

Borrower Can't Pay? No Problem

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Traditionally, the role and position of guarantors has been viewed as sacrosanct in the eyes of the law, with guarantors' obligations being strictly interpreted and enforced. When a person agrees to guarantee a borrower's obligations for a loan, the common understanding is that the guarantor is liable to make the creditor whole if the borrower, as principal obligor, fails to repay. This proposition, however, is not always the case, as shown in the recent Ontario Court of Appeal decision in *Madison Joe Holdings Inc. v. Mill Street & Co. Inc.*, which describes the somewhat peculiar scenario where guarantors were required to repay debts and obligations of a borrower that the borrower itself was not required to make under the terms of the loan documents.

Facts

In consideration for a portion of the purchase price for Mill Street & Co. Inc.'s (Mill Street) acquisition of All Source Security Container Mfg. Corp. (All Source) from Madison Joe Holdings Inc. (MJH), All Source issued a number of promissory notes with monthly interest costs to MJH (collectively, the Notes) which were guaranteed by Mill Street and certain individuals related to the business (collectively, the Guarantors).

In connection with the acquisition, All Source also entered into a loan agreement with The Toronto-Dominion Bank (TD Bank), and All Source, TD Bank and MJH entered into an inter-creditor and subordination agreement (the ICA) to restrict payments from All Source to MJH under the Notes if such payments would put All Source offside the financial covenants set out in the loan agreement with TD Bank.

Eventually, All Source was unable to make payments under the Notes due to the payments restriction contained in the ICA, and MJH commenced an action against All Source and the Guarantors to recover the amounts owed to it.

Motion Judge's Decision

The motion judge's decision turned on the interpretation of the following three provisions:

1. "Notwithstanding any other provision of this Agreement, Borrower [All Source] may make and MJH may accept, collect and receive, Permitted Payments, provided: ...*(b) the making of any such payment will not result in a Default under the TD Loan Agreement.*" – excerpted from the ICA

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[Emphasis added.]

2. *“The outstanding Principal Amount and all accrued and unpaid interest thereon shall, at the option of [MJH], be immediately due and payable without notice upon the occurrence of any of the following events of default (each, an “Event of Default”): (a) [All Source] fails to make any payment of interest or of the Principal Amount when due under the [Notes]...(provided, however, that if [All Source] is prevented by reason of the refusal of any required consent by [TD Bank] from making such payment of Principal Amount or interest when due hereunder or under [the other Notes] pursuant to the [ICA], then such failure **shall not be considered an Event of Default** ...for the purpose of permitting MJH... to demand cash payment in full...”* – excerpted from the Notes [Emphasis added.]
3. *“If, as a result of [All Source]’s **default in making payments due under the [Notes]** in accordance with its terms, [All Source] shall owe monies to [MJH], the due payment of such monies is hereby jointly and severally guaranteed by the Guarantors.”* – excerpted from the guarantee portion of the Notes [Emphasis added.]

The motion judge found that despite the ICA restricting All Source from making the payments to MJH given its financial condition, the ICA did not similarly protect the Guarantors from their obligations under the Notes and therefore they owed MJH that which All Source was restricted from paying. This conclusion came about due to the emphasis the motion judge placed on the use of the word ‘default’ as opposed to ‘Event of Default’ in the third excerpt above. The motion judge found that a default generally is a failure to pay and was therefore triggered by All Source when it failed to make the monthly payment due to MJH under the Notes.

Appeal

The Guarantors appealed to the Ontario Court of Appeal (the Court), with the principal issue being whether the motion judge erred in its interpretation of the guarantees by ignoring the use of the phrase “in accordance with its terms,” which the Guarantors argued would prevent enforcement of the guarantees on the same terms as enforcement could be made on the Notes. The Guarantors’ position was that All Source’s non-payment in this instance was not a default under the terms of the Notes, and therefore, without a default, there could be no enforcement on the guarantees.

Decision

Majority

The majority of the Court did not find that the motion judge had made a palpable and overriding error. The

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majority agreed with the motion judge's findings that the trigger in the guarantees did not reference or specify an 'Event of Default' by All Source but rather simply a generic 'default', and that All Source's failure to pay (due to the restrictions contained in the ICA) could be considered a default that would trigger the ability to call on or enforce the guarantees. Importantly, the majority supported the motion judge's view that to interpret this matter in the alternative would render the security of the guarantees illusory, because the Guarantors wouldn't have to pay where All Source was financially compromised – a context where guarantees are ordinarily called upon. As such, the majority dismissed the appeal and the respondents were entitled to judgement against the Guarantors, but not All Source.

Dissent

The dissenting judge in the Court's decision highlighted many challenges with accepting the majority's interpretation of the loan documents. The dissent's view centred around the principle that a guarantor is only liable if the borrower, as principal obligor, defaults on its obligations. As All Source didn't make the payments to MJH due to the restrictions contained in the ICA (restrictions, which the motion judge noted, MJH acknowledged and agreed to as a party to the ICA), there was no default under the Notes and so the contingent obligation of the Guarantors should not have been triggered under the guarantees.

In the dissent's view, the motion judge ignored the fundamental principle relating to guarantees that all contractual arrangements must be considered to evaluate the relative obligations of the parties (i.e., the guarantee needs to be read in the context of the contractual arrangements of the principal debt). The majority's emphasis on the failure to use the defined term 'Event of Default' left no meaning for the use of 'in accordance with its terms', which in the dissenting judge's view, connected the obligations of the Guarantors to the contractual arrangements between All Source and MJH. The dissenting judge did not find this interpretation made the guarantees illusory – rather it merely prevented the guarantees from being enforced where no default had occurred due to the terms of the ICA which MJH had acknowledged and agreed to.

The dissenting judge also highlighted an interesting anomaly that arises with the motion judge's interpretation. Guarantors have a right to demand payment from the principal obligor if they are called upon to pay and perform the obligations of the principal obligor. If, under the terms of the ICA, All Source was precluded from repaying the Guarantors, then this would prejudice the Guarantors as they could not recoup what they were made to pay due to All Source's failure to pay MJH. However, on the other hand, if the terms of the ICA did not prevent All Source from repaying the Guarantors (since the Guarantors were not party to the ICA), this would enable MJH to have indirectly received payment from All Source, prejudicing TD Bank and undermining the purpose of the restriction in the ICA as agreed to by All Source, MJH and TD Bank. The dissenting judge concluded by reiterating that "a guarantor is only liable where the principal [obligor] is obliged to pay but fails to do so."

Key Takeaway

At a first glance, one might see this case as simply a cautionary tale for every drafting exercise, as the Court took a very strict view of the use of defined terms, and the motion judge and majority's determination may have been quite different if the guarantee trigger had simply said 'Event of Default' as opposed to 'default.' However, in the broader context of lending arrangements, this case highlights many important considerations that guarantors, subordinate lenders, senior lenders and their counsel need to carefully consider when structuring and drafting lending and intercreditor arrangements - such as:

- Should senior lenders require that intercreditor agreements also restrict guarantee payments?
- Will guarantors now proactively request to be included in intercreditor agreements?
- If a guarantor is not aware of a payment restriction (of the underlying debt) contained in an intercreditor agreement, should that be a defence to its guarantee (as the payment restriction has a material impact on the guarantor)?

At a minimum, guarantors, subordinate lenders, senior lenders and their counsel need to fully consider on a case by case basis whether guarantee payments are intended to be restricted in these circumstances and ensure that the intercreditor agreement reflect the business deal.

This publication is a general summary of the law. It does not replace legal advice tailored to your specific circumstances.