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Issues to Consider When a Revocable Trust Is a Guarantor

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A trust is a legal entity that is created by a person (the "grantor") to hold and manage assets "in trust" for the benefit of a designated beneficiary. There are two basic types of trusts: revocable trusts and irrevocable trusts. A revocable trust allows the grantor to change the terms of the trust at any time prior to his or her death, whereas the terms of an irrevocable trust are generally unable to be changed once the trust agreement is executed. This article will focus on the unique issues presented when dealing with a revocable trust as a guarantor on a loan.

Revocable trusts are a popular estate-planning tool because they provide a number of valuable benefits to the grantor. Such benefits include the ability to avoid probate upon the death of the grantor while maintaining the flexibility to amend or revoke the trusts at any time while the grantor is still alive. Given the various benefits of revocable trusts, some high-net-worth individuals may hold a majority of their assets through a revocable trust rather than in their own names. Consequently, when these individuals want to obtain commercial real estate loans, we often see them propose their revocable trusts as the guarantor on their loans. In these instances, the inclusion of the revocable trust as a guarantor will be necessary in order to have a deep pocket on the hook, but it also creates several concerns that lenders need to consider.

The first issue that lenders need to think about is how to calculate the net worth or liquidity of a revocable trust for purposes of both underwriting the loan and formulating any ongoing net worth or liquidity covenants for the guarantor. Because of the level of control that a grantor can maintain over a revocable trust, courts in most states treat revocable trusts as an "alter ego" of the grantor and do not allow individuals to use a revocable trust to shield their assets from creditors. As a result, in such states the revocable trust will not be treated as a separate legal entity and the assets of the trust will be available to satisfy the debts of the trust's grantor. If the grantor has liabilities that exceed his or her assets, the failure to consider the liabilities of the grantor when calculating the net worth or liquidity for the trust would result in an over-inflated valuation. Therefore, in order to accurately calculate the net worth or liquidity of a revocable trust, any liabilities of the grantor in excess of his or her assets should also be factored into the calculation.

The second issue that lenders need to consider is whether the revocable nature of the trust will impede their ability to collect on a guaranty if the trust is the only guarantor on the hook for the loan. If a lender makes a claim on a guaranty where the guarantor is a revocable trust and the grantor of the trust responds by revoking the trust, what happens to the assets of the trust? Will the lender still be able to collect against such assets even if the ownership of such assets reverts back to the grantor? Other types of commonly used legal entities (*e.g.*, limited liability companies) have to first undergo statutorily prescribed procedures for the liquidation of assets and winding up before dissolution. Such procedures typically require the repayment of creditors prior to the distribution of assets to its beneficial owners. Any transfer of assets outside these procedures to avoid the repayment of creditors would be easy to establish as a fraudulent conveyance in most jurisdictions. However, because revocable trusts can simply be revoked in accordance with the applicable trust documents, without undergoing any such statutorily mandated dissolution procedures, it opens the door to debate whether the transfer of assets back to the grantor due to the revocation of the trust constitutes a fraudulent conveyance. Although there is a persuasive argument that the revocation of a trust to avoid paying creditors should also constitute a fraudulent transfer, unfortunately this issue is an unsettled matter of law in most jurisdictions. Even if a lender is able to prevail on its claim that such revocation constitutes a fraudulent transfer, it may suffer significant delays and legal costs litigating the matter due to the scant legal precedent on the issue.

The good news is that Lenders can fairly easily address this concern by requiring the grantor for the trust to also sign onto the guaranty on a joint and several basis in their individual capacity. Although we have seen some pushback on this request at times, it should not be a controversial ask and, in our experience, is usually expected and accepted without objection. If the grantor is added in their individual capacity, this also solves the issue discussed above pertaining to calculating the guarantor's net worth or liquidity.