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Collecting From Guarantors

To sue and continue to trial or to settle That is the \$100.00 question

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I. Introduction

My topic is dear to the hearts of all credit officers, especially those in the special loans groups of our major financial institutions. I do not have a magical answer but hopefully my practical suggestions gained through my experience in numerous guarantee actions will be of assistance.

II. Move Quickly

It is imperative that once the decision is made to demand on a guarantee certain matters be addressed expeditiously. From my experience it is unusual for the credit officer making the decision to commence enforcement proceedings on the guarantee to have any personal knowledge of the circumstances under which the guarantee was given. Any knowledge of those circumstances, if it exists at all, can only be found from a review of the financial institution's credit file. In many instances the individuals having personal knowledge of the circumstances under which the guarantee was given are no longer employed by the financial institution. Thus, it is imperative that the credit file be reviewed **in depth** either by the credit officer or the legal counsel retained to handle the collection from the guarantor(s).

I know many of you believe such a review would be a wasted effort and an unnecessary expenditure of money on legal fees. However, I can assure you that such a review will in the long run lessen the burden of the financial institution's legal retainer. It is far better to know the weaknesses of one's legal position prior to engaging in legal combat than to be ambushed with an unanticipated legal position advanced by defence counsel. In the absence of success in securing a summary judgment, a financial institution's entire file will be made available to defence counsel through the discovery process and as such if there are time bombs in that file, it is better to know about it prior to making the decision to proceed with an action. From my experience, no criticism intended, there is always ammunition for the defence contained within a bank's file as credit officers, when putting pen to paper, tend to be

overly optimistic and use the English language somewhat loosely. The monthly or quarterly credit reports going up the chain of command are, from my experience, usually a gold mine for defence counsel. It is thus imperative that a financial institution's file be completely reviewed prior to the commencement of an action.

III. You Can't Get Blood Out of a Stone

Probably the first assessment which should be made prior to a decision being made to incur legal fees in pursuing collection on a guarantee, is whether the guarantor has the financial capacity to satisfy any judgment which may be obtained. You would be amazed by the lack of knowledge of financial institutions regarding guarantors of a debt. If they have any information it is usually 10 years out of date and more fiction than fact. Once again you will be faced with a creditor officer who usually has no personal knowledge about the guarantor and usually will be relying on outdated information contained within the file. If the guarantor is not anticipating a demand upon his/her guarantee, one should attempt to obtain an updated financial statement from the guarantor. Once that information is obtained attempts should be made to verify the financial information provided by the guarantor. From my experience verification is rarely done which is in my view a drastic mistake. If a guarantor does not have the financial resources to satisfy a judgment on the guarantee, why sue? In such circumstances I recommend to my clients that they not waste their financial resources on legal fees, but rather, recover what they can through settlement by using the threat of legal proceedings as leverage.

In the absence of current and reliable information about the guarantor's financial liability one should secure a Dunn & Bradstreet report or other such credit report, conduct PPSA searches to ascertain whether the guarantor has given a security interest in an asset to another creditor and conduct execution and bankruptcy searches. If real property is owned by the guarantor, or purported to be owned, a search of title should be conducted. You would be amazed at the number of guarantors who list as an asset their family home when that asset is registered in the name of their spouse.

IV. The Guarantor - The Person

It is important to assess the knowledge of the guarantor with respect to the debt guaranteed. To my mind there is a substantial difference when one is faced with an action against what I classify as an "accommodation guarantor" versus a guarantor who is and has been actively involved in the business obligated to pay the primary debt. To my mind the number of legitimate defences which can be put forward by an accommodation guarantor are somewhat more in number than that which can be

advanced by a guarantor who has specific knowledge of the primary debt. The most common defences put forward by accommodation guarantors are *non est factum* or a lack of knowledge regarding the guarantor's ongoing obligations for the debt. To my mind both are actual defences. The success of a *non est factum* defence in guarantee cases has been greatly lessened as a consequence of independent legal advice certificates. Accommodation guarantors will in many instances argue that it was their understanding that the guarantee was for a specific loan in a specific amount. As we all know a guarantee may be either specific or continuing. A specific guarantee is a guarantee for a particular transaction and usually for a specified sum. Repayment of the specified sum discharges the guarantee. However, the more common form of commercial guarantee is the continuing guarantee. Under such a guarantee the guarantor's liability is not fixed but varies according to the amount owed at any time.

