Private Placement Life Insurance and Personal Guarantees

Issue 7 – 5 March 2009

A lender who provides finance to a Business which is a separate legal entity to that of the Principal may want some form of security to make sure that the loan is protected and repaid — such as personal guarantees by individuals — in addition to the securities given by the business, being the separate legal entity.

The requirement of a Personal Guarantee maybe reasonable security because so many corporate entities only have a nominal number of shares at a nominal value (like the issue of two $1 shares) as their capital — or corporate entities are established as the trustee of a trust that holds the assets and is the borrowing entity.

A corporate entity may operate with assets worth many times the value of its potential nominal capital and its directors may be contracting debts, dealing in assets and involving their corporate entity in liabilities far in excess of the capital of the corporate entity.

As consequence of providing a Personal Guarantee the Principal may wish to protect their personal assets in the event of their untimely Death, Total and Permanent Disablement and Trauma by effecting Life Insurance.

What follows is an overview of Personal Guarantees and how such guarantees may need to be covered by Life Insurance.

Defining a Guarantee

A guarantee is a contract to answer for the debt of another, such as a director of a corporate entity promising to pay the creditor under a finance contract if the corporate entity defaults.

To enforce its debt or obligation, the creditor being the financier can sue the Principal debtor being the corporate entity for the contract debt because the debtor’s liability is primary, or the creditor can sue the guarantor that is the director of the corporate entity on the contract of guarantee as the guarantor’s liability is secondary.

Implication: Where a guarantee is provided consider utilising Life Insurance to provide liquidity in the event of Death, Total and Permanent Disablement or Life Insurance.

“All moneys” guarantee

An “all moneys” guarantee secures the amount that may be owing under the guarantee now and in the future. Because it is not for a fixed amount, the extent of the guarantor’s possible liability is uncertain.

Some all moneys guarantees have given rise to claims of unconscionable conduct and now

must be disclosed under the Code of Banking Practice.

Implication: Should a guarantor seek Life Insurance it is important that the quantum of liability be ascertained at the time of issuing of the Life Insurance and updated as future potential liabilities may be incurred.

Guarantee or indemnity

A contract of indemnity is another method by which a person's obligation can be secured by another person entering an obligation to pay.

Under an indemnity and in contrast to a guarantee the promisor intends to become directly responsible to the promisee. Under an indemnity, the promisor, indemnifier or surety undertakes to become directly responsible to the promisee, that is to the person indemnified for the action.

The difference between guarantee and indemnity is important.

(1) In a contract of indemnity the indemnifier (A) is under primary liability, whereas in a contract of guarantee the principal debtor (C) is primarily liable while the guarantor (A) is under secondary liability if the debtor defaults. In other words, because a guarantee arrangement involves three parties, it gives rise to primary and secondary liability, whereas there is only primary liability under an indemnity.

(2) In the jurisdictions where it applies, the Statute of Frauds requires contracts of guarantee to be evidenced in writing whereas contracts of indemnity can be oral.

In its widest sense, a contract of indemnity includes a contract of guarantee. The word "surety" includes both guarantor and indemnifier, but where appropriate in this discussion the generic "guarantee" is used to cover contracts of both guarantee and indemnity.

Implication: From a practical perspective representations from a client may be sufficient to ascertain quantum of cover unless the sum insured is large enough or sought for underwriting purposes in which case documentation will be critical.

Essentials of a guarantee

The essentials of a guarantee include:

- the Statute of Frauds requirement of evidence in writing
- the ability to fulfil all the requirements of a valid contract
- the Consumer Credit Code formalities – if obligations under a credit contract are guaranteed and the guarantor is a natural person or a strata corporation. If applicable, this legislation requires writing signed by the guarantor and other important formalities before a regulated contract can be enforceable:

The operation of the guarantee itself is a matter of negotiation, and it may be retrospective or prospective, limited or unlimited, conditional or unconditional, continuing with divisible consideration or continuing with indivisible consideration.

As discussed below, a guarantee may be set aside on grounds such as misrepresentation,

undue influence and unconscionability but a guarantee is not in itself a contract of the utmost good faith (as is an insurance contract)

Implication: Policy ownership is critical in respect to Contacts of indemnity and should be utilised especially if the indemnifier is an individual.

Rights and liabilities of Guarantors

Guarantor's liability

The guarantor is not liable to the creditor **until** there is an accrued liability such as default by the principal debtor.

Once the guarantor is liable, its liability must be the same as that of the debtor because the guarantor's liability is co-extensive with that of the debtor. If the debtor is a minor, the guarantor is still liable on the guarantee:

The conduct of the guarantor may be "misleading or deceptive" under s 52 of the *Trade Practices Act 1974 (Cth)* or Fair Trading Act equivalents.

The guarantor's liability arises when the principal debtor defaults. The guarantor is not entitled to any cross-claim available to the debtor against the creditor.

The duration of the guarantor's liability depends on the agreement — some guarantees are limited to a single transaction, and others, called continuing guarantees, cover a number of transactions over a period of time. Although the relationship of creditor/guarantor is not normally based on utmost good faith and is not normally fiduciary, there are a number of potential defences to liability open to a guarantor:

- Principal contract unenforceable. If the contract between lender and debtor is void, voidable or unenforceable — such as a claim for moneys which is void because it is unenforceable against the debtor as a penalty - the contract of guarantee will also be unenforceable against the guarantor;
- Misrepresentation;
- Undue influence; and
- Unconscionability, in equity as in Garcia's case, under s 51AA - 51AB of the *Trade Practices Act 1974* and Fair Trading Act equivalents, and under the Consumer Credit Code.

