TAB 10

Limited And Non-Recourse Guarantees

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BASIC CONCEPTS

a.) The Nature of a Guarantee

A guarantee is a form of a contract evidencing a relationship between: i) a party entitled to benefits under an existing contract (an “obligee”) and, ii) a party who assures to the obligee the performance of the obligations under such contract in the event that the party responsible for same (the “obligor”) fails to perform such obligations in a timely manner as required. In law, a contract of guarantee is known as a “surety contract” and the guarantor is called a “surety”. For the purposes of this paper I will limit my commentary to guarantees of financial obligations where the obligor is commonly referred to as the ”debtor” and the obligee is referred to as the “creditor”.

Whenever a guarantee is rendered, there are two contractual obligations in existence and the creditor is a party common to both contracts. The first contractual obligation is the obligation of the debtor to the creditor (the “Primary Debt Obligation”). The second contractual obligation is the obligation of the guarantor (surety) to the creditor to satisfy the Primary Debt Obligation (the “Guarantee”). By this guarantee the surety or guarantor accommodates both the debtor and the creditor by enhancing and assuring to the creditor the timely performance of the obligations of the debtor pursuant to a Primary Debt Obligation and agreeing to satisfy such obligations should the debtor fail to do so.

The Guarantee is a secondary obligation in that it is only enforceable if a valid Primary Debt Obligation is in existence. A guarantee may secure past, contemporaneous or future indebtedness.

b.) <u>Basic Features of a Guarantee</u>

Since a guarantee is a form of contract it requires all of the elements necessary to create an enforceable contract in law including:

i) <u>Mutual Assent</u>: As in any other contract, there must be agreement between the parties. In the case of a guarantee, a guarantor has made an offer which has been accepted by the creditor thus creating a contract. Without this mutual assent, no contract of guarantee can exist and the guarantee will not be enforceable.

ii) <u>Valuable Consideration</u>: The guarantee must be either under seal (a seal, in law evidencing receipt of adequate consideration) or it must be for stated or implied valuable consideration flowing from the creditor to the guarantor. Provision or extention of credit by a creditor to the debtor qualifies as valuable consideration flowing to the guarantor.

iii) <u>Capacity and Authority</u>: Both parties must have legal capacity in order to create a contract of guarantee. In the case of individuals, they must be of legal age and of sufficient mental capacity to understand the nature of the contract and the obligations to be entered into. In the case of corporations, there must be evidence of proper corporate authority given by the shareholders and/or directors to support the corporate guarantee.

iv) <u>Guarantee must be in Writing</u>: Pursuant to the *Statute of Frauds Act* (Ontario), a guarantee must be in written form, failing which it will not be enforceable. An oral guarantee in itself is not void but merely unenforceable. Thus, if an oral guarantee is subsequently confirmed or acknowledged in writing by the guarantor it will be held to be enforceable.

GUARANTEES AS SECONDARY OBLIGATIONS

The primary obligation for the payment of a debt rests at all times with the debtor pursuant to the Primary Debt Obligation. Since the contractual obligations of the guarantor pursuant to the guarantee contract are contingent upon the existence, validity and enforceability of the Primary Debt Obligation, such obligations are considered secondary in nature and constitute a back up to the Primary Debt Obligation.

Although a guarantor's obligation is secondary in nature, the modern judicial interpretation of guarantees allows for their enforcement at any time that the Primary Debt Obligation remains extant, without the necessity of the creditor first enforcing the Primary Debt Obligation against the debtor.

GUARANTEES OF PART OF THE OBLIGATIONS

Guarantees can assure payment of an entire debt or payment of part only of a debt.

a.) Partial Guarantees v. Limited Guarantees:

There is an important distinction between partial guarantees, being guarantees of part of a debt only, and guarantees limited in the aggregate to a specific absolute monetary amount. When a guarantor guarantees a portion or part of a debt only, an issue arises as to the identification of that portion or part of such debt for which the guarantor is responsible. This becomes particularly significant when part of the debt owing is repaid by or on behalf of the debtor and a determination has to be made whether or not such payment reduces the gross balance guaranteed. By way of example, if a guarantor guarantees $2,000,000.00 of a $10,000,000.00 debt, what happens when $2,000,000.00 of such debt is then repaid? Is the guarantor released? Was it the first or the last $2,000,000.00 which was guaranteed?

