LAW REFORM COMMISSION OF BRITISH COLUMBIA

REPORT ON

GUARANTEES OF CONSUMER DEBTS

LRC 43

1979

The Law Reform Commission of British Columbia was established by the *Law Reform Commission Act* in 1969 and began functioning in 1970.

The Commissioners are:

Peter Fraser, *Acting Chairman*
Paul Fraser
Leon Getz
Kenneth C. Mackenzie

Arthur L. Close is Counsel to the Commission.
Douglas R. Chalke and George Copley are Legal Research officers to the Commission.
Patricia Kilpatrick is Secretary to the Commission.

The Commission offices are located on the 10th floor, 1055 West Hastings Street, Vancouver, B.C. V6E 2E9.

TABLE OF CONTENTS

				Page
I	INTRODUCTION			6
	A.	What is the Problem?	6	
II	THE RECOMMENDATIONS			9
	A.	Introduction	9	
	B.	Who is a Consumer Guarantor?: Chapter IV		9
	C.	The Creation of a Consumer Guarantee: Chapter V		9
	D.	Other Disclosure Requirements: Chapter VI		11
	E.	Rights of the Guarantor After Default: Chapter VII		11
		1. A Right to Exoneration		11
		2. A Right to Revoke a Continuing Guarantee		11
		3. A Comprehensive Right of Reimbursement		11
	F.	Discharge of the Guarantor: Chapter VIII	12	
	G.	Liability on the Contract of Guarantee: Chapter IX		12
	H.	Guarantees by Way of Negotiable Instrument: Chapter X	13	
	I.	Contracting Out: Chapter XI		13
	J.	Conclusion		13
III	THE WORKING PAPER		15	
	A.	Introduction	15	
	B.	The Response to the Working Paper 15		
	C.	Guarantees by a Spouse	15	
	D.	Guarantees of Commercial Debts	17	
IV	WHO IS A CONSUMER GUARANTOR?			19
V	THE CREATION OF A CONSUMER GUARANTEE			27
	A.	An Informed Choice	27	
	B.	Formal Disclosure	28	
	C.	The Consequences of NonCompliance	31	
	D.	Recommendations	34	
VI	OTHER DISCLOSURE REQUIREMENTS		36	
	A.	A General Duty of Disclosure	36	
	B.	Disclosure of Specific Matters	38	
		1. Other Indebtedness	38	
		2. Details of the Principal Transaction	39	
		3. Information During the Currency of the Guarantee	41	
	C.	Consequences of NonDisclosure	43	
	D.	Recommendations	44	
VII	RIGHTS OF THE GUARANTOR AFTER DEFAULT			46

A. Introduction 46
B. The Quia Timet Action The Right to Exoneration 46
C. The Right to Revoke a Continuing Guarantee 53
D. Reimbursement 56
1. Right to Securities 57
2. Right of Subrogation 58
3. Right to Indemnification 59

VIII DISCHARGE OF THE GUARANTOR 63
A. By Discharge of the Principle Transaction 63
1. Payment or Performance 63
2. By Agreement 65
B. By Variation of the Principal Contract, Extension of Time, or Dealing with Securities 67
1. Variation of the Principal Contract: Extension of Time 67
2. Dealing with Securities 68

IX LIABILITY ON THE CONTRACT OF GUARANTEE 74
A. Introduction 74
B. The Limitations Act 76
C. Guarantors of Minors' Contracts 81
D. Bankruptcy 82
E. Other Statutory Defences and Consumer Protection Legislation 84
1. Personal Property Transactions 84
2. Real Property Transactions 90
F. Contractual Defences 92
G. Illegality 96
H. Inability of the Principal Debtor to Rely on Defences 98

X GUARANTEES BY WAY OF NEGOTIABLE INSTRUMENT 100
A. The Issues 102
B. Our Recommendations 105

XI CONTRACTING OUT 108

XII CONCLUSION 110
A. Summary of Recommendations 110
B. Acknowledgements 117

APPENDICES
A. Appendix A 118
B. Appendix B 120

TO THE HONOURABLE GARDE B. GARDOM, Q.C.
ATTORNEYGENERAL FOR BRITISH COLUMBIA

The Law Reform Commission of British Columbia has the honour to present the following:

REPORT ON

GUARANTEES OF CONSUMER DEBTS

The past few years have seen a growing recognition that legal rules developed to regulate transactions between businessmen are not always apt in relation to the supply of goods, services and credit to ordinary consumers. This has led to the growth of socalled "consumer protection" legislation which modifies those rules in appropriate circumstances.

One aspect of consumer credit that has received little attention is the legal position of guarantors. Here the law is surrounded by uncertainty and is, in many respects, inequitable. This Report sets out recommendations aimed at achieving an appropriate balance between the interests of creditors, principal debtors and guarantors.

CHAPTER I INTRODUCTION

A. What is the Problem?

A creditor will often seek to protect himself from a potential default of a debtor by demanding that a third party undertake to make good any default that might occur. This third party is known as a guarantor and the agreement entered into by him is known as a guarantee. This Report concerns the special considerations involved where an individual contracts to guarantee a "consumer debt," that is, a debt created to enable the debtor to acquire property or obtain services for personal, family or household purposes. With one modest exception, guarantors of consumer debt have been overlooked by the various measures designed to reform the law of consumer transactions.
Because of this and because the relevant provisions cf the new Act have not yet been proclaimed in force, we have decided to predicate the recommendations in this Report on the law as it exists now, although the potential effect of the Act is discussed in the context of particular issues.

The rationale for that exclusion is difficult to understand, particularly in the consumer context where the guarantor frequently stands to gain nothing. He is often a friend or relative of the potential debtor. Although in technical legal terms he receives "consideration," any real benefit is enjoyed by the creditor and the debtor:

> A contract of suretyship, like any other contract, must be supported by consideration if it is not under seal. Where the surety guarantees some future debt or transaction, the consideration may be a promise on the part of the creditor to grant the credit or enter into the transaction, or the actual act of doing so. Even if (as is commonly the case) the surety derives no benefit from the transaction, the creditor suffers a detriment which is sufficient consideration.

Despite the absence of real benefit to the guarantor, the law holds him to his word, even if the guarantee is of a large debt. In the result, from the point of view of creditors, the guarantee is a most useful commercial tool.

Where lawmakers have responded to the special difficulties presented by the contract of guarantee that response bias been largely favourable to the interests of guarantors, however, because it has been directed at specific issues in a piecemeal fashion, a morass of technical and sometimes conflicting legal rules has been created. In some cases legislation relating to consumer contracts has ignored the legal position of guarantors, and the courts have been left to resolve that problem when it arises. The resolution has not always been entirely satisfactory. In other cases, general legislation has sought to protect guarantors by extending its provisions so as to include them. In so doing, however, the distinction between the "consumer" guarantor and the guarantor who assumes liability under a recourse agreement in the ordinary course of his business has not been taken into account.

The constitutional arrangement created by the *British North America Act* gives rise to further difficulties. Under this enactment, jurisdiction in Canada over private legal rights is entrusted to the provincial Legislatures. It is

this jurisdiction which empowers the provinces to enact legislation respecting the law of contract in general. In specific instances the law of consumer contracts, secured transactions, the regulation of securities, landlordtenant relations, and the like are the subject of valid provincial legislation. It would seem that this authority would extend to legislation involving contracts of guarantee as well.

This is true to a limited extent, however, because guarantees are often taken by way of negotiable instruments such as cheques and promissory notes. The *British North America Act* does not enable a province to enact laws governing negotiable instruments, and vests exclusive jurisdiction in respect of that matter in the Federal Parliament. The task is therefore to develop provincial legislation which may cover negotiable instruments, while at the same time keeping within constitutional boundaries. Although the difficulties are not insurmountable, they offer another example of the special problems presented by contracts of guarantee.

In British Columbia, the legislation relating to consumer contracts of guarantee is to be found in such diverse enactments as the federal *Bills of Exchange Act,* and in the *Conditional Sales Act*, the *Bills of Sale Act,* the *Consumer Protection Act*, the *Laws Declaratory Act* and the *Trade Practices Act* of the Province.

The goals of law reform in this area are twofold. The first aspect calls for a critical evaluation of the substantive law respecting guarantees and a consideration of the extent to which widely accepted notions of "consumer protection" should apply to guarantors. The second aspect concerns a rationalization of the law with a view to achieving simplicity, clarity and consistency. A guiding principle is that the rights and liabilities of a guarantor should reflect substantive social and legal policies rather than arid technical distinctions unrelated to the merits of has legal position.

The issues were confronted by us in a Working Paper that was circulated for comment and criticism early in 1978 and which set out a number of tentative conclusions and proposals for changes in the law. A substantial volume of response was rrbeived. In the light of that response all aspects of this topic were reconsidered and our final conclusions and recommendations are set out in this Report. The response is discussed in a general fashion in Chapter.

CHAPTER II THE RECOMMENDATIONS

A. Introduction

In an area as complex and elusive as guarantees our recommendations must necessarily span a wide range of legal concepts and issues. While our recommendations are aimed at arriving at a comprehensive and consistent "package," a detailed consideration of the issues must start at some point and the choice of such a point is, in a sense, arbitrary. We recognize that this may pose difficulties to the reader in that the full implications of a single early recommendation may not be clear until other recommendations are considered.

For this reason we deport from our usual practice and present, in this chapter, an early summary of our recommendations in narrative form in a way which we hope will lend perspective to the specific recommendations as they emerge. This has the added advantage of providing a framework for the discussion of the responses to the Working Paper in the next chapter. At the conclusion of this chapter a formal recommendation for new legislation is set out.

B. Who is a Consumer Guarantor?: Chapter IV

The scope of our recommendations is determined by the meaning to be given to the concept of a "consumer guarantor." In devising a comprehensive definition of a consumer guarantor, and a contract of guarantee as a consumer debt, it is central that substance must prevail over form. The legal position of an individual who undertakes a contractual obligation to compensate a creditor for losses arising from a debtor's default should be considered without regard to the form of the transaction which creates this liability. It is recommended that a contract of guarantee be defined so as to include a contract of indemnity, a mortgage, or any other undertaking of a like nature entered into by an individual to secure the obligations of another incurred on a consumer transaction. The term "consumer transaction" would be defined as a loan of money or an extension of credit to an individual which the creditor knows, or ought to know, will enable that individual to purchase, lease, or otherwise acquire, real or personal property, or obtain services, for purposes that are primarily personal, family or household. This definition is aimed at encompassing the concept of consumer transaction to be found in existing consumer protection legislation and expanding it to include certain real property transactions.

The final recommendation in Chapter IV recognizes that there is one kind of guarantee of a consumer debt which does not required the recommended protection. In some cases, guarantees of consumer obligations are entered into by retailers as a condition of a financing arrangement when consumer contracts are assigned. These "recourse guarantors" are, of course, operating in a commercial context and would seem to have no need of the protection extended to consumer guarantors. We therefore recommend their exclusion.

C. The Creation of a Consumer Guarantee: Chapter V

In the context of consumer transactions the majority of persons are unlikely to appreciate fully the very serious legal and financial implications of affixing their signatures to contracts of guarantee. Moreover, they are unlikely to know of the legal rights now afforded them at common law and by statute, or which may be available under future consumer protection legislation. The recommendations in Chapter V are designed to ensure that such guarantees are prepared so as to avoid misunderstanding.

The notion that contracts of guarantee deserve special treatment is reflected in the attitude of many legislatures in enacting statutes which provide that certain formalities must be observed when certain contracts are made. In the absence of statute, otherwise valid contracts are enforceable on the oral testimony of any competent witness. For three centuries in England, and from the reception of English law in British Columbia, guarantees have not been enforceable unless the party who seeks to rely on the guarantee adduces evidence of it in writing. The policy upon which this special treatment is founded is, in our view, sound:

> ... if oral contracts of guarantee are allowed we feel that there is a real danger of inexperienced people being led into undertaking obligations that they do not fully understand, and that opportunities will be given to the unscrupulous to assert that credit was given on the faith of a guarantee which in fact the alleged surety had no intention of giving ... [T]he necessity of writing would at least give the proposed surety an opportunity of pausing and considering, not only the nature of the obligation he is undertaking, but also its terms ... [I]n the majority of cases the surety is getting nothing out of the bargain; hence the greater reason for securing, if possible, that no mistake shall occur.

We have concluded, however, that the law in this regard is inadequate.

In a Report dealing with the formalities imposed on contracts on guarantee under the *Statute of Frauds* we expressed:

> ... serious doubts as to the effectiveness of the *Statute of Frauds* in providing the protection thought necessary in the context of *consumer guarantees*.

It seems we are not alone in those doubts. In 1971 the Crowther Committee on Consumer Credit made the following remarks in this context:

> Where the credit grantor is not entirely satisfied about the creditworthiness of the borrower, he may insist on a third party guaranteeing the debtor's obligations, or giving an indemnity against the loss the credit grantor may suffer as a result of extending the credit. Guarantors and indemnifiers have long been the Cinderellas of protective legislation ...

In the United States, the National Conference of Commissioners on Uniform State Laws recommended recently that the *Uniform Consumer Credit Code* be amended to provide that a guarantor is freed from liability unless before or at the time of signing he was given (1) "a clear and conspicuous notice" warning him as to the extent of his obligations and (2) a copy of the agreement between the creditor and debtor.

In the recommendations set out in Chapter V we describe the minimum standards of disclosure which we believe must be observed by creditors who take contracts of guarantee to secure consumer obligations. We characterize these as "formalities," that are essential to the creation of an enforceable guarantee.

D. Other Disclosure Requirements: Chapter VI

The duties of disclosure set out in Chapter V are not exhaustive and, in particular circumstances, there may be other facts or matters known to the credit grantor that should be available to the guarantor. In Chapter VI additional duties relating to the disclosure of information are explored. It is recommended that there should be a general duty imposed through defining a guarantee as one of "utmost good faith." In addition, a credit grantor would be under a specific duty to disclose matters such as the state of accounts and other indebtedness of the borrower that are known to him. A failure to provide the information called for by the recommendations would lead to an abatement of the guarantor's liability to the extent he had been prejudiced.

E. Rights of the Guarantor After Default: Chapter VII

1. A Right to Exoneration

The next set of recommendations concern the difficulties that arise on default where the creditor, knowing that he has a guarantor liable to make good his losses, fails to proceed with due diligence in enforcing his rights against the principal debtor. At present a guarantor has no substantial right to interfere under those circumstances. He is afforded relief, if at all, only where the creditor's delay is such that any right of action he may have against the

principal debtor is barred by the *Limitations Act* as a result of the creditor's prevarication. Under our recommendations, a guarantor would be able to request that the creditor proceed against the principal debtor or his assets. Where the creditor fails to comply with that request the guarantor's liability would be reduced to the extent that he has been prejudiced by the creditor's inaction.

2. ___A Right to Revoke a Continuing Guarantee

It is possible for a guarantee to be drafted so as to render the guarantor liable for his principal's future indebtedness to the creditor for an indefinite period. The existence of a right to revoke such a "continuing guarantee" depends upon the common law of contract and, for reasons which we make clear later, we do not consider the present law entirely satisfactory in this regard. Accordingly, we recommend that there be an absolute right to revoke a continuing guarantee, but at the same time ensure that a revocation under our recommendations does not affect the liability of a consumer guarantor for any obligation incurred by the principal debtor before the time of revocation.

3. ___A Comprehensive Right of Reimbursement

The interest of a guarantor undergoes a transformation once he pays the creditor and seeks to recoup his losses from his principal debtor. In some instances, the right of recovery may result in a greater liability on the part of the principal than would be the case if he was sued by his original creditor. In other situations the extent or even the existence of a right to reimbursement may depend upon the precise nunner in which it is exercised by the guarantor. We recommend a comprehensive "right of recovery" that we believe introduces consistency and fairness to an area of the law which is now both obscure and sometimes irrational. At the same time we suggest machinery to ensure that this right of recovery will not operate to the prejudice of the principal debtor.

F. Discharge of the Guarantor: Chapter VIII

There are a number of legal rules which define the circumstances in which a guarantor will be relieved of liability. The most obvious of these occurs when the principal debtor fulfils his part of the contract. This is not as straightforward as it might seem for, under the present law, it is open to a creditor to allocate the payment from the principal debtor so as to reduce a debt different from that secured by the guarantee. For example, a debtor might owe a total of $1,000 to a large store, $250 of which is guaranteed by the debtor's friend. Under the present law, when the debtor, without making a specific allocation, repays the store $250, the store is entitled to apply it to the unsecured portion rather than to apply it to relieve the guarantor of his obligation. Only if the debtor pays the store $1,000 will the guarantor be relieved of his obligation. This we believe to be manifestly prejudicial to consumer guarantors and recommend that the creditors right of appropriation be limited.

Another situation where at guarantor will be discharged from liability is upon the execution of an agreement between the creditor and principal debtor whereby the principal is discharged. our research has revealed, however, that this rule is not without its failings. The effect of such a "discharge" depends, it seems, on its precise legal form and certain legal technicalities that guarantors or principal debtors are not likely, to appreciate. A related difficulty which we believe deserves attention arises from the application of a legal fiction which in some cases renders a principal debtor liable to a guarantor notwithstanding that he is no longer liable to his creditor. This has the deplorable effect of rendering a release signed by a creditor against the debtor useless because the creditor may still collect the debt from the guarantor who may then claim reimbursement from the debtor.

We recommend the abrogation of the artificial distinction between the various forms of discharge and that a purported "reservation" of rights against a guarantor in a release should be ineffective.

The remaining recommendations in Chapter VIII relate to the reform of the legal and equitable rules which impose various duties on creditors in respect of dealing with securities and extensions of time. The violation of those duties in some cases renders a contract of guarantee unenforceable, and in other cases reduces its value to the creditor. At common law and equity it is accepted that a guarantor ought not to be prejudiced by acts of the creditor, either alone or in combination with the principal debtor, over which he has no control. Accordingly, the most insignificant transgression of a creditor, unless it benefits a guarantor, releases the guarantor from liability. The response to this state of affairs has been of two sorts. In some jurisdictions legislation has relaxed the common law and equitable rules. In others, creditors have responded by inserting terms in standardform contracts of guarantee which give them unrestricted freedom. That is the case in British Columbia. It is clear to us that neither the present law nor the unilateral contractual reforms devised by creditors fairly meet the needs of all of the parties to the contract of guarantee. We therefore recommend a number of modifications to the present rules. The result, in our opinion, achieves the appropriate balancing of interests which was previously lacking.

G. Liability on the Contract of Guarantee: Chapter IX

In Chapter IX we examine the principle of co-extensiveness, namely that the liability of a guarantor should be no greater than the liability of his principal. It has been recognized in other jurisdictions that the principle of co-extensiveness is fundamental to the law of guarantees and we recommend that it be embodied in consumer protection legislation in British Columbia.

It is conceded, however, that in specific cases, the policy in favour of co-extensiveness must fall to other countervailing policies which argue for the enforcement of guarantees notwithstanding the unenforceability of the principal debt itself. Those cases are discussed and specific recommendations are made respecting them.

We noted at the outset that consumer protection legislation has not adequately responded to the special difficulties of consumer contracts of guarantee. Specifically, the provisions of the *Conditional Sales Act* and *Bills of Sale*

Act which restrict the manner in which a creditor may enforce his security interest in goods may leave open the possibility that a creditor might avoid the legislation by enforcing a contract of guarantee. In addition, the *Trade Practices Act*,

10. S.B.C. 1974 , c. 96. comprehensive as it is, affects the law of guarantees in only a cursory manner. We recommend that the specific protections afforded to consumers under those statutes be extended to consumer guarantors.

H. Guarantees by Way of Negotiable Instrument: Chapter X

All the recommendations made in Chapters IV to IX are aimed at modifying the law concerning guarantees that are created by contract. But a creditor can achieve security that is functionally identical by calling on the "guarantor" to make or endorse a negotiable instrument such as a cheque or promissory note. Owing to the division of legislative authority created by the *British North America Act* the power to enact legislation that affects the rights of holders of instruments is a matter within the exclusive jurisdiction of the Parliament of Canada.

Our research has revealed, however, that the Province is not totally without power to enact legislation that may incidentally touch upon negotiable instruments. In Chapter X we set out a scheme which we believe will provide the maximum protection possible for the guarantor by way of negotiable instrument while, at the same time, staying within the lawful limits of provincial jurisdiction.

I. Contracting Out: Chapter XI

Our final recommendations would preclude a waiver, by the guarantor, of the protection provided by any of the foregoing recommendations. It is indisputable that to allow alteration of the rights of guarantors would be to permit the total circumvention of the recommendations.

J. Conclusion

While we are alive to the argument of creditors that the changes we recommend may complicate their dealings with principal debtors, we consider it a paramount responsibility to provide for the involvement of guarantors, not only at the time that the principal transaction is entered into, but for as long as the debtor has not fulfilled his obligations and the creditor has not received what he has bargainer for.

There is no doubt that these recommendations contemplate some interference with normal debtorcreditor relations. It is our view, however, that this is both unavoidable and justifiable as a guarantor often receives no tangible benefit for his promises, and his interests, where he is unable to bargain and negotiate for their protection, must be bargained and negotiated for on his behalf.

To provide a framework for these recommendations a starting point is new legislation designed to improve the position of the consumer guarantor.

The Commission recommends that:

1. *Legislation be enacted that embodies the recommendations set out below concerning the rights and liabilities of guarantors of consumer transactions.*

CHAPTER III THE WORKING PAPER

A. Introduction

The recommendations summarized in the previous chapter correspond generally to the proposals for reform that were set out in our Working Paper. We say generally because in some instances, particular aspects of our recommendations represent a considerable modification of the tentative proposals set out in the Working Paper. Most of these modifications relate to drafting improvements which we believe tend toward greater clarity and simplicity, so far as those goals may be realized in such a complex area of the law. It is fair to say that there has been no retreat on major issues of policy, nor has there been any new recommendations in areas not discussed in the Working Paper.

B. The Response to the Working Paper

The Working Paper was widely circulated both to the credit grantors and their representatives and to persons and groups who could be identified as speaking for consumers. Not surprisingly, the responses which we received were diverse in tenor and viewpoint. A view expressed with greater or lesser force in the submissions of the credit grantors was that we had "gone too far," while those speaking for consumers, suggested that we had not gone far enough. The very diversity of the response received, however, leads CLS to conclude that our proposals represented something of at middle ground which, while perhaps wholly satisfactory to no one, provide a fair and workable balance of the interests at stake.

The body of this Report does not contain an extensive discussion of the response which was directed at particular aspects of the law or specific proposals. This does not reflect a disregard of that response. All the submissions that we received were carefully considered and debated. They assisted considerably in sharpening our views and in developing final recommendations that are both practical and fair. A list of persons who submitted comments is set out as Appendix C to this Report.

The omission of this discussion reflects our desire to produce a final Report that is somewhat more compact and readable than the Working Paper. The Working Paper was, admittedly, a bulky document but, for the purpose of consultation, it was felt that a relatively elaborate exposition was called for. Nonetheless it was somewhat sobering when, shortly after the distribution of the Working Paper, we received the Report of the Law Reform Committee of South Australia concerning Reform of the Law of Suretyship. That Report covers a number of matters that were canvassed in the Working Paper (and some that were not). Our Working Paper ran to over 300 typescript pages. The South Australia Report occupied a mere 8 pages.