The Code of Banking Practice (2003) and in particular cl 25 sets out the standards of good banking practice to be aimed for in the case of guarantees.

Implication: Should a liability occur then liquid funds may be required to repay the liability. If a contingent event such as death occurs consideration needs to be given to whether the death proceeds should or could be available to creditors given the creditor provisions of the Life Insurance Act.

Guarantor's rights against creditor

Before payment to the creditor, the guarantor can require the creditor to approach first the principal debtor for payment. If this is unsuccessful and if the guarantor is required to pay, the guarantor is subrogated to the creditor's rights and can "stand in the shoes" of the creditor to sue

the principal debtor for indemnity. This includes the right to enforce all the rights of the creditor over the debt including an assignment of all judgments and securities of the creditor over the debt.

The creditor is under a duty to protect the interests of the guarantor by not modifying the principal contract without the express or implied agreement of the guarantor, but as yet there is no duty to maximise the guarantor's position. However, the creditor must not recklessly risk the position of the guarantor. The law expects of the creditor reasonable protection of the debtor's property and reasonable sale and realisation by the creditor of the debtor's property.

Implication: Care should be taken to ensure that if Life Insurance is utilised for outstanding payments to creditors then policy ownership is correctly structured.

Guarantor's rights against principal debtor

The guarantor can claim an indemnity from the principal debtor, which becomes a debt due once the guarantor has paid the creditor:

- After payment of the guarantee, the guarantor has a right against the debtor for payment known as its "equity of indemnity".
- If required to pay the creditor, the guarantor is subrogated to the creditor's rights to sue the principal debtor for indemnity (compare subrogation in insurance.
- If sued by the creditor, the guarantor can issue a third party notice against the debtor to claim an indemnity from the debtor.

Implication: Care should be taken to ensure that if Life Insurance is utilised for outstanding payments to creditors then policy ownership is correctly structured.

Guarantor's rights against co-guarantor

On the basis of natural justice and fairness, the law provides that a guarantor is entitled on equitable principles to contribution from co-guarantors in proportion to the amount guaranteed.

Example: Assume that there are three co-guarantors of C's debt of $30,000.

- If A1 has paid $10,000, A1 has no right of contribution and A2 and A3 remain liable for $10,000 each.
- If A1 has paid the whole $30,000, A1 can claim contribution from A2 and A3.
- If A2 is unable to contribute, for example due to bankruptcy, A1 can claim $15,000 from A3.

Guarantors of the same debt are bound jointly – jointly and severally (i.e. separately:), or severally (separately) – whether by the same or different documents, and whether or not they knew of each other – so they cannot usually avoid contribution.

Contribution may be avoided if the guarantors can show that they did not intend to become co-guarantors – for example by expressly contracting to be individually liable for their own share only.

Implication: In the event of guarantees been provided on a joint and several basis quantum of cover should be based on the full amount of the guarantee

and not on the % interest of the co-guarantor.

Discharge of guarantee

A guarantor will be discharged from its obligations under the guarantee — the guarantee will be terminated — by:

(1) payment — when the principal pays out (discharges) the guaranteed debt

(2) unenforceability of the primary obligation due to unconscionability, etc, as discussed at

(3) variation or material alteration of the principal contract between the creditor and debtor which could prejudice the guarantor

(4) Revocation of guarantee. A continuing guarantee with divisible consideration — e.g. goods supplied and to be supplied — can be revoked regarding liability for future transactions (i.e. goods to be supplied).

If allowed by the guarantee, a guarantor can revoke a single guarantee by notice, agreement, waiver and/or novation (substituting a new contract).

Revocation does not discharge the guarantor from liability which has already accrued.

If the consideration for the guarantee is indivisible and has been executed by the creditor (i.e. past consideration), the guarantee cannot be revoked without the consent of the creditor.

(5) A change in the constitution of a partnership (in the absence of an agreement to the contrary) in the case of a continuing guarantee given by a firm:

(6) Death of the guarantor. If the guarantor dies, in the case of future debts under a continuing guarantee, the estate of the deceased guarantor will not be bound (unless the guarantee provides otherwise). The death of one co-guarantor does not discharge the liability of the others.

Implication: Care should be taken to ensure that if Life Insurance is utilised for outstanding payments to creditors then policy ownership is correctly structured.

Conclusion

For more information about how ili can assist you to adopt skills and implementation tools in respect to Estate Preservation Planning and Business Succession Strategies please visit our website www.ili.com.au.

Copyright Notice

©ili.

All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, transmitted or copied in any form or by any means (graphic, electronic, mechanical, photocopying, microcopying, scanning or otherwise) except as permitted under the Copyright Act, without the prior written permission of ili . Any enquiries should be addressed to ili .

Disclaimer

This publication is designed to provide accurate information regarding the subject matter which it covers. It is distributed on the understanding that ili is not engaged in rendering professional or expert services or advice (legal, accounting, financial planning or otherwise). The information provided in this publication does not constitute such advice or services and should not be relied on as such. If professional or expert assistance is required, the services or advice of a competent person should be sought.

Neither ili nor its directors, employees, associates, agents or other representatives and affiliates are liable for any liability, loss, damage or injury arising from or in relation to the direct or indirect use of, or reliance on, the whole or any part of the information contained in this publication. Without limiting the generality of the above, neither ili nor its authors, consultants and writers are liable or responsible for anything done or omitted to be done by any person in respect to this publication.

For Further information please visit www.ili.com.au
or contact:
Melinda Wood - ili Enquiries
(02) 9251 3611
enquiries@ili.com.au