Have a business debt? Don’t think you’re immune from personal insolvency

They’ve been described as a business owner’s “Kryptonite”. But just how risky are personal guarantees?

It’s quite common for banks, specialist lenders and credit providers to ask the directors of an SME to provide a personal guarantee on business loans and credit (the term ‘personal guarantee’ is often interchanged with ‘director’s guarantee’). And with the volatility of the current economic climate, more and more lenders and credit providers are requiring personal guarantees.

More often than not, directors provide personal guarantees for their company’s debts. That can include:

- Finance on vehicles
- Debtor factoring / invoicing facilities
- Lending from financiers (e.g., overdraft, term loans)
- Credit application for the supply of goods

When it comes to small business, it’s not unusual for personal and business finances to be interlinked. But it’s important to understand that the use of personal borrowings and mortgage guarantees for business borrowings means household and individual financial vulnerabilities will increase. Traditionally, a large proportion of personal insolvencies may be a by-product of failed businesses.

We’ve seen many small business owners and/or directors of corporate entities go into bankruptcy because they’ve provided personal guarantees on business debts. In the event of a default on a loan or should the business go into external administration, typically if the creditor (guarantee holder) doesn’t receive sufficient funds from the corporate administration (i.e., a dividend), which is often the case, they look to other avenues to recover their debt. That means they can pursue the director for the debt owed by the corporate entity, and they can take steps to enforce the personal guarantees of the director. That can leave a director’s assets exposed – including any property they hold. While the corporate entity is a separate legal entity, a director’s personal guarantee provides additional security to the supplier for the debt. The result? The director could lose their assets or even risk going into bankruptcy.

Credit applications: read the fine print!

If it’s a prerequisite for your corporate entity to complete a credit application to be able to receive supply, review the application carefully. It’s common that personal guarantee clauses are contained within that credit application.

Some applications also provide the right for the supplier to lodge a caveat over the personal assets of the director – and that’s often the director’s home. And having it in joint names

doesn't automatically provide protection. The supplier usually still has the right to lodge a caveat over it. If you do intend to defend the equity in the jointly-held property, you'll most likely need to engage a solicitor to argue the point, which is an additional expense.

It's important to note, too, that it's possible the joint owners' equity in the home could be eroded by the amount of corporate debt that the director has guaranteed.

Tips for protecting your personal exposure

- If you're setting up a business / corporate entity, seek advice on the appropriate type of structure.
- Seek advice on how to structure personal assets and/or jointly held assets.
- Review every loan or credit application to understand exactly to what extent the personal guarantee is being offered.
- Negotiate and amend any document to limit your personal exposure to corporate debt (e.g., to a dollar value).
- Keep a register and copies of all documents/credit applications that have been signed and that contain personal guarantee clauses.

Ultimately, when you're starting or running an existing business, it's important to understand the risks and how to protect your assets and yourself. That's why speaking with a trusted adviser early on should be at the top of your list. Keep that Kryptonite at bay.

Andrew Mattinson
Principal – Jirsch Sutherland