Whether a guarantee is a continuing guarantee is a question of interpretation of the language used in the guarantee. However, if a court is uncertain about the correct interpretation of the language used in the guarantee, extrinsic evidence and subsequent conduct to determine the intention of the parties may be resorted to assist with respect to the interpretation. In the recent Ontario Court of Appeal decision in *Montreal Trust v. Birmingham Lodge Ltd.* (1995), 24 O.R. (3d) 97 (C.A.), Laskin, J.A. stated:

"All these cases turn on the specific language of the document being considered. The mere inclusion of the phrase such as 'the guarantor shall be considered as primarily liable' is not determinative. A court should examine the entire document to ascertain the parties' intention. If the court is uncertain about the correct interpretation, it may resort to extrinsic evidence to assist it."

Continuing at page 108 of Justice Laskin's reasons for judgment he stated:

"Subsequent conduct may be used to interpret a written agreement because it may be helpful in showing what meaning the parties attach to the document after its execution, and this in turn may suggest that they took the same view at the earlier date."

When conducting the file review discussed above one should have in mind extrinsic evidence such as correspondence, notes of conversations or documentation signed by the guarantor which can be presented as evidence of the guarantor's knowledge and understanding of his/her legal obligations under the guarantee. If an I.L.A. Certificate was obtained, one should make a note of that fact to ensure that the lawyer's I.L.A. file is produced in the litigation if such a defence is raised. A financial institution is not obliged to explain a guarantee paragraph by paragraph. See: *Royal Bank of Canada v. Beswick Electric Ltd.* (unreported: Ontario Court (General Division),

September 15, 1995, Gotlib J.). However, if notes exist of what explanation was given to the guarantor prior to the signing of the guarantee, such should be maintained for important extrinsic evidence to rebut what I classify as the lack of knowledge defence.

With accommodation guarantees anticipate the lack of knowledge defences. With knowledgeable guarantors anticipate estoppel, waiver, misrepresentation and improvident realization defences with respect to the primary debt.

V. The Language of the Guarantee

Historically, during hard economic times the common law courts have gone to remarkable lengths to accommodate the complaints of guarantors. In response to this judicial tendency, creditors, through the services of their corporate lawyers, have attempted to draft guarantees which provide for all possible contingencies. The end result is a standard form guarantee which is comprised of a long list of highly specific legal jargon which is beyond the scope of understanding of the average lay person. It is this legal boilerplate gobbledegook which, in my humble opinion, has forced our courts to make some of the remarkable decisions which they have made in circumstances where it would be inequitable to enforce a guarantee upon a guarantor who clearly had no understanding of the document being signed. From a practical point of view I would suggest that financial institutions have their guarantors sign their standard form guarantee, which no reasonable lay person could ever understand, but at the same time do a covering two paragraph letter in providing a copy of the guarantee confirming the guarantor's understanding of the extent of the guarantor's liability. However, more frequently there are guarantees being drafted which do not follow the standard format used by most financial institutions, the terms of which have been developed over time to respond to judicial decisions. If the standard format of guarantee is not that which you are faced with, one should review it carefully so as to anticipate defences which might be available which would not normally be available. The one standard provision which comes to mind and which is of utmost importance in most guarantee actions is the provision excluding equitable defences afforded a guarantor.

