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MEMORANDUM

TO: Jeff Flora

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SUBJECT: Dealer Personal Guaranties

Tightening credit standards and a lack of competition in financing sources has led lenders and manufacturers to seek additional security when making loans to dealerships. In many cases, this has led to a lenderôs demand that the owners of the dealership personally guarantee the debt of the dealership. Because the issues of how to address personal guaranties are becoming more frequent and important to the dealers, we prepared this outline of the key issues to give dealerôs direction in handling these lender requests.

The bottom line is that a personal guaranty creates significant risk to a dealer ï all of his or her assets are exposed to the risks of the loan. Dealers need to understand this and should take the time to evaluate the risks of the loan going bad and what personal assets are being exposed.

We will address the following topics in this memo:

- Why do lenders want dealers to sign personal guaranties?
- Who should and who should not sign a personal guaranty?
- What is the risk that the dealer is personally guaranteeing?
- Is a personal guaranty reasonable based on the type of loan involved?
- How should a dealer approach a personal guaranty?
- Other key terms in a personal guaranty.
- Managing risk.

Why do lenders want dealers to sign personal guaranties??

A personal guaranty puts the lender in the same place as if the dealer and the dealership were one and the same. Without the personal guaranty, only the assets in the dealership are exposed to the risks of the loan. With a personal guaranty the dealer adds his personal assets owned ñoutsideò the company to the risk of the loan.

Lenders also know that if a loan is personally guaranteed, that obligation will usually move up near the front of the line for payment if the dealership is having cash flow problems. In working with dealerships that are experiencing stress it is not unusual for advisors to ask: ñAre you current on the payment of employment tax and what loans have you personally guaranteed?ò The employment tax question is important because the responsible officer is personally liable and this liability is not dischargeable in bankruptcy. The personal guaranty question is important because a bad business loan can put a dealer in personal bankruptcy.

Who should and who should not sign a personal guaranty?

In general, if the dealer does not have a say in the business the dealer should not sign a personal guaranty. In fact, if a dealer does not have ñcontrolò of the business, the dealer should be cautious in signing a personal guaranty ï control means owning at least 51% of the stock of the company. The reason is simple. If the dealer cannot control the risk that the company is taking, does it make sense for him to expose all of his personal assets to the decisions of others who do have control?

Some lenders require owners of 10% or more of the company to sign a personal guaranty. At a minimum, someone who signs a personal guaranty should be (a) an owner, (b) an officer and (c) a director (if a corporation). As an owner, a dealer has an equity stake in the business, which may justify the risk ï and if it doesnœt donœt become an owner. As an officer and director, the dealer has legal access to the books and records of the business and some say in the risks undertaken by the business.

Spouses are often asked to sign personal guaranties. If the spouse is not an owner of the business, the spouse should have serious reservations in signing the personal guaranty. Such caution is understandable because there could be a divorce and the ex-spouse would remain exposed to the loan liability. Moreover, it is not unusual for spouses to have inherited property that they feel should not be exposed to the risks of the business. Accordingly, it is not unreasonable for a non-owner spouse to refuse to sign a personal guaranty. In some instances we have seen lenders back away from this requirement and nonetheless, make the loan ï even though having only one of the spouses on the guaranty has effectively removed half of the coupleœs assets from exposure.

If a dealership is being sold, it is important that the dealer get released from all personal guaranties as part of the sale ï this should be made a condition of closing the sale. It is not automatic. At the time of the sale, lenders will usually release the sellers if the new owners sign personal guaranties and have some financial resources. We have heard of instances in which dealers have sold their businesses, did not bother to get releases and years later were called upon to make good under their personal guaranties. If this were to happen it would ruin a dealerœs day.

How can a personal guaranty impact a dealer?

A personal guaranty can have a significant impact on a dealer. Of course, the biggest and most obvious impact is that personal assets may be called upon to pay off dealership debt. There are, however, less obvious impacts that also need to be considered, particularly if the personal guarantor is not actively involved in the management of the business:

- A dealerôs individual credit score may be impacted by the dealershipôs payment history.

- The contingent liabilities associated with a personal guaranty may limit the amount of funds that other lenders will loan a dealer for personal or business interests that are unrelated to the dealership (e.g., loans for farming operations).

- Signing a personal guaranty may cause a default under other loans to the dealer. This might occur either due to an outright prohibition on giving additional personal guaranties in another loan or because a financial covenant is broken due to the additional debt attributed to the dealer by signing the personal guaranty. As a result, a dealer must consider these potential limitations before signing a guaranty.

Is a personal guaranty reasonable based on the type of loan involved?

