The ABC of getting a

By Ben Sewell

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Credit Managers will be aware that signs of doom and gloom are spreading over the Australian economy. Company management will be looking to its credit managers to limit the downside risk from the inevitable fallout of a recession. One technique for limiting risk is to take security in the form of a personal guarantee from the proprietors of a debtor company.

The technique of taking a personal guarantee has been used by financiers for centuries. The first form of guarantee known in history goes back to 2250BC. This article aims to give credit managers an overview of how to obtain an effective personal guarantee and some of the pitfalls that may make a guarantee unenforceable. This article is particularly relevant to credit managers that deal with the proverbial "$2 Company" that represents a high credit risk in a recessionary environment.

Scenario: You are told by your sales team that one of the customers, ABC Pty Ltd, is in trouble and you know that its receiveables position has been slipping for months. You are concerned that ABC Pty Ltd may go into insolvent administration and you want to protect you company against this future risk. You contact the directors of ABC Pty Ltd, Mr A and Mr B, and tell them that they will need to provide personal guarantees or you will close the account.

What is a guarantee?

A guarantee is the promise of one person to be answerable for a debt or obligation of another person if that other person defaults. It is a unique form of contract and there is a complex body of law that has developed relating to this suretyship.

A guarantee is a "secondary" obligation because it relies upon the existence of a principal obligation being owed, i.e. Mr A and Mr B's obligation as guarantors continue only to the extent that ABC Pty Ltd's debt is enforceable. If ABC Pty Ltd is excused as a debtor or its debt is waived in some way, generally Mr A and Mr B's obligations as guarantors will also be extinguished.

The second principle that should be kept in mind is that not only is the guarantor's liability secondary to the principal debtor's continued liability, but it is also contingent upon that principal debtor's default (i.e. non payment of a debt that is due and payable).

What document needs to be signed?

There have been examples of an oral undertaking being found to be an enforceable guarantee. For example, a chief executive provided an undertaking to provide a personal guarantee "in due course" and a Court held it to be a representation that the chief executive was required to honour.

Credit managers should avoid relying on oral undertakings and be aware that because a guarantee is a unique form of contract the Courts will generally extend a guarantor's liability only so far as the written (i.e. expressed) terms of the guarantee provide. The Courts will "read down" a guarantee so that it is interpreted in favour of the guarantor.

A properly drafted written guarantee is therefore essential for credit managers. Unless a contract of guarantee is in the form of a deed (i.e. signed, sealed and delivered) a contract of guarantee must be supported by consideration. Broadly, consideration is a legal concept that means that both sides of a contract must "get something" from it. This is in contrast to a gratuitous promise (i.e. a gift) that is not enforceable as a contract. The usual technique for meeting this requirement is to include the personal guarantee in your credit application to link the opening of a credit account with the provision of the personal guarantee.

If you attempt to obtain a personal guarantee after the credit account has been opened, then it may become a matter of argument regarding whether or not you have a valid personal guarantee. In these circumstances you should obtain a deed of guarantee to overcome the hurdle of the consideration requirement. For example, If you intend to rely on a recent email received from Mr A and Mr B promising to guarantee all indebtness of ABC Pty Ltd this promise may fail for want of consideration.

What form of words need to be used and what to watch out for

The usual form of words for the provision of a guarantee is something like:

> *"in consideration of [your company] agreeing to supply goods and services to the above customer, at the request of its directors, I/we agree to jointly and severely personally guarantee the performance of all obligations and payment of all debts incurred by [the customer]"*

These words are a standard form that may be provided in credit applications.

The second component is the form of words that provide that the guarantee is irrevocable. A guarantee, unless it is stated to be irrevocable, may be withdrawn by a guarantor at any time.

The third component is that it contain a specification that the guarantee is for "all monies". An all monies guarantee has the effect of increasing the scope of the guarantee from any money that is owing presently to encompassing all debts incurred at a future time. This is a necessary component of a guarantee.

The usual form of words for the scope of a guarantee may be:

> *"This is a continuing and irrevocable guarantee for all monies which are now or may be from time to time owing or remain unpaid by [the customer]."*

The key method of avoiding issues with the form of words used is to ensure that your credit application is drafted by a solicitor so that it meets the legal requirements of a guarantee. For example, your guarantee may be prepared in the form of a deed attached to your credit application to ensure that its terms may be strictly enforced. The credit manager in the scenario should obtain a deed of guarantee from Mr A and Mr B to ensure that the guarantees are enforceable.

Other key risks that might cause a written guarantee to be unenforceable by a Court include where:

guarantee

1. The contract with the principal debtor is either discharged or varied;
2. The guarantee is put at risk by waivers or extensions of time granted to the principal debtor;
3. There is a deficiency in the execution of the guarantee document;

Assuming that the Credit Manager in the scenario obtains an enforceable guarantee actions that may put this guarantee at risk include:

1. The credit manager agrees to changing the terms of trade with ABC Pty Ltd;
2. The credit manager releases Mr A but not Mr B from his guarantee;
3. The credit manager's company is in fundamental breach of its contract with ABC Pty Ltd.

Going beyond and a checklist

Many credit managers use a credit application form that incorporates both a guarantee and an indemnity. An indemnity is a principal obligation whereby the indemnifier makes a promise to be responsible to a creditor for any loss suffered by the creditor if the principal fails to perform its obligation. A contract of indemnity is a primary liability on the part of the indemnifier and is generally unaffected by some of the problems with the validity or unenforceability of the principal contract because it is not contingent upon the principal debtor's obligation. More sophisticated credit managers usually insist upon an indemnification provision being included within any customer's guarantee.

Checklist

- The guarantee is part of your customer credit application;
- The guarantee requires specific execution by your proposed guarantors;
- It uses a form of words that includes "continuing and irrevocable" and "all monies" references;
- Ideally, it should be executed in the form of a deed with witnesses;
- If you are providing consumer credit, you should seek legal advice;
- You should use a credit check to ensure the identities of all parties are verifiable. ■

This article is not intended to be comprehensive but rather to offer credit managers a starting point when obtaining personal guarantees from your customers. Some other issues you may also consider include insolvency events, obtaining caveatable interests over guarantor's real property, trading trusts, consumer credit check consent, etc.

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