Equity confers on guarantors a number of rights which creditors must respect at the risk of losing recourse to their guarantees. There are also a bewildering array of defences that seem to be available to guarantors in response to claims by creditors for payment or performance under their guarantees. Generally, a creditor may not do anything which prejudices the guarantor's rights of contribution from co-guarantors or rights of indemnification from the principal debtor. As well, a creditor cannot, without affecting the guarantee, vary the risk assumed by the guarantor at the time the guarantee was given. If the creditor fails to respect these rights or varies the guarantor's risk, the guarantor will be relieved from liability to the extent of the prejudice suffered.

It is a fundamental principle that the parties to an agreement are free to structure their relationship as they desire; they may allocate rights and duties between themselves in any manner they see fit. Accordingly, all of the rights and defences of a guarantor may, in principle, be excluded by express or implied agreement. Moreover, the courts will usually enforce such waivers. The Supreme Court of Canada made this abundantly clear in *Bauer v. Bank of Montreal* (1980), 110 D.L.R. (3d) 424 [hereinafter *Bauer*]. In that case, Mr. Justice McIntyre clearly recognized (at p. 427) that a guarantor's rights and equitable defences can be effectively excluded by provisions in a guarantee agreement: Despite this rule, it is open to the parties to make their own arrangements, and a guarantor is competent to contract himself out of the protection of the equitable rule requiring preservation of his security."

The Supreme Court of Canada's decision in *Bauer*, is a landmark case in the law of guarantees. Subsequent to *Bauer*, a considerable number of decisions have precluded guarantors from relying on their traditional rights and defences simply because of the presence of a waiver in the guarantee agreement. Included in these decisions are several appellate level decisions.

In *Bank of Montreal v. Soja* (1982), 14 A.C.W.S. (2d) 298 (Ont. C.A.), [hereinafter *Soja*] the guarantors alleged that the bank had failed to realize upon some of the inventory subject to its security which would have satisfied the debt owed. At trial, there was no specific finding of fact as to whether the inventory left behind had any realizable value. The Court of Appeal held that, even if the inventory had been substantial, the guarantors would not have been permitted to raise the equitable defence of negligent realization. The court concluded that if the terms of the guarantee provided the bank was not obligated to exhaust its recourse against the principal debtor or the security, then, according to *Bauer*, the guarantors were prevented from raising a defence of improvident realization of the security.

Similarly, in *Roynat Limited v. Denis* (1982), 18 B.L.R. 259 (Sask. C.A.), [hereinafter *Roynat*] the guarantors argued, *inter alia*, that they should be relieved of liability under the guarantee agreement because the creditor had acted unreasonably and negligently in operating and disposing of a hotel. The trial judge found that there was no factual basis to support the guarantors' allegations and the Saskatchewan Court of Appeal was unwilling to disturb this finding. The court, however, went further and held that, even if the evidence did support a finding of negligence on the part of the creditor, the guarantors would be unable to rely on negligence as a defence because, under *Bauer*, the terms the guarantee precluded the defence. To the same effect is the decision of the British Columbia Court of Appeal in *Bank of British Columbia v. Butterfield* (1984), 25 A.C.W.S. (2d) 366 (B.C.C.A.) in which the issue was disposed of in the following terms:

The only defence suggested in the material placed before the court was that the plaintiff had released or abandoned some securities it held. The guarantees permitted the bank to deal with or fail to deal with securities and allowed the bank to give up, modify, or abstain from perfecting or taking advantage of any securities.

Unless we are to overrule *Bauer v. Bank of Montreal*, a decision of the Supreme Court of Canada, there is simply no arguable defence [emphasis added].

This is not to suggest, however, that the courts will always enforce a guarantor's waiver of rights in a guarantee. The courts have long recognized that the mere fact that a guarantor did not fully understand the terms of the guarantee would not necessarily make the guarantee unenforceable. Consequently, in *Stewart and McDonald v. Young* (1894), 38 Sol. Jo. 385 (Q.B.), Mr. Justice Wills stated:

If the defendant had understood the words of the guarantee he would not have entered into it, and the language carried more perhaps than the parties contemplated, but that is no reason for reading into the guarantee words which I should have to do to hold the guarantee discharged.

