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RECENT DEVELOPMENTS IN THE LAW OF GUARANTEES

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Guarantees are curious things. They are contracts in which the surety's consideration is normally that the creditor agrees to contract with a third party. It is assumed that, given their relationship, the surety ***wants*** the creditor to contract with this third party on the terms proposed. Often this is true, but the law mandates no actual inquiry before the surety is bound.

Because of this, the law has traditionally been rather protective of sureties. Numerous legal and equitable rules have been developed to protect them from the potentially onerous liability that a guarantee may entail. These rules, however, cannot change the fact that guarantees are contracts. Sureties and creditors may agree to dispense with most of the protections that the courts have devised. The result has been an arms race in which creditors (through their counsel) devise increasing broad contractual language in an attempt to bind sureties to the principal's obligations, while sureties' defence lawyers work equally hard to find new defences.

This article considers three aspects of law of guarantees, with reference to three recent appellate decisions. It considers: (i) what a creditor needs to do to make a claim on a guarantee, (ii) how a surety can protect its rights when paying on a guarantee, and (iii) the current state of the law on the effect of a variation to the underlying obligation. Before considering these topics, however, we pause to review what guarantees are.

FORMALITIES – WHAT GUARANTEES ARE

A guarantee is a promise by one person (the "surety") that a second person (the "principal") will fulfil his or her obligations to a third person (the "creditor"). Usually, and especially in the banking context, the underlying obligation is a loan. If the principal defaults on the loan, then the surety must pay it – subject to the terms of the guarantee.

Guarantees are a species of contract, subject to the general law of contract. This includes the law of contractual interpretation, the parol evidence rule and, of course, the requirement for consideration.

The type of consideration given for a guarantee is particularly important. As noted in the introduction, many sureties provide the guarantee in order to obtain a benefit for the principal. Often, these sureties are husbands or wives guaranteeing their spouse's business, or parents guaranteeing their child's venture. For such sureties, who are referred to as "accommodation sureties," the actual benefit is really rather ephemeral, and frequently in hindsight often quite disproportionate to the surety's liability. For this reason, the law can be quite protective of accommodation sureties.

There are also sureties who are in the business of providing guarantees for profit. Such sureties have been referred to as "professional sureties." They have found themselves held to a higher standard at law.

Regardless of the type of surety, it is a requirement of the *Statute of Frauds*[1] that the guarantee "or some memorandum or note thereof" be in writing and be signed by the surety. The absence of a written guarantee will normally be fatal to any attempt by the creditor to enforce the guarantee.[2] However, equity has prevailed over the statute of frauds in at least one case. In *Hatch Associates Ltd. v. Dual Removal Systems Ltd.*,[3] the court held that a surety may be estopped, in extraordinary circumstances, from relying on the *Statute of Frauds* to invalidate a guarantee where the surety has deliberately failed to sign a guarantee despite undertaking to do so.

Apart from the requirements of the *Statute of Frauds*, most provinces have not imposed any other statutory formalities on the making of guarantees. Counsel should be aware, however, that additional formalities do exist in Alberta (pursuant to the *Guarantees Acknowledgement Act*[4]) and Saskatchewan (pursuant to the *Saskatchewan Farm Security Act*[5]). The former is uniquely burdensome, and dangerous to the unwary. The *Guarantees Acknowledgement Act* requires that a prospective surety acknowledge his or her obligation under guarantee before a lawyer, who must then confirm the acknowledgement by endorsement on the guarantee agreement. The failure to obtain the acknowledgement will render a guarantee unenforceable.

MAKING A CLAIM ON A GUARANTEE

Since a guarantee is a form of contract, the normal rules of contractual interpretation apply: the intentions of the parties as to the obligations of the surety are to be found in the language of the guarantee itself.[6] In many cases, a guarantee will set out a procedure to be followed when a claim is made - such as a requirement that the creditor make a demand for payment to the principal, or give a notice of default to the surety prior to enforcing a claim. If contained in the guarantee, such a requirement may be found to be a condition precedent to a claim by the creditor under the guarantee.

The recent decision of the BC Court of Appeal in *0867740 BC Limited v. Quails View Farm*[7] is instructive. In that case, the

[1] R.S.O. 1990, c. S-19, s. 4 and 5
[2] See, for example, *Entry Point Investments v. Invis Inc.*, 2015 ONCA 701 at paragraph 10
[3] 1998 CanLII 4840 (ONCA)
[4] R.S.A. 2000, c. G-11
[5] S.Sask. 1988-89, c. S-17.1
[6] *Whitby Landmark Development Inc. v. Mollenhauer Construction Ltd.*, 2003 CanLII 50085 (ONCA) at paragraph 16
[7] 2014 BCCA 252

plaintiff had contracted to build a trailer park for the corporate defendant, whose obligation to pay the plaintiff was guaranteed by the individual defendants.

