

Banking and Finance Law

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Enforceability of Spousal Guarantees

The British Columbia Court of Appeal's decision in *Collum v. Bank of Montreal* (leave to appeal to Supreme Court of Canada dismissed) may have broadened the duty of lenders to disclose material facts to spousal guarantors and should cause lenders to consider whether independent legal advice provided to spousal guarantors is sufficient protection to ensure enforceability of those guarantees.

I. Facts

In *Collum*, Deborah Collum, the wife of one of the two principals of Excel Engineering Ltd. ("Excel"), signed a guarantee (the "1993 Guarantee") for \$100,000 in favour of Bank of Montreal ("BMO") in support of an operating line of credit extended by BMO to Excel. Excel, its two principals and the wives of the principals each gave security for the operating line. In particular, Excel granted BMO an assignment of all accounts receivable.

Two years later, in 1995, the two principals of Excel determined that further financing was required and approached both BMO and Federal Business Development Bank ("FBDB"). BMO provided an additional loan for approximately \$78,000, of which 85% was guaranteed by the Government of Canada. FBDB agreed to lend Excel \$100,000 on condition that BMO give FBDB priority over Excel's foreign accounts receivable. BMO agreed to this priority arrangement and FBDB advanced its loan accordingly.

Some time after the 1995 arrangements were concluded, the two principals of Excel developed differences and

Mr. Collum purchased the other principal's interest in Excel. A condition of that purchase required BMO to release the departing principal and his wife from their guarantees and collateral mortgages. BMO agreed to do so on the condition that Mr. Collum contribute additional funds to Excel, and that the guarantees and security instruments granted by Mr. and Mrs. Collum be modified to cover the amounts previously secured by the guarantees and security given by the departing principal and his spouse.

Mrs. Collum was aware that the requested increase in the amount of her guarantee and security was to replace the security previously provided by the departing principal and spouse. In August, 1995, Mrs. Collum signed a guarantee of Excel's indebtedness to BMO to a maximum amount of \$200,000 (the "1995 Guarantee") and entered into a new collateral mortgage limited to that amount. Mrs. Collum received independent legal advice on both the execution of the 1995 Guarantee and the new collateral mortgage. However, Mrs. Collum was never informed by BMO that it had made an additional loan to Excel or that it had given priority to FBDB over Excel's foreign accounts receivable. In addition, these facts were not disclosed in the independent legal advice that Mrs. Collum received relating to the 1995 Guarantee and mortgage.

II. Trial Court Findings

Excel subsequently defaulted on its loans to BMO. BMO then successfully sought to enforce the 1995 Guarantee and mortgage against Mrs. Collum in trial proceedings in British Columbia.

The trial judge found that BMO had no duty to disclose any particular circumstances concerning the change in the underlying security held by BMO over the assets of Excel. In addition (citing the broad language contained in both the 1993 and 1995 Guarantees which allowed BMO to grant releases and discharges or otherwise deal with the customer, and all other persons and securities of the customer, as the banks saw fit), the trial judge ruled that BMO and Mrs. Collum had contracted out of

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the equitable rule that a creditor must protect and preserve security granted by its customer and created in its favour.

III. Court of Appeal

The central issue in the appeal was whether BMO had a duty to disclose the changes to Excel's underlying financing arrangements to Mrs. Collum prior to Mrs. Collum giving the 1995 Guarantee. The Court of Appeal found that the prior legal authorities clearly impose a duty upon a creditor to disclose material facts to a surety.

The Court of Appeal addressed this issue by first examining the relevant law distinguishing between disclosure obligations to what are referred to as "accommodation sureties" (those who have entered into a guarantee in the expectation of little or no remuneration and for the purpose of accommodating others or assisting others in the accomplishment of their plans) and "compensation sureties" (those receiving compensation or some type of remuneration). The law generally affords accommodation sureties greater protection than compensation sureties.

On the basis that Mrs. Collum was an accommodation surety, the Court of Appeal went on to consider the standard of disclosure required to an accommodation surety who is married to the debtor or principal of the debtor. Based upon a review of the relevant cases, the Court of Appeal ruled that three questions needed to be answered to determine whether BMO had a duty of disclosure to Mrs. Collum.

1. Was the non-disclosed information material enough that it would likely affect the mind of a reasonable guarantor?
2. If the information was material, would that information constitute facts connected to the dealings between the debtor and creditor which the surety would not expect to exist?
3. Did facts exist that would prevent the guarantor from avoiding its obligations under its guarantee, such as the presence of independent legal advice, the guarantor's actual knowledge or the terms of a prior guarantee?

In answering the first question, the Court of Appeal found that the strength of a creditor's security does bear

upon the risk assumed by a guarantor and was material information. The guarantor's ability to benefit by stepping into the creditor's shoes after paying under the guarantee would likely be materially impacted by the creditor significantly altering the strength of its security over the debtor's assets.

Moving on to the second question, the Court of Appeal found that BMO's subordination of its priority to the foreign accounts receivable of Excel was information that the surety would not expect to exist. Therefore, BMO was required to disclose this information to Mrs. Collum. In coming to this conclusion, the Court of Appeal rejected arguments by BMO that language in the 1993 Guarantee allowing BMO to make changes in BMO's security without the consent of Mrs. Collum prevented Mrs. Collum from denying liability under the 1995 Guarantee due to the fact that the 1995 Guarantee doubled Mrs. Collum's exposure to BMO and that it was the 1995 Guarantee that BMO was seeking to enforce. The Court of Appeal disagreed with the finding of the trial judge that the undisclosed information was not "unusual" enough to require disclosure.

Finally, notwithstanding that Mrs. Collum had received independent legal advice prior to signing the 1995 Guarantee, the Court of Appeal found that the lawyer advising Mrs. Collum was not provided with the undisclosed financial information and could not possibly have advised her of the extent of her potential exposure (other than in general terms that related to the effect of guarantees and security). As such information was not in the hands of Mrs. Collum's legal advisor, the Court of Appeal found that Mrs. Collum could not be said to have had a positive duty to make enquiries before signing the 1995 Guarantee. Furthermore, the Court of Appeal stated that the obligation on BMO to disclose the material changes was not an unreasonable obligation to expect the Bank to fulfill. A simple letter outlining the security held by it and the outstanding obligations of Excel would not have been difficult to provide.

As an additional matter, the Court of Appeal rejected the trial court's finding that BMO should be entitled to rely on the fact of marriage and to assume that Mrs. Collum would obtain the necessary disclosure through her relationship with her husband, whose interest and ability to obtain financing may have depended upon his spouse's willingness to stand as surety.

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Accordingly, the Court of Appeal found that the material non-disclosure of the circumstances relating to BMO's subordination of its rights to the foreign accounts receivable of Excel vitiated the 1995 Guarantee and the 1995 Mortgage.

Conclusion

Based on the *Collum* case, independent legal advice provided to a spousal guarantor may no longer be sufficient in and of itself to ensure the enforceability of a spousal guarantee. Lenders must be careful to consider the facts of each situation before deciding whether to provide more fullsome disclosure to spousal guarantors and/or their legal counsel of material facts that might impact the ultimate liability of those guarantors.

If you wish to discuss the decision or have any questions regarding the enforceability of spousal guarantees, please contact a member of the Banking and Finance Law team.

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