C. Guarantees by a Spouse

The recommendations set out in this Report and the proposals that preceded them are directed at "consumer guarantees" in general. It is the character of the transaction guaranteed rather than the nature of the relationship between the guarantor and the principal debtor on which the applicability of our recommendations hinges. Thus, so long as the guarantee is of a "consumer debt," it makes no difference whether the guarantor is a parent, child, spouse or merely a friend of the debtor.

A number of response received from persons and agencies concerned with the interests of consumers singled out the position of spouses for special comment. It was urged on us that this is an area where coercion and pressure by the credit grantor and the principal debtor presents particular problems. The extract set out below is representative:

> A very substantial problem exists in the area of guarantees or cosignatures of loans by family members, such as a wife and at commonlaw wife ... As the paper recognizes, these people invariably do not understand the significance or the legal consequences of the transaction ... There is no question about the inequality of bargaining power

> between the bank and a family guarantor. Add to this the added pressure on, for example, a wife or common law wife by her spouse to consign a note or guarantee a loan, and we have a situation of gross inequality. At [the writer's agency] we constantly see estranged wives or common law wives who now find themselves stuck with their husband's debts. While I realize that cosignatures and guarantees by family members are an important tool in commercial transactions today the protection of wives and other family members who enter into contracts of guarantees or cosignatures must be of paramount importance. We ... see far too many women who are now divorced or estranged from their husband and after the divorce suddenly find themselves saddled with several debts as a result of the period of matrimonial bliss. Those people should be given special protection, and, it is felt, should have special provisions to further protect them and make them aware of their obligations when entering into a contract of guarantee.

It is clear that the writer's concern is not limited to consumer transactions but also extends to situations where, for example, a wife guarantees her husband's business debts.

Some suggestions were advanced in respect of these concerns. They included a requirement of independent legal advice for spouses, and a "cooling off" period during which the guarantor could withdraw from the transaction, similar to that provided by the *Consumer Protection Act* with respect to doortodoor sales. We have given careful consideration to these suggestions and have concluded that they raise problems of their own which would significantly detract from their utility.

A primary source of the concern with respect to spouses as guarantors is the opportunity for coercion and the inequality of bargaining power that may be implicit in such a relationship. One answer may lie in a new line of case law, directed specifically at those circumstances, in which the courts appear to be much more willing to strike down "unequal" bargins than in the past. We are encouraged by this trend and believe the application of the principles enunciated in these cases would result in a more precise allocation of responsibility than any, attempt, by statute, to subclassify guarantors into familial, spousal or other subgroups and provide special rules for each.

Another submission directed our attention to certain collection practices where guarantees by spouses are involved:

> One problem which was not addressed by the Commission in this paper is that of creditors using the guarantor as a collection agent. This occurs most often when a woman has cosigned for her husband and the husband deserts, leaving the wife with responsibility for payment. Often the woman has no means of paying the debt. In such cases she is often "urged" by the creditor to locate the husband for them so that they can attempt collection. Such pressures at a time of marital breakdown often serve only to aid in further deterioration of the relationship.

While we sympathize with spouses in the position described we are not sure that this issue is one that should be confronted in a Report concerning the substantive law in relation to the creation and enforcement of guarantees. Rather it is one that should be resolved in the context of the *Debt Collection Act* which contains specific prohibitions against unreasonable collection practices.

In summary, while we realize that guarantees given by spouses are capable of giving rise to special problems, on balance we do not believe that special provisions can be justified. We hope that by significantly improving the legal position of all consumer guarantors these problems would become much less severe and pronounced.

D. Guarantees of Commercial Debts

We again draw attention to the scope of this Report. At the consultation stage of this project we said:

> Although the working paper does not extend to commercial guarantees, many of the issues canvassed have application in that area; and the law in both is complex, inconsistent and obscure. We invite comment whether a study of commercial guarantees would be a worthwhile project for the Commission to undertake.

That invitation did not result in a flood of submissions.

Only one person who responded addressed this issue. Speaking as a grantor of commercial credit, he suggested that most of the assumptions on which our proposals were based, and which may justify changes in the law with respect to consumer debts, do not exist in the business context.

While we concede that there may be difficulties in translating our recommendations into a form appropriate in the commercial context, we are far from convinced that the *status quo* should be maintained. We note that the Report of the South Australian Committee, that recommended a number of changes in the law of suretyship, did not distinguish between commercial and consumer guarantees.

In the previous section it was pointed out that one spouse will often guarantee the business debts of his or her partner. There is no reason to believe that such a spouse is better informed or less in need of protection than if the guarantee covered a major consumer purchase. Moreover, our own experience as lawyers leads us to a conclusion that, in so far as small business is concerned, the notion that credit is freely negotiated is as much a myth as with respect to consumer transactions.

We are therefore continuing to keep the matter of commercial guarantees under review and would welcome further submissions on this aspect of our work, particularly from the small business community in which our Working Paper was not widely circulated.

CHAPTER IV WHO IS A CONSUMER GUARANTOR?

The evolution of commercial law has resulted in the creation of a variety of arrangements which, although they differ radically in their legal effect, are functionally identical in providing security to credit grantors. Our research has identified a number of transactions which, although they exhibit marked differences in form, create legal relationships which fall within the general notion of guarantee and are of concern in the context of consumer credit.

The first relationship arises when a person promises to fulfil the obligations of a principal debtor if the principal debtor defaults on a contract which has been, or is to be entered into by the creditor and principal debtor. This is the conventional contract of guarantee and its essence is the creation of a tripartite relationship consisting of:

(a) A principal contract creating rights and obligations between a creditor and principal debtor, and

(b) A contract of guarantee executed by the creditor and a guarantor whereby the guarantor agrees to fulfil the obligations of the principal debtor if he defaults on the principal agreement.

The second relationship, identical in function to the first, is created when a third person gives a security interest such as a mortgage in his own property to a creditor in order to secure the obligation of a principal debtor created under a principal agreement. The taking of a security interest in the property of a third party is no different than the taking of his personal covenant under a conventional guarantee. The same relationship arises where the third person physically deposits (pledges) his own property to secure another's obligations,and often these various forms of guarantee are used in combination.

A comparable relationship may also be created through the use of a negotiable instrument, such as a cheque or promissory note. A negotiable instrument may give rise to the tripartite relationship of "creditordebtor-guarantor" in either of two ways. The first arises where a third party endorses a negotiable instrument which has been made by a principal debtor in favour of at creditor. The second occurs where the third party himself makes a negotiable instrument in favour of a creditor in order to secure the obligations of a principal debtor. The functional effect of endorsing or making a negotiable instrument is to constitute the third person as a guarantor. The inherent simplicity of the note or cheque makes this an attractive form of security which is widely used.

Another form of collateral security is the contract of indemnity, whereby a third party (the indemnitor) agrees with a creditor to be responsible for any loss arising from the principal contract. The fundamental difference between a contract of indemnity and a contract of guarantee is the nature of the obligation undertaken by the third party. Under a contract of indemnity, the indemnitor undertakes to be primarily liable for any losses ascertained by reference to the principal contract. In a contract of guarantee the guarantor assumes only a secondary liability to answer for the principal debtor who remains primarily liable for his obligations.

Notwithstanding the fundamental difference, as a matter of legal theory, between a contract of indemnity and a contract of guarantee, it has been argued, even with respect to commercial transactions, that they should be afforded the same treatment under the law:

> The distinction between a guarantee and an *irm* demnity is it most difficult one. Lord Justice Harman has described it as "a most barren controversy" and said that the question "has raised many hairsplitting distinctions of exactly that kind which brings the law into hatred, ridicule and contempt by the public." ... [W]e very much hope that the Law Commission will investigate the present unsatisfactory state of law in this regard.

The illogicality of the present law is widely recognized. As Professor Goode points out:

> A guarantor is one whose liability is secondary, i.e. dependent on that of the principal debtor. He incurs no liability until the debtor has made default, and unless otherwise provided by the contract of guarantee can repudiate the guarantee if the principal contract to which the guarantee relates is invalid or unenforceable. On the other hand, the liability of an indemnifier under a contract of guarantee ... is a principal liability and not in any way dependent on default by the principal debtor or on the validity of the contract entered into by the debtor. The classic ... example [is where] A says to B: "Supply goods to C and if he does not pay you, I will." That is a contract of guarantee. A says to B: "Supply goods to C and I will see that you are paid." That is a contract of indemnity. The difference between the two contracts produces substantial legal consequences, yet in most cases it is totally unreal. If the obligations of the indemnifier have the same content as those of the principal debtor, it is mere sophistry to say that the indemnifier's liability is not dependent on the principal debtor's default; for performance of their respective obligations falls due at the same time and if the principal debtor meets his obligations, there will be no remaining liability to which the indemnity can attach.

The distinction between contracts of guarantee and contracts of indemnity has, for the purposes of a wide variety of consumer transactions, been eliminated by legislation in England. The latest strip in this direction is the *Consumer Credit Act, 1974,* in which "security" is defined as:

> ... a mortgage, charge, pledge, bond, debenture, indemnity, (guarantee, bill, note or other right provided by the debtor or hirer at his request (express or implied), to secure the carrying out of the obligations of the debtor or hirer under the agreement;

In British Columbia the new *Consumer Protection Act*, defines guarantor so as to include:

> ... a guarantor, surety, indemnitor and endorser, or other individual liable for the payment or repayment of the money owing or on an agreement or collateral or other security given in respect of it ...

The approach of the English legislation and the *Consumer Protection Act* concerning the scope of protection is, in our view correct. Consumer guarantors are unlikely to appreciate technical niceties of the sort described above. We have concluded that the legal position of consumer guarantors ought to be considered without regard to the technical form of their undertaking.

It is clear, in principle, that the position of a guarantor by way of a negotiable instrument should be consistent with the position of a guarantor under a contract of guarantee or pursuant to a security agreement. It is, however, equally clear that constitutional limitations preclude the direct involvement of provincial legislation with the law relating to negotiable instruments. For that reason, special recommendations are necessary to assimilate their position, as far as possible, to that of guarantors by way of contract. A separate chapter of this Report is devoted to the special issues associated with guarantees taken by way of instrument. The vocabulary we adopt is set out in the recommendations at the conclusion of this chapter.

The scope of the recommended legislation must be defined with reference to "consumer transactions" and it remains to give that expression some meaning. It is clear that the nature of the principal transaction, and of the obligations created thereby, are of critical importance.

Several provincial statutes now contain definitions of a consumer transaction, the most comprehensive of which is found in section 1(1) of the *Trade Practices Act*:

> "consumer transaction" means
>
> (i) a sale, lease, rental, assignment, award by chance, or other disposition or supply of any kind of personal property to an individual for purposes that are primarily personal, family, or household, or that relate to a business opportunity requiring both expenditure of money or property and personal services by that individual and in which he has not been previously engaged ...

Although we agree with the general tenor of that definition, it would, if transposed without alteration into legislation concerning contracts of guarantee, result in the exclusion of agreements given with respect to transactions involving real property. Thus contracts of guarantee given to secure a tenant's obligations under a residential lease, or a purchaser's or mortgagor's obligations under an agreement for sale or mortgage of residential real estate, would be excluded from the proposed legislation.

The focus of our recommendations is to ensure that the consumer guarantor has adequate information concerning his rights, liability, and risk and to modify the substantive law to remedy imbalances in the rights of the parties. The concerns addressed by the recommendations are not peculiar to personal property transactions. There is no reason to believe that a guarantor of obligations arising out of a real property transacton is any better able to protect his interests, or is any better informed than is a guarantor of obligations involving goods. It is difficult to justify the granting of rights to a guarantor of obligations arising on the purchase of an autombile while withholding those rights from a guarantor of obligations incurred on the purchase of a home.

It seems to us that persons who guarantee the obligations of tenants, purchasers, or mortgagors of real property deserve, and are in need of the same rights and privileges which may be proposed with respect to guarantors of consumer obligations in general.

Should a definition of "consumer transaction" extend to a simple loan of money for the purposes of our recommendations? If this were the case then a guarantee given to secure the obligations of a borrower who has been advanced money by a lending institution, where the advance enables the borrower to enter into a consumer transaction, would be covered by our recommendations.

The *Consumer Protection Act* provides a measure of protection to guarantors who guarantee obligations arising out of "purchase financing transactions" which are defined as:

> ... the extension of credit to a borrower by a creditor where the creditor knows or ought to know that the credit proceeds will be used by the borrower to purchase goods or services from a seller.

The federal *Bills of Exchange Act* which provides rights to consumer guarantors by way of negotiable instruments is more restrictive. Its protection extends to a bill of exchange or a promissory note only where:

> (a) the consideration for its issue was the lending or advancing of money or other valuable security by a person other than the seller, in order to enable the purchaser to make the consumer purchase; and
>
> (b) the seller and the person who lent or advanced the money or other valuable security were, at the time the bill or note was issued, not dealing with each other at arm's length with the meaning of the *Income Tax Act*.

It is difficult to justify restricting the protection to cases where the seller and lender are not dealing with each other at arm's length thus excluding independent banking and consumer financing institutions from the ambit of protective legislation. The approach of the *Consumer Protection Act* seems preferable.

We realize, of course, that to include contracts of guarantee given with respect to borrowing transactions would place an onus on consumer lenders to police their financial arrangements, and to make appropriate inquiries before advancing money or other valuable security. We believe, however, that this is the present practice among commercial lenders, thus no new duty would, in reality, be imposed. It is our view, therefore, that guarantees of lending transactions should be subject to our recommendations where the creditor knows or ought to know the money is to be applied in a consumer transaction. The inclusion of an objective test of knowledge is necessary to ensure that creditors make reasonable inquiries relating to the purpose of the loan We believe that this duty is not an unreasonable one.

In most of the situations discussed so far the guarantor will be a close friend or relative of the consumer purchaser. Yet it is not unusual for the guarantor of a consumeris obligations to be an individual or corporation who ought to have access to legal advice and expertise. The most frequent example of this situation is the relationship between a retail seller aind at financial institution arising on an assignment of the seller's rights.

It is a common practice for retailers to assign their rights under conditional sales contracts and associated negotiable instruments to commercial financers such as finance companies in return for cash. The financers, seeking to protect their interests, often require the retailer to guarantee the consumer's obligations, or to agree to indemnify the financer for any losses arising from the consumer is default. Those agreements, known colloquially as recourse agreements, are not uncommon. As Atiyah points out:

> Frequently the finance company insists that the retailer should act as guarantor. The finance companies regard themselves as mere bankers, and if there is default in payment or any difficulty in connection with the contract, the finance company does not want (as it probably has not the facilities) to be forced to take possession of the goods. They expect the retailers to step in at this stage to pay them off the balance owing. The retailer is then left, by way of subrogation or by express assignment, to enforce the hirepurchase agreement as best he can.

Since the recommendations set out in this Report are essentially of a consumer protection character, their potential application to recourse guarantees raises serious questions. Those respondents to the Working Paper who considered the position of recourse guarantors were in agreement that recourse arrangements should be governed by the general law concerning guarantees rather than our proposals.

There are two possible approaches to rationalizing the position of recourse guarantors under our recommendations. The first is simply to exclude them from the ambit of reforming legislation. The second is to include them within the legislation but to permit the parties to "contract out" of any or all of its provisions in respect of recourse guarantees. It was the second approach that commended itself to us in the Working Paper.

On reconsidering this issue we have concluded that the second alternative has certain weaknesses. First, we believe that almost invariably the parties will attempt to contract out of the legislation thus adding to the "boilerplate" clauses associated with recourse agreements. Secondly, even though our original proposal would have permitted contracting out, the potential application of the legislation is perceived by commercial financers as an impediment to the use of recourse arrangements. While we do not agree that this would be the case, this is an issue on which the concerns of the financers can be met without doing violence to our basic scheme. We have therefore concluded that recourse guarantees should be entirely excluded from the legislation we recommend.

It remains, however, to develop criteria to differentiate between recourse guarantors and other consumer guarantors. One rough test is to draw a distinction between guarantors that are "natural persons" and those that are not. This technique has been adopted by the Province of Alberta in the *Guarantees Acknowledgement Act*. That Act provides that certain contracts of guarantee are of no effect unless the guarantor appears before a notary public, and acknowledges his execution of the contract and his understanding of its consequences. The Act does not apply, however, to corporate guarantors, and in a recent review of the legislation, the Alberta Institute of Law Research and Reform endorsed their exception on the ground that corporations are likely to obtain legal advice before undertaking any serious financial commitment.

An entirely different technique is used in recent amendments to the federal *Bills of Exchange Act*, under which certain guarantors of consumer transactions now enjoy a measure of protection. The Act is restricted to "accommodators" of consumer transactions, and in section 55(1) of the Act, an accommodation party is defined as:

> ... a person who has signed a bill as a drawer, acceptor, or endorser, *without receiving value therefor*, and for the purpose of lending his name to some other person.

The fact that a recourse guarantor will receive value from the financing institution in return for the assignment of his rights under the consumer transaction, and for guaranteeing the consumer's obligations, effectively precludes him from coming within the ambit of the federal legislation.

English legislation which provides protection and affords rights to consumer guarantors, is restricted to those who have obligated themselves or their property at the *request of the principal debtor,* and thus would not apply to a retailer in the legal guise of a guarantor. It is true that retailers could bring themselves within the protective measures of the legislation by inserting standard term in retail sales contracts whereby the purchaser would request the retailer to guarantee the purchaser's obligations, but this has not, apparently, been the case. In any revent, that possibility could be eliminated without difficulty if such terms were prohibited by law.

In the United States, a distinction has been drawn, at common law, between gratuitous guarantors and corporate guarantors. The *Uniform Consumer Credit Code*, which provides for disclosure in the case of consumer contracts of guarantee, excepts from the formality, a guarantee given by "a seller, lessor, or lender who is obligated to an assignee of his rights." A similar technique has been adopted in the Manitoba *Consumer Protection Act*.

Finally, the British Columbia *Consumer Protection Act*, in defining "guarantor" excludes any person that acts as a surety in the ordinary course of business.

After considering these alternatives, we have concluded that the simplest, and we believe most effective, way to exclude a recourse guarantor from the recommended legislation is to provide that it does not apply to a guarantee

entered into by the original retailer or lender who is obligated to an assignee of his rights. Such a guarantee would continue to be governed by the general law and the formalities now required under section 5 of the *Statute of Frauds*. This policy could be reinforced by restricting the ambit of the legislation to guarantees given by individuals.

The recommendations that follouw set out what we believe to define the proper scope of reforming legislation. While the definitions that are developed may appear to be overly elaborate for the purposes of the present context, in an area of the law as complex as this it seems preferable to adopt and define an appropriate vocabulary at the outset and theri employ it. consistently throughout the text and recommendations.

The Commission recommends that:

2. The recommended legislation should govern all guarantees other than recourse guarantees.

3. In the recommendations set out in this Report:

"consumer transaction" means an extension of credit to an individual where the creditor knows or ought to know that the credit proceeds will be used by that individual to purchase, lease or otherwise acquire real or personal property for purposes that are primarily personal, family or household.

"creditor" means the person for the time being entitled to enforce a guarantee.

"guarantee" means an undertaking such as a guarantee, contract of indemnity or suretyship, or security agreement or similar undertaking made or given by an individual to secure the payment or performance of the obligations of a principal debtor arising under a consumer transaction.

"guarantor" means an individual who makes or gives a guarantee.

"principal debtor" means the person to whom credit is extended under a consumer transaction.

"recourse guarantee" means a consumer guarantee under which the creditor is an assignee of the guarantor's rights under the consumer transaction.

CHAPTER V THE CREATION OF A CONSUMER GUARANTEE

A. An Informed Choice

A central theme of the consumer protection legislation that has been enacted in Canada in the past 20 years is that there should be full and fair disclosure by a supplier of relevant information to the consumer. Underlying this trend is a recognition that in today's consumer marketplace the notion of freedom of contract is something of at myth. First, there is an enormous disparity of bargaining power between the supplier and consumer. Usually, the consumer’s only freedom is to "take it or leave it." Secondly, the implications of at choice are not always clear to the legally unsophisticated consumer. He lacks information on the legal nature of what it is that he is invited to accept or reject. While consumer protection legislation cannot reduce the disparity of bargaining power, it can prescribe certain formalities and standards of disclosure that must be met if a transaction is to be enforceable. The aim of such

legislation is to enable the consumer to make an informed choice whether or not to enter into a particular transaction.

Are similar considerations present in the context of consumer guarantees? Does the present law impose standards of disclosure and formalities such that the potential guarantor may make an informed choice? This issue has been considered by other law reform agencies that have expressed concern.

In 1967 the Latey Committee on the Age of majority made the following remarks:

> There is however one matter that greatly troubles us. We have had evidence that guarantees (or indemnities) are lightly entered into by persons who do not appreciate that they are themselves accepting a real financial responsibility which may well materialise and cause hardships. Sometimes this is because the distinction between a mere reference and a contractual obligation is not understood; sometimes it is seen as a conventional act of friendship or something of that kind.
>
> We think that more should be done to ensure that person; accepting such liability grasp all the implications of what they are doing. It is too much to expect that they will read all the terms of a printed or typewritten document usually drafted by lawyers, or that they will understand all its legal effects if they do read it. One suggestion is that such obligations should only be enforceable if entered into after a solicitor has explained the position, but a similar provision in the *Bills of Sale Act* has not worked well and it would increase expense. We have come to the conclusion that a more effective solution would be to ... prescribe that the signature of the hirer under a hirepurchase agreement must be inserted in a space outlined in red ink and stating in red:
>
> "This document contains the terms of a hirepurchase agreement. Sign it only if you want to be legally bound by them."

In 1971, the Crowther Committee on Consumer Credit repeated that statement, and again referred to the lack of awareness on the part of consumer guarantors:

> There is a substantial volume of evidence to show that many of those who enter into credit agreements have little idea of the nature of the contract, the extent of their commitments under it and their basic legal rights and obligations. It is unlikely that those who stand guarantor for persons entering into credit agreements are better informed, and indeed some may be people of little substance and not in a position to undertake liabilities of this nature. We are left with the impression that, whether by reason of persuasive sales talk ("it's just a formality"), or for some other reason, many of those entering into guarantees do so with little thought and in a very casual manner ... it is just as important that a guarantor should be made aware of the nature of the transaction he is entering into as it is for a hirer under a hirepurchase or a buyer under a credit sale agreement.

While, in the course of this study, we have not carried out any empirical research, the experience of individual Commission members supports a view that substantial changes to the law in this area are called for.

There is at wide range of facts and matters that should be made known to the potential guarantor if he is to make an informed choice concerning his committment. These may range from general legal information designed to bring home to the guarantor the nature and extent of his liability to the disclosure of specific facts that may be peculiar to the individual transaction in issue. The challenge is to develop a set of rules concerning disclosure that will strike an appropriate balance between measures credit guarantors can comply with without an unreasonable dislocation of their business and a level of disclosure that will benefit a majority of consumer guarantors.

In pursuing this objective we have found it useful to divide the information requirements into two groups. The first group of requirements consists of information and facts that directly define the guarantor's liability and that can aptly be treated as "formalities" to be regarded as an essential feature in the creation of all consumer guarantees. The second group concerns a disclosure of other facts that, although they do not directly define the guarantor's legal liability, do concern his exposure to risk, and thus are relevant to an informed choice.

The balance of this chapter is concerned with the first group, that is, information requirements that should be part of the formality of entering into a consumer guarantee. The following chapter will consider the second group of disclosure requirements.

