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Guarantor beware: Potential liability without borrower default

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If you guarantee a loan, you are only responsible to repay the debt if the borrower, as principal obligor, is officially in default, right? Guarantors have generally been safe to rely upon this principle, but a recent Ontario Court of Appeal decision comes to a different conclusion. In *Madison Joe Holdings Inc. v Mill Street & Co. Inc.* (Madison), the Court held that guarantors may be responsible for the debts and obligations of a borrower, even if the borrower itself has not defaulted under the terms of the loan documents.

In some ways, *Madison* is a cautionary tale for drafters, but it does call on loan parties and lenders alike to take a careful look at their documents to make sure they capture the parties' true intentions both in terms of guarantor recourse and intercreditor rights.

Facts

In 2014, Mill Street agreed to buy a company called All Source from Madison Joe Holdings Inc. (MJH). Mill Street purchased the first 50% of All Source through, among other things, two vendor-take back promissory notes to MJH. In 2016, Mill Street acquired the remaining 50% interest in All Source. At that time, Mill Street still owed payments to MJH in connection with the first purchase. To restructure the debt, the existing promissory notes were extinguished and All Source executed two new ones in their place. The new notes were guaranteed by Mill Street and its two principals, Noah and Roy Murad.

In connection with the second 50% purchase, All Source entered into a loan agreement with TD Bank. In addition, TD Bank, All Source and MJH entered into an intercreditor and subordination agreement (ICA). The ICA restricted All Source from making payments to MJH under the notes if such payments would cause All Source to break the financial covenants set out in the loan agreement with TD Bank. After the new notes were executed, All Source paid the required monthly interest payments but failed to pay the principal and outstanding interest owing upon their maturity date due to the restrictions in the ICA. MJH commenced an action against All Source as the principal obligor, and Mill Street, Noah and Roy as guarantors.

Motion judge's reasoning

The motion judge found that although the ICA had restricted All Source from making payments to MJH due to its financial condition, it did not protect the guarantors from their obligations under the notes. The notes echoed the ICA, providing that it was an "Event of Default" for All Source to fail to make any payments when due unless All Source was prevented from doing so by TD Bank's refusal to provide the required consent to such payments. The guarantee, on the other hand, did not refer to any exemption related to the ICA and said instead that the guarantors would owe money to MJH "as a result of [All

Source]'s default in making payments due under the [notes] in accordance with its terms …".

Even though All Source was not in default of the principal payments according to the notes, the principal's default did technically take place when All Source failed to pay. The guarantors were therefore found to be liable to MJH for all that All Source was restricted from paying.

Ontario Court of Appeal decision

The majority of the Court agreed with the motion judge and found that All Source's failure to pay MJH due to the financial restrictions in the ICA could be considered a default that triggered the ability to call on or enforce the guarantees. The decision relied on the reference to "default" rather than "Event of Default" as the trigger to the guarantees. The appellant's argument that non-payment did not equal default was rejected, and the Court reinforced that guarantees are to be read so as to give effect to the apparent intent of the parties, so as to afford fair protection to the creditor.

Key takeaways…

…For guarantors

Guarantors should be careful to ensure that they are aware of whether or not their guarantee payments are restricted. The key takeaways for guarantors and their counsel are:

- Be careful to match the language of the guarantees to include any exemptions provided to the borrower in the underlying loan agreement.
- Consider a request to be party to or at least included in the negotiation of any intercreditor agreements.
- Consider the "fair protection rule" that courts always interpret a guarantee so that the protection or security which it affords to a creditor is rendered real rather than illusory.

…For lenders

Although this case appears to be a direct warning to guarantors about potential liability above-and-beyond what may be expected, there are a few considerations for subordinate and senior lenders to take note of:

- Consider whether any proposed restrictions to guarantee payments in the underlying documents or the intercreditor agreement itself would prejudice lenders' intercreditor rights.
- Even with standard, full-recourse guarantees, speak with counsel about any potential limitations on your recourse against guarantors.

All parties and their counsel should carefully consider their interests and how to manage possible risks. The outcome in *Madison* is an example of the importance of careful drafting, thoughtful consideration of the parties' intentions, and understanding the big picture when balancing the interests in multi-party loan structures.