Nor will the courts intervene to discharge a guarantor from a guarantee which has become more onerous than the guarantor intended, unless there is evidence of undue influence and duress: *Bauer, supra*, at 429-30.

Moreover, if a waiver clause appears to be unusually broad in its scope, such that its effect is to permit much more than a simple variation of an ordinary term of a guarantee (as, for example, a blanket waiver which eliminates all of a guarantor's rights and defences), then that clause, if ambiguous, will be subject to the *contra proferentum* rule of construction: *Bauer, supra* at 428 (see also Mr. Justice McIntyre's categorization of exemption clauses into three major groups). The *contra proferentum* rule is a principle of construction which provides that ambiguous clauses in a document are to be construed against the party who prepared it.

Strict interpretation of waiver provisions, which amount to exculpatory clauses, is clearly justified. K.P. McGuinness, *The Law of Guarantee: A Treatise on Guarantee, Indemnity and the Standby Letter of Credit* (Toronto: Carswell, 1986), c. 4 - 5 at p. 299 has explained the reason for giving such provisions a narrow interpretation, in the following manner:

It is one thing to say that a party may, if he so chooses, agree to assume an excessive burden and to waive the rights which the law generally recognizes as existing for his protection; it is quite another thing to assume that the parties necessarily intend to enter into such obligations. The more natural assumption is the exact opposite. Where the guarantee was drafted by the creditor and there is any ambiguity or impression in the terms of a provision which purports to limit the rights of a surety, it is only fair that the ambiguity be resolved against the party who prepared the document. If the creditor wishes to take away a right belonging to the surety, he should use clear language in the document.

There is strong authority for the view that waiver clauses that permit a creditor to deal with the debtor, guarantor or securities in any manner the creditor sees fit, must be construed as extending only to lawful dealings: *Bank of Montreal v. Wilder*, [1986] 2 S.C.R. 551, aff'g (1983), 149 D.L.R. (3d) 193 at 231 (B.C.C.A.), per Lambert J.A. [hereinafter *Wilder*]; *Bank of Nova Scotia v. Ham*, [1986] 5 W.W.R. 249 at 259-60 (Sask. C.A.); but see *Royal Bank of Canada v. McMurchy* (1986), 70 A.R. 295 (C.A.) [hereinafter *McMurchy*]. In *Wilder*, for example, over a number of years, guarantees had been given by family members to cover loans to the family's companies. In June 1975, in order to resolve various cash flow problems, the bank agreed to increase the company's credit, to honour the company's cheques and to forbear from demanding repayment of its loans for a certain period of time. In return, the family members were to inject new capital into the company and to provide further guarantees. The capital infusion was made and a guarantee was given but the bank, nonetheless, immediately ceased to honour the company's cheques. Shortly thereafter, the bank served a demand on the company at 11:40 a.m. for payment to be made by noon of the same day. Later that same day the bank appointed a receiver who took possession of the company's assets.

The bank's breach of its agreement with the guarantors was held by the Supreme Court of Canada to have increased the guarantors' risk, impaired their security, and placed the debtor out of business and into bankruptcy. The court further held that the bank's breach of the agreement discharged the guarantors. The bank was not protected by the provision in the guarantee which allowed it to deal with the debtor, guarantors and securities as it saw fit. The court held that the type of dealings contemplated by the clause were only those which were legally permissible and did not include wrongful or improper dealings such as the bank's breach of contract.

In summary, therefore, courts can generally be expected to give effect to a waiver of rights provision in a guarantee, absent considerations of undue influence or duress in the formation or execution of the guarantee. If such a provision is considered to be an exemption clause, however, it may be strictly construed against the creditor. Finally, where a waiver of rights provision is valid, the courts are unlikely to permit it to protect the creditor from wrongful or improper conduct.