B. Formal Disclosure

The only formality the law now imposes on the creation of guarantees is that it be evidenced in writing and signed by the guarantor or his agent. In a recent Report we argued that the formal requirement of writing is valuable as a *cautionary* device, focussing the attention of an individual who is about to enter into a guarantee on the implications of his act and in so doing, reduce unconsidered behaviour. We noted our suspicions, however, that the mere requirment of a signature on a document, the terms of which may be incomprehsible, is likely to do nothing more than confuse the issue. It seems to us that more stringent and particular formalities are called for in the context of consumer contracts of guarantee.

We believe that, as a practical matter, consumer guarantors do not fully appreciate the very serious implications of affixing their signature to contracts of guarantee. While, in most cases, consumer guarantors are given copies of their agreements, if the standard form contracts of guarantee set out in Appendix A are indicative of what consumer guarantors are likely to receive, there is little to be said in favour of the present law or practice in the area of disclosure of material information.

In every case in which a consumer guarantee is solicited, the credit grantor should provide to the potential guarantor a disclosure statement that sets out specified information concerning both the legal and financial implications of the agreement in terms whose import the guarantor can easily understand. It ought to include a warning that the person signing will be bound to fulfil the terms of the contract, and a statement of the limit of liability if the guarantee is a limited one. In addition, the size of type and the placement of the signature in relation to the disclosure should be regulated.

A requirement that consumer guarantors be provided with reasonable and adequate notice of their "potential liability" and the legal significance of the document they are signing, although obviously not unimportant, does not go far enough. There will often be other matters that are of critical importance to guarantors. For example, a lender may, in the past, have extended credit to the principal debtor and the guarantee is intended to secure payment of that obligation. It is a virtual certainty that disclosure of such a prior debt to a potential guarantor would influence his decision to undertake contractual responsibility on behalf of the principal debtor.

Under the present law, guarantors of consumer obligations are left entirely to their own devices if they desire to obtain information with regard to their potential liability. The cases make it clear that the onus is on the guarantor to make the appropriate inquiries of the creditor, and that the creditor is under no obligation to disclose information unless it differs radically from what the guarantor could reasonably expect. In a short passage from The Law of Banking, the difficulties are illustrated nicely:

> A guarantee is not a contract *uberrimae fidei*, necessitating full disclosure of all material facts. The bank is under no duty to volunteer information concerning the financial position of the principal debtor to a prospective guarantor ... [or] to give information on matters about which it is asked no questions, but that if questions are asked the answers must not mislead or misrepresent the fact ...
>
> At times the dividing line can be rather thin between (a) the nondisclosure of facts concerning which no questions have been directed and (b) a misrepresentation enabling the guarantee to be avoided. It has been said in a Scottish case that a banker is entitled to assume that the guarantor "has informed himself upon the various matters material to the obligation he is about to undertake." The bank "is not bound to volunteer any information or statements as to the accounts, although if information is asked he is bound to give it, and to give it truthfully." Where

> the contract is not of the class *uberrimae fidei* and there is no duty of disclosure, simple "reticence does not amount to legal fraud, however it may be viewed by moralists," nor does it constitute innocent misrepresentation grounding a claim to avoid a guarantee. On the other hand, very little may be required to constitute a misrepresentation of the facts. Words or conduct or perhaps in certain circumstances, even silence on the part of the banker, may convey a wrong impression to an intending guarantor, concerning matters under discussion.

The issue of nondisclosure was considered recently by the Supreme Court of British Columbia in *Bank of Nova Scotia* v. *Boehm*. In that case the defendant had guaranteed both the past and future indebtedness of a company to the bank, after the bank's representative had informed him of a two thousand dollar overdraft. There was no disclosure, however, of two earlier demand loans which increased the company's debt to nine thousand dollars. The defendant was held liable to the bank as a guarantor of the entire indebtedness of the company, and it was held, notwithstanding the nondisclosure of the demand loans, that there was no fraudulent or innocent misrepresentation that would allow the defendant to rescind the contract of guarantee. As Berger J. pointed out:

> ... there was [no] fraudulent intent on the part of [the plaintiff]. I have into account the fact that he may have had a motive for deceiving Mr. Boehm. The bank would be better off if it could obtain a guarantee covering the whole of the company's indebtedness ... and Mr. Boehm was no doubt rather more willing to sign the guarantee than he would have been if he had been told the true state of affairs ... [The bank] is entitled to assume, in the absence of any inquiry by Mr. Boehm regarding the state of the company's accounts with the bank, that he knew of the earlier loans. Mr. Boehm was prepared to sign a guarantee, and did sign a guarantee, which in terms covered past as well as future indebtedness. Mr. Boehm could read. Yet he made no inquiry, and asked no questions. So I do not think that [the bank] was bound to disclose the earlier loans.

The remarks of Romer L.J. in *Seaton* v. *Heath* present accurately the policy considerations in favour of nondisclosure:

> In general, the creditor does not himself go to the surety, or represent, or explain to the surety, the risk to be run. The surety often takes the position from motives of friendship to the debtor and generally not as the result of any direct bargaining between him and the creditor, or in consideration of any remuneration passing to him from the creditor. The risk undertaken is generally known to the surety, and the circumstances generally point to the view that as between the creditor and surety it was contemplated and intended that the surety should take upon himself to ascertain exactly what risk he was taking upon himself.

We believe that those remarks are wholly inappropriate in the context of consumer guarantees and reiterate our conclusion that creditors should be required to disclose certain "material" information to the potential guarantor.

In summary, we believe that credit grantors should be under a duty to provide a disclosure statement containing the following information and facts.

(1) A statement comparable to the following:

"A guarantee is a binding legal document, that imposes a serious liability. It is not a mere formality. Sign it only if you wish to be bound."

(2) A statement that sets out the guarantor's maximum liability under the guarantee or if the guarantor's liability is unlimited, a statement to that effect.

(3) If the guarantee covers past indebtedness of the principal debtor, a statement to that effect and the amount of the past indebtedness.

(4) If the guarantee covers future indebtedness of the principal debtor, a statement to that effect.

C. The Consequences of NonCompliance

We have equated the provision of a disclosure statement with the formalities of the creation of a guarantee and this aspect of our recommendations calls for some elaboration. In most cases where certain formalities are called for in the creation of legal relationships, the effect of a failure to observe those formalities is to render the transaction a nullity or to make unenforceable the rights purported to be created under the transaction. This, in general terms, we see as an appropriate consequence of a failure to observe the very minimal "disclosure" requirements described above.

An important issue whenever formality is imposed on otherwise uncomplicated transactions, is the nature of the rights of the parties to the transaction where the formalities are not observed. Too often this matter is left unresolved, with results that are fortuitous at best, and that may, in fact, conflict with the very policies sought to be achieved by the requirement of formalities in the first place.

For example, the Ontario *Consumer Protection Act*,

17. (1976) 9 O.R. 404. provides that the result of noncompliance with formality is an agreement that is not binding on the buyer. Yet in *CT. Schofield Manuel Ltd*. v. *Rose et al*. Cornish C.C.J. held that a consumer could not rely on the Act where the contract had been partially performed. It is at least arguable that this case was wrongly decided, but we mention it here to point out the need for careful consideration where the effect of informality is at issue.

An example of such care is, we believe, to be found in section 106 of the English *Consumer Credit Act, 1974*. It provides that where a "security" is ineffective:

> (a) the security, so far as it is so provided, shall be treated as never having effect;
>
> (b) any property lodged with the creditor or owner solely for the purposes of the security as so provided shall be returned by him forthwith;
>
> (c) the creditor or owner shall take any necessary action to remove or cancel an entry in any register, so far as the entry relates to the security as so provided; and
>
> (d) any amount received by the creditor or owner on realisation of the security shall, so far as it is referable to the agreement, be repaid to the surety.

In our view the recommended legislation should specify the consequences of unenforceability in a similar fashion. The clarification of the property rights involved and a positive duty to clear any charges registered against a guarantor's property, if the guarantee took the form of a security agreement, would be very useful in the light of the unfortunate decision in *Re Leippi*.

While the civil consequences of noncompliance will go some way toward ensuring compliance with the recommended formal requirements, they may be inadequate to cope with recurring violations of the formal requirements by a supplier. In such cases we believe a further sanction may be called for the enforcement provisions of the *Trade Practices Act*.

Under various sections of that Act, consumers are given the right to challenge the enforceability of transactions where the commercial retailer or lender has been guilty of unconscionable or deceptive acts or practices. In addition, the retailer or lender may be subject to relatively onerous penalties, and the Director of Trade Practices is given authority to police the activity of those who deal with consumers and to institute legal proceedings on behalf of consumers where their interests have not been respected. The failure by credit grantors to observe fundamental

principles of disclosure is, we believe, precisely the sort of activity which ought to be included in a definition of "deceptive act or practice." By using that technique the full weight of the *Trade Practices Act* could be brought to bear in an effort to ensure fair treatment of consumer guarantors.

A difficulty that arises whenever formality is imposed on otherwise simple transactions is that *bona fide* agreements may be avoided solely on the ground that highly technical requirements of form have not been met. While we have stressed the importance and value of formality in achieving some measure of balance between the interests of consumer guarantors and the interests of retailers of consumer goods, we appreciate that inequities and hardship which may occur if the requirements of formality are left open to abuse.

The Crowther Committee on Consumer Credit reflected on the need to afford some relief to those who, in good faith, fail to comply with statutory requirements:

> A considerable number of statutory provisions regulating credit transactions are devoted to the formalities of contract and of registration. We accept, of course, the necessity for some measure of formality in the registration of security interests and in consumer protection legislation it is also necessary to make provision for the form and/ or contents of the contract document and ancillary matters. All too often, however, debtors can rely on a pure technicality to defeat a just claim ...

We acknowledge the accuracy of those comments, and believe that some attempt must be made to avoid those difficulties. Section 105(7) of the *Consumer Credit Act, 1974*, which embodies the recommendations of the Crowther Committee, provides for such relief at the discretion of the court. The provision, however, fails to set out the relevant considerations which ought to be taken into account in exercising that discretion.

At the other extreme is a series of provisions contained in the Manitoba *Consumer Protection Act*. Sections 4 and 5 of the Act impose elaborate disclosure requirements in the context of retail credit sales and hirepurchase agreements, and section 3 goes on to provide for relief from noncompliance under equally elaborate and complex circumstances.

Although we accept the fact that relief from non-compliance with formalities ought to be available to those who grant credit to consumers, the precise nature of that relief has given us some difficulty. What we are seeking to achieve is the proper balance between the requirements of formality and disclosure and the requirement of fairness that guarantors be prevented from avoiding contractual obligations which they have fully understood and considered.

It is arguable that relief from noncompliance with formality should be afforded where there has been a judicial determination, on an *objective* basis, that a guarantor ought not to have been misled by the irregularities. We have concluded, however, that a decision on an objective basis is likely to be influenced by the court's own views of the level of awareness on the part of consumers who enter into contracts of guarantee. In the light of the special knowledge of legal matters which lawyers and judges exhibit, these views may not coincide with the realities of consumer "negotiation."

We believe that the best resolution of the conflict between requirements of formality and our concern that some consumers might abuse measures enacted for their protection, would be to provide for the enforceability of irregular consumer guarantees only where there has been a judicial determination that the supplier's error or omission did not prejudice the guarantor.

D. Recommendations

The Commission recommends that:

4. *In every transaction in which a guarantee is sought the creditor should provide to the potential guarantor a disclosure statement that contains:*

   (a) *a notice to the guarantor comparable to the following:*

   "A guarantee is a binding legal document that imposes a serious liability it is not a mere formality. Sign it only if you wish to be bound."

   (b) *a statement is comparable to the following:*

   "Your maximum liability under this guarantee is $ ________________

   or

   "You are liable for an unlimited amount under this guarantee."

   as the case may be.

   (c) *If applicable a statement comparable to the following:*

   "This guarantee makes you responsible for the past debts of [principal debtor] in the amount of $ _______________

   (d) *If applicable a statement comparable to the following:*

   "This guarantee makes you responsible for debts incurred in the future by [principal debtor] to [creditor].

   (e) *Any matter to be included in the disclosure statement under other recommendations. [See recommendation No. 211*

5. *Regulations should be enacted to prescribe the format and size of type used in disclosure statements and the placement of the guarantor's signature.*

6. *(1) The disclosure statement should formpart of the document that creates the guarantee.*

   (2) A copy of the document that creates the guarantee should be delivered to the guarantor forthwith after its execution by him.

7. *A guarantee is not enforceable where:*

   (a) *the disclosure statement is omitted from a guarantee in violation of recommendation 6, or*

   (b) *the disclosure statement does not comply with recommendation 4, or*

   (c) *the creditor fails to deliver ii copy of the document that creates the guarantee in violation of recommendation 6(2).*

unless the creditor proves that the guarantor was not prejudiced by the noncompliance.

8. *Where a guarantee is not enforceable:*

(a) *the guarantee should be treated as never having had any effect;*

(b) *any property of the guarantor which was taken by the creditor should be returned to the guarantor, and if the creditor is unable to return the property, the creditor should compensate the guarantor accordingly;*

(c) *the creditor should be required to take appropriate action to remove or cancel any entry on any register so far as it relates to the guarantee, and*

(d) *any money received by or on behalf of the creditor pursuant to the guarantee should be repaid to the guarantor.*

9. *The* Trade Practices Act *should be amended to provide that; a failure to comply with recommendations 4, 6 or regulations contemplated by recommendation 5 is a deceptive act or practice.*

CHAPTER VI OTHER DISCLOSURE REQUIREMENTS

A. A General Duty of Disclosure

In the previous chapter we explored means of making the consumer guarantor fully aware of the extent of his liability under a guarantee. To this end, we recommended that the disclosure of certain matters be made an essential part of the formalities associated with the creation of a guarantee. A failure to observe those “formalities of disclosure" would nullify the guarantee in whole or in part.

The range of matters to be disclosed as a “formality," however, is relatively narrow and there may be a number of other facts known to the credit grantor that, if known to the potential guarantor, would significantly influence a decision to guarantee a consumer debt. To give an example, the principal debtor may be deeply indebted to the lender on loans that are not covered by the guarantee, or the credit grantor may know of substantial debts owed to other persons. In other words, the lender may have substantially better information concerning the credit worthiness of the principal debtor than has the guarantor. The whole purpose of the guarantee is to shift the risk, to the guarantor, that the principal debtor may not be credit worthy. How far does, or should, the law permit this risk to be shifted by the credit grantor without disclosing any or all of the facts known to him that are relevant to the risk of default by the principal debtor.

We saw in the previous chapter that the general law concerning guarantees seems to impose a very low standard of disclosure. Essentially, the only duty on the lender is not to mislead or misrepresent. All of this is summed up in the statement quoted earlier from The Law of Banking that "a guarantee is not a contract *uberrimae fidei*.” The latin phrase translates as "utmost good faith" and a contract that is *uberrimae fidei* carries with it a duty to volunteer information that is relevant to matters in issue.

The "no duty of disclosure" rule is not totally clearcut. The common law has not been entirely ignorant of the difficulties occasioned by an inequality of bargaining power between parties to contractual arrangements. Recent

decisions in England and Canada give strength to a view that particular fact situations may give rise to a special duty on the part of creditors to ensure that guarantors fully appreciate what they are doing.

In *McKenzie* v. *Bank of Montreal*, the defendant bank knew of particular matters relating to the principal debtor's undertaking which were likely to affect the actions of any potential guarantor. Mr. Justice Stark made it clear that it was the responsibility of the bank, if it wished to obtain an enforceable contract of guarantee, to disclose those matters to the guarantor:

> ... the bank, knowing all of this, and knowing [the principal debtor's] precarious financial condition, with unsatisfied judgments against him and with full knowledge of his untrustworthiness, did not apparently deem it necessary or advisable to take any steps to ensure that the plaintiff appreciated the full extent of what she was doing.
>
> With the knowledge that the bank possessed, there was surely some duty resting upon the bank, either to require that she obtain independent advice or at the least to ensure that full disclosure be made to her of Lawrence's ' heavy debts with the bank, of his failure to keep up mortgage payments and taxes on the farm, and therefore of the unlikelihood that the farming venture could ever succeed. These explanations were never attempted, on the bank's own admission; and in any event, could never have been delivered in the few minutes allotted for the signing (of the necessary papers ....
>
> It appears to me that in the case at bar, the bank was under a special duty to the plaintiff not to dismiss the matter as a mere formality but to provide the plaintiff with the necessary information or advice, or to see that she obtained it. Had the bank not been personally interested in the result, the advice would have been quite different.

The decision of Mr. Justice Stark was affirmed by the Ontario Court of Appeal.

In the course of the decision in *McKenzie* v. *Bank of Montreal* reference was made to a decision of the English Court of Appeal in *Lloyds Bank Ltd*. v. *Bundy* illustrating the developing common law principles relating to unfair bargains. Although those principles are clearly applicable to all contracts, it is significant that the decision itself concerned a species of guarantee, a mortgage taken from an elderly gentleman for the purposes of securing certain business debts owed by his son to the bank. The bank had specific knowledge of serious financial difficulties which the son was attempting to escape, and chose not to disclose that information to the defendant when it extracted security for the obligations. The English Court of Appeal held that the mortgage could not be enforced by the bank.

In his judgment Lord Denning makes special reference to the special arrangement contemplated to a contract of guarantee, and in doing so cites a centuryold decision of the House of Lords in *Williams* v. *Bayley*:

> A contract to give security for the debt of another, which is a contract without consideration, is above all things, a contract that should be based upon the free and voluntary agency of the individual who enters into it.

After reviewing a variety of historical examples of intervention by the courts to relieve a party from contractual obligations, he concluded:

> Gathering all together, would suggest that through all these instances there runs a single thread. They rest on "inequality of bargaining power." By virtue of it, the English law gives relief to one who, without independent advice, enters into a contract upon terms which are very unfair or transfers property for a consideration which is grossly inadequate, when his bargaining power is grievously impaired by reason of his own needs or desires, or by his own ignorance or infirmity, coupled with undue influences or pressures brought to bear on him by or for the benefit of the other. When I use the word “undue" I do not mean to suggest that the principle depends on proof of any wrongdoing. The one who stipulates for an unfair advantage may be moved solely by his own selfinterest, unconscious of the distress he is bringing to the other. I have also avoided any reference to the will of the one being "dominated" or "overcome" by the other. One who is in extreme need may knowingly consent to a most

> improvident bargain, solely to relieve the straits in which he finds himself. Again, I do not mean to suggest that every transaction is saved by independent advice. But the absence of it may be fatal. With these explanations, I hope this principle will be found to reconcile the cases.

It is clear that the decision in that case modifies a number of longstanding common law principles relating to the law of contract in general, and it is not the place here to discuss its full implications. It is important, nonetheless, to say that the decision, in so far as it relates to guarantors, is one with which we are in full agreement.

While we applaud the tendency of the *McKenzie* and *Bundy* cases owe are apprehensive about leaving additional duties of disclosure to the common law. First, those cases are not firmly established in British Columbia jurisprudence and it is not yet clear that our courts will respond in a sensitive manner to the policy behind them. The courts still face a substantial body of authority that denies a duty of disclosure. Secondly, the duty of disclosure would emerge on something of a hit or miss basis. Finally, the scope of a duty of disclosure that might be imposed by the courts would not necessarily be wide enough in the context of consumer guarantees.

We have concluded that the credit grantor should be under a statutory duty to disclose all information known to him that is material to the guarantors risk. The best technique of imposing that duty, however, is not an easy issue. Under the present law, a consumer guarantor is expected to make all the "right inquiries" in the hope that the creditor will disclose to him matters which might affect his liability and which will surely influence a decision to complete the transaction. Just as the potential guarantor faces difficulty in knowing what questions to ask, it is impossible to set out, in a statute *a priori* the information that should be supplied to him in a specific case. This suggests that the duty should be framed in general terms.

Nonetheless there are certain aspects of disclosure that may call for separate enumeration apart from a general duty. These relate to facts that are in issue frequently, in which case separate enumeration may lead to greater certainty in the application of the general duty; or they may concern the disclosure of other matters that are necessary to reinforce the guarantor's rights under other recommendations.

We believe that the best approach to framing the general duty is to specify that, as a matter of law, a consumer guarantee is "a contract of the utmost good faith." The *uberrimae fidei* concept is relevant to another branch of suretyship law, insurance, and it has served the interests of professional sureties well. There is no reason why it should not also serve the interests of nonprofessional sureties.

B. Disclosure of Specific Matters

1. ___Other Indebtedness

As we indicated earlier, while it is impossible to set out *a priori*, in legislation, all the information that should be disclosed in a particular transaction, it is possible to identify certain areas in which a specific duty of disclosure is desirable.

A principle area of concern has already been referred to, namely, access by the guarantor to information concerning the "total debt picture" of the principal debtor. Even though a debt or debts are not covered by the guarantee sought by a lender, knowledge of their existence may be crucial to an informed choice by the potential guarantor. For example, if A proposes to loan $5000 to B and seeks a guarantee from C, that arrangement may be quite acceptable in principle to C having regard to B's income and assets. But B may also owe $5000 to each of D, E, F, and G, all of whom will be competing with A for repayment. If C knows of this he may be less willing to guarantee B's debt to A, and rightly so, as the risk of default by B may be significantly greater. We believe that if A knows, or ought to know, of the indebtedness to D, E, F, and G he should be under a duty to disclose that to C.

This result would probably flow from the general duty described above, but we believe that, for greater certainty, it should also be imposed as a specific duty by the recommended legislation. Our recommendation, therefore, is that a lender should be under a specific duty to disclose to the guarantor the existence of all debts owed by the principal debtor to any person of which the lender has, or reasonably ought to have knowledge.

2. Details of the Principal Transaction.

We also believe specific disclosure requirements are called for with respect to the terms of the consumer transaction under which the principal debt arises, and details of any other document that may be relevant such as a security agreement executed by the principal debtor. Serious difficulties may arise if there is insufficient disclosure of the terms of the principal consumer transaction terms that may have a considerable, impact on the liability of the guarantor.

The new *Consumer Protection Act* goes some way in meeting our concerns. The relevant definitions and provisos are:

> "borrower" means an individual who receives credit;
>
> "credit" means credit
>
> (i) for which a borrower incurs a cost of borrowing, and
> (ii) given under an executory contract or by the advancement of money;
>
> "debtor" includes a borrower, buyer or guarantor;
>
> “executory contract" means a contract between a buyer and a seller for the purchase and sale or the lease of goods or services, or of goods and services, in respect of which delivery of the goods or performance of the services or payment in full of the consideration is not made at the time the contract is made, including a contract which is partly executed, but does not include an executory contract for the sale or the lease of goods or services, or for goods and services, by and under which the consideration, excluding the cost of borrowing, is less than $20 or such larger amount as may be determined by the regulations in respect of any particular class of seller;
>
> "guarantor" includes a guarantor, surety, indemnitor and endorser, or other individual liable for the payment or repayment of the money owing or on an agreement or collateral or other security given in respect of it, but does not include a person who, in the course of business, acts in any of those capacities;
>
> "variable credit" means credit made available in advance by a lender to a borrower who may draw on it, from time to time, up to the specified limit, in accordance with the terms and conditions of the credit transaction, and includes credit cards, credit accounts, budget accounts, cyclical accounts and any other similar arrangements.

Disclosure Requirements

> 12. (1) An executory contract shall contain in the prescribed manner and form the information and particulars required by the regulations.
>
> (2) An executory contract is unenforceable by the seller, unless
>
> (a) the contract is made in accordance with this section and the regulations,
>
> (b) it is signed by the buyer, and the guarantor if applicable, and
>
> (c) within 7 days after the day it is signed by the buyer, and the guarantor if applicable, a copy of it has been received by the buyer, or both of them, as the case may be.

