal wealth of the debtor is at risk in case the loan or obligation goes into default.

As the following hypothetical illustrates, however, the standard personal guarantee language utilized in some commercial contracts today can be vague, confusing and even deceptive to the ordinary person. Accordingly, business owners, entrepreneurs or investors who are required to pledge a personal guarantee should negotiate the parameters of such liability in light of the principles enunciated in this article.

### **CASE STUDY: THE CURIOUS LANGUAGE OF PERSONAL GUARANTEES**

• Naïve Joe is an entrepreneur and business owner. He has been thinking about starting his own property management business for a long time, and he finally has the resources and knowledge necessary to start. He decides to form a Subchapter S Corporation because he did not wish to subject himself to unlimited personal liability by doing business as a sole proprietor. Soon, he forms Naïve Joe Management Inc., an S corporation based in the mythical state of DCMet, of which he served as the President. To generate business, he employs the services of a well-known national advertising company, Predatory Corp Inc., that promises to “make it rain” through so-

<sup>2</sup> This article assumes that the debtor or borrower does not own or operate as a sole proprietorship or general partnership as those leave him with unlimited personal liability for all the debts of his business.

<sup>3</sup> U.S. Small Business Administration 7(a) Loan Program, available at <http://www.sba.gov/content/7a-loan-repayment-terms>.

phisticated Search Engine Marketing, telemarketing, direct mail and other advertising.

Before signing the advertising services contract, the smooth-talking sales representative for Predatory Corp Inc. assures Naïve Joe that this “paperwork stuff” was just a formality—“in merry sport,” as Shylock would say. Naïve Joe tried reading the entire contract for a while but the small print and complicated legal terminology gave him a headache. At no point before signing on the dotted line did Naïve Joe think that he was incurring personal liability for the corporation’s debt in the event that the company failed to pay the hefty advertising services fees. The key terms of the contract are as follows:

### Signature Block

This is an advertising contract between Predatory Corporation Inc., and Naive Joe Management, LLC, and

\_\_\_\_\_  
Print Customer Name

X Naïve Joe **PRESIDENT**  
**Authorized Signature Individually and for the Customer (Read paragraph 15 on the reverse hereof) The Small Print In the Box to the Left of the Signature Block**

This constitutes a contract for advertising with Predatory Corporation Inc. in the next edition of the above telephone directories and/or for future internet services. The terms and conditions set forth or referred to herein and on the reverse hereof, including terms and conditions set forth at [www.predatorycorp.com](http://www.predatorycorp.com), are agreed to by customer and signer.

### Terms and Conditions on the Reverse of the Contract

**1. Directory Advertising Internet Services; Terms and Conditions.** (*Customer and Publisher (Predatory Corporation Inc.) agree that Publisher will publish advertising in the directories and/or provide the internet services, in accordance with the terms and conditions of this agreement...* (emphasis added).

**3. Credit.** Signer authorizes Publisher to check credit history of *signer and Customer* with bank and trade references and business and/or consumer credit reporting agencies and further authorities any such credit reporting agency to provide credit information about signer and/or Customer to Publisher. Signer and Customer agree that Publisher may share *signer’s and/or Customer’s* payment record with credit reporting agencies....(emphasis added)

### 6. Payment (Print Advertising and Internet Services).

A. *Customer* agrees to pay the amounts listed on the reverse side of this agreement for print advertising in the Directories and/or Internet Services.

B. For print advertising, Publisher will *bill Customer* monthly for the issue period of each Directory...

C. For internet services, Publisher may require full payment in advance or at its discretion may *bill Customer* monthly or annually ...(emphasis added)

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**12. Collection Expenses.** In the event Publisher refers Customer's account to a collection agency or attorney due to a non-payment, *Customer will be liable* for all of Publisher's reasonable costs and expenses incurred in connection with Customer's non-payment, including, without limitation, court costs and reasonable attorneys' fees up to 25% of the amount of the unpaid account balance (plus interest accrued thereon) (emphasis added).

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**15. Authority; Persons Obligated; Signer Obligated.** The signer agrees that he/she has the authority and is signing this agreement: (1) in his/her *individual capacity*; (2) as a *representative of the Customer*; and (3) as a representative of the entity identified in the advertisement or for whose benefit the advertisement is being purchased (if the entity identified in the advertisement is not the same as Customer or the signer). By his/her execution of the agreement, the signer *personally and individually* undertakes and assumes, *jointly and severally with the Customer*, the full performance of this agreement, including payment of amounts due hereunder (emphasis added).

Soon after signing the contract, Naïve Joe's property management business turns out to be a miserable failure. With accumulating advertising costs and no business income to defray those expenses, he decides to shut down Naïve Joe Management Inc. Of course, all those unpaid advertising bills continued gathering interest, and Predatory Corp would soon forward the case to an overzealous collections attorney.

Almost a year after that unfortunate business venture, Naïve Joe had already moved forward

with his new mobile computing business. Things were going well when one fine day Naïve Joe was served with notice of a lawsuit—Predatory Corp was directly suing him in his personal capacity to collect on all the outstanding fees for advertising services rendered to Naïve Joe Management Inc., plus interest, costs and attorney fees.

The complaint alleges, in part, that based on the terms of the contract Naïve Joe is personally liable for the debts of the now dissolved company, Naïve Joe Management Inc.

**CASE ANALYSIS** • At first glance, it may seem that Predatory Corp (“Creditor”) will likely prevail in this lawsuit based on section 15 of the terms and conditions holding “signer,” Naïve Joe, “personally and individually” and “jointly and severally liable” for payments of any amounts due under the contract. A deeper analysis of the underlying legal issues reveals, however, that the creditor must overcome several substantive and procedural hurdles in order to hold debtor personally liable.

The legal framework analyzes two specific issues that are crucial to determining the liability of the signatory: (a) did the signatory to the contract expressly consent to be bound for the debts of the corporate entity? The answer to this issue partly depends on whether Naïve Joe signed in his representative capacity as the agent of the corporate principal or in his personal capacity. Furthermore, a related issue is whether the terms of the contract are ambiguous on the issue of personal liability; (b) If the signatory did give express consent to be bound in his personal capacity and the contract is not ambiguous, then the next level in this analysis examines whether he is liable as an absolute guarantor, conditional guarantor or surety under the terms of the contract? These significant sub-issues embedded within the overall legal framework must be resolved in order to reach a satisfactory outcome on the issue of personal liability.