

# Personal Guarantees

## Viabile in Volatile Economy

By Gregory Richmond and Kevin Kidd

*Today's economy requires every risk mitigation tool*

### KEY NOTES

- ▶▶ While a personal guarantee may be valid and enforceable, litigation to enforce payment can be time consuming and costly.
- ▶▶ When a guarantor recognizes that his or her house or personal savings is at risk if the business doesn't pay its guaranteed debts, he or she is much more likely to ensure the business fulfills its obligations.
- ▶▶ Ensure that the guarantor is the owner of the business and that the guarantee is clearly stated in the merchant agreement, and consult an attorney when drafting provisions.

For years, banks and ISOs have relied on the additional security of a personal guarantee when establishing merchant accounts for most small and medium-sized businesses. The idea is simple: The guarantor (usually the business owner) legally agrees to be personally responsible for all debts the business fails to pay. This lets the bank or ISO sidestep this liability protection and permits the bank or ISO to collect on the debts of the business directly from the owner who has guaranteed those debts. More typically, businesses are set up as corporations, limited partnerships, or limited liability companies, and those business structures legally protect the owners from the creditors of the business.

The financial value of a personal guarantee relies on the ability of the guarantor to actually repay the obligation. And in today's volatile economy, that's not a given. Guarantors who may have been able to fulfill their businesses' obligations as little as a year ago have seen their personal assets decrease significantly since that time. As much as they might want to fulfill their guarantee, in some cases, they just don't have the net worth to do so.

Even if the guarantor has sufficient as-

sets, they are worthless to the collecting bank or ISO if they can't be liquidated. Further, guarantors may have multiple obligations, of which the bank or ISO is only one.

The value of a personal guarantee is largely in its use as a psychological tool. When a guarantor recognizes that his or her house or personal savings is at risk if the business doesn't pay its guaranteed debts, he or she is much more likely to ensure the business fulfills its obligations in a timely manner if at all possible. In a work-out scenario, the guarantor is more likely to ensure that proper, and sometimes preferential, attention is paid to the creditor of guaranteed obligations (as opposed to non-guaranteed obligations).

### Enforcement Costly

Obtaining the personal guarantee is generally part of the ordinary documentation in signing a new small- to medium-sized merchant. The personal guarantee is generally easy to obtain from an owner of a business, with no filings or registrations with any governmental agencies required (although copies of certain identification may be required to comply with the U.S. Patriot Act and other federal laws). Although the law affords guarantors various legal defenses when the guarantee



and guarantee. The growing number of merchant bankruptcies, often coupled with the personal bankruptcies of their owners, has tested this position of late. However, ISOs and banks are typically moving forward in enforcing their rights against merchants and personal guarantors.

### Words of Caution

Banks and ISOs should take note of a few precautionary measures in obtaining guarantees from the owners of their merchants. First, it is always best to ensure that the guarantor is, in fact, the owner of the business. If there are multiple business owners, each owner should sign a “joint and several” and “unlimited” guarantee (meaning they all are obligated for the entire amount together and individually). Second, the bank or ISO should ensure that the guarantee is clearly stated in the merchant agreement (or in a separate agreement) and not lost in the fine print. Third, because it is important for the guarantor to waive certain common law and other defenses, it is advisable to consult an attorney when drafting such provisions.

Today’s volatile economy demands more security, not less. Obtaining a personal guarantee from the owner of a merchant is a simple strategy that can and should continue to play a valuable role in a bank’s or ISO’s risk mitigation efforts. **TT**

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is enforced against them, in the context of the owner-guarantor of a merchant, the properly executed guarantee is generally enforceable as long as the form is properly drafted.

For example, in the case of *First Data Services v. Parisel Associates Inc.*, First Data brought an action against a personal guarantor for more than \$11,000 in unpaid chargebacks. The Superior Court of Connecticut ruled that the personal guarantor was indeed responsible for the charges because the merchant failed to follow the procedures for processing credit transactions as described in the merchant agreement. In *Card Establishment Services Inc. v. The Mac Shop Inc.*, the Superior Court of Rhode Island ruled

that a personal guarantee was legally enforceable under a merchant agreement for more than \$20,000 in chargebacks.

While the personal guarantee is often valid and enforceable in these cases, such litigation can be time consuming and costly. Depending on both the amount of the obligation and the likelihood that the guarantor can actually meet it, the value of pursuing litigation must generally be decided on a case-by-case basis. Some banks and ISOs, however, in order to establish an aggressive reputation, take the position that virtually no amount is too small to collect, which may keep some merchants and guarantors from failing to fulfill their obligations under the merchant agreement