

Personal guarantees

✓ What you need to know

Guarantors are people who agree to repay a debt that another person incurred if that person defaults. Company directors frequently guarantee debts of their company. If the company goes into liquidation or receivership the creditor may seek to recover what is owed from the guarantor. Professional advice should be sought.

Where the company has entered voluntary administration the creditor must await the outcome of the administration before pursuing the guarantor. If the outcome is unsuccessful the creditor is then free to pursue the guarantor for the debt. A Deed of Company Arrangement releases the company's obligation to pay the debt owed but it does not affect or discharge the liability of a guarantor and the creditor can seek to enforce their personal guarantee. Professional advice should be sought.

A case study

XYZ Limited is a limited liability company. Mark and Angela are directors and shareholders. They asked their neighbours Frank and Michelle to act as guarantors for the lease of XYZ Limited's business premises. Mark and Angela provided personal guarantees but the landlord wanted someone else on the lease to protect his interests. Frank and Michelle are told that if XYZ Limited defaults on the lease, Mark and Angela have to pay. If Mark and Angela cannot pay, Frank and Michelle will have to.

Confident in Mark and Angela's ability to make XYZ Limited a financial success and after receiving independent legal advice, Frank and Michelle sign as guarantors under the lease agreement.

XYZ Limited was initially a success but ran into financial trouble after the cancellation of a large international order. Mark and Angela are beside themselves with worry. Without an equally large order in the next two weeks, the company will be unable to pay any of its debts, including the lease.

Two weeks pass with no orders. Mark and Angela have invested everything in the company and have nothing personal left to sell and no way to raise credit.

The landlord is not paid so sends a reminder notice to the company, Mark and Angela and Frank and Michelle. The company does not pay.

The landlord asks Mark and Angela to pay. They explain they have no money. Other creditors start to press for payment. Mark and Angela have no choice but to pass a special shareholders' resolution placing the company into voluntary liquidation.

Mark and Angela have personally guaranteed a number of other company debts. Realising they do not have the money to pay any of the debts, they declare themselves bankrupt.

The landlord knows XYZ Limited is in liquidation and Mark and Angela are bankrupt. The landlord contacts Frank and Michelle about payment of NZ\$18,000 now owed under the lease agreement. Since neither the company nor Mark and Angela can pay, the landlord can pursue Frank and Michelle and threatens bankruptcy proceedings if they do not pay. Frank and Michelle refinance their mortgage and pay the NZ\$18,000.

Frank and Michelle now become creditors of XYZ Limited as they paid the company debt. They can make claims in both the liquidation and individual bankruptcies of Mark and Angela for the NZ\$18,000.