

RBI GUIDELINES ON PERSONAL GUARANTEE OF DIRECTORS WHERE LOAN RAISED BY COMPANY'S

Introduction

When someone (individual, corporate, company etc) go to the bank for loan normally bank insist for personal guarantees, third party guarantee, corporate guarantee and so. Many questions come in our mind e.g. why bank ask for such guarantees? What is its importance? The answer is simple to protect its interest and make the promoters more answerable and liable.

We may broadly say that lender normally ask for personal guarantee of promoter-directors which may serve the following purpose:

1. To make committed the promoters to check the borrower from default
2. The promoters cannot part themselves from the company without permission/Knowledge of lender
3. To make the promoters personally liable
4. Bring a system of self control so that speculations and personal gain may be checked as the lender put on stake the public money.

RBI Guidelines/directives

A. **In the following cases the bank/FI may waive to take the personal guarantee of directors subject to other terms & conditions**

1. When lending institution is satisfied about the management, its stake in the concern, economic viability of the proposal and the financial position and capacity for cash generation:
 - a. in the case of public limited companies: no personal guarantee need be insisted upon.
 - b. in the case of widely owned public limited companies (which may be rated as first class): guarantees may not be necessary even if the advances are unsecured.
2. Where the lending institutions are not so convinced about the aspects of loan proposals mentioned above, they should seek to stipulate conditions to make the

proposals acceptable without such guarantees. In some cases, more stringent forms of financial discipline like restrictions on distribution of dividends, further expansion, aggregate borrowings, creation of further charge on assets and stipulation of maintenance of minimum net working capital may be necessary. Also, the parity between owned funds and capital investment and the overall debt-equity ratio may have to be taken into account.

3. In the case of companies, whether private or public, which are under professional management, guarantees may not be insisted upon from persons who are connected with the management solely by virtue of their professional/technical qualifications and not consequent upon any significant shareholding in the company concerned. In this case the stakeholders having significant holding may be asked to give their personal guarantee.

B. In following cases bank normally ask for personal guarantee:

- I. In companies (whether private or public) where shares are held closely by a person or connected persons or a group (not being professionals or Government), irrespective of other factors, such as financial condition, security available, etc.

The exception being in respect of companies where, by court or statutory order, the management of the company is vested in a person or persons, whether called directors or by any other name, who are not required to be elected by the shareholders.

Where personal guarantee is considered necessary, the guarantee should preferably be that of the principal members of the group holding shares in the borrowing company rather than that of the director/managerial personnel functioning as director or in any managerial capacity.

- II. Even if a company is not closely held, there may be justification for a personal guarantee of directors to ensure continuity of management. It helps the bank/FI to put a check that the changes in management take place with their knowledge. Even where personal guarantees are waived, bank/FI normally asks for undertaking from the borrowing company that no change in the management would be made without the consent of the lending institution. Similarly, during the formative stages of a company, it may be in the interest of the company, as well as the lending institution, to obtain guarantees to ensure continuity of management.
- III. Personal guarantees of directors may be helpful with regard to public limited companies other than those which may be rated as first class, where the advance is on an unsecured basis.
- IV. There may be public limited companies, whose financial position and/or capacity for cash generation is not satisfactory even though the relevant advances are secured. In such cases, personal guarantees are useful.

- V. Cases where there is likely to be considerable delay in the creation of a charge on assets, guarantee may be taken, where deemed necessary, to cover the interim period between the disbursement of loan and the creation of the charge on assets.
- VI. The guarantee of parent companies may be obtained in the case of subsidiaries whose own financial condition is not considered satisfactory.
- VII. Personal guarantees are relevant where the balance sheet or financial statement of a company discloses interlocking of funds between the company and other concerns owned or managed by the same group.

C. Worth of the guarantors, payment of guarantee commission, etc.

Bank/FI herewith ensures that the system of obtaining guarantees should not be used by the directors and other managerial personnel as a source of income from the company.

Therefore banks obtain an undertaking from the borrowing company as well as the guarantors that no consideration whether by way of commission, brokerage fees or any other form, would be paid by the former or received by the latter, directly or indirectly.

Bank incorporates such requirement in its sanction letter. Also during the periodic inspections, the bank's inspectors verify that this stipulation has been complied with.

There may, however, be exceptional cases where payment of remuneration may be permitted e.g. where assisted concerns are not doing well and the existing guarantors are no longer connected with the management but continuance of their guarantees is considered essential because the new management's guarantee is either not available or is found inadequate and payment of remuneration to guarantors by way of guarantee commission is allowed.

D. Personal guarantees in the case of sick units

As the personal guarantees of promoters/ directors generally instill greater accountability and responsibility on their part and prompt the managements to conduct the running of the assisted units on sound and healthy lines and to ensure financial discipline, banks, may in their discretion, obtain guarantees from directors (excluding the nominee directors) and other managerial personnel in their individual capacities.

In case, for any reasons, a guarantee is not considered expedient by the bank at the time of sanctioning the advance, an undertaking should be obtained from the individual directors and a covenant should invariably be incorporated in the loan agreement that in case the borrowing unit show cash losses or adverse current ratio or diversion of fund, the directors would be under an obligation to execute guarantees in their individual capacities, if required by the banks.

Banks may also obtain guarantees at their discretion from the parent/holding company when credit facilities are extended to borrowing units in the same Group.