Before a dealer decides whether or not it is reasonable to sign a personal guaranty, the type of loan that is involved must be considered. Depending on the loan involved, a personal guaranty may be a very legitimate request by the lender or it may simply reflect an aggressive stance by a lender seeking to get as much collateral as possible. We address the most typical loan types that a dealership will encounter below. PLEASE NOTE: Even if a lender is not considered ñout of boundsò by requesting a personal guaranty, the dealer still needs to consider other factors before agreeing to give a guaranty, e.g., the economics of the loan itself, any limits on the guaranty and the actual terms of the guaranty.

- <u>Floorplan Financing</u>: Financing companies do not always require personal guaranties of this type of financing, although we are seeing an increase in lenders seeking personal guaranties. Because the financing is tied directly to collateral intended for re-sale, this type of debt is generally short term in nature (as it applies to specific collateral) and the lender has more assurances that it will be able to recover the loan by foreclosing on its security interest in the collateral because equipment inventory can be more easily liquidated then other collateral, either through a third party sale or manufacturer repurchase obligations. As a result of these factors and assuming the dealership has a good track record of payment, a dealer has justification to object to a personal guaranty for this type of financing.

- <u>Retail Financing</u>: If a dealer participates in a retail financing program, the lender may require the dealership to ñrepurchaseò the loan the financing company made to the dealershipôs customer. In situations where this occurs simply because a customer doesnôt pay, this obligation is called ñrecourse financing.ò If a dealership is involved in this type of financing, the lender might also seek a personal guaranty from the dealer. Our recommendation is that a dealer should not give a personal guaranty in connection with recourse financing. The reason is that it is the lender who is making the credit decision with respect to a customer and we do not think it is appropriate for the lender to allocate this risk to the dealer. In addition, unlike direct loans to a dealership, the dealer will have no control over whether a customer will default. As a result, there is a more risk associated with a guaranty in this type of financing.

- Acquisition Financing or Operating Lines: Personal guaranties are often reasonably required from dealers in connection with loans made to enable the purchase of another dealership or a general operating line of credit. In both cases, the collateral for the loans is often the non-inventory collateral, which is much harder to value and to sell in case of a default. As a result, the lender will have more risk. Acquisition financing also involves a lender assessing how a dealer will operate a new business. Since there is no direct track record involved, a lender may reasonably want some additional protection through a personal guaranty. Operating lines often involve a lender taking a security interest on assets that are junior to the interests of other lenders, creating another reason to require additional security that comes with a personal guaranty.

- Personally Guaranteeing Lender Mistakes: We have reviewed many loan documents from lenders over the years and have run into several situations in which the lender has attempted to make the dealership and the dealer personally liable for lender mistakes ï such as not timely filing a UCC Financing Statement. Such results are not evident in the reading of the personal guaranty itself. Rather this result arises from the interplay of provisions in several documents including the credit agreement and security agreement. Provisions like this are overreaching and should never be agreed to.

How should a dealer approach a personal guaranty?

When faced with a lender request for a personal guaranty, a dealer should consider the following questions before deciding how to respond to the lenderõs request:

- Is this the type of financing where personal guaranties are almost always required?
- Are there other lenders that may offer similar financing without a personal guaranty?
- Can the dealership make do without the financing? In other words, how significant is the opportunity we would miss without the financing vs. the additional risk associated with a personal guaranty?
- Are there specific personal assets that I could grant a security interest in instead of a general personal guaranty? Note that this may have a downside in that it makes the collateral completely unavailable for future use. A personal guaranty will not generally prevent a dealer from using individual property as collateral for other loans.
- Is there some level of financial risk that I am willing to assume?

Obviously, a dealer with the most options will be able to have the most conviction and success in refusing to sign a personal guaranty. But if the dealer is not that fortunate, he or she must then focus on (a) any limits that might be incorporated into a guaranty and (b) other terms that make the guaranty less onerous. (Please see the next section for more information.)

The following are some suggestions for dealers to consider when negotiating limits on personal guaranties with lenders:

- Cap. Seek to cap the overall liability to a fixed dollar amount.
- Burn Off. If part of the issue is lack of a track record or uncertainty of performance, consider offering to provide a guaranty for a limited period of time and/or until certain

mutually agreed upon financial objectives are achieved. Once these limits are reached, then the guarantee will ñburn offò or go away.

- Liability between Owners. A dealership with multiple owners that are each being required to give a personal guaranty may seek to limit the liability of each owner to a percentage of the debt owed (or in default). This may be particularly important protection to a dealer that is not actively involved in the day-to-day operations of the dealership.

Note that any combination of these topics can also be incorporated. For example, if a ñburn offò is agreed upon, the consequence of triggering the burn off is that a cap could be incorporated in the personal guaranty instead of an unlimited personal guaranty.

Other key terms in a personal guaranty

Not all personal guaranties are created equal and there are several specific provisions that should be studied before determining whether to sign a personal guaranty. Below are some of the more problematic terms that appear in ñtypicalò personal guaranties:

- Most forms make dealers personally liable for obligations of the dealership even if the dealership might have legal defenses to payment. Lenders include provisions that a dealerôs liability is unconditional and absolute. There is no justification for requiring a dealer to agree to be personally liable for charges that the dealership does not have to pay. Dealers should insist that they are only liable to the extent the dealership would also be liable.

