Lieb: The pitfalls of a guaranty on your next commercial lease

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By Andrew M. Lieb March 3, 2021

When should a business owner guaranty a lease?

Only when they must. However, that happens more often than you'd think.

Here is why and what you should consider when you are negotiating a guaranty on your next commercial lease.

A guaranty means that an individual, or other business, is vouching for the creditworthiness of a tenant under a lease. Stated otherwise, a guaranty exposes the guarantor to liability should the prime tenant breach their lease. As a result, a guaranty enables a landlord to sue the guarantor to enforce its lease.

In other words, a guaranty undoes all the advantages that an individual otherwise seeks in forming an entity (i.e., LLC or corporation) in the first place. It turns back the clock and makes the individual business owner personally liable for the wrongs of his or her entity with respect to the lease contract. So, why would a business owner ever agree to guaranty its entity's lease?

A guaranty is necessary for a commercial tenant when the tenant-entity lacks the resources to assuage the landlord's concerns as to whether it is incentivized to perform under its lease. A tenant is not incentivized to perform when it is judgment proof; where it has limited or no

assets and intends to simply dissolve as an entity upon the receipt of an adverse judgment. Simply, a commercial landlord necessitates a guaranty where it believes that its tenant has no risk in breaching its contractual obligations under its lease.

A lease is a contract and, just like every other business contract, it can be enforced by a lawsuit for a money judgment, which judgment is thereafter enforceable for the next 20 years and generates 9% statutory interest until it is satisfied. Yes, a lease is also enforceable by an eviction proceeding; to the extent that there are no current eviction moratoriums (current commercial moratorium expires on February 26, 2021), but it is primarily a contract.

A commercial lease is an agreement where the landlord exchanges space for a promise of future payments. The landlord can't charge more rent than is agreed upon in the lease, regardless of changing market conditions, and the tenant must pay rent for the entire lease term regardless of changes in its business or the overall market. A lease is a promise for a promise.

If the tenant's promise is meaningless, because its promise to make those future payments cannot be enforced, a guaranty is necessary. Otherwise, the tenant has no incentivization to satisfy its obligations under the lease. The tenant could close or relocate without exposure. So, how does a tenant avoid a guaranty?

To avoid a guaranty, a tenant needs to demonstrate its business entity's creditworthiness to its prospective landlord. If a business has tangible assets, contracts with third parties for future income, or a history of profitability, the business owner should provide proof of the same to the landlord in seeking to avoid a guaranty, or, at least, in avoiding a personal guaranty. Otherwise, where a business is judgment proof, its owner should expect to sign a personal guaranty.

A personal guaranty causes both the tenant and the guarantor to be exposed under the lease. Alternatively, a good-guy guaranty results in both the tenant and the guarantor being exposed under the lease, except that the guaranty is voidable should the tenant both be current on the lease and notice the landlord, in accordance with the formula set forth in the lease, of its intent to prematurely surrender prior to the end of the lease. Finally, a bad-guy guaranty means that only the tenant is exposed, except that a personal guaranty will spring into existence if certain scenarios materialize, such as an unauthorized business ownership transfer, a bankruptcy filing, or a million other possibilities.

As you can see, understanding why guaranties are sought and the alternatives available to a personal guaranty makes good business sense. To negotiate, businesses need to understand the why rather than just focusing on the what.

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