Personal guarantees: for all the wrong reasons

Ieva Strunkiene looks at the growth of personal guarantees in Lithuania

IEVA STRUNKIENE
Associate with Triniti, Advocates, Vilnius, Lithuania; Winner of the Richard Turton Award in 2011

Personal guarantees are a very old form of security, used almost universally. Everyone is familiar with the concept of the director's personal guarantee. Generally this works to the benefit of the company by making it possible for the lender to advance necessary working capital.

However, in Lithuania, the standard practice of financial institutions granting credit is to require virtually all loans to be guaranteed[1] by the company's shareholders or managers. This is particularly the case of small and medium-sized enterprises. This article explores the failed logic and misleading results of such "security" for the banking sector.

Shareholder or manager's limits of liability

In the Republic of Lithuania, as in most of Europe, legal persons are divided into those with limited and unlimited civil liability. Where the property of a legal person with unlimited liability is insufficient to discharge its obligations, the members of the legal person shall be liable for its obligations while members of a legal person of limited liability are not liable. Sole trader enterprises and commercial partnerships are legal persons of unlimited civil liability.

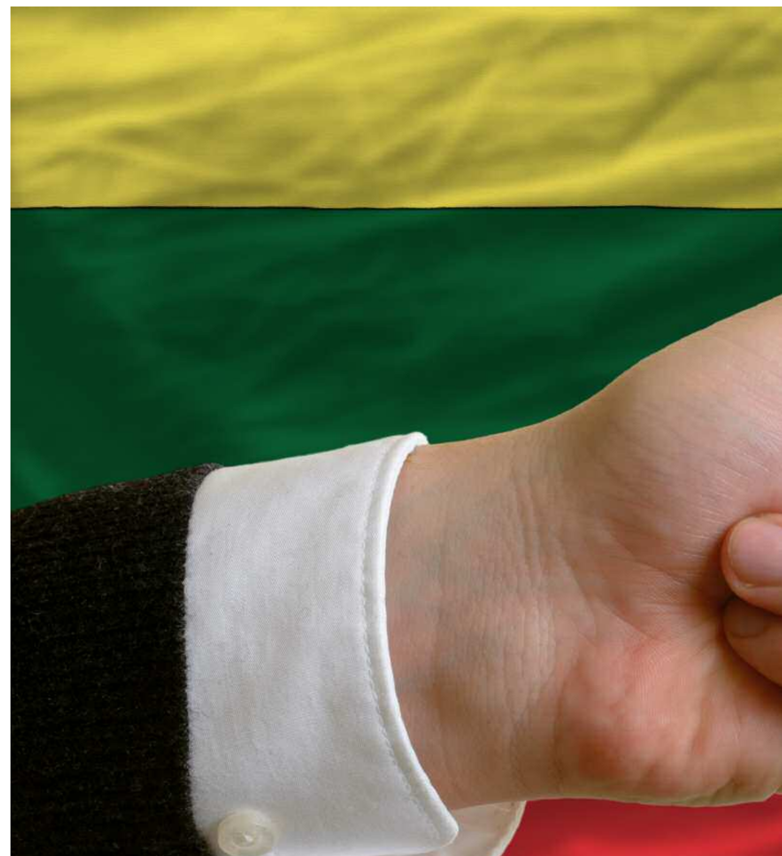
Since personal suretyship of a shareholder or the manager of the company is now a common feature of a credit relationship in Lithuania, the boundary between limited and unlimited liability legal entities blurs. As a result, the expectation of a member of a limited liability legal entity that his personal property will be protected in the case of business failure is illusory. The surety is liable to the same extent as the debtor for the payment of principle, interest and penalty and any compensation for damages[3].

The company's bankruptcy will not avoid obligations to the credit institution

Quite typically, the surety contracts used by Lithuanian credit institutions provide for the principal debtor and the guarantor to be joint debtors with joint and several liabilities whereby the credit institution is entitled to look to both principal debtor and guarantor and either one of them separately. Thus, the bankruptcy of the company is not going to avoid the surety's liability to the creditors.

The recent growth in personal guarantees and in personal bankruptcy

Recently, the volume of loans guaranteed by natural persons (as opposed to corporate entities) has



Share your views!

increased dramatically. In Lithuania, banks typically provide loans to small businesses and, in cases where the debtor is unable to provide the collateral of choice, real estate, the banks almost always require that the obligations be guaranteed. In 2015, sureties by natural persons were provided for 75 percent of loans to individual enterprises and over 30 percent of public and private limited liability companies. Moreover, in 76 percent of cases, the availability of an appropriate surety was the initial condition of credit institutions approached for the provision of a business loan. This means that for owners of small enterprises, the provision of a personal guarantee is the only means of obtaining access to the business finance.

The Bank of Lithuania has sought to establish the extent and reason for the growth in the use of guarantees as security for business loans and the significant increase in the proportion of business loans secured by personal sureties. In the period 2004 to 2009, this proportion increased from 4% to 20%, and in the period 2010 to 2014, business loans secured by personal sureties increased by a further 15%. Therefore, personal surety secured almost one in three business loans over the past three years.

Of course, the requirement for a surety has no negative consequences if the primary borrower fulfils the terms and conditions of the credit agreement. However, the analysis of the causes of bankruptcy of natural persons in 2013-2015 reveals that the granting of sureties for the obligations of others is the second greatest cause of the bankruptcy of natural persons (25%), closely related to the debtor's loss of his or her employment (55%). While the bankruptcy of the principal debtor will precede the bankruptcy of the surety, one can see the cumulative consequences of job loss and the illusory protection granted by sureties under the current system.

Who is to blame?

It would be easy to criticise the individuals agreeing to guarantee these loans but one must also challenge the banks. It would appear that commercial banks and other credit institutions do not properly evaluate the risks of granting credit to many borrowers: their enthusiasm to lend regardless of the risk of bad debts; without assessing the risk born by the guarantor, or the extent of their income or property that would be available to meet any claim made under their guarantee should the principal debtor fail.

According to the typical conditions of Lithuanian contracts of suretyship, if the debtor fails to perform the obligation, both the debtor and the surety shall be liable as solidary debtors to the creditor for the fulfilment of this obligation. The essence of solidary liability of borrowers is that the credit institution is entitled to require that both the principal debtor and the surety or either of them separately shall comply with the obligation. The Supreme Court of Lithuania has stated that, when a company faces the problems related with the credit payments, the credit institution has the right to immediately redirect the requirement to the surety and his property. And in this case, the natural person guarantor will not be able to offer the defence that the principal debtor has not failed; that he did not understand the obligations, made a mistake or was deceived, since the word “to guarantee” reveals its main meaning, i.e. to ensure, to secure.

There is no problem if the guarantor has sufficient assets to fulfil the suretyship obligations, or the income of the guarantor enables them to fulfil the obligations in the credit agreement, but in real life the obligations assumed by a company usually exceed the assets of a natural person, and the repayments under a credit agreement usually exceed the income of the natural person. Therefore, in such a situation, the

COMMERCIAL BANKS AND OTHER CREDIT INSTITUTIONS DO NOT PROPERLY EVALUATE THE RISKS OF GRANTING CREDIT TO MANY BORROWERS