(3) Money paid by the debtor to the seller pursuant to an unenforceable executory contract may be recovered by the debtor as a simple contract debt.

(4) The burden of proving that this section has been complied with is on the seller.

Disclosure of cost of borrowing

26. Except as provided in section 27, every lender shall furnish to the debtor before extending credit a statement, in the prescribed manner and form, disclosing information pertaining to

(a) the principal sum;
(b) the charges,
(c) the cost of borrowing,
(d) the calculation, and
(e) any other particulars required by the regulations with respect to the credit transaction.

Requirements when extending variable credit

27. A lender who makes available variable credit shall,

(a) before making it available, disclose to the debtor in the prescribed manner and form,

(i) the cost of borrowing, and
(ii) any other information required by the regulations ...

Improper disclosure

35. (1) A lender who

(a) fails to provide the debtor with a disclosure statement in accordance with sections 26 and 27 and the regulations, or

(b) fails to give the debtor a completed copy of the prescribed ending transaction documents on or before the date on which a cost of borrowing starts to accrue

is not entitled to collect any cost of borrowing.

It will be noted that where the principal transaction is an "executory contract" (in contrast to an extension of credit by way of a loan) section 12 calls for a copy of the contract to be given to the guarantor. If that requirement is not met the contract is "unenforceable." Under sections 26 and 27, in any extension of credit, the "debtor" (which includes guarantor) is entitled to the disclosure of certain matters. If those disclosure requirements are not met, or the "debtor" has not received a copy of the "lending transaction documents," then the lender, under section 35(1) is not entitled to collect the cost of borrowing.

There are, however, ways in which the provisions of the *Consumer Protection Act* are insufficient to meet our concerns. First, the range of "consumer transactions" addressed by the disclosure provisions of the Act is narrower than the scope that our recommendations would give that term. Thus a guarantee of payments under a mortgage of residential property would escape the disclosure requirements. We recommended earlier that such transactions should be covered by reforming legislation.

Secondly, the consequences of a failure to meet the disclosure requirements are inappropriate when applied to guarantors. Depending on the nature of the breach, the contract may be unenforceable or the lender may simply lose his right to interest. We do not believe that either sanction is appropriate, as we discuss in greater detail later in this chapter.

Finally, the Act is ambiguous as to the result when an instrument guarantee is enforced by a holder in due course and the original lender has not complied with the Act. The final recommendations made in this Report meet all these concerns.

3. ___Information During the Currency of the Guarantee

The "formal" disclosure requirements recommended in the previous chapter and those discussed earlier in this chapter are all concerned with provision of information to the potential guarantor before he enters into the guarantee. The aim is to place the potential guarantor in a position where he can make an informed choice on the assumption of liability for the principal debt.

Once such a liability has been assumed, is the need for disclosure of information fully satisfied? We think not. Even though the guarantor has bound himself he may still have positive rights visavis the lender. A decision concerning the exercise of those rights may call for information concerning the state of accounts between the lender and the principal debtor, information as to the principal debtor's performance under the obligation and any other information relevant to the guarantor's risk.

For example, either under the terms of the guarantee or under our recommendations, if a guarantee covers debts to be incurred in the future, the guarantor may have a right to revoke the guarantee with respect to debts not yet incurred. But a decision to do so cannot be made in a vacuum, thus the guarantor may need information as to matters arising after he has entered into the guarantee.

(a) ___*The State of Accounts*

It cannot be disputed that a guarantor liable to fulfil the obligations of his principal upon default has a legitimate and continuing interest in obtaining information concerning the relationship between the parties (or their assignees) to the principal transaction. The law does not now recognize that interest, and it seems to us that defect ought to be remedied. The *Conditional Sales Act*, and the *Bills of Sale Act*, provide for disclosure of the state of accounts between a creditor and principal debtor, but it is not clear under those Acts how far a guarantor would have the right to that information. The *Consumer Protection Act,* in section 27, calls for full disclosure to the "debtor" (which includes a guarantor) at the time credit is first extended, but provides for the disclosure of the state of accounts during the extension of credit only to the "borrower." It is arguable that the proposed *Personal Property Security Act* may provide for such a right where the creditor takes a security interest in the property of the principal debtor.

Because a guarantor will be liable to fulfil the obligations of his principal on default, fairness demands that his right to information to the state of accounts between the creditor and principal debtor be recognized at law. The guarantor should have a right to request, and the lender should be under a duty to provide, this information.

There are, however, transactions in which the provision of information as to the state of accounts to the guarantor should be as a matter of course rather than only as and when requested by the guarantor. We refer to those transactions defined in the *Consumer Protection Act* as an extension of "variable credit." The definition of that term was set out earlier in this chapter. Variable credit includes such arrangements as department store charge accounts and credit card agreements.

Some characteristics of "variable credit" arrangements should be noted.

1. The credit is usually extended pursuant to a "master agreement" of some kind, the terms of which govern all transactions or purchases made pursuant to the agreement. In other words

in, say, a credit card arrangement, purchases with the card are not regarded ais a series individual extensions of credit but as part of a larger continuing legal relationship.

2. Under a variable credit arrangement the credit grantor will normally send to the debtor, a statement of account at regular intervals one month is a common period. A statement will usually set out particulars of individual "charges" incurred and payments made by the debtor since the previous statement, and record the total amount owing by the debtor as of the date of the statement.

3. The debtor may be obliged to pay off the total amount owing, as indicated by the statement, or only a specified part of it, depending on the terms of the master agreement.

4. The amount owing by the debtor may vary widely from statement to statement depending on the use the debtor has made of the credit during the statement period and the extent to which he has made payments relating to previous statements.

A variable credit arrangement may be the subject matter of a guarantee taken as part of, or in conjunction with the master agreement. It is the last characteristic set out above that puts variable credit in a special category as far as the guarantor is concerned.

The fact that the debtor's obligation can fluctuate widely means that the guarantor's potential liability will do likewise. Variable credit, therefore, poses at special threat to the guarantor that is not present in other types of credit transactions where the amount and timing of advances and of repayment are more rigidly prescribed in the credit document.

We do not believe that, in the context of variable credit, a right in the guarantor to request, from time to time, information as to the state of accounts from the lender is sufficient to allow him to safeguard his interests. In our view the guarantor should be entitled to receive, at least as often as the principal debtor, a statement setting out the amount owing under the credit arrangement as of the statement date and the amount of any payment made since the previous statement. With this information, the guarantor would quickly detect any behaviour by the principal debtor tending to increase the guarantor's risk beyond an acceptable limit and enable him to take whatever steps may be available to preserve his position with respect to future charges.

The obligation to provide a periodic statement to guarantors should not place a significant burden on those who extend variable credit. It is now an almost universal practice that variable credit arrangements are processed through and statements prepared with computers. A data processing system that is capable of sending periodic statements to the principal debtor is equally capable of sending a statement to the guarantor.

(b) *Changes in Circumstances*

Earlier in this chapter we pointed to the total amount of a person's indebtedness as relevant to an informed decision its to whether a particular part of it should be guaranteed. We recommended that the lender seeking a guarantee should be obliged to disclose the amount and existence of other debts that are known or ought to be known to him. This same information is also relevant while a guarantee is in force.

Again, it is a question of giving the guarantor a meaningful opportunity to exercise any positive rights he may have while the guarantee is effective. Those arguments that support disclosure of the state of accounts apply with equal force in this context. We therefore believe that this duty to disclose other debts known to the lender should be a continuing one. Similarly, the provision that defines a guarantee as being at "contract of the utmost good faith"

should make it clear that the duty of disclosure associated with that concept exists throughout the life of the guarantee.

C. Consequences of NonDisclosure

In the previous chapter we examined certain matters relating to the nature and scope of the guarantor's liability and concluded that they were so fundamental they a failure by the lender properly to disclose then should render the guarantee unenforceable. Relief would be available to the lender only if he establishes that the noncompliance was inadvertent and then only to the extent he proves that the guarantor has not been prejudiced.

The discussion in this chapter is primarily concerned with the disclosure of matters material to the guarantor's risk. While the distinction between liability and risk may not always be clearcut, we believe it is a legitimate one. Thus we have considered these aspects of disclosure separately. We believe this separate treatment should extend to the consequences of at failure by the lender to abide by the duties of disclosure.

Where the guarantor has been misled as to his risk we do not believe that it is appropriate to, *prima facie*, render the entire guarantee unenforceable. We believe that a better balance of the interests at stake would be achieved by a diminuation of the guarantor's liability to the extent that he has been prejudiced. The burden of establishing the existence and extent of "prejudice" would, in this case, be on the guarantor.

The practical consequences of a failure to disclose would, therefore, vary from case to case. In some cases the effect might be to wholly discharge the guarantor from liability. Where the guarantor can establish that had a certain fact been disclosed to him he never would have entered into the guarantee would be such a case. On the other hand, the deviation from the required standard of disclosure may be so manifestly trivial that no guarantor could credibly claim prejudice. We believe that this formulation injects a necessary degree of flexibility into an area where fact patterns can vary enormously.

D. Recommendations

The Commission recommends that:

10. *(1) A guarantee should be specified by law to be at transaction of utmost good faith under which a creditor is obliged to disclose to the guarantor all facts and matters material to the guarantor's liability or risk.*

(2) The obligation imposed by (1) should exist both before and after the creation of a guarantee and should not be limited by or detract from any other recommendation, statute or rule of law relating to disclosure.

11. *(1) The creditor should be under a duty to disclose to the guarantor*

(a) *the existence and amount of all outstanding obligations due from the principal debtor to any person, and*

(b) *particulars of any other guarantees or security taken in respect of such obligations*

that are known, or reasonably ought to be known to the creditor.

(2) The obligation imposed by (1) should arise before the creation of the guarantee and continue so long as the guarantee remains in force.

12. *A creditor seeking a guarantee should be under a duty to provide to the potential guarantor*

    (a) a copy of any document or documents evidencing the transaction under which the principal debt arises, and

    (b) particulars of any other security given by the principal debtor.

13. *(1) A guarantor should be able to demand and the creditor should be under a duty to provide in writing*

    (a) a statement of the amount owing under the principal transaction as of the date specified in the demand, and

    (b) particulars of any additional security taken in respect of the principal transaction

    or either within 15 days of receipt of the demand.

    (2) Where the person receiving a demand under (1) no longer has an interest in the principal transaction or collateral, he should be under a duty to disclose, within 15 days of receipt of the demand, the name and address of the latest successor in interest if known to him.

14. *Where the consumer transaction is an extension of "variable credit" as defined in the* Consumer Protection Act *the creditor should deliver a statement of account to the guarantor at least as often as a statement of account is delivered to the principal debtor in the usual course of the creditor's business,*

    (2) A statement of account delivered to a guarantor under (1) should specify

    (a) the total amount owing by the principal debtor at the statement date, and

    (b) the amount paid to the creditor since the previous statement.

15. *Where a creditor, without reasonable excuse, has failed to comply with a duty imposed by any of recommendations 10 to 14, the liability of the guarantor under the guarantee should be reduced to the extent that the guarantor establishes that he has been prejudiced by the failure.*

CHAPTER VII RIGHTS OF THE GUARANTOR AFTER DEFAULT

A. Introduction

Our recommendations so far have not purported to alter the substantive legal rules concerning consumer guarantees. Rather, we have focussed on the disclosure of information to the guarantor. If our recommendations were to stop at that point then the creditor, upon meeting all the disclosure requirements, would be free to enforce the guarantee according to its terms under the general law.

There are, however, aspects of the general law that we believe are unsatisfactory or unclear. Moreover, the wide freedom of contract enjoyed by creditors in consumer transactions often leads to unfair results through the imposition of terms that favour the interests of the creditor.

The three chapters that follow are devoted to an examination of a number of aspects of the substantive law in relation to the enforcement of guarantees. This chapter concerns certain rights that the consumer guarantor has, or ought to have after default.

B. The Quia Timet Action The Right to Exoneration

At common law, there is no rule that compels a creditor to exhaust his remedies against the principal debtor before enforcing his rights against a guarantor. Thus a guarantor may be compelled to pay the creditor notwithstanding that the principal debtor has sufficient assets to meet the claims of the creditor, and notwithstanding that the creditor may have taken security for the principal debt which he could enforce if he chose to do so. Guarantors do, however have the benefit of an equitable remedy known as the *quia timet* action.

Historically, guarantors (who often receive no tangible benefit in return for their undertaking) have enjoyed an extraordinary right at equity. Put simply, the court may allow a guarantor, *before he suffers any damage*, to bring an action against a principal debtor who is in default to a creditor, and to obtain an order of the court that the debtor pay the debt and thus discharge the guarantor. A similar right is recognized in the United States:

> The hardship upon a surety of compelling him to pay the creditor and thereafter to seek redress against the principal is in some degree mitigated by equity which enforces specifically the principal's express or implied obligation to indemnify the surety allowing the surety to sue the principal on maturity of the obligation and decreeing that the principal shall pay the creditor, thereby exonerating the surety.

The Supreme Court of Ontario considered this right in *Double Diamond Bowling Supply Ltd.* v. *Eglinton Bowling Ltd*. The plaintiff, who had endorsed several of the defendant's promissory notes, sought a declaration that the defendant (i.e. the principal debtor) pay the balance owing on the notes. The Court so ordered, and cited a decision of the Supreme Court of Canada as authority for its jurisdiction to do so:

> I prefer to rest upon this; that the surety can at all times appeal to the equitable jurisdiction of the court to have his principal as soon as the debt becomes due, and without any payment of the debt, ordered to pay the debt and relieve the surety ...

It seems that recourse guarantors should not, under the present law, enjoy the right to exoneration. The right is based on the existence of a duty owned by the principal debtor to the guarantor, that the guarantor will be saved harmless by the principal debtor. It seems clear, where the debtor does not know of the existence of the guarantor, that the duty to save harmless cannot arise.

Although it has been held that this right is independent of the wishes of the creditor, there is *obiter dictas* in which it is suggested, where the contract of guarantee provides that the guarantor is not liable until the creditor makes a demand for payment, that the guarantor cannot bring an action until the demand is made.

There may yet be further difficulties where the contract of guarantee is revocable at the option of the guarantor, and provides for at specified period of notice prior to the revocation. The decision in *Morrison* v. *Barking Chemicals Co. Ltd*. illustrates the effect of such a provision. In that case an action in the nature of *quia timet* vias unsuccessful, since in the opinion of Sargant J.:

> Under this scheme, though there may be an expectation or anticipation of liability on the part of the surety throughout the continuance of the current dealings between the customer and the bank, there is no accrued or definite liability on the part of the surety until there has been some such termination and ascertainment [under the contract of guarantee] .

It is unfortunate that a term which affords a guarantor the right to terminate his liability subject to a notice requirement should be used by a creditor to preclude a guarantor from exercising his right to exoneration.

It has also been argued, albeit unsuccessfully, that the creditor is a necessary party to such an action, but it is clear that his absence is of little concern where the result is merely an order that the debtor pay the creditor, which may be enforced, it seems, only through contempt of court proceedings. It is at least arguable, however, that the result of proceedings in the nature of *quia timet* should be quite different.

Under the present law, the nature of the relief available to guarantors is uncertain, and so far as it is possible to ascertain, somewhat limited in its utility. The relief sought is generally a declaration that the guarantor is discharged on payment by his principal and an order that the payment be made. One court has commented as follows:

> Upon those authorities, it seems to me that the court should grant a surety in the position of the present plaintiff, the relief which is asked, but in so doing I desire to guard myself against any suggestion that the order to pay can be enforced in any specific manner.

The equitable remedy of *quia timet* is somewhat obscure, yet the accepted rationale for its existence "it being unreasonable that at man should always have such a cloud hanging over him," appears uncontroversial. The obscurity of the remedy is not surprising as it is exceedingly inefficient, and its application is fraught with technicalities.

We have concluded that the *quia timet* action, in its present form, affords insufficient protection to the consumer guarantor. The main weakness in this regard is that an order in a *quia timet* action has effect only between the guarantor and the principal debtor. It does not impinge on the rights of the creditor or purport to balance the competing interests at stake. The interests we refer to, of course, are those of the creditor, who desires unrestricted freedom to enforce his contractual rights, and the interests of the guarantor, who, not unreasonably, believes that the principal debtor ought to be primarily liable. At present, this competition is resolved totally in favour of the creditor.

It would be possible to expand and rationalize the *quia timet* action so as to involve the creditor as a party and, in the process, achieve a balance of these interests. There may, however, be other approaches that are preferable.

One of the first attempts to balance the competing interests is found in the *Magna Charta*, which included the following provision:

> WE or our Bailiffs shall not seise any land or rent for any debt, as long as the present Goods and Chattels of the debtor do suffice to pay the debt, and the debtor himself be ready to satisfy therefore. (2) Neither shall the pledges of the debtor be distrained, as long as the principal debtor is sufficient for the payment of the debt. (3) And if the principal debtor fail in payment of the debt, having nothing wherewith to pay, or will not pay where he is able, the pledges shall answer for the debt. (4) And if they will, they shall have the lands and rents of the debtor, until they be satisfied of that which they before payed for him, except that the debtor can shew himself to be acquitted against the said sureties.

That provision has not been afforded a great deal of recognition and, as a general rule, at guarantor's liability accrues upon the default of the principal debtor.

The ability of the principal debtor to meet his obligations, or the existence of alternate security held by the creditor are matters which are not available as grounds of defence when the creditor chooses, for whatever reason, to look to the guarantor instead:

> Once the principal has actually committed a default for which the surety is responsible, *as a general rule a cause of action immediately arises against the surety*. And, consequently, as a general rule, and in the absence of any express or implied stipulation to the contrary, the creditor need not, before suing the surety, sue the principal debtor, even though such principal debtor be quite *solvent* ...
>
> It is quite clear, therefore, that, *in the absence* of express stipulation to that effect, a creditor who holds sureties from the principal debtor for his debt need not first resort to them before suing the surety.

The AngloCanadian position, biased as it is, towards the interests of creditors, differs to a marked degree from both the civilian approach and the American law.

In most civilian jurisdictions guarantors enjoy what is referred to as the *benefit of discussion*. Under that principal a creditor in order to obtain the right to sue a guarantor must first pursue the principal debtor:

> This doctrine of the English law, that a right of action accrues to the creditor as against the surety *immediately* upon any default of the principal debtor, is a peculiar one, and does not, generally speaking, prevail in other systems of jurisprudence.
>
> The Roman Law gave to sureties the power to compel the creditor to sue the principal debtor, before having recourse to the sureties, unless, indeed, he could show that such a proceeding would be useless by reason of the debtor's insolvency or absence, or unless the surety expressly renounced this power of compelling the creditor to sue.
>
> The provision of the Roman law seems to have been adopted in most of those countries whose municipal law is based upon the Roman civil law. Chancellor Kent has well remarked, that "a rule of such general adoption shows that there is nothing in it inconsistent with the relative rights and duties of principal and surety, and that it accords with a common sense of justice and the natural equity of mankind."

The civilian approach recommends itself to those who view the contract of guarantee as subsidiary security to those who believe that it is he who benefits from the arrangement the principal debtor) who must pay the costs if he is able.

The most persuasive argument against the adoption of the civilian approach is that the procedure may generate substantial costs. The benefit of discussion is now enjoyed by guarantors in the Province of Quebec, but the Civil Code Revision Office has recommended its repeal:

> The existing rule in the Civil Code not correspond to economic realities. It is up to the surety far more than to the creditor to establish and verify the solvency of the debtor. Moreover, most suretyships today contain clauses renouncing the benefit of discussion. It therefore seemed imperative to bring the law into line with reality. A contrary stipulation is always possible.

It was recommended further, that where the parties have contracted so as to allow the surety to enjoy the benefit of discussion, the surety must bear certain, relatively onerous obligations:

> The benefit of discussion should be conventional. The surety who wishes to exercise the benefit of discussion must advance the necessary expenses, and indicate which property can be seized.

The law in the United States also indicates a substantial concern with the rights of guarantors who are faced with liability on their undertaking, in circumstances where it is evident that the creditor is in a position to enforce his

rights against security given by the principal debtor, or to bring legal proceedings against the principal debtor personally.

In addition to cases in the United States which set out the right of exoneration, there are a number of American decisions in which it has been held that a guarantor may bring proceedings in equity "to compel the creditor to proceed against the principal, providing he indemnify the creditor against the expense of the proceedings."

Moreover, although the view is obviously not unanimous, some states have enacted legislation which obliges a creditor, upon a request by a guarantor, to look first to the principal debtor upon his default.

That doctrine rests on the theory that:

> [The] creditor was under an equitable obligation to secure payment from the principal and not from the surety, unless the former was unable to pay, and so it was inequitable for the creditor, by failing to sue when requested, to increase the surety's risk.

The interference with the rights' of creditors by forcing them to proceed against the principal debtor when requested to do so by the guarantor was first enunciated by a New York court in *Pain* v. *Packard,* and has been adopted by a substantial minority of American states. An example of a statutory provision which embodies the principle set out in *Pain* v. *Packard*, is section 12191 of the Ohio General Code:

> A person bound as surety in a written instrument for the payment of money, or other valuable thing, may, if a right of action accrue thereon, require his creditor, by notice in writing, to commence an action on such instrument forthwith, against the principal debtor; and unless the creditor commence such action within a reasonable time thereafter, and proceed with due diligence, in the ordinary course of law, to recover judgment against the principal debtor for the money or other valuable thing due thereby, and to make, by execution, the amount thereof, the creditor, or the assignee of such instrument, so failing to comply with the requisition of such surety, shall thereby forfeit the right which he would otherwise have to demand and receive of such surety the amount due thereon.

Other jurisdictions insist that the creditor pursue the principal debtor and enforce any other security he might have before proceeding against the guarantor. For example, section 2850 of the California Civil Code provides:

> Whenever property of a surety is hypothecated with property of the principal, the surety is entitled to have the property of the principal first applied to the discharge of the obligation.

And section 2845 provides:

> A surety may require his creditor to proceed against the principal, or to pursue any other remedy in his power which the surety can not himself pursue, and which would lighten his burden; and if in such case the creditor neglects to do so, the surety is exonerated to the extent to which he is thereby prejudiced.

In a leading American text on the Law of Suretyship, the principles are set out as follows:

> [E]quity has frequently enjoined at creditor from collecting from the surety until he has first exhausted his remedies against the principal. In equity, the surety is entitled to the benefit of security which the creditor has obtained from the principal and the creditor must exhaust this security before looking to the surety for payment where there is no danger of hardship to the creditor and substantial injury to the surety can be avoided thereby. This equitable doctrine has frequently been called into application where the principal is insolvent, but it exists wherever the surety would be unable to enforce the collateral after paying the debt.
>
> Such relief is based upon special equities and is not extended where, to do so, would work a hardship upon the creditor or where the creditor merely exercises his choice of two remedies for the collection of the debt, leaving

> the securities in his hands immediately available to the promisor by subrogation, in case the creditor chooses to enforce his rights against the surety.
>
> Where the principal and his surety each puts up separate property as security for the principal's debt, or they join in a mortgage on property in which each has an estate or interest, the surety has an equity to have the property or interest of the principal sold first and the proceeds applied in satisfaction of the debt ...

In 1941 the American Law Institute in their Report on Security reviewed the law relating to a creditor's "choice of remedies" and rejected the policy in *Pain* v. *Packard* on the grounds, *inter alia*, that the limitation would diminish the utility of guarantees, and that the guarantor on payment may himself assert the remedies of the creditor.