- Some lenders ask for personal guaranties that make an individual liable in an amount that is disproportionate to an individualôs ownership interest. This is commonly referred to as ñjoint and several liability.ò A common protection tool among business owners is an agreement that each will only be obligated to pay off a guaranty in proportion to the ownership interest they have in the company. To enforce this, the owners agree between themselves that if one owner has to pay more than his share to the lender, the owner can require the other owners to make up this difference (often called a "right of contribution"). The guaranty must recognize this right of contribution and any limitation on these rights should be eliminated.

- The guaranty does not go away when a person dies. If heirs receive property following a dealerôs death, the property may be subject to the claims of the lender.

- Many forms require personal guarantors to provide whatever financial records that the lender may want to see at any time. Dealers should require this information to be specifically identified in the personal guaranty.

- A personal guaranty may say that the lender can share the dealerôs personal financial information as they see fit. This is NEVER acceptable. While it is appropriate for a lender to do credit checks on dealers that are personal guarantors, it is entirely inappropriate for a lender to be able to share whatever information they want with others.

- Many personal guaranties continue past the time when an individual has any interest in the dealership. In addition, some agreements allow a lender to declare the dealership loan in default based upon something as simple as a retirement of an owner.

- Personal guaranties often allow the lender to go after a dealer’s personal assets even though the lender has not pursued recovery from the dealership and/or repossessed and liquidated the collateral. In practice, most lenders will pursue remedies against all parties at the same time.

- Most personal guaranties also contain language that is designed to limit a dealer’s rights. These include provisions that strip away rights to jury trials as well as agreements to submit to a far-away jurisdiction that will limit a dealer’s ability to defend itself in a court of law.

- Some personal guaranties allow a lender to liquidate dealership collateral without notifying the guarantors. If the dealer is not actively involved in the dealership, it will be important for the dealer to require notice provisions in the guaranty or the loan agreement to make sure the dealer is aware of these circumstances.

- Many personal guaranties include representations and warranties that are not true. As a result, dealers must carefully review these and if there is a representation in the document that is not true, the dealer should require the representation to be changed or eliminated so that it is true.

Managing Risk

Because many dealers will have to sign at least one personal guaranty, it is important to also consider how dealers can manage the risks associated with a personal guaranty. The list below identifies some topics that should be considered in managing or limiting a dealer’s risks. Certain of the ideas relate to the dealership’s operations while others are focused on the dealer’s personal situation.

- Minimize the amount of debt on accounts subject to personal guaranties. This may mean carrying fewer products on your lot, but if a representative sampling of products are available for customers to view and inspect, lower inventories can be managed easier. If equipment can be delivered quickly directly from the manufacturer to meet customer demand, this can be a very effective way of limiting risk.

- Manage the number and identity of equipment lines carried. Since some manufacturers provide their own floor-plan financing, competition among manufacturers may be important to determining whether a personal guaranty will be needed. While dealerships will want to carry the products that are best suited for their customers, it is certainly appropriate to consider personal guaranties when deciding between relatively similar lines of equipment.

- Arrange alternative financing to move equipment off of the account that requires a personal guaranty. One of the advantages with some floor plans is that a dealer will receive a period that requires no interest payments or curtailments. To take advantage of these programs, a dealer can place equipment on the guaranteed account and then arrange for alternative borrowing once the equipment becomes due. If a dealer has access to financing from other lenders, such as a hometown bank, the amount of borrowings for which a personal guaranty is required can be minimized while the dealer continues to take advantage of manufacturer programs.

- Limit the likely pool of guarantors by limiting the number of owners. Lenders will often seek personal guaranties only from owners of the dealership, especially in connection with floor plan or retail financing. Because of this, limiting risk may be a reason not to own a dealership in the name of a husband and wife or with children. Depending on the applicable state, assets held jointly or in the name of a spouse will not be available to a creditor that has a personal guaranty from the other spouse. If a lender requests a guaranty from a dealerôs spouse, we recommend that a dealer strongly object.

- Evaluate personal assets and determine if they can be re-titled to a family member as part of a retirement or estate-planning process or if assets can be converted to assets that are more likely to be protected in the context of a bankruptcy proceeding. There is nothing inherently wrong with engaging in asset protection planning as long as it isnôt done with a fraudulent intent. The effectiveness of any such planning will vary widely based on the types of assets owned, the location of the assets and the owners and restrictions in any loan agreements or agreements with other owners of the dealership. For example, assets owned in a qualified retirement plan might not be subject to the reach of the lender under a personal guaranty. An in-depth discussion of asset protection planning is another topic for another day.