After default by the corporate defendant, the plaintiff sued the sureties without making a separate prior demand for payment. The guarantee was payable on demand. The sureties defended on the basis that no demand had been given. The plaintiff argued that their pleading itself was the demand.

The BC Court of Appeal held that in the absence of a formal demand to the sureties, the claim against them was premature. In coming to this conclusion, the Court noted that the defendants were accommodation sureties who are entitled to the strict benefit of the protections available to them. As the court noted, at paragraph 61:

> The personal appellants concede that their position is very technical. That does not make it less valid. … it cannot be assumed that if a demand had been made prior to action being commenced no defences would have been open to the personal appellants.

The decision of the BC Court is consistent with the law in Ontario. In *Bank of Nova Scotia v. Williamson*,[8] the Ontario Court of Appeal held (at para 13):

> Where the obligation of a third-party guarantor is to pay on demand, then demand is a condition precedent to that obligation. The rationale is that where the guarantee obligation is made on demand, the third-party guarantor is given an opportunity to marshal the funds before the obligation is due.

The failure to make a demand to an accommodation surety will normally be fatal to the enforceability of a guarantee that is payable on demand. The situation is different, however, for professional sureties.

In *Citadel Insurance v. Johns-Manville Canada*,[9] the Supreme Court of Canada has held that professional sureties are not entitled to the strict protections that are afforded to accommodation sureties. A failure to give demand, or to observe other conditions of the guarantee, will only defeat a claim against a professional surety if the latter has suffered actual prejudice as a consequence. Justice McIntyre wrote, for the court (at p. 524):

> It is my view, however, that the rules which have been applied to accommodation sureties are in many ways unrealistic and inapplicable to cases where professional sureties, in the course of their ordinary business, undertake surety contracts for profit and thereby approach very closely the role of the insurer. The basis of the surety's liability must, of course, be found in the bond into which it has entered, but in the case of the compensated surety it cannot be every variation in the guaranteed contract, however minor, or every failure of a claimant to meet the conditions imposed by the bond, however trivial, which will enable the surety to escape liability. Where, as here, the object of the notice provisions in the bond has been fully achieved within the time limits imposed and where there has been no prejudice whatever to the appellant, the whole purpose for the obtaining of the bond would be defeated if the appellant were to be discharged.

If the creditor does seek to realize against the principal's assets, it must do so in a commercially reasonable manner. This obligation too may be waived by agreement between the creditor and the surety.[10] Even where this obligation exists, however, it does not apply to the lender's decision whether or not to enforce its contractual rights in the first place. Thus a surety has no right to challenge a creditor's decision to force a receivership rather than to permit an insolvent principal to be sold as a going concern.[11]

In the absence of a contractual requirement, however, there is no obligation on the part of the creditor to bring an action or to seek to collect from the principal before making a claim against the surety.[12] Nor is the surety entitled, as a matter of law, to be notified of the principal's default before a claim is made against the surety.[13] An action to enforce the guarantee may also be brought separately from any action to enforce the principal debt (if indeed such an action is even brought). Actions on guarantees are frequently resolved on motion for summary judgment, and the new rules in Ontario have only increased this trend.

SURETY'S RIGHTS WHEN PAYING A CLAIM

The *Mercantile Law Amendment Act* provides that, on payment of a claim, a surety becomes subrogated to the rights of the creditor as against the debtor and any co-sureties.[14] As a general, rule, this means that a surety who honours a guarantee may seek contribution against any defaulting co-sureties. There are, however, important limits to this right.

Can-Win Leasing (Toronto) Limited v. Moncayo[15] was a case in which the Ontario Court of Appeal refused to permit a surety to recover against his co-surety, because the court said payment of the debt had been premature.

In that case, the two co-sureties had guaranteed the debts of their jointly-owned truck company. In addition to the guarantees, these debts were also secured against certain real estate. One of the co-sureties became concerned about the possibility that the bank may try to realize on the security against the real estate, which he did not want to risk happening. So he decided to pay out the loan

[8] 2009 ONCA 754
[9] [1983] 1 S.C.R. 513
[10] *Toronto-Dominion Bank v. McCowen*, 1995 CanLII 1322 (ONCA); *Business Development Bank of Canada v. Druckmann*, 2015 ONSC 1517
[11] *Fifth Third Bank v. O'Brien*, 2013 ONCA 5
[12] *Global Food Traders Inc. v. Massalin*, 2015 ONCA 362
[13] McGuinness, Kevin; The Law of Guarantee, 3d ed. (LexisNexis, Markham: 2013)
[14] *Mercantile Law Amendment Act*, R.S.O. 1990, c. M-10, s. 2(2)
[15] 2014 ONCA 689

himself. He then turned to his co-surety and demanded to be reimbursed for the latter's share.