In our view, the duty imposed on creditors by the equitable principle enunciated in *Pain* v. *Packard*, or under the statutory provisions that embody it, is entirely appropriate in relation to guarantors of consumer transactions in British Columbia. The most persuasive argument against the imposition of "a duty to look first to the principal debtor," is the existence of the right now enjoyed by guarantors to pay off the debt and look to the principal debtor for reimbursement. However persuasive that position might be in theory, it is our view that as a practical matter, consumer guarantors are not likely to foresee contingent liabilities of this nature and could not reasonably be expected to have the assets necessary either to meet that obligation if and when it becomes due, or to engage the services of legal counsel in pursuing the principal debtor for reimbursement.

In any event, we believe that the consumer guarantor who may receive no tangible benefit in return for his undertaking ought to be protected from the hardship occasioned by the crystallization of his liability, in circumstances where the. creditor has other security for the principal debt, or where the principal debtor has exigible assets within the jurisdiction of the court, and thus has the opportunity to recover from the party primarily liable.

We believe that this protection would be best achieved through the enactment of legislation that embodies the principle of equity enunciated in *Pain* v. *Packard*, and promulgated in statute law in California and Ohio. A guarantor should be able to direct the creditor to commence legal proceedings against the principal debtor. If the creditor chooses to ignore that direction, the guarantor should be relieved of liability to the extent that he has been prejudiced.

The Commission recommends that:

16. A guarantor should be able, where the principal debtor has defaulted on the consumer transaction, to demand by notice in writing that the creditor commence an action against the principal debtor, or to enforce his security interest in any collateral given by the principal debtor to secure the principal obligation, or both.

If the creditor fails to comply with such a demand the liability of the guarantor should abate to the extent that he has been prejudiced.

The protection afforded by this recommendation will, however, be illusory unless the guarantor knows of the default of the principal debtor. This suggests that there will be a need for a further type of disclosure.

In the Working Paper we proposed that the creditor should be obliged to provide to the guarantor a notice of the principal debtor's default within 15 days thereof. In response to this proposal a number of commercial lenders made the point that minor defaults were relatively common in respect of consumer transactions and are usually overlooked so long as the obligation was brought back into good standing in a reasonable time. They voiced concern that the creditor would no longer be able to overlook minor defaults, and ought not to be burdened with a "noticeof-default" requirement in such cases.

It should be noted that the effect of such a recommendation is merely to place the risk of error in such cases on the party responsible, the creditor. He need not notify the guarantor in every case of default, nor is he compelled to pursue the principal debtor. Where the creditor, however, is mistaken in his assessment of the debtor's financial status, then it would be the creditor rather than the guarantor that would bear the additional costs occasioned by delay. It is the lender who first extended credit and who is in a unique position to monitor the debtor's finances. No longer would the guarantor be responsible for the creditor's inaction, whether purposeful or inadvertent. Put another way, the recommendations do not insist upon notice to the guarantor, litigation or realization on security. Rather, they establish incentives to the creditor to police his debtor's behaviour more closely than would be the case if he were not conscious of his inchoate liability for error.

Even so, the 15 day time limit proposed in the Working Paper may be too severe. It is probable that a majority of consumer obligations involve monthly repayment schedules. Accordingly, it might be reasonable to shield the creditor from responsibility for his inaction, for, let us say, 45 days; that is, until the debtor, who has defaulted once, has had the opportunity to remedy his default when his next payment became due.

The Commission recommends that:

17. A creditor should be required to provide notice of the default of a principal debtor to any guarantor of the obligation in respect of which the default occurs, within 45 days of the default.

18. Where a lender has failed to comply with the duty imposed by Recommendation 17, without reasonable excuse, or has failed to comply,with a demand delivered under Recommendation 16 then the liability of the guarantor under the guarantee should be reduced to the extent that the guarantor establishes he has been prejudiced by the failure.

C. The Right to Revoke a Continuing Guarantee

Recommendations 16 through 18 concern the situation where a guarantor seeks to mitigate his position with respect to the past indebtedness of the principal debtor. Different issues arise where the contract of guarantee purports to continue the liability of the guarantor for a specific period of time, or if silent as to time, provides that the guarantor is liable for the obligations incurred by the principal debtor up to a specified amount.

The legal position of a guarantor who seeks to terminate his liability with respect to obligations which a principal debtor might incur in the future, depends on the nature of the consideration for which the contract of guarantee was given:

> A contract of suretyship is formed, like any other contract, by offer and acceptance, supported by consideration. But difficulty had been encountered in applying the ordinary principles to contracts of this nature, particularly with regard to the revocation of guarantees. The difficulty stems largely from the fact that it is frequently hard to say whether the contract is intended to be unilateral or bilateral. If the guarantee is given in return for a *promise* by the creditor that he will enter into some transaction with the principal debtor, then the guarantee will constitute a binding bilateral contract as soon as it is given and accepted, and it cannot then be revoked. But if (as is more usually the case) the gbarantee is given in return for an act or forbearance on the part of the creditor, the contract will not be made until the act is done or the forbearance is given, and until then, the guarantee remains revocable.
>
> Where the guarantee is a continuing one, the question whether it can be revoked after the consideration has been partly performed depends on whether the consideration is divisible or entire. In the former event the guarantee is treated rather like a standing offer which is accepted *pro tanto* by part performance of the consideration, but remains revocable at all times as to future liabilities. Therefore, in the case of a continuing guarantee to secure the

> balance of a running account at a bank, a surety may at any moment revoke his guarantee in respect of future advances ...
>
> Where, on the other hand, the consideration for the guarantee is entire and indivisible, the surety has no right to revoke his guarantee unless such a right is expressly conferred by the agreement ... The principle underlying these cases segms to be that if, in reliance on the guarantee, the creditor has entered into an irrevocable transaction with the debtor, he should not be deprived of his security by revocation of the guarantee. But where the transaction entered into by the creditor is itself terminable, he would not be prejudiced if the guarantee were revoked as to the future, for the creditor could then decide whether or not to terminate the main transaction.

The relationship of "consideration" to the law of guarantees was reviewed by the Ontario Court of Appeal in *Royal Bank of Canada* v. *Kiska*. In that case the plaintiff alleged that the defendant had guaranteed the debts of his brother in return for the plaintiff forbearing to enforce his claims against the brother. Kelly J.A. explained the differdnce between a guarantee given in return for a *promise to forbear* (which is binding on both parties at the time of agreement), and a guarantee is given in return for *forbearance* which is binding on the guarantor only when the creditor, in fact has forborne for a reasonable length of time, and concluded that:

> Looking upon the guarantee at no higher than a promise offered for an act of forbearance, unless the offer be withdrawn before the act be performed, upon the performance of the act of forbearance the contract was complete and enforceable against the defendant.

Where a guarantee is given to a creditor in return for his promise to enter into a transaction with the principal debtor, or to forbear to enforce his legal rights against the principal, then the guarantee is irrevocable. The promise by the guarantor, as soon as it is accepted and the creditor gives his promise in return, creates a legally enforceable obligation.

We have concluded, after serious consideration of the implications of any modification of the existing law, that where reciprocal promises of this sort are given, the guarantor should be given the right to cancel the transaction. This recommendation, although perhaps radical in terms of accepted notions of the sanctity of contracts and the like, is not, in practice, likely to work serious hardship. If the creditor has relied on the agreement, and has in fact, entered into a legally binding agreement with the principal, then it is our opinion that the right to revoke would leave unaffected the guarantor's liability for the principal's obligations incurred under it prior to the revocation.

We note that the *Consumer Protection Act* also recognizes that under certain circumstances consumers ought to have the right to cancel longterm commitments. We believe that this policy is especially appropriate in this context.

The revocability of a guarantee may be at issue as well where a guarantee is given with respect to obligations of a principal debtor which may be incurred, for example, when the creditor supplies goods or advances credit to the principal. The guarantor's undertaking, which is commonly referred to as et "continuing guarantee," is treated as a standing offer and thus is revocable until it is accepted (i.e. until the creditor supplies the goods or advances the credit).

We believe that legislation should specifically provide for the right to revoke a guarantee and that this right should be available whether or not the guarantee is revocable under the general principles of contract law.

There are, however, further matters which remain to be resolved. Where a revocable contract of guarantee includes a term requiring a specified period of notice pribr to the revocation, it has been held that the guarantor is liable for obligations incurred by the principal debtor, which the creditor, having knowledge of the guarantor's intended revocation, could have avoided. It has been argued, however, in view of the fact that the continuing guaran-

tee is but a gratuitous offer, unenforceable until and unless it is accepted, that no such period of notice is enforceable.

We are aware that, in certain circumstances, it might be exceedingly difficult for a creditor to adjust his business without loss if a revocation were to be operative immediately upon its receipt by him. At the same time, to propose that a creditor should be able to continue to rely on a contract of guarantee after receipt of a notice of its revocation, even for a short time, would open the door to abuse. For example, the debtor and creditor might collude so as to permit the debtor to run up debts during the waiting period, so as to prejudice the guarantor. We have concluded that, on balance, the elimination of this possibility is more important than the limitation of effectiveness of a revocation in order to allow a creditor to adjust his business without loss.

Accordingly, we recommend first, that a guarantor should be able to revoke any contract of guarantee with respect to obligations of the principal debtor incurred after the creditor receives the notice of revocation, and second, that ai contractual term in the guarantee itself, that is designed to suspend the effect of a revocation, should be of no effect. That would flow from our position, as set out in a later recommendation, relating to the propriety of allowing consumer guarantors to "contract out" of the protection afforded by these recommendations.

An issue of a similar sort arises when the estate of a guarantor is sued by a creditor who seeks to enforce a contract of guarantee, with the intent to recover losses occasioned by the default of the principal debtor on obligations incurred after the death of the guarantor. It has been held that the death of a guarantor does not of itself revoke a revocable guarantee, and that revocation will be effective only when notice of the death is given to the creditor. Where the guarantee is irrevocable, then the death of the guarantor, or notice of that event, is irrelevant.

Yet if a continuing guarantee is truly a standing offer, then it is at least arguable that the death of the offeror should, of itself, end the matter. The American position would seem to suffer from the same uncertainty. The effect of the death of a guarantor should be put beyond doubt, and be consistent with the effect of a notice of revocation.

The Commission recommends that:

19. (1) A guarantor should be able to revoke a contract of guarantee with respect to obligations of a principal debtor incurred after the creditor receives the notice of revocation.

(2) The death of the guarantor should be deemed to revoke a contract of guarantee with respect to future obligations of the principal debtor.

It is important to appreciate that the right set out in Recommendation 19(1) is of little importance unless the guarantor is aware of the right to revoke, and avails himself of it in the proper manner. The decision of the Supreme Court of British Columbia in *Canadian Imperial Bank of Commerce* v. *Beliveau*, is an indication of the difficulties that arise where a guarantor is ignorant of the required manner of revocation:

> The conduct of the Canadian Imperial Bank of Commerce in not drawing to the attention of Mr. Beliveau the fact that he would continue to be liable under the guarantee bond unless 30 days written notice were given to the bank, even though he had terminated the relationship with *Freejay Industries* and had so communicated this fact to the bank is lamentable, to give it a very charitable description. However, the defendant has been unable to convince this Court that he should not be held responsible for liabilities he has incurred under the terms of the guarantee bond which he signed.

We have concluded that these difficulties could be reduced if the existence of the right to revoke, and the manner in which this right could be properly exercised, were disclosed to the guarantor.

The Commission recommends that:

20. A notice of revocation need be in no specific form and should be effective upon receipt by the creditor.

21. Where a guarantee covers future debts of the principal debtor, then the disclosure statement referred to in Recommendation 4 should contain a statement comparable to the following:

"You may revoke this guarantee with respect to future debts at any time by delivering or communicating a notice of revocation to [creditor]."

D. Reimbursement

1. Right to Securities

A guarantor who has paid the debt of a principal debtor, or who has otherwise performed the obligations owed to the creditor, is entitled to an assignment of security which the creditor has taken from the principal debtor in order to secure that obligation or debt. Until the mid-nineteenth Century, however, this right did not apply to securities which were extinguished by payment of the debt.

This anomaly was eliminated by the enactment of section 5 of the *Mercantile Law Amendment Act, 1856,* which now appears as section 24 of the *Laws Declaratory Act*:

> 24. Every person who, being surety for the debt or duty of another, or being liable with another for any debt or duty, pays the debt or performs the duty is entitled to have assigned to him, or to a trustee for him, every judgment, specialty, or other security which is held by the creditor in respect of the debt or duty, whether the judgment, specialty, or other security is or is not deemed at law to have been satisfied by the payment of the debt or performance of the duty ... and the payment or performance so made by the surety is not pleadable in bar of any such action or other proceeding by him ...

This right extends to all securities held by the creditor, whether or not they were taken before the contract of guarantee was entered into, and whether or not the guarantor had any knowledge of, or had otherwise relied upon, the continued existence of the securities.

The rights and duties of a guarantor after he has taken an assignment of the securities are identical to those formerly enjoyed by, or imposed on, the secured creditor. The proposed *Personal Property Security Act* restates the common law on this matter:

> A person who is liable to a secured party under a guarantee, endorsement, covenant, repurchase agreement, or the like and who receives a transfer of collateral from the secured party or is subrogated to his rights has thereafter the rights and duties of the secured party ...

The right to securities is but one aspect of the equitable principle of subrogation:

> The object of subrogation is the prevention of injustice. It is designed to promote and to accomplish justice, and is the mode which equity adopts to compel the ultimate payment of a debt by one who, in justice, equity, and good conscience, should pay it. It is an appropriate means of preventing unjust enrichment. The doctrine of subrogation is applied to subserve the ends of justice, to do equity in the particular case under consideration, and to prevent fraud or relieve from mistake.
>
> Suretyship does not furnish the only application of the doctrine, but it furnishes the commonest one. A surety who has paid the debt is entitled to the right for the purpose of charging property or persons equitably bound to pay the debt before himself. The justice of the principle will be apparent if it is observed that in this way the creditor is denied the power of throwing the ultimate payment of the debt in one way or another as suits his ca-

> price. Subrogation does not depend upon contract, but on the equities of the situation. Therefore, a surety who did not become such at the request of the principal, and who has no privity of contract with him, is not thereby deprived of the right of subrogation on payment of the debt.

The "justice of the principle", and the fact that consumers are not affected adversely by an assignment of securities, persuade us that the right ought to continue to be available to guarantors of consumer transactions.

2. ___Right of Subrogation

As we noted above, the right to securities is but one constituent of the much broader equitable principle of subrogation which extends to all of the rights enjoyed by the creditor.

> In *Craythorne* v. *Swinburne*, Sir Samuel Romilly described it in the following words, which gained the approval of Lord Eldon. He said:
>
> ... a surety will be entitled to every remedy, which the creditor has against the principal debtor; to enforce every security and all means of payment; to stand in the place of the creditor; not only through the medium of contract, but even by means of securities, entered into without the knowledge of the surety; having a right to have those securities transferred to him; though there was no stipulation for that; and to avail himself of all those securities against the debtor. This right of a surety also stands, not upon contract, but upon a principle of natural justice ....
>
> Subrogation is not then based on contract, for the surety "seldom if ever stipulated for the benefit of the security which the principal debtor has given." Its basis is natural justice; it is against conscience for the debtor to regain the securities from the creditor on the discharge of the debt by the surety, because it is the debtor's obligation to indemnify the surety against any loss he incurs.

That principle is now set out in section 24 of the *Laws Declaratory Act* which provides, *inter alia* that:

> ... [the guarantor] is entitled to stand in the place of the creditor, and to use all the remedies, and, if need be, and upon a proper indemnity, to use the name of the creditor, in any proceeding at law or in equity in order to obtain from the principal debtor ... indemnification for the advances made and loss sustained by the person who has so paid the debt or performed the duty and the payment or performance so made by the surety is not pleadable in bar of any action or other proceedings by him ...

The legal position of an "accommodator" on a negotiable instrument is the same:

> An accommodation party is to all intents and purposes a surety for the person for whom he has become a party to the bill. His rights against that person are the same as the rights of a surety against the principle.

The legal rights of an indemnitor are, however, somewhat uncertain and it is our view, for the reasons expressed earlier, that the law should not make a distinction between the legal rights of indemnitors and guarantors.

3. Right to Indemnification

Associated with the right of subrogation to securities and nights held by a creditor, is the more general right to be reimbursed by the debtor for financial loss incurred when the guarantor must meet his obligations under the contract of guarantee. The right to indemnification has been identified as contractual in nature where the principal debtor has requested the guarantor to enter into the contract of guarantee, or as restitutionary where there has been no such request. There is no statutory provision, corresponding to section 24 of the *Laws Declaratory Act*, which embodies that principle.

In our analysis of the right to securities, the right of subrogation, and the right to indemnification, we did riot allude to the precise time at which they become available to a guarantor. It seems that the right of subrogation to securities and to rights enjoyed by the creditor, will not arise until the guarantor has performed the obligations of the principal debtor in full. The argument in favour of this restriction is, in the opinion of the Commission, indisputable; for to provide at guarantor with those rights, and thus to deprive a creditor of his security when part of the debt remains unsatisfied, would be to work serious hardship on him.

On the other hand, the purely equitable right to reimbursement comes into existence whenever the guarantor has paid anything on the contract of guarantee:

> The surety, as often as he pays anything under his guarantee in relief of the principal debtor, has an immediate right of action against the latter, though lie cannot accelerate his remedy by paying the guaranteed debt before it becomes legally due. Consequently, the principal debtor may be exposed to several actions at the suit of the same surety, from which inconvenience and hardship he is not protected by any rule of law requiring the surety to pay the whole debt due from the principal debtor before compelling reimbursement from the latter.

We have concluded that the existence of an outstanding debt should not preclude an action for reimbursement. While we agree that the opportunity for abuse exists, we suspect that a close friend or relative of the principal debtor, who has been obliged to fulfil his obligations under a contract of guarantee, would not generally abuse this privilege, and accordingly, we suggest no modification of the existing law.

It seems to us that the right to securities, the right of subrogation, and the more general right to indemnification ought to be set out together in any legislation which embodies our recommendations.

The Commission recommends that:

22. *A guarantor who pays the debt, or fulfils the obligations of a principal debtor, in whole or in part, should be able to bring an action for reimbursement from the principal debtor for the amount that he has paid to the creditor, for all liability sustained in meeting his obligations under the contract of guarantee and reasonable expenses incurred in so doing.*

23. The recommended legislation should contain a provision comparable to section 24 of the Laws Declaratory Act.

So far in our analysis of the guarantor's right to reimbursement we have not considered whether the right should exist where the guarantor has paid the creditor more than he is legally obligated to pay. In that situation, the payment by the guarantor may be viewed as a purely voluntary payment for which there ought not to be an action for reimbursement. In *Alexander* v. *Vane* a guarantor had fulfilled his obligations under a contract of guarantee that was unenforceable clue to noncompliance with the *Statute of Frauds*. It was held that the fact that the guarantor was under no legal obligation to pay the creditor did not preclude a successful action for reimbursement.

In *Re Chetwynd Estate* a guarantor recovered reimbursement for his losses under a contract of guarantee unenforceable by virtue of a breach of *the Moneylenders Act, 1927*.

60. (1938) Ch. 13; *see also In re Forster Estate*, (1941) 4 D.L.R. 750; *see also Argo Caribbean Group* v. *Lewis*, [1976] 2 Ll. R. 289 where the English Court of Appeal followed *Re Chetwynd Estate*.

61. 17 & 18 Geo. V, c. 21, s. 6. It was suggested in that case, however, that the precise terms of the request by the principal debtor to the guarantor to enter into the contract of guarantee, will govern the right to reimbursement where a guarantor fails to avail himself of defences open to him. Thus, at guarantor might find it difficult to obtain reimbursement where he has met obligations which he could have avoided if he had taken full advantage of his legal rights.

This possibility might to be avoided. There is nothing to be said in favour of allowing a principal debtor to escape his obligation to reimburse a guarantor, when the guarantor's payment to the creditor has reduced or extinguished the principal debtor's liability on the consumer transaction.

The Commission recommends that:

24. The right to reimbursement should not be affected by any matter of fact, law or mixed facts and law, upon which the guarantor could have relied, to reduce or extinguish his obligations to the creditor.

The right of a guarantor to reimbursement from his principal may give rise to further difficulties, where the debtor, if he had been sued directly by the creditor, could have avoided liability. That situation was also presented to the court in *Re Chetwynd's Estate,* where a principal debtor, by virtue of a creditor's breach of the *Moneylenders Act* was under no legal obligation to repay the loan. His guarantor, however, paid the creditor, and it was held that the guarantor could recover that amount from the principal debtor. It is difficult, from the point of view of a principal debtor in a consumer transaction, to justify a rule of law that imposes on him a greater liability when sued by a guarantor, than would be the case where he is sued by the party with whom he contracted originally.

It is equally difficult, however, from the point of view of a consumer guarantor, to justify a rule of law that restricts his right of recovery because the original creditor failed to meet his contractual obligations, or failed to comply with the strict requirements of consumer protection legislation. This would seem to be the case under one aspect of the present law. Under the *Conditional Sales Act* and the *Bills of Sale Act* it is provided that the rights of a guarantor or indemnitor do not exceed the rights of a creditor.

Moreover, it is arguable that under the *Consumer Protection Act*, a guarantor who takes an assignment of securities, or is subrogated to a creditor's rights pursuant to section 24 of the *Laws Declaratory Act*, would take subject to any defences available to the principal debtor against the creditor. Section 3(1) of the *Consumer Protection Act* provides that:

> Subject to subsection (2), the assignee of a right of a lender or seller in a transaction to which this Act applies has no greater right than, and is subject to the same obligations, liabilities, and duties as, the assignor.

That policy represented by that provision is also reflected in the proposed *Personal Property Security Act*.

We have no disagreement with the present law in so far as it relates to recourse guarantors. We agree that they should be in no better position than the original creditor, and we cannot justify the alternate rule which would result in the loss of rights now enjoyed to consumers when sued by recourse guarantors.

This approach, however, is inappropriate where an action for reimbursement is brought by a consumer guarantor. Legislative policies which impose disclosure requirements on lenders in the business of extending credit to consumers, or which restrict the rights of creditors with respect to the enforcement of security, obviously do not insist on the extension of those sorts of restrictions to consumers who guarantee the debts of other consumers. Yet to provide consumer guarantors with a "full right of recovery by way of an action for reimbursement" may involve the loss of rights of principal debtors who might otherwise be able to raise certain matters if sued by their original creditors.

The best approach to balancing the competing interests of the consumer guarantor and the principal debtor in this context is to provide the consumer guarantor with a full right of recovery, *and* to ameliorate any resulting prejudice to the principal debtor by affording him a statutory right over against the creditor.

The Commission recommends that:

25. *Where a guarantor brings an action for reimbursement, the principal debtor should not be able to rely on any matter of fact, law or mixed fact and law, upon which he could have relied to reduce or extinguish his obligations to the creditor.*

26. *Where a principal debtor is precluded under Recommendation 25 from relying upon any matter, he should be able to recover from the creditor an amount of money equal to the amount his liability to the consumer guarantor would have been reduced had he been able to rely on the matter.*

CHAPTER VIII DISCHARGE OF THE GUARANTOR

A. By Discharge of the Principal Transaction

1. ___Payment or Performance

It is wellestablished that payment of the debt or performance of the obligation due under the principal transaction will, if it discharges the principal debtor, discharge the guarantor. In addition, partpayment or partperformance of the principal obligation will discharge the guarantor *pro tanto*. Yet the matter is not that simple, for as pointed out in *Chitty on Contracts,* it is not uncommon for the principal to owe more than one debt to his creditor and, in the absence of a specific appropriation by the debtor, the law does not restrict the right of the debtor or creditor to apply a payment to an unsecured obligation.