For the above reason it is always prudent to draft guarantees as guarantees of the total indebtedness owing and then limit the aggregate amount which can be recovered from a guarantor to a specific monetary amount or percentage of the debt. This effectively allows the last portion of the debt to be repaid to be guaranteed, thus making certain that partial repayments of the debt down to the amount guaranteed will not adversely impact on the guarantee.

b.) Absolute or Proportionate Limitation:

The aggregate limit of liability can be expressed as:

i) a proportion or percentage of a designated amount, such as a percentage of the debt owing from time to time, or a percentage of ownership of the property at any given time; or,

ii) a specified absolute monetary amount.

From a creditor's perspective it is always recommended that the limit be expressed as a fixed absolute monetary amount, rather than an amount which may be subject to variance or reduction over the term that the debt remains outstanding. This provides the creditor with more certainty and greater security and leaves less room for interpretation and creative defences.

From a guarantor's point of view, the faster the guarantee is reduced the less exposure for the guarantor. Thus, limiting the guarantee to a proportion or percentage of a reducing debt amount owing from time to time would be advantageous to a guarantor.

c.) <u>Interest and Costs</u>:

In all instances the limitation on the amount of recovery should include:

i) interest at the rate of interest provided in the Primary Debt Obligation from the date of demand on the guarantee until payment in full of the amount guaranteed; and

ii) all costs of enforcement of the guarantee on a substantial indemnity basis;

d.) <u>Preservation of Limit of Guarantee</u>:

Where a limit of recovery is imposed on a guarantee, guarantors must make sure that any intended limitation isn't inadvertently broadened or nullified in collateral or additional security documents such as:

i) unlimited environmental warranties and indemnities;

ii) completion obligations under construction loans;

iii) collateral indemnity provisions;

iv) letter of credit indemnities; and,

v) beneficial owner obligations pursuant to law or as may be contained in Beneficial Owner Agreements.

If the intent is to limit the guarantors aggregate liability in all respects to that contained in the guarantee limit, then all other obligations of such guarantors as beneficial owners and pursuant to other separate contractual obligations should be limited in the aggregate to the guarantee limit.

If, on the other hand, the intent is that such additional obligations should stand on their own and remain unlimited and not subject in the aggregate to the limits contained in the guarantee, then clear and unequivocal wording to that effect should be stipulated in the security documents.

COLLATERAL MORTGAGE AS A FORM OF GUARANTEE

In order to further assure and secure indebtedness by a debtor, creditors will at times require security by way of a mortgage of real property owned by parties other than the debtor. The most common use of such arrangement is where one spouse borrows money from a bank and requests the other spouse, who is the registered owner of a property, to mortgage such property as security for the debtor spouse's obligations to the creditor (mortgagee). Another example is where a corporate entity related to the debtor is requested to mortgage real property owned by it to secure a debt owing by the debtor.

In such instances lawyers some times interpose a guarantee from the spouse or related entity holding title to the real property in order to create a direct contractual link between the owner of the property and the creditor. The mortgage is then given as collateral security for such guarantee. Although interposition of a guarantee may be of value to preclude possible defences to enforcement of the collateral mortgage by reason of intervening changes to the Primary Debt Obligation, it is not necessary in law to create such a link. The collateral mortgage is in itself a form of a guarantee or surety contract, being a covenant for payment and pledge of security to the creditor by a party other than the debtor. As long as the mortgage contains provisions which are usually contained in a guarantee form and which preserve the enforcement and validity of the mortgage notwithstanding various dealings between the debtor and the creditor, no separate guarantee is necessary, as all of the safeguards offered by a guarantee would then be contained in the collateral mortgage.

NON-RECOURSE FORM OF SURETY CONTRACTS

Collateral mortgages or pledges of corporate or other securities are often given by third parties to further assure and secure to a creditor performance of obligations by a debtor, without the intent of such third party mortgagor or (surety) being liable pursuant to any covenants. In other words, the mortgage or pledge of security is intended to be strictly an asset-based pledge or guarantee without any recourse as against the surety. Non-recourse pledges of securities may arise where the party granting same, for regulatory or business reasons, is not prepared to be obligated pursuant to any personal covenants, whether positive or negative and whether monetary or otherwise. In such instances, the surety wants to limit its liability and risk solely to the security and to the value of the assets pledged or mortgaged as may be recoverable by the creditor upon enforcement, and nothing more. Caution must be exercised in such instances to specifically make the surety contract non-recourse, failing which, by signing same, the surety may inadvertently become obligated by the covenants for payment and performance stipulated therein.