The court observed that a guarantee is a secondary and contingent liability. It is secondary to the primary obligation of the principal. It is contingent on a default by the principal. At its earliest, therefore, liability under a guarantee may only arise once there has been a default by the principal (and if it is a demand guarantee, after a demand has been made).

In this case, the principal was not in default. The result was that the co-surety who paid the loan was held to be an officious volunteer. Although he had paid the loan, he had no right to seek contribution from the co-surety.

On a practical level, this result makes intuitive sense: if a co-surety were able to subrogate itself at will to the rights of the creditor, and by doing so to force the other co-sureties and the principal to pay the debt, the co-surety would in effect have the right to accelerate the loan. This would mean that a co-surety could create liabilities for the others than would be more onerous (in the sense of being more immediate) than the liabilities under the primary obligation. The principal would be exposed to a liability it might otherwise be able to avoid.

A co-surety must therefore be very careful not to act prematurely. He or she must wait until the liability under the guarantee has crystallized.

The court did admit of one limited exception to this rule: where the failure of the principal is inevitable, a surety may pay out on a guarantee to "stop the bleeding" if doing so will not disadvantage the co-sureties. The onus of proving this, however, lies on the co-surety who pays out the loan.

Where the right to contribution does arise, it is limited to contribution by the co-surety of that proportion of the total debt for which it "is justly liable."[16] The proportion of just contribution may be set by agreement between the co-sureties. In the default, each will bear an equal contribution.

SURETY'S DEFENCE: VARIATION OF THE UNDERLYING OBLIGATION

The most frequently raised defence to a claim to enforce a guarantee is that the underlying obligation has been impermissibly varied without the consent of the surety. This defence arises from the rule first articulated by Lord Coton in the old case of *Holme v. Brunskill* that the surety must consent to any variation to the obligation that he or she has guaranteed:[17]

> The true rule in my opinion is, that if there is any agreement between the principals with reference to the contract guaranteed, the surety ought to be consulted, and that if he has not consented to the alteration, although in cases where it is without inquiry evident that the alteration is unsubstantial, or that it cannot be otherwise than beneficial to the surety, the surety may not be discharged; yet, if it if not self-evident that the alteration is unsubstantial, or one which cannot be prejudicial to the surety, the Court…will hold that in such a case the surety himself must be the sole judge whether or not he will consent to remain liable notwithstanding the alternation, and if he has not so consented he will be discharged.

The rule in *Holme v. Brunskill* was adopted by the Supreme Court of Canada in *Manulife Bank of Canada v. Conlin.*[18] In that case, the Court held that a change in the terms of a loan or obligation, or the renewal of a loan, will release the surety unless clear language permits the alteration of the loan without the surety's consent.

Most recently, in *Turfpro Investments Inc. v. Heinrichs,*[19] the Ontario Court of Appeal summarized and restated the law regarding the effect on a guarantee of a variation to the underlying obligation. The rule, which is predicated on fairness to the surety, is that the latter will be discharged upon a variation of the underlying obligation unless one of the following four exceptions applies:[20] (i) that the alteration is "plainly unsubstantial"; (ii) that the alteration is "necessarily beneficial" to the surety; (iii) that the surety has contracted out of the protection of the rule; or (iv) that the surety has consented to the alteration.

The application of this defence can be seen in two recent decisions of the Ontario Court of Appeal. In *GMAC Leaseco Corporation v. Jaroszynski,*[21] the Court released a surety from liability on a vehicle lease because the lease had been extended without his knowledge or consent. In *Royal Bank of Canada v. Samson Management & Solutions Ltd.,*[22] the Court enforced a "continuing guarantee" despite the fact that the underlying debt had been increased, because the surety was found to have contracted out of the protection of their rule.[23]

POSTSCRIPT

As with any contract, the parties are best served by clear drafting that sets out each side's obligations. In the area of guarantees, however, the constant skirmishing between creditors and sureties leads to a substantial volume of case law. Counsel and parties are well advised, therefore, to keep up to date.

[16] *Mercantile Law Amendment Act*, R.S.O. 1990, c. M-10, s. 2(3)
[17] (1878), 3 Q.B. 495 (C.A.) at pages 505-506
[18] [1996] 3 S.C.R. 415
[19] 2014 ONCA 502
[20] *ibid*, at paragraphs 15 to 19
[21] 2013 ONCA 765
[22] 2013 ONCA 313
[23] In this case, the surety had signed a "continuing all accounts guarantee."