In *Bank of Nova Scotia* v. *Neil,* the plaintiff had advanced $2,000 to a company and received a promissory note from the borrower for that amount a note that was endorsed by the defendant as a guarantor. Later, the bank advanced a further $3,000 to the company and took back a second note for that amount. The second debt was not guaranteed. Subsequently the company repaid over $2,000 which the bank appropriated to the debt evidenced by the second note. The company then borrowed over $6,000 from the bank and gave a third note for that amount. The bank then received $8,000 on the company's account, used that amount to satisfy the liability of the company evidenced by the second and third notes, and sued the defendant guarantor for the balance owing on the first debt. The Court of Appeal held that there was no right in the guarantor to direct how the monies paid by the company were to be used by the bank.

Yet it has been admitted that the rules prohibiting a guarantor from appropriating payments often operate to his prejudice:

> ... no authority has been cited nor do I know of any for the proposition that money paid to a creditor generally, in the absence of a specific appropriation by the debtor, must be allocated by the creditor to a secured debt in preference to an unsecured debt. The principle of law applied by the Court of Appeal for British Columbia in *Bank of N.S.* v. *Neil* (1968), 65 W.W.R. 215, 69 D.L.R. (2d) 357, and by the Court of Appeal for Ontario in *Royal Bank of Can.* v. *Slack*, [1958] O.R. 262, 11 D.L.R. (2d) 737 (C.A.), appears not to favour that proposition ... The Court in each case found that there was no legal compulsion upon the creditor to make such an allocation notwithstanding that a third party, in those cases a surety, was prejudiced by the allocation.

The law in some American states seems to allow a more equitable allocation of legal rights in the situation described above. Although the common law in the United States is similar to that which exists in British Columbia, its rigour has been softened through the development of certain equitable rules:

> These rules have been developed by the courts in an effort to do whatever is most equitable under the circumstances. Following this principle, it has sometimes been held that the payment should be applied to the debt for which there is a surety. Thus, if the surety furnishes the principal with money to pay the debt on which he is surety, the creditor must apply the money to such debt, unless he is unaware of the source of the money. When payments are made f rom the proceeds or fruits of a contract, business or transaction covered by the obligation of a surety, and when the source of the funds in known to the creditor receiving the same, the surety equitably is entitled to have the payments applied to the discharge of the debt for which he is bound, even though other application has been made by the creditor.

The number of cases in which this point has been in dispute is, in the light of the clarity of Canadian law on this matter, surprisingly large. It indicates, in our opinion, a manifestly inequitable resolution of the conflict between the competing interests involved in such cases. This is especially so where the guarantee arises in the context of a consumer transaction.

The Commission recommends that:

27. *Where a principal debtor has made a payment to a creditor, or has otherwise performed all or part of an obligation due to a creditor, which payment or performance could have been applied to reduce or extinguish those obligations secured by a guarantee, the creditor should be required to apply the payment or performance to reduce or extinguish the obligation in respect of which the guarantee was given.*

This recommendation does not provide guidance in the situation where more than one debt is owed to a single creditor, each of which is secured by a guarantee given by different individuals. One answer to the conflict between the guarantors in such a case each of whom is likely to desire appropriation in respect of the debt guaranteed by himself is to provide that each debt should be reduced by an amount relative to its proportion of the total. This, on first glance, is an appealing solution. Yet, if a consumer assumes liability as a guarantor of one debt, it seems unfair that he should be affected adversely by the coming into existence of a second debt, and the taking of another contract of guarantee from a different individual.

Where the guarantor undertakes responsibility for one debt, the has some assurance that any payment by his principal will be applied to reduce the indebtedness for which he is responsible. That is the purpose and effect of Recommendation 27. To allow that reliance to be undermined where the creditor advances credit to the same debtor on some future occasion, and takes as security a second guarantee, is to erode the position of the first guarantor without justification.

Another solution is to provide that the debts be paid off in the order in which they were guaranteed. Thus would seem to preclude prejudice as a result of later events over which a guarantor would have no control. So long as the later guarantor is aware of a prior guaranteed obligation, as he would be under a prior recommendation, no prejudice would result.

The Commission recommends that:

28. *Where a principal debtor owes more than one debt to a creditor, each of which is secured by a guarantee, any payment or performance by the principal debtor must be applied to reduce or extinguish the debts in the order in which they were guaranteed.*

2. ___By Agreement

A binding legal agreement whereby a creditor discharges at principal debtor, will discharge a guarantor of the obligations for which the principal debtor is no longer liable. The explanation of that rule has been set out as follows:

> The reason why the surety is discharged if the principal debtor is discharged is that the courts took the view that any other rule would lead to one or other of two strange results, having regard to the surety's normal right to an indemnity from the debtor. If the surety were compelled to meet the liability, any attempt by him to sue the debtor for an indemnity might be met by the plea that the debt had gone and the debtor was no longer liable. If this were a good answer to the surety he would be deprived, by the unilateral act of the creditor, of a right which he would have expected to have. On the other hand, if the debtor remained liable to indemnify the surety despite his own discharge, the effect would be to render the discharge largely nugatory. In the result the courts treated the discharge of the surety as a necessary consequence of the discharge of the debtor.

There are, however, several situations where the application of this doctrine leads to results which are not entirely satisfactory.

The first is the case of a *covenant not to sue* executed by a creditor in favour of a debtor. The precise legal effect of such an agreement is not clear, and is complicated by cases replete with logical absurdities, as well as questionable policy. One commentator considers "it possible that a court would today hold that an agreement not to sue the debtor does not discharge the surety." It is our opinion that the effect of a covenant not to sue is anomalous, and ought to be consistent with the result of a discharge.

Another possible area of confusion is the effect of a discharge where the contract of guarantee is construed as an indemnity. That uncertainty should also be eliminated.

Finally, the legal effect of a discharge may be quite different than that set out above, if the creditor, either in the original consumer agreement or in the discharge itself, reserves his rights against a guarantor. The effect of a "reservation of rights" clause is to preserve the guarantor's liability to the creditor, had thus to continue the principal debtor's liability to the guarantor.

The rationale for this rule of law was restated by the English Court of Appeal in *Cole* v. *Lynn* put simply, the Court held that the "reservation of rights" clause was sufficient notice to the principal debtor (the defendant) that the guarantor was to remain liable, and thus that the guarantor would be able to look to him for reimbursement once the creditor enforced the contract of guarantee. But again matters are complicated if the agreement between the principal debtor and creditor is construed as an absolute release, the effect of which is not merely a personal restriction on the right of the creditor to sue, but the extinction of the debt itself.

That differing legal rules apply to the discharge of a principal debtor according to the form rather than to the subject of the agreement is, in the opinion of the Commission, objectionable. It is unlikely that consumers appreciate fine legal niceties of this sort, and we do not believe that the legal rights of consumers should be affected by matters of which they have little, if any, understanding. We recommend, therefore, that the effect of a discharge, release, covenant not to sue, or any agreement of a like nature, should be consistent.

Our concern with the law associated with a reservation of rights clause is less easily resolved in 1931 the American Law Institute made the point that the legal effect of a reservation of rights clause was to render the discharge agreement nugatory, and noted that:

> Words which purport to discharge the principal are repugnant to words which purport to reserve rights against the surety.

Fortytwo years later, in the revised draft of the *Restatement of Contract 2d*, the Institute noted once again that:

> [T]he reservation subjects the [principal debtor] to the risk that the protection the covenant affords may be illusory.

We recognize that it will be only in the most unusual of cases that a consumer debtor will appreciate the legal implications of a provision that reserves his creditor's rights against his guarantor. This lack of awareness is even more disturbing in the light of the effect of such a clause. As a practical matter the consumer debtor gains nothing from the discharge or compromise agreement. We agree with the Institute's appraisal of the present law and we have concluded that the failure of consumer debtors to appreciate the continuation of their liability ought not to be countenanced.

In our view the complexity and inconsistency of the law relating to the reservation of rights clause should be eliminated through a reformulation of the law which would deny that clause any legal effect. The principal objection to such a step is that, if reservations of rights clauses were to be deemed void, any discharge or release of the principal debtor would *automatically* discharge or release a guarantor. Creditors might be reluctant to compromise their interests to such a degree, thus the opportunity of principal debtors to negotiate their liability where they are unable to fulfil their obligations would be severely prejudiced.

We do not believe these objections are fatal. The right of a debtor to "negotiate" and reach a “compromise" with his creditor is an exceedingly hollow one. if he is to remain exposed to liability to his guarantor.

The Commission recommends that:

29. *Notwithstanding at reservation by a creditor of his rights against a guarantor, a release, covenant not to sue, or an agreement to discharge, to extinguish, or to otherwise reduce the obligation of a principal debtor to a creditor, entered into by a creditor and principal debtor, should reduce or extinguish the liability of a guarantor of those obligations, to the extent that the principal debtor's obligations are reduced or extinguished.*

B. By Variation of the Principal Contract, Extension of Time, or Dealing with Securities

1. ___Variation of the Principal Contract: Extension of Time

Because the liability of a guarantor is so closely associated with the terms and conditions of the principal consumer transaction, it is trite law that any variation of the principal contract will discharge a guarantor. There is, however, an exception to this rule, for a guarantor will not be discharged where it is selfevident that a variation of the principal contract could not operate to his prejudice:

> ... materiality of any change or alteration in the contract is not a question of fact for the court it is for the surety to judge except in those cases where it can plainly be seen without inquiry that the change or alteration was unsubstantial or necessarily beneficial to the surety.

Another principle, closely associated with the "no variation" rule, holds that. any extension of time given to the principal debtor, however short, if given pursuant to a binding legal agreement, will discharge a guarantor:

> If, without the consent of the surety, the creditor enters into a binding agreement with the principal debtor to allow him further time for payment, the thereby discharges the surety. The reason given for this rule is that by giving time to the principal debtor the creditor temporarily puts it out of the power of the surety to call upon the

debtor to pay of f the debt, or to pay it off himself and recover the amount f rom the debtor, and so the surety's position is altered to his detriment without his consent.

The fact that an extension of time does not, in fact, prejudice a guarantor, does not affect his right to be discharged from his obligations.

It is important to note, however, that a guarantor will be discharged only where the creditor has *contracted* with the principal debtor that he will extend the time for payment or performance. Mere gratuitous forbearance on the part of the creditor will not result in the discharge of a guarantor regardless of the prejudice which a guarantor may suffer because of the creditor's inaction. At present, a guarantor can do nothing where a creditor refuses to hold his principal to the terms of the principal transaction. The rights afforded guarantors under Recommendations 16 through 18 should ameliorate that situation.

Yet it would seem that the law, in so far as it relates to an agreement to give time which absolves a guarantor of all liability notwithstanding that he suffers no prejudice is equally unjust to creditors. It has been argued that rigidity of the "extension of time" doctrine is manifestly impractical, and over a century ago the English Court of Appeal recommended legislative action to remedy the many inequities apparent from its continued application.

Professor Glanville Williams contends that an extension of time does not generally prejudice a guarantor at all, but rather, saves him from the crystallization of his liability by allowing his principal an opportunity to recover, and Cardozo J. has ridiculed the law in its misguided assumptions:

> The law has shaped its judgments upon the fictitious assumption that a surety, who has probably lain awake nights for fear that payment may some day be demanded, has in truth been smarting under a repressed desire to force an unwelcome payment on a reluctant or capricious creditor.

2. ___Dealing with Securities

Where the creditor releases, surrenders, or otherwise deals with any security given by the principal debtor, so that the rights of a guarantor to that security are prejudiced, the guarantor will be discharged wholly or *pro tanto* depending upon the terms of the contract of guarantee:

> ... if the existence of the security was an essential part of the contract of suretyship, then release of the security will discharge the surety entirely, but if it ;qas not an essential part of the bargain (for example), because it was supplied by the debtor after the contract of suretyship was made) the surety will only be discharged to the extent that he had been prejudiced. And if he has not been prejudiced at all, for example, because the security was worthless, or because the security was not one to which the surety was entitled, he remains liable in full.

The law relating to the discharge of guarantors, where the creditor has dealt with the security given by the principal debtor, vias considered recently by the Ontario Court of Appeal in *Rose* v. *Aftenberger et al*. Laskin J.A. (as he then was) delivered the reasons for judgment and held that:

> ... where security is taken at the time or after the guarantee, but without it being a condition of the guarantee, and the creditor improperly disposes of the security ... the guarantor is discharged *pro tanto* only, that is, to the extent of the loss.

Of course, where a creditor has realized on the security, and has credited the resulting proceeds to the account of the principal debtor (as he must), the guarantor is not adversely affected and thus is not discharged. It is. important to note, nonetheless, that the guarantor will be discharged not only where the creditor releases or surrenders security to the principal debtor, but also where the creditor does any act, or omits to do some act (such as to register his security interest) which reduces or destroys the value of the security.

Any impairment of the collateral, the continued existence of which is an essential harm of the guarantee, results in the discharge of a guarantor from all liability. This is true even if the total value of the collateral is less than the liability of the guarantor. This rule has been justly criticized:

> Although the statements are general that loss or surrender of security by the creditor involves the loss only of such portion of his claim against the surety as equals the value of the security lost or surrendered, a distinction has been taken in an unusual decision between securities given to the creditor at the time of the original contract with the surety, and with reference to which, therefore, the surety's contract was made, and securities (given to the creditor later or under other circumstances. In the former case, it is said that the surrender of the securities involves a change in the surety's contract which, like any alteration of risk, discharges the surety altogether. This seems an unnecessarily harsh rule.
>
> It may be conceded that a change of risk imposing an uncertain additional burden on the surety can only be dealt with in fairness to the surety by discharging him altogether. But where the value of security is merely a readily ascertainable sum of money, there seems no reason for imagining the surety has suffered loss beyond that sum, and if he has not, it is an obvious injustice to discharge him to a greater extent.

Thus in *Polak* v. *Everett*, a guarantor was discharged from all liability on a debt of $6,000 where securities having a facevalue of only $4,000 were improperly surrendered.

The response to criticism directed at the legal rules relating to the "extension of time" and "dealing with securities" doctrines has been of two sorts. The first has been the addition of a standard term in contracts of guarantee that allows a creditor to give binding extensions of time to the principal debtor, and to deal with securities without discharging the guarantor. The efficacy of such provisions in avoiding the rigours of the doctrines cannot be disputed:

The operation of the rules thus stated is, of course dependent upon the variation in the contract provisions being made without the surety's consent. That consent may, however, be given before the variations are made, as well as after. Standard form contracts of guarantee, examples of which are set out in Appendix A, illustrate that the protection afforded guarantors has been effectively abrogated.

The other response to the difficulties posed by the strict application of the rules, has been the introduction in some jurisdictions of legislation which, while preserving the principle that a guarantor ought not to be prejudiced by acts of a creditor and debtor which have taken place without his knowledge or consent, relaxes the equitable rules and provides for the discharge of the guarantor only to the extent that he has been prejudiced.

Such legislation now exists in Manitoba and Saskatchewan, and we have been unable to discover whether similar policies have been adopted in other jurisdictions. Section 4 of *The Mercantile Law Amendment Act* of Manitoba provides that:

> 4. Giving time to a principal debtor, or dealing with or altering the security held by the principal creditor, does not itself discharge a surety or guarantor; in such cases a surety oi guarantor is entitled to set up the giving of time or dealing with or alteration of the security as a defence, but the defence shall be allowed in so far only as that the surety has thereby been prejudiced.

Part 18 of section 45 of the Saskatchewan *Queen's Bench Act* is to the same effect.

The decisions in cases in which these provisions have been considered, provide ample proof of the utility of the policy they represent. The remarks of Mr. Justice Bain in *Blackwood* v. *Percival* coincide with our own views of the rules, and of the modification represented by the Manitoba and Saskatchewan legislation:

[At common law] if the creditor did violate the right of the surety, the penalty was that he forfeited his whole remedy, without regard to the question whether the extension of time was for the benefit of the surety or not. But now what would seem to be the juster principle is to prevail that, if the surety can show that he has been prejudiced by the giving of time, he is entitled to compensation from the creditor for his loss. The onus of proving that he has been prejudiced must rest on the surety; and, as I understand the Act, he must show that he suffered pecuniary loss or damage as the reasonably direct and natural result of the creditor having given the extension of time; and the defence will avail him to the extent of the loss or damage he can prove. It will be found, I imagine, that few cases will occur in which sureties will be able to establish actual loss or damage under this defence; and I think the defendant has failed to establish any in the present case.

The Manitoba and Saskatchewan statutes do not modify the law relating to the effect of a variation of the terms of the principal transaction. As.Anglin C.J.C. said in *Gordon* v. *Hepplewhite:*

The law affecting the relations of creditor and surety is materially modified in the Province of Manitoba ...

Because it introduces a new principle in derogation of the ordinary legal rights of a surety this statute must be taken to alter the law only in so far as its terms clearly express legislative intent to do so ... Except in the case of merely giving time to the principal debtor, nothing in the section under consideration interferes with the legal effect of a variation in the contractual obligation either of the debtor or of the surety effected without the surety's assent and any such change (not obviously unsubstantial) resulting from the action of the creditor will still discharge the surety in Manitoba as it does in other provinces where English law prevails ...

We have concluded that the rules, as they now stand, favour guarantors to an extent that cannot be justified either in fairness or common sense. At the same time, it is easy to see that unless steps are taken (either through the incorporation of contractual terms designed to abrogate the rules, or through legislative intervention to the same end) the behaviour of creditors and debtors would be restricted to a degree detrimental to all concerned. Yet we believe that the contractual terms now common, at least in the case of consumer contracts of guarantee, favour creditors to an extent that is equally unjustifiable. The reconciliation of the legitimate interest of creditors and consumer debtors to be able to deal with one another with relative ease, with the interests of guarantors to be protected from prejudicial acts over which they have no control, is in our opinion, best carried out by provisions similar to those now in force in Manitoba and Saskatchewan.

It seems, however, that certain matters relating to the discharge of guarantors call for discrete recommendations. The clearest case is the law relating to the absolute discharge of guarantors where the creditor deals with or otherwise reduces the value of any security taken from the principal debtor. The modifications represented by the Manitoba and Saskatchewan legislation appear to resolve this difficulty in an eminently fair manner.

The Commission recommends that:

30. *Any dealing with or alteration of the security held by the creditor, or any act or omission of the creditor that affects the value of the security, should discharge a guarantor to the extent that he has been prejudiced.*

It would seem that a similar rule is called for in an attempt to introduce an element of fairness in the law relating to agreements extending the time of payment. Once again, the Manitoba and Saskatchewan legislation provide proven examples of its value an agreement between a creditor and principal debtor extending the time of payment on the principal transaction should discharge a guarantor only to the extent that he is prejudiced thereby.

The Commission recommends that:

31. *An agreement to extend the time for a principal debtor to fulfill his obligations under a consumer transaction, should discharge a guarantor to the extent that he has been prejudiced.*

Those recommendations are not intended to modify the rule that results in the discharge of a guarantor whenever there has been a variation of the principal contract.

We considered seriously a recommendation that would allow variations of the principal contract to take place unless the guarantor was prejudiced as a result. Such a right has been set out in the proposed *Personal Property Security Act* to resolve a corresponding difficulty arising in the context of secured transactions.

41. American Law Institute, Uniform Commercial Code, 1972 Official Text and Comments of Article 9, Secured Transactions 121 (1972).

The difficulty arises, not uncommonly, where a secured creditor and a debtor wish to vary the terms of an executory contract that has been assigned by the creditor to a third party. The assignee is in a position similar to that of a guarantor unable to control events which may alter radically his obligations. At common law, any attempted variation of the executory contract was void, and the doctrine caused extraordinary inconvenience and interfered to an unwarranted degree with normal commercial practice.

The comments cm the analogous rprovisions of the Uniform Commercial Code suggest that the resolution of the difficulty in the context of secured transactions, approximates closely the policy embodied in the Manitoba andSaskatchewan legislation referred to earlier:

> Prior law was in confusion as to whether modification of an executory contract by account debtor and assignor without the assignee's consent was possible after notification of ark assignment. Subsection (2) makes good faith modifications by assignor and account debtor without the assignee's consent effective against the assignee even after notification. This rule may do some violence to accepted doctrines of contract law. Nevertheless it is a sound and indeed a necessary rule in view of the realities of large scale procurement ... This subsection gives the prime contractor (the account debtor) the right to make the required arrangments directly with his subcontractors without undertaking the task of procuring assents from the many banks to whom rights under the contracts may have been assigned.

After a great deal of thought we have concluded that such a change in the law in the context of consumer guarantees may create more difficulties than it cures. We foresee difficulties associated with any provision that would impose on a court the responsibility of interpreting new terms either as modifications and variations of prior agreements, or as the abrogation or waiver of the old agreement and the substitution of an entirely new contractual arrangment. In addition, the determination of prejudice in absolute terms would be exceedingly complex and time-consuming. In default of any reforms which would clearly result in an improvement in the present law, we have concluded that matters should remain as they are.

The Commission recommends that:

32. *Subject to Recommendations 30 and 31, any variation of the principal transaction should, unless the variation is manifestly unsubstantial or necessarily beneficial to the guarantor, render the guarantee unenforceable.*

33. *Where a guarantee is unenforceable under Recommendation 32, Recommendation 8 should apply.*

CHAPTER IX LIABILITY ON THE CONTRACT OF GUARANTEE

A. Introduction

An analysis of the law relating to the liability of a party under a contract of guarantee must begin with a discussion of the principle of co-extensiveness. That principle, which describes the relationship between the liability of a guarantor under a contract of guarantee and the liability of his principal under the principal obligation, holds in the absence of other matters, that the former must be identical with the latter.

A contract of guarantee is simply a promise to fulfil another's obligation it is but one of many possible arrangements open to a creditor who seeks security for a debt owed to him. It follows, as a matter of logic as well as fairness, that the security (the contract of guarantee) should not be more onerous than the debt itself. A creditor's right to enforce security from a third party should be no greater than his right to enforce the principal obligation. It would be incorrect, however, to suppose that the principle of co-extensiveness is applicable, without exception, in defining the liability of a guarantor. Like most legal rules, the principal of co-extensiveness cannot be applied mechanically as one would employ a mathematical formula, it is not absolute:

> The extent to which a guarantor's liability is co-extensive with that of the principal debtor is one of the more intractable problems of English law. The starting point must, of course, be the nature of a guarantor's undertaking. A contract of guarantee is an accessory contract. In its usual form it is an undertaking given by the guarantor to the creditor that he will ensure that the principal debtor (called "the debtor" herein) performs the principal obligation. Accordingly, if the debtor fails to fulfil the principal obligation the creditor can recover from the guarantor, as damages for breach of his guarantee, whatever sum the creditor could have recovered from the debtor himself. Conceptualistic reasoning therefore leads to the conclusion the liability of a debtor and a guarantor is co-extensive. If this deduction reflected a principle of universal validity it would follow that:
>
> (a) the guarantor is not liable if the principal obligation cannot be enforced;
>
> (b) the guarantor can rely on any defence or counterclaim which the debtor could have raised if he had been sued.
>
> It would have been surprising if the law in relation to the complex relationships between creditor, debtor and guarantor had been reducible to quite such elementary propositions. It clearly is not.

