

FEBRUARY 2016

## When is a Guarantee Unenforceable?

A creditor who loans money has a duty not to breach its contract or act “unconscionably” towards the guarantor or surety of the loan. Accordingly, only in the most egregious circumstances will a Court discharge a guarantee on the basis of the creditor’s improper conduct.

A recent decision of the Ontario Court of Appeal, *Bank of Montreal v. Javed*, 2016 ONCA 49, per Lauwers J.A. (“*Javed*”) illustrates that a guarantor or surety will not lightly be discharged from obligations under a guarantee based on the creditor’s behavior.

### The Facts

In *Javed*, the defendant Shah and his co-defendant Javed gave the Bank a joint and several guarantee to secure a small business loan to their company. The parties operated a donut restaurant. The Bank loaned the company \$213,486. Shah’s guarantee was limited to \$53,371, in addition to interest.

Ultimately, Shah resigned from the company. The company defaulted on its loan and the Bank demanded payment from Shah under his guarantee.

Shah defended the Bank’s action against him, in part, by arguing that when he contacted the Bank to obtain the company’s business account information following his

resignation from the company, the Bank refused to provide it to him. The Bank claimed that Shah was not entitled to the information because he was no longer an authorized signing officer for the Company’s business account.

The motions judge dismissed Shah’s position. The Court granted judgment against Shah on the guarantee in the amount of \$53,371.

On appeal, Shah argued that the Bank’s conduct in refusing to provide information to him amounted to “unconscionable” conduct and a breach of contract.

The Court of Appeal held that the Bank’s conduct was not unconscionable. The Court further



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held that while the Bank's failure to provide Shah with disclosure amounted to a breach of its contract, the breach was not serious enough to warrant discharging Shah from his obligations under the guarantee.

### 1. The New Duty of Honest Contractual Performance Does Not Extend the Doctrine of Unconscionability

The Court's first lesson in *Javed* is that the Supreme Court of Canada's recent recognition of a duty of "honest contractual performance" in *Bhasin v. Hrynew*, 2014 SCC 71 ("Bhasin") did not extend the doctrine of "unconscionability" in contract law.

The doctrine of unconscionability provides that a contract is unenforceable where its terms are extremely unfair or one-sided, particularly if there is an inequality of bargaining power between the contracting parties.

In order to prove that a contract is unconscionable, the plaintiff must show that: (i) the defendant abused its bargaining power; (ii) the defendant preyed upon the plaintiff; or (iii) that the bargain was improvident.

In *Bhasin*, the Supreme Court of Canada recognized a new duty of honest contractual performance. The Court held that parties to a contract have a duty to act honestly towards one another during the performance of the contract.

Shah argued that *Bhasin*

modified the test for contractual unconscionability. That is, the doctrine of unconscionability now involved an analysis not only of the equities of the contract or transaction, but of the party's performance of its obligations under the agreement.

The Court of Appeal rejected this argument. *Bhasin* provided no basis for the argument that the Supreme Court of Canada extended the doctrine of unconscionability so as to engage an assessment of the party's behavior under the contract. *Bhasin* simply recognized a duty of honest contractual performance.

In this case, the Bank acted honestly throughout. Any alleged breach by the Bank of its duty of disclosure to Shah did not amount to a duty not to perform its obligations under the contract honestly. Moreover, the evidence failed to support a claim that the contract was itself unconscionable.

### 2. Guarantees Will Only Be Set Aside in Egregious Cases

The second lesson from *Javed* is that a simple breach of contract by the creditor may be insufficient to discharge a guarantee.

In this case, the Court held that the Bank breached its contractual duties to Shah by refusing to respond to his request for information. The language of the guarantee required that Shah could seek information from the Bank regarding the debt secured by the guarantee.

However, the Bank's breach did not justify discharging the guarantee. The Court held that only the most serious misconduct on the part of a creditor would be sufficient to discharge a guarantee. Cases in which a guarantee could be discharged based on the creditor's conduct included where:

- i. the creditor acts in bad faith towards the surety;
- ii. the creditor hides material information at the guarantee's inception;
- iii. the creditor causes or "connives" the debtor's default under the guarantee; or
- iv. the terms of the contract between the creditor and the debtor are varied so that the interests of the surety are prejudiced.

The rationale for holding that a guarantee will be rescinded only where there is proven prejudice to the guarantor is the fact that it is the guarantor, and not the creditor, who is liable for observing the debtor's conduct.

Citing Kevin McGuinness, *The Law of Guarantee*, 3rd ed. (Markham: LexisNexis Canada, 2013) at p.948, the Court noted that there is "no general duty of active diligence imposed by law on the creditor; as a person who has given a guarantee, it is the surety's business, rather than the creditor's, to see that the principal [debtor] performs the guaranteed obligation".

In this case, Shah argued that if he had been given information about the loan by the Bank, he would have been able to revive the company or persuaded his business partner to repay the loan. However, the Court noted that Shah did not seek any information from the company regarding its debt to the Bank. The Court characterized Shah's position as "abstract and speculative".

Accordingly, Shah failed to prove damages resulting from the Bank's breach in not providing him with disclosure. Shah was therefore not entitled to any reduction owing on the guarantee.

### Conclusion

The decision in *Javed* makes it clear that Ontario Courts are reluctant to discharge a guarantee in the absence of unconscionable or egregious behavior on the part of the creditor.

Moreover, it is clear that the new duty of "honest contractual performance" is in no way to be confused with the long-standing doctrine of "unconscionability": the former assesses the party's honesty during the performance of the contract while the latter looks to the equities of the contract or transaction.

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