VI. Summary Judgment

In almost every case on which I have acted for a financial institution on a guarantee action, I will always recommend a summary judgment motion after completion of pleadings. I make such a recommendation, firstly to avoid legal costs and secondly to hopefully avoid production of the bank's entire credit file. The production of the bank's credit file may enable defence counsel to put forward further defences which have little merit in law or fact and is a great administrative expense to the financial institution. One of the great tragedies of our alleged court reform which took place several years ago was the doing away with the Specially Endorsed Writ of Summons which obligated the defendant to raise a legitimate defence from his or her knowledge. This prevented a fishing expedition by defence counsel within the bank's files. If a defendant had a defence to a guarantee action, it was the obligation of the defendant to put his or her best foot forward and convince the Judge that a legitimate defence of merit had been put forward which should proceed to trial. In many jurisdictions that is still the procedure that a defendant must raise a legitimate defence prior to the action proceeding in the normal course. The summary judgment process has further overburdened our courts and added great legal expense to get to the same place as one would have been under the Specially Endorsed Writ of Summons' procedure. Court reform with respect to summary judgments was not a reform at all, but rather, it was a step backwards.

However I still employ the summary judgment procedure as a consequence of several recent decisions where the plaintiff was not required to deliver an affidavit of documents in the face of a summary judgment motion. Justice Rosenberg in the *Bank of Montreal v. Negin* (unreported: Ontario Court (General Division), January 13, 1995) stated at page 2:

"Attempting to substantiate their evidence by finding documents in the possession of the plaintiff was not appropriate on the summary judgment motion. It constituted a fishing expedition in an attempt to find other defences."

Thus, it appears that where a plaintiff moves for summary judgment there is no right (despite what the rules appear to say) for a defendant to demand an affidavit of documents and copies of listed productions. (Similar findings were made in the following two unreported decisions: *Royal Bank of Canada v. Richwill Oshawa Development Ltd.* (Master Clark, August 1992) and *Bank of Montreal v. Vih* (Master Sandler, April 15, 1992)).

VII. Conclusion

In summary, I record my practical advice in point form as follows:

1. Review the financial institution's credit file with a view to ascertaining the circumstances under which the guarantee was given, the knowledge of the guarantor respecting his or her legal obligations under the guarantee and, most importantly of all, to ascertain whether the guarantor has the financial resources to meet the demand made upon the guarantee.
2. If you have no knowledge as to the financial capacity of the guarantor, secure a Dunn & Bradstreet/credit report and conduct execution, bankruptcy and PPSA searches. In addition conduct a title search of any real property allegedly owned by the guarantor. Attempt to get current financial information directly from the guarantor.
3. If the guarantor appears to be judgment proof, to avoid unnecessary legal costs, attempt to negotiate a settlement under the threat of litigation. Something is better than nothing.
4. If a decision is made to proceed with litigation, I would still recommend to my clients that subsequent to demand being made settlement discussions take place primarily to avoid unnecessary legal costs. One should have in mind a net recovery keeping in mind what it costs to proceed with litigation these days.
5. If a settlement cannot be concluded, an action should be commenced and your lawyer should be under instructions to prosecute it expeditiously.
6. To avoid unnecessary costs and through the production of the bank's file, a summary judgment motion should be launched with a view to hopefully securing summary judgment on the guarantee.

Guarantee law is not entirely clear in that this area of law is continuing to evolve and is more factually oriented than determined as a consequence of legal principles. The evidence in guarantee actions is far more important in the ultimate decision. Accordingly, financial institutions should be more particular and careful at the time the guarantee is given than, from my experience, they have been. Mistakes five or 10 years prior to demand being made on a guarantee ultimately come back to impair its enforceability. Uncertainty will always prevail in this area of law by reason of decisions resting more on the evidence than on the developed legal principles. It is for

that reason that one should cross their T's and dot their I's at the time the guarantee is given.

About the author

Peter Greene is a founding partner of Affleck Greene Orr LLP. He practises commercial litigation, with an emphasis on surety, fidelity and dishonesty bond claims, banking and securities litigation.