Put in its simplest and most rigid terms, the principle of coextensiveness holds that matters which affect the enforceability of the principal contract *automatically* affect the enforceability of a collateral guarantee. The matter is, however, not that simple:

> [I]t can be said that, with certain exceptions, English law recognises the rule of civil law that a contract of suretyship is dependent upon the existence and continued existence of a principal obligation. But the gendral rule of co-extensive liability is subject to important modifications some of which, on a logical analysis, depend on fine distinctions such as the differences between void and illegal contracts, between extinction and unenforceability of an obligation, and the like. It should be understood, however, that judicial approach to the problems posed by the cases has not been on this basis but rather on the basis that the general rule should release the surety unless there is some countervailing factor or interest which compels the court to hold the contrary. Such countervailing factors and interests will frequently be found in the policy of the legislation or the rule of law which has operated to free the principal from liability but may also arise from the particular facts of the case under review.

The legal rules which have evolved so far in an attempt to define and limit the liability of a guarantor involve, as do most legal rules, the balancing of countervailing policies. The fundamental policy is, of course, the principle of coextensiveness that a person secondarily liable for a debt should not be in a worse position than the person primarily liable. Yet that policy must be balanced against other policies of equal or greater importance which may call for the enforcement of collateral security notwithstanding the unenforceability of the principal obligation.

During the development of the law relating to commercial and then consumer contracts, the principle of co-extensiveness suffered intrusions only in limited circumstances. For the most part, private bargains were left untouched by legislatures. Matters restricting the enforceability of consensual agreements arose mostly as a result of the common law, and the issue of whether a guarantor should be able to rely on his principal's common law defences arose only rarely. When it did arise, and where the courts were of the view that the security ought to be enforced notwithstanding the unenforceability of the principal obligation, the contractual arrangement was sometimes construed as an indemnity where the principle of co-extensiveness does not come into play. In other cases the courts were more forthright in their analysis, and stated openly that the principle of co-extensiveness must fall to more important policies.

In more recent times society has considered it both necessary and proper to interfere with otherwise insulated arrangements. Interference has been considered especially appropriate in the case of consumer transactions. Creditors must now abide by rules which relate, for example, to the terms of agreements, to their, behaviour prior to entering into certain agreements, and to the manner in which they can enforce contractual arrangements. With this increased interference with private consensual rights and obligations has code a potential increase of intrusions to the principle of co-extensiveness. Yet the issue of whether the principle of coextensiveness ought to be respected or abrogated when legislative policy calls for a limitation on the enforceability of contracts has not often been debated either in the courts or legislatures.

The issues are complicated by the variety of defences available to principal debtors. Some defences, such as fraud or duress, involve an element of moral turpitude on the part of the creditor. Others, such as minority, or reduced intellectual capacity involve no such wrongdoing, and are premised on a personal characteristic of the principal debtor.

Still other defences, sugh as bankruptcy, contemplate the precise situation which led the creditor to seek a guarantee in the first place, and it would be unreasonable to destroy the value of that security pursuant to a general policy of co-extensiveness. Finally, there are many defences available to a principal debtor only if he choses to rely on them. If he chooses not to, or is precluded from doing so, it must be resolved whether or not a guarantor should be affected by these matters.

It is our view that the principle of coextensiveness should not be extended to the case where the defence arises out of a separate transaction. A guarantor of a consumer obligation should be able to raise only those matters which are related to the consumer transaction itself.

The general policy of co-extensiveness which we believe ought to govern the liability of guarantors of consumer transactions is set out below:

The Commission recommends that:

34. Where an action is brought to enforce a guarantee, a guarantor should be able to rely on, or raise, in diminution of his liability, any matter or fact, law, or mixed fact and law, which the principal debtor could have relied on or raised in an action on the consumer transaction, so long as the matter of fact, law, or mixed fact and law, is related to, or connected with the consumer transaction.

As noted above, it may be that the principle of co-extensiveness should not be applied indiscriminately to all classes of guarantors, or with respect to all types of defences. Therefore, in succeeding sections of this chapter we examine a variety of defences now available to. consumer debtors, and consider whether the policy embodied in Recommendation 34 should be applied, or be diverged from, in those specific cases.

B. The Limitations Act

The principle that a person who has a legal claim against another must pursue his rights within a reasonable length of time is fundamental to English and Canadian law. The rules in British Columbia relating to the time in which legal rights must be enforced have recently undergone extensive revision, and it is to the defence of the *Limitations Act,* that we now turn our attention. Section 9(1) of the *Limitations Act* provides that:

> ... On the expiration of a limitation period fixed by this Act for a cause of action to recover any debt; damages, or other money, or for an accounting in respect of any matter, the right and title of the person formerly having the cause of action and of a person claiming through him in respect of that matter is, as against the person against whom the cause of action formerly lay and as against his successors, extinguished.

Under the Act the limitation period begins to run when the plaintiff's cause of action accrues.

In some cases, and in the absence of a contrary intention, the claim of a creditor against a guarantor will arise on the default of the principal debtor, and thus the limitation periods on the contract of guarantee and the principal contract will begin, and expire, simultaneously. Thus in *Rural Municipality of Wellington* v. *Dale, Saskatchewan General Trusts Corporation and Braithwaite*, Haultain C.J.S. held that:

> Under an ordinary contract of guarantee or suretyship, the cause of action against the guarantor arises at the time the guarantor becomes liable to make a payment to the creditor. In the present case the liability of [the guarantor] arose as soon as the goods were delivered to [the principal debtor] ... The plaintiff's cause of action against her, therefore, accrued on that day, and time under the statute began to run on that day.

It is often the case, however, that the contract of guarantee provides that the guarantor is liable to the creditor "on demand." In those circumstances, notwithstanding the fact that the limitation period has started to run against the creditor with respect to his claim against the principal debtor, the creditor's cause of action against the guarantor arises only when the demand is made. The limitation period with respect to the guarantee will begin to run from that later time. In *Dominion Bank* v. *Elliot,* Armour J. pointed out that:

> [T]he terms of the guarantee bond provided that the liability of the defendant to pay should first arise when notice in writing was given her requiring her to pay. Consequently the Statute of Limitations did not run from the date of the guarantee, but from the date of the notice in writing demanding payment given thereunder. The defence under the Statute of Limitations therefore failed.

A result of the legal rules relating to the running of time on right of action against a guarantor, it is not unusual that the creditor's claim against the principal debtor is barred by the *Limitations Act*, while his claim against the guarantor remains enforceable.

Under Recommendation 34 a guarantor could rely on the principal debtor's defence of the *Limitations Act*; whether he could do so under the present law is uncertain.

That point was considered in the English decision of *Carter* v. *White*. There, the plaintiff, by depositing certificates of stock with a creditor, had guaranteed the obligations of a principal debtor under a bill of exchange. The plaintiff brought an action in which he sought a declaration that the stock certificates be discharged from the creditor's claims. He alleged, on the ground that the creditor's claim against the principal debtor was statutebarred, that he, as a guarantor of the principal debtor's obligation, was also discharged. Lindley L.J. said:

> It was next said that the Defendant had discharged his surety by holding the bills till the *Statute of Limitations* had run. Is it the law that a creditor who neglects to sue his debtor till the statute has run will thereby discharge his surety? There is no decision to that effect. On the contrary, the true principle is that a mere omission to sue

> does not discharge the surety, because the surety can himself set the law in operation against the debtor. That disposes cd most of the grounds of appeal.

The issue arose again in the case of *In Re Powers, Lindsell* v. *Phillips* where a guarantor had given a personal bond to secure a mortgage debt. The creditor's claim against the mortgage was barred by section 8 of the *Real Property Limitations Act, 1874,* and it was held that the creditor's claim against the guarantor, which was subject to a longer limitation period, was not affected by the expiry of the creditor's rights of the principal transaction. In *McPherson* v. *McBain*, a contract of guarantee was subject to a limitation period of twenty years and it was held that the *Real Property Limitations Act* which barred an action on the principal contract, did not affect the liability of the guarantor.

The law in British Columbia may, however, be the opposite. It has been said that the effect of the legislation at issue in the cases referred to above, is merely to render a transaction unenforceable. That is, while the legislation may bar the remedy of the party seeking to enforce the transaction, it leaves the obligation extant, and does not affect any rights acquired pursuant to it. It could therefore be argued that the subsistence of the principal obligation, notwithstanding the abrogation of any enforcement procedure, provides the *nexus* upon which a contract of guarantee rests.

The *Limitations Act* now in force in British Columbia reverses that state of affairs, for section 9(1) of the Act states in the most positive of terms that the expiry of a limitation period extinguishes the principal obligation It has been held, where the provisions of other statutes were at issue, that the unenforceability of at principal transaction may leave tantouched ix collateral contract of guarantee. Conversely, it has been held that where a principal obligation is *extinguished*, any collateral obligation fails. Therefore, it may be the case in British Columbia, that a contract of guarantee will be unenforceable when the *Limitations Act* extinguishes rights on the principal consumer transaction.

It seems that where a guarantor is liable to a creditor, he will be successful in an action against the principal debtor for reimbursement. This is so notwithstanding that the principal debtor might have relied on a statute of limitations if sued by his creditor.

Under Recommendation 34, the guarantor of a consumer's obligations will be able to rely on the principal debtor's defence of the *Limitations Act*. That Recommendation, as it applies to the defence of the *Limitations Act*, is in accord with the policy considerations which we expressed in our Report on Limitations.

If the expiry of the limitation period with respect to a creditor's claim against the principal may be relied upon by a guarantor where the creditor brings an action on a contract of guarantee, one must consider whether matters which extend the limitation period with respect to the principal transaction, should prevent a guarantor from relying on that defence.

The following example illustrates the difficulty nicely:

> On January 1, 1975, *D* purchases an automobile from *C*, and *G* guarantees *D*'s debt on demand. *D* defaults on January 1, 1977, and on January 1, 1978 *C* demands payment from *G*. Subsequently, on January 1, 1979, *D* acknowledges his debt to *C*, or alternatively, pays *C* part of the debt. Nothing more happens until January 2, 1983, when *C* sues *G* on the contract of guarantee.

C's rights against *G*, which arose when the demand for payment was made on January 1, 1978, do not expire until 1984. *G* seeks to escape liability, however, by pleading *D*'s defence of the *Limitations Act*. *C* argues, on the basis of the acknowledgement or payment by *D* on January 1, 1979, that his rights against *D* are not extinguished until 1985. *G* argues that under section 5 of the *Limitations Act*, he is not affected by the acknowledgement or payment. Section 5 of the *Limitations Act* provides, *inter alia*, that:

> 5. (1) Where, after time has commenced to run with respect to a limitation period fixed by this Act, but before the expiration of the limitation period, a person against whom an action lies confirms the cause of action, the time during which the limitation period runs before the date of the confirmation does nct count in the reckoning of the limitation period for the action by a person having the benefit of the confirmation against a person bound by the confirmation ...
>
> (7) For the purposes of this section, a person is bound by a confirmation only if
>
> (a) he is a maker of the confirmation; or
>
> (b) after the making of the confirmation, he becomes, in relation to the cause of action, a successor of the maker; or
>
> (c) the maker is, at the time when he makes the confirmation, a trustee, and the firstmentioned person is at the date of the confirmation or afterwards becomes a trustee of the trust of which the maker is a trustee; or ...

This raises an apparent conflict between the policy represented in section 5(7) of the *Limitations Act*, and the principle of co-extensiveness. It should, in our opinion, be resolved in favour of the latter. That is, a guarantor should be able to rely only on a matter (i.e. the defence of the *Limitations Act*) which at debtor could have relied upon if sued by the creditor on the principal transaction. If a debtor has made a confirmation within the meaning of that term in the *Limitations Act*, and thus cannot rely on the Act, then a guarantor should be under the same disability.

The Commission recommends that:

35. Notwithstanding section 5(7) of the Limitations Act*, a guarantor who seeks to rely on the defence of a principal debtor arising from that Act, should be bound by any confirmation which binds the principal debtor.*

The final point to be considered, is the effect of section 5(7) of the *Limitations Act* on the legal position of a guarantor who alleges, notwithstanding the fact that confirmations by the principal debtor have extended the limitation period with respect to the creditor's claim against the principal debtor, that the limitation period with *respect to the contract of guarantee* has expired.

In *In Re Powers, Lindsell Phillips* it was suggested that partpayment (i.e. a confirmation within the meaning of that term in section 5 of the *Limitations Act*) by the principal debtor will interrupt the running of the limitation period on the contract of guarantee.

In *In Re Fishy, Allison* v. *Fisby*, a mortgagor (the principal debtor), had paid interest on a mortgage debt to his mortgagee for over twelve years. Subsequently, upon the mortgagor's default, the creditor brought an action against a guarantor of the mortgagor's obligations. It was held that the guarantor was bound by the partpayments of the principal debtor, and that those payments interrupted the running of the limitation period with respect to the creditor's rights on the contract of guarantee:

> But is the claim [against the guarantor] kept alive by the payment of interest by the mortgagor? In my opinion it is. The section says nothing about the person by whom the money is paid, and in my opinion it is satisfied if the payment is made by any one liable to pay. If the surety takes the benef it of the section he must also take the burden. I think that payment by either principal or surety takes the case out of the statute as against both of them.
>
> ... the question is whether the payment of interest by the mortgagor do not take the case out of the section as against the surety. I think that it does. The section does not say by whom the payment is to be made, so the case

> is within the terms. In my, opinion a payment resatisfying the words of the section is made whenever there is a tender of money to a person entitled to receive it by a person liable to pay it. I agree that payment by a stranger would not do, the money in that case not being paid in discharge of a liability of the person paying it. If we were to confine "payment" to a payment by the person against whom or his representatives the action is brought, I think we should be doing great injustice. It is usual for the mortgagor not the surety to pay the interest, and it would be contrary to good sense and the common understanding of mankind that while he is doing so the statute should run in favour of the surety unless he makes a payment or gives an acknowledgement.

The same point is made in *Darby & Bosanquet on Limitations*.

In *Re Thompson*, however, the Ontario Court of Appeal reached a different conclusion. In that case the defendant had guaranteed his sister's debt owed to the plaintiff. The Court held that partpayment by the principal debtor did not prevent the defendant from relying on the *Limitations Act* which barred an action brought on the contract of guarantee:

The Statute of Limitations here applicable is that relating to simple contract debts. It contains no provision preventing its operation by reason of part payment, and a part payment operates to prevent the statute from running only because from it is implied a new promise to pay the balance remaining due. But, as pointed out in more than one decision ... a payment by one person cannot operate as a new promise by another unless there is some relationship by which the one can bind the other. Where the contract was joint, it was, before the amendment to the statute, held that the payment by one joint contractor operated to keep the liability of all alive. For in the case of joint contractors ... I Payment by one, is payment for all, the one acting, virtually, as agent for the rest.' This cannot be applied to the case of suretyship, for the law is clear that the debtor cannot vary the contract of surety in the least degree, and he is in no way the agent of the surety so that the payment will imply a new promise by the surety.

These cases suggest that the terms of the particular limitations statute in force where the action is brought will determine whether or not a guarantor will be bound by the acts of the principal debtor. As we noted earlier, section 5(7) of the *Limitations Act* now in force in British Columbia puts the matter beyond any doubt, limiting the affect of a confirmation to its maker or his successor in interest.

The Commission believes it unreasonable that the limitation period on a contract of guarantee is left unaffected by acts of the principal debtor who is fulfilling his obligations under the principal transaction. In fact, it is difficult to conceive how a creditor is to avoid the expiry of the limitation period on the contract of guarantee where the principal debtor is not in default, and we agree with Fry L.J., that "it would be contrary to good sense and the common understanding of mankind that while [the principal debtor is fulfilling the contractual obligations] the statute should run in favour of the guarantor unless he makes a payment or gives an acknowledgement."

The Commission recommends that:

36. *Notwithstanding section 5(7) of the* Limitations Act*, a guarantor who seeks to rely on that Act, otherwise than pursuant to Recommendation 34, should be bound by any confirmation which binds the principal debtor.*

C. Guarantors of Minors' Contracts

In 1976 this Commission issued a *Report on Minors' Contracts*, where we set out the law with respect to the liability of a guarantor of a minor's obligations. Although the law is not clear, it has been suggested that a contract of guarantee urill be enforceable rnotwithstanding that the principal obligation may not be enforced against a person who has not reached the age of majority.

We concluded in our Report that the interests of minors in obtaining credit would be unreasonably prejudiced if they were denied the right to offer a guarantor as security and recommended.

> A guarantor of an obligation of a minor should be bound by his guarantee to the same extent that he would be bound if the minor were an adult.

That recommendation retains its force as the view of the Commission.

> *37. Notwithstanding Recommendation 34, a guarantor of an obligation of a minor should be bound by his guarantee to the same extent that he would be bound if the principal debtor were an adult.*

D. Bankruptcy

A discharge from bankruptcy will result in the release of the debtor from all obligations owed to his creditors:

> Bankruptcy is a legal process, which is entirely the creation of statute, whereby a person who is unable to discharge his financial liabilities is declared insolvent, subjected to certain disabilities, and deprived of his property in order to ensure a more just and equitable distribution of such assets as he has amongst his various creditors. The aims of the complex legal process involved in this are that, since the person to be made bankrupt is unable to satisfy all his creditors, such property as he does have should be shared amongst them, that he should subsequently be relieved from all further liability, as long as he has not been guilty of any improprieties, and that he should eventually be enabled to make a fresh start in business or otherwise ...
>
> So far as his liabilities are concerned, the discharged bankrupt is released from all debts provable in bankruptcy except for those which are specifically excluded from such release by the provisions of the Act. This means that, unless the liability is one so excluded, then, if it is a debt provable in bankruptcy within the meaning of the Act, and as long as it arose and accrued before thie discharge, the bankrupt can plead the discharge as a defence. As seen above, this is provided in precise terms by the Act.

At common law, a guarantor of the obligations of a discharged bankrupt remained liable on his guarantee notwithstanding that the principal obligation was no longer enforceable. Yet the courts struggled with the opposite view that a discharge from bankruptcy, if it operated to release the principal debtor, but left unaffected the liability of the guarantor, seriously prejudiced the guarantor's tight to bring an action for reimbursement from the principal debtor.

In England, the conflict was resolved in favour of the creditor by the enactment of section 28(4) of the *Bankruptcy Act, 1914* and the same policy has been adopted in Canada. Section 149 of the *Bankruptcy Act* provides that:

> An order of discharge does not release a person who at the date of the bankruptcy was a partner or cotrustee with the bankrupt or was jointly bound or had made a joint contract with him, or a person who was surety or in the nature of a surety for him.

The effect of this provision was considered by Houlden and Morawetz in *Bankruptcy Law in Canada*:

> The discharge of the bankrupt in no way affects the liability cof persons to have guaranteed the debts of the bankrupt. In *Gagnon* v. *Jobin*, 26 C.B.R. 127, it was held that the endorser of a promissory note was not released because the maker of the note became bankrupt and afterwards was discharged. The discharge of the bankrupt is personal and does not affect the endorser of a promissory note.

Although a guarantor remains liable to the creditors of a discharged bankrupt, the guarantor is afforded the right to prove his claim for reimbursement in the bankruptcy proceedings:

> Where a debt has been guaranteed, so as to involve the possible liability of a surety in payment of the amount owed, there might be a contingent liability on the part of the surety.
>
> The surety may not prove in the bankruptcy of the debtor before the debt has been paid by him, unless the creditor has renounced is right to prove, or unless the need to prove arises out of the doctrine of fraudulent preferences. However, if the surety has paid he will have the creditor's rights and securities, and any dividends received by the creditor.

A Bill enacting a revised *Bankruptcy Act*, recently introduced in the Senate, effects no modification of the existing law. The term guarantor is defined in section 2 of the proposed legislation as:

> ... a person who, in respect of another person,
>
> (a) is in a relationship analogous to one of guaranty, or
>
> (b) has any property that has been transferred or charged to secure a debt of that other person;

Section 239 of the Bill reenacts section 149 of the old Act:

> 239. The release by this Act of a debtor in respect of a debt does not affect the liability of a person who was, in respect of the debt, a partner or a guarantor or jointly and severally bound with the debtor.

The proposed bankruptcy legislation also provides, in limited circumstances, for proceedings short of bankruptcy. These proceedings are referred to as arrangements by way of extension, and arrangements by way of composition.

The effect of a request for a "proposal for an arrangement by way of extension" is set out in section 71 of the Bill:

> (1) Subject to subsections (2) and (5), no creditor who would have an admissible claim pursuant to section 76 if an arrangement were made may, from the date of the proposed arrangement, exercise a remedy against the debtor or his property or institute or continue a proceeding for the recovery of a debt from the debtor until
>
> (a) the proposed arrangement is withdrawn or rejected; or
>
> (b) the court, on application, so allows, in which case the remedy may be exercised or the proceeding may be instituted or continued subject to such terms and conditions as the court may impose.

Because section 239 of the proposed legislation provides for the continuation of the liability of a guarantor on the release of the principal debtor, it may not be applicable to the restriction on enforceability set out in section 71. As we point out later, provisions such as section 71, which leave the principal obligation extent, and merely place a procedural limitation on its enforcement, may not affect the liability of a guarantor. Therefore, a guarantor of obligations of a principal debtor who has filed a request for an extension might continue to be liable to a creditor, and presumably would have his right to reimbursement limited to what the creditor could have recovered.

The effect of a proposal for an arrangement which is by way of composition is set out in section 85:

> Where a proposed arrangement is accepted or deemed to be accepted, the debtor is released, to the extent provided for in the arrangement, from the debts for which a claim is admissible under section 76 and to which he was subject at the date of the proposed arrangement and, if he is a bankrupt, from the debts from which he had been released by the effect of the bankruptcy order.

It seems to us, in the light of the generality of section 239 of the Bill, that pre-bankruptcy compositions will result in the continuation of the liability of the guarantor for which he will have only limited recourse against the principal debtor.

This continuation of liability, which existed at common law, and which has not been modified to any significant extent in the past century, has been justified on grounds with which we are in agreement:

> ... because the insolvency or bankruptcy of the principal is the chief risk against which the creditor seeks to protect himself by requiring a surety, it can be stated as a general rule that one liable with the bankrupt as a surety on a debt is not relieved of his liability by the discharge of the principal debtor in bankruptcy.

There is little doubt that conflict exists between the provisions of Recommendation 34 and section 149 of the *Bankruptcy Act*. We think it is clear, however, that a guarantor cannot rely on a discharge from bankruptcy of, or the initiation of pre-bankruptcy proceedings against, the principal debtor, in order to escape liability on his contract of guarantee and that no specific recommendation is necessary.

E. Other Statutory Defences and Consumer Protection Legislation

1. ___Personal Property Transactions

There are at number of Provincial statutes which impose obligations on, or restrict the rights of creditors who seek to enforce contractual obligations. Some of these statutes are limited in scope to consumer transactions, others are designed to regulate contractual obligations in general. The policy considerations which justify the restrictions or obligations borne by creditors vary from statute to statute, but the result of noncompliance is remarkably uniforma debtor will be able to raise the contravention as at defence in any proceedings brought by a creditor to enforce the transaction.

Our Working Paper set out an extensive examination of the case law concerning statutory defences generally. We concluded that there are many statutory defences available to a principal debtor which, under the present law, will be unavailable to a guarantor of his obligations. A guarantor will be relieved from liability only where:

> (a) the result of the contravention of a statutory requirement is the impairment of the right of a creditor to enforce security given by the principal debtor; or
>
> (b) the result of a contravention of a statutory requirement, or of an act of the creditor, is the extinction of the principal debtor's obligation.

A guarantor will not be relieved from liability where a statutory provision merely restricts the right of a creditor to enforce a principal transaction in a certain manner that is, where the statute creates a procedural limitation.

The effect of Recommendation 34 would be to allow at guarantor to rely on statutory provisions which merely render a principal debt unenforceable. We now turn to an examination of legislation in force in British Columbia in order to ascertain the implications; of that recommendation on the legal position of guarantors in this Province.

The *Conditional Sales Act* contains a number of provisions which restrict the right of a creditor to enforce a conditional sales contract. The most important of these is set out in section 14 which in essence obliges the creditor to elect between his remedy by way of action against the debtor personally and his right to seize the subjectmatter of the sale.

The fact that repossession of the goods which are the subjectmatter of the conditional sales agreement will, under section 14(2), *extinguish* the buyer's obligations under the principal transaction is, in the light of the authorities, a persuasive argument in favour of the view that a guarantor of those obligations would be relieved of liability. It is possible, however, that an indemnitor would remain liable if the terms of the contract of indemnity were drawn in broad enough terms. Section 22A of the *Bills of Sale Act*, is identical to section 14 of the *Conditional Sales Act* and it is our belief that the legal position of a guarantor of a secured transaction regulated by that Act would be the same. Thus, even in the absence of the right of a guarantor which we set out in Recommendation 34, a secured creditor, once he repossesses goods under a conditional sales agreement or a chattel mortgage, could not enforce a collateral contract of guarantee.

It seems, however, that a creditor could enforce a contract of guarantee and then repossess the principal debtor's goods or obtain a judgment against the principal debtor. When the contract of guarantee is enforced there is no matter of fact, law, or mixed fact and law, which the guarantor could rely on to reduce his liability to the creditor. Later, when the creditor repossesses the principal debtor's goods, there is nothing in the *Conditional Sales Act* or the *Bills of Sale Act* which would prevent his success.

Although there is nothing on the face of those Acts which prevents a creditor from suing a debtor on his personal obligation and then seizing the goods of a guarantor which were offered as security, a recent decision suggests that a guarantor will be relieved of liability in such a case. In *Metrocan Leasing Ltd*. v. *Virani*, Anderson J. discussed the common law rules relating to the discharge of a guarantor where the creditor impaired the guarantor's right to security, and explained the relationship of that doctrine to the "seizeorsue" provisions of the *Bills of Sale Act*:

By virtue of section 22C, the rights of a guarantor are limited tn the rights of the creditor and if the creditor does anything to limit his right of recovery against the debtor, the right of recovery of the guarantor is likewise limited.

> It appears from the above that when the plaintiff sued Mahal for the monies owing on the chattel mortgage it was effectively prevented from seizing the goods charged by the chattel mortgage pursuant to the items of the chattel mortgage. The plaintiff could, of course, have obtained judgment and seized the goods pursuant to a writ of execution (subject to the rights of other ordinary creditors) but, in such case, the amount recoverable would be limited to the amount recovered from the "execution" sale. It also appears that the rights of the guarantor were seriously affected because he lost the opportunity to seize and sell the goods pursuant to the terms of the chattel mortgage. In other words, the guarantors security was substantially impaired.
>
> Having regard to the above, as the guarantor's security bias been impaired or destroyed by the positive act of the plaintiff (suing Mahal), the obligations of the guarantor are discharged.

Under section 14 of the *Conditional Sales Act*, and under section 22A of the *Bills of Sale Act,* a secured creditor is provided with a choice; he may repossess the goods in full satisfaction of the principal debtor's obligation, or he may sue the principal debtor, in which case he will not be able to enforce his security interest in the goods. We suspect, however, that he has another option; that is, he may sue the principal debtor's guarantor or enforce his security interest in the property of the guarantor, and then sue the principal debtor or repossess the principal debtor's property, to recoup his losses. Moreover, notwithstanding *Metrocan*, the creditor may be able to sue the principal debtor, and then sue the guarantor or enforce his security interest in the guarantor's property, and in any event it is open to the creditor to have the guarantor waive his rights with respect to security and thus avoid the effect of *Metrocan*.

In 1972, this Commission recommended the enactment of "seizeorsue" legislation, and commented on the possibility that collateral contracts of guarantee might be used to circumvent it:

> The proposed legislation should make it clear that the benefit of the election is conferred not only upon the purchaser of the goods but also upon the guarantor of his obligations. To permit the seller to repossess the goods and claim any deficiency remaining after resale from a guarantor is quite inconsistent with the principle of the recommendation made. The law relating to guarantee may prohibit such a claim in any event; however, the

> Commission feels that any legislation should make this perfectly clear. The Alberta legislation would appear to permit the seller to commence an action against a guarantor only, take judgment and collect what money he could, and still repossess the goods at a later date. This possibility should be eliminated. A provision to the effect that for the purposes of the limitation imposed on the secured party's rights, an action against a guarantor be deemed an action against the principal debtor should be effective ...

The Commission recommends:

> The proposed legislation provide that an action against a guarantor be deemed to be an action against the principal debtor in cases where the secured party takes proceedings against a guarantor after repossession or attempts to repossess after taking proceedings against a guarantor.

Under the definition of guarantee set out in Recommendation 3, and pursuant to the rights afforded guarantors under Recommendation 34, all guarantors, regardless of the form of their undertaking, could rely on the defences provided by this "seizeorsue" legislation, either where the creditor repossesses the goods which were the subject of the security agreement and then seeks to enforce the contract of guarantee, or proceeds against the principal debtor personally and then looks to the guarantor.

Recommendation 34 would not, however, affect the rights of a creditor in any way, if he first pursues the guarantor (or his property) and then turn his attention to the principal debtor.

In 1975, we submitted our *Report on Personal Property Security* where we reviewed the provisions of the *Conditional Sales Act* and *Bills of Sale Act*, and recommended that the "seizeorsue" provisions now applicable to all financing arrangements be restricted to the financing of consumer transactions, and that the principle be embodied in separate but complementary legislation designed to regulate consumer transactions. We have not retreated from that evaluation of the seizeorsue provisions, and premise the following recommendation on the implementation of the recommendations set out in this Commission's *Report on Personal Property Security*.

The Commission recommends that:

38. *Consumer protection legislation which is designed to complement the* Personal Property Security Act*, and which preserves the "seize orsue" provisions now set out in the* Conditional Sales Act *and the* Bills of Sale Act*, should provide that an action against a guarantor be deemed to be an action against the principal debtor where*

    (a) the secured party takes proceedings against a guarantor after repossession, or

    (b) where the secured party attempts to repossess after taking proceedings against a guarantor.

Under recommendation 16 a guarantor would be able to call on his creditor to commence proceedings against the principal debtor, to enforce his security interest in any collateral given by the principal debtor, or both. Where the creditor fails to comply with such a request, the guarantor would be relieved of his liability to the extent that he is prejudiced by the creditor's inaction. Where the creditor complies with the request, the effect of recommendation 38 would be to relieve the guarantor of all liability. This can place the creditor in a very difficult position.

It is clear that this difficulty arises only when both recommendations are brought into play, and the only solution would seem to be the abrogation of one. Although we appreciate the importance of both principles, we have concluded that it is manifestly unfair to allow them to be used in combination. Recommendation 38 operates harshly only where a guarantor, in reliance on the rights set out in Recommendation 16, has requested that the creditor proceed against his principal, and the creditor has acceded to that request, and to allow a guarantor to rely on recommendation 38 in those circumstances unjustifiably and unreasonably exposes the creditor to the loss of his

rights under the guarantee. Accordingly we recommend that the seizeorsue provisions, to the extent that they may be relied upon by a guarantor to reduce or extinguish his liability, should be abrogated.

The Commission recommends that:

39. Where a guarantor has made a request under Recommendation 16, and a creditor has acted on the request, the guarantor should not be able to rely on the "seizeorsue" provisions to reduce or extinguish his obligation to the creditor.

Another restriction on creditors' rights now set out in the *Conditional Sales Act* and the *Bills of Sale Act* is the requirement that a creditor obtain the consent of the court before he seizes goods when the principal debtor has paid more than twothirds of the secured debt. Those provisions leave open the possibility, on the ground that they create mere procedural imitations, that at guarantor who has given a security interest in his own property could have that property seized, notwithstanding that his principal had paid twothirds of the debt.

In our Report on Deficiency Claims and Repossessions we set out the policy considerations that justify judicial supervision of the right to seize goods in such circumstances:

> ... the recommendations thus far made would have the effect of forcing the secured party, if he repossesses, to resell for the best price obtainable unless the debtor's default occurs relatively late in the term of the contract. In that case, repossession and resale may cause the debtor unwarranted hardship. The Commission feels that where the debtor has a substantial equity in the goods and the resale might reasonably be expected to generate a surplus, the repossession procedure should be subject to special rules.

The policy underlying the requirement of judicial supervision insists that it be imposed where a creditor intends to seize the property of someone other than the debtor.

The Commission recommends that:

40. Consumer protection legislation which is enacted to complement the Personal Property Security Act*, and which proildes for judicial supervision where a creditor seeks to repossess goods when a debtor has paid twothirds or more of the principal obligation fixed by the consumer agreement, should impose the same restriction where the creditor seeks to enforce a security interest in a guarantor's property.*

Another provincial statute which imposes restrictions on the behaviour of creditors, and provides consumers with an impressive array of legal rights is the *Trade Practices Act*. The principal features of the Act are summarized below:

(1) A consumer transaction may be declared unenforceable if a court finds an unconscionable act or practice by the creditor (section3(3));

(2) Property or money acquired by the creditor, through a deceptive or unconscionable act or practice must be returned to the consumer (sections 15(l)(c) and 16(3)); and

(3) A consumer who has entered into a consumer transaction involving a deceptive act or practice may be awarded:

(a) damages in the amount of any loss or damage suffered; and

(b) restitution of any money, property or other consideration given to the creditor (section 20(1)).

The effect of these provisions on the legal position of a guarantor is uncertain. In section 1(1) of the Act, "consumer" is defined to include a guarantor of an individual who participates in a consumer transaction, and thus retailers in the guise of recourse guarantors enjoy the protection of the Act, while consumer indemnitors may not.

Under recommendation 34 a guarantor, regardless of the form of his undertaking, would be able to rely on the unenforceability of a consumer transaction, where the creditor has acted in a deceptive or unconscionable manner. However, it is not clear that every person within recommendation 34 could bring an action under section 20 of the Act in order to obtain damages or restitution for his losses.

It is our view that it would be appropriate to amend the *Trade Practices Act* so as to clarify beyond doubt the legal position of guarantors and indemnitors under the Act. Some provinces have enacted legislation which defines the legal position of guarantors in express terms. Although such legislation has given rise to difficulty where the liability of a recourse guarantor has been at issue, it is possible, with proper drafting, to except this class of guarantors from the Act.

The Commission recommends that:

55. *The* Trade Practices Act *be amended to including a definition of guarantee which corresponds with the definition set out in recommendation 2.*

2. Real Property Transactions

(a) *Effect of foreclosure*

Section 28 of the *Conveyancing and Law of Property Act* provides that:

> After the making of an order absolute for foreclosure or for cancellation of an agreement for sale, a mortgagee or vendor has no right to enforce the personal covenant of the mortgagor or purchaser, as the case may be, to pay, nor shall he issue execution on a judgment taken on the covenant to pay unless by process of law the order absolute is set aside or reopened.

That provision coupled with Recommendation 34 would seem to provide adequate protection for the guarantor of a mortgagor's or purchaser's obligation.

Other provisions of legislation in force in this Province affect the legal position of mortgagors or purchasers, but do so by affording them certain rights. Recommendation 34 would not allow guarantors of the obligations of mortgagors or purchasers of real estate to enjoy those rights. Although a general policy of co-extensiveness suggests that those rights ought to be made available to guarantors, on closer examination we have concluded that such action is not called for.

The only such right likely to be of substantial benefit to a guarantor is the right to statements provided by section 29 of the *Conveyancing and Law of Property Act*. A previous recommendation would give the guarantor a corresponding right to information as to the state of accounts so no modification of the Act seems necessary.

(b) *The right of a guarantor to participate in foreclosure proceedings*

Falconbridge has pointed out that:

62. Falconbridge, The Law of Mortgages of Land 434 (3rd ed. 1942). *See also Allison* v. *Rent*, [1926] 1 D.L.R. 885.

> A mere surety by covenant who has paid nothing is not a necessary party to an action for foreclosure, but a surety who has joined as co-mortgagor with the principal debtor is a necessary party. A wife who joins as comortgagor, and not merely to bar dower, in a mortgage made by her husband for a debt of his, is a surety and entitled to redeem.
>
> Where there is a surety for the payment of the mortgage debt in default of payment by the mortgagor, it is desirable to join the surety as a defendant in the action against the mortgagor, because when judgement is recovered against the principal the right of action on the covenant is merged in the judgment, and subsequent accruing interest may not be otherwise recoverable against the surety.
>
> Where a surety by the terms of his agreement has become liable for the deficiency on a mortgage, the mortgagee cannot require him to pay until the security has been realized and the deficiency ascertained.

Although it might be to the advantage of a mortgagee to join a guarantor in foreclosure proceedings, it is clear that a guarantor who has not signed as a co-mortgagor is not a necessary party.

It is open to a guarantor to redeem the mortgage, and once he pays the mortgagee he is entitled to an assignment of the mortgage and stands in the place of the mortgagee; with priority as against subsequent encumbrancers. Thus in *Swire* v. *Redman and Holt*, it was held that:

> The relation of principal and surety gives to the surety certain rights. Amongst others the surety bias has right *at any* time to apply to the creditor and pay him off, and then (on giving property indemnity for costs) to sue the principal in the creditor's name.

And in Rowlatt on Principal and Surety, it is said that:

> The right of the surety to the securities of the creditor is prior to that of later incumbrancers, who are subject to the creditor's mortgages; and it does not seem material whether the security was given by a deed in which the surety joined, or whether the subsequent incumbrancer had notice of the suretyship, for the surety comes in the place of the creditor he pays off, and the subsequent security is not lessened by his coming in.

In summary, we are of the view that no modification of the existing law relating to real property is called for to accommodate our recommendation that certain guarantees given in respect of land transactions be subject to the new regime.

F. Contractual Defences

The extent to which a guarantor may rely on or assert a defence or claim in the nature of a breach of warranty, fraud or misrepresentation, which would be available to a principal debtor if sued on the principal transaction, is exceedingly complex.

In *Chitty on Contracts*, the following propositions are set out:

> If the creditor is guilty of a breach of contract as against the debtor, and as at result the debtor is discharged, a guarantor cannot be liable any more than the debtor. Similarly, where a person guarantees payment of a sum due from the debtor under an entire contract and the creditor cannot sue the debtor because there has been no complete performance, the surety is also not liable. So also if there is a breach of contract by the creditor which does not discharge the debtor but gives him a right to counterclaim for damages, the surety can avail himself of this right by way of setoff. Similarly, if the debtor has some other valid defence to a claim by the creditor, for example, that the creditor has already elected to exercise a remedy inconsistent with a claim for damages, or that the sum claimed is a penalty, or that the creditor has failed to mitigate the damage resulting from the debtor's breach of contract, a guarantor can take advantage of the defence available to the debtor. But in all these cases the position is different where the contract is one of indemnity and not guarantee. If, on the true construction of the contract,

> the surety has undertaken to pay a given sum on a given event, then he is liable to pay it on that event, and it is immaterial that the principal debtor could not be sued for it by the creditor.

In direct conflict with that statement of law is the view set out in Rowlatt on the Law of Principle and Surety:

> ... as a general principle that where the debtor is not before the court the mere existence of an independent crossdebt from the creditor to the principal is no defence to the guarantor.

Yet another conflicting opinion is that suggested by the editors of *Halsbury*:

> The surety, on being sued by the creditor for payment of the debt guaranteed, may avail himself of any setoff or counterclaim which the principal debtor possesses against the creditor, and any division of the High Court can give effect to it or to any equitable defence raised. Whenever the setoff or counterclaim relied on does not operate directly to reduce the debt guaranteed, the principal debtor should be made a party, so as to bind him and prevent him afterwards claiming payment from the creditor.

In *Bechervaise* v. *Lewis* the English Court of Common Pleas held that a guarantor who enjoys the right of exoneration, must be allowed to plead a right of setoff which could be raised by his principal, and which arose out of the transaction which was secured by the contract of guarantee. The right to such a setoff was allowed notwithstanding that the principal debtor was not a party to the action.

In *Murphy* v. *Glass* the Privy Council considered a similar claim. The defendant had guaranteed the payment of certain monies due from the principal debtor to the plaintiff. The principal debt arose out of an agreement for the purchase and sale of certain lands which provided for the settlement of any disputes through arbitration. A dispute arose, the arbitrator found the plaintiff in the wrong, and held in his award that the plaintiff should pay to the principal debtor a sum equal to almost half of that guaranteed. The guarantor sought to reduce his liability by that sum, and the court held, notwithstanding that the principal debtor was not before it, that it ought to "do complete and final justice between the parties," and accordingly allowed the guarantor's equitable defence.

In *The Alcoy and Gandia Railway and Harbour Company* v. *Greenhill* the court allowed a guarantor to setoff an amount due from the creditor to his principal debtor, where that sum arose out of a transaction other than the principal transaction secured by the contract of guarantee.

In *Electricity Meter Manufacturing Company* v. *D'Ombrian* an Australian court held that at guarantor's liability would be reduced by an amount representing the principal debtors damages which arose as a result of the creditor's breach of contract for the sale of goods. The creditor argued that the guarantors ought to pay and then recover against the principal debtor who could in turn sue the plaintiffs for the breach now relied on by the defendants. This argument was dismissed as it would lead to circuitry of action, and would "certainly lead to injustice if the principal debtor was not in a position to reimburse the guarantor."

In *Wilson* v. *Mitchell*, however, Finlay L.J. held that a guarantor could not raise a crossclaim for damages which arose from the transaction which was secured by the contract of guarantee. Finlay L.J. noted that even if he were wrong, the claim of the principal debtor for breach of contract could not be of assistance to a guarantor unless the principal debtor was joined as a party.

A recent case on point is a decision of the New South Wales Supreme Court in *Cellulose Products Pty* v. *Truda*. In that case a guarantor isought to reduce his liability by an amount equal to his principal's claim against his creditor for a breach of the implied warranties under the *Sale of Goods Act*. The Court reviewed the history of the English law on this matter, the American jurisprudence and leading texts, and concluded that:

> ... when [the guarantor] is sued he has a right immediately to join the debtor as a third party and claim complete indemnity from him. The debtor has then a right to join the plaintiff as a fourth party, claiming damages for breach of warranty and so obtain indemnity either in whole or in part. All the actions would be heard together, the rights of all persons determined and appropriate setoffs made after the verdict, and if there be any surplus of damages over and above that which is required to meet the guarantee, the debtor will have recovered that from the creditor who, in the result, will get no more than that to which he would be justly entitled.

The American law generally denies any right in a guarantor to avail himself of claims which seem to enure only to the benefit of the principal debtor. But even in the United States a guarantor has been allowed to assert his principal's crossclaim where the principal is insolvent; for as Judge Learned Hand once said:

> The principal is allowed at his pleasure to prosecute his own claims, so long as he remains able to respond to the surety's claim over against him for indemnity. But this ceases to be true as soon as the principal becomes insolvent. If the creditor then recovers from the surety, the surety has no recourse over against the principal, but must bear the loss except for such dividends as he may get in the insolvency proceedings ... Thus, the upshot of denying the surety a right to assert the counterclaim is to enhance the principal's estate at the expense of the surety, which is contrary to the fundamental relation between the two.

The right of a guarantor to assert such claims of his principal has not been the subject of a great deal of litigation in Canada. In *Lee* v. *Ellis* a trustee of an estate advanced funds to one of the beneficiaries of the estate, on the condition that the resulting obligation be guaranteed by the recipient's husband. The beneficiary defaulted and the trustee sued her and her husband as guarantor. The wife admitted liability at trial, and the court found against the guarantor. It was held on appeal, however, that the guarantor was not liable for the debt, the decision in favour of the guarantor resting on the existence of the debt owed by the estate to the wife as beneficiary. The court followed *Bechervaise* v. *Lewis*, and held that the guarantor liad a right to are accounting of the reciproval debts owed by the principal debtor and creditor (the beneficiary and the trustee) to each other, and would be liable only for the balance.

In *Reid* v. *Gould* the Ontario High Court noted that:

> ... in the interest of justice, the guarantors should not be required to pay more than the amount that the plaintiff is entitled to recover against the principal debtor. The [principal debtor] should not be obliged to bring a separate action for damages when the claim may be properly disposed of in this action.

In that case, however, the guarantor was given the right to assert his principal's damage claim where the principal was joined as a party.

Possibly the leading Canadian case on point is a decision of the Ontario Court of Appeal in *Diebel* v. *Stratford Improvement Co*. There, a guarantor had undertaken liability for payments due to the plaintiff on a construction contract which had not been performed to the satisfaction of the principal debtor. The Court held that the contract had been substantially completed, and that the creditor could recover from the principal debtor the contract price less as much as ought to be allowed for defects. The guarantor was under no greater at liability, for in the opinion of the Court:

> ... equity would require that [the guarantor] should be allowed to setoff that which the debtor himself could setoff.

Other socalled "contractual defences" include fraud, innocent misrepresentation, duress, unconscionability and the like. As a general rule such behaviour by the creditor will render the principal obligation either void or voidable at the option of the principal debtor. If that option is exercised, it seems that the guarantor must be released from liability, for the rescission of the principal obligation puts an end to the agreement and as has been said so of-

ten, one cannot guarantee what does not exist. Of course, the liability of an indemnitor may continue, for a contract of indemnity is independent of the existence of the principal obligation.

The matter is not that simple, however, if the principal debtor chooses to affirm the transaction notwithstanding the misbehaviour of the creditor. In that case it is arguable, on the ground that the principal obligation continues ta be a legally binding agreement, that a guarantor would remain liable.

In *Williston on Contracts* the following statement of the law is set out:

> Generally, the surety sued alone will not be allowed the principal's personal defences of duress or fraud because the principal should be allowed to affirm the obligation if he so desires ... the question is whether to allow the surety to usurp his principal's right of election to affirm or disaffirm the transaction.

A different view is that of the American Law Institute in their *Restatement of the Law of Security:*

> ... where the principal has been induced to assume an obligation by the fraud or duress of the creditor, the surety is not liable to the creditor.

In its explanatory note, the Institute explains that position:

> The creditor's conduct does not give him any standing to insist that the surety excuse the wrong which once existed.

The difficulties which may occur where a principal debtor chooses, for whatever reason, to forego his legal right to avoid his obligations arise not only where he affirms a transaction upon discovering, for example, that a creditor misrepresented certain matters or is in breach of his contractual obligations. They also extend to the effect of a waiver by the principal debtor, at the time of contracting, of contractual breaches which may occur in the future, or of compliance with legislative provisions which impose obligations on, or restrict the rights of creditors. We prefer to leave the analysis of waiver and affirmation to the conclusion of this chapter.

It is our view that recommendation 34, as it now stands, does and should extend to "contractual defences" such as breach of warranty, fraud, misrepresentation and the like. The recommendation does not require, nor do we think it necessary, that a guarantor join his principal as a party to the proceedings where he wishes to rely on or assert those types of claims.

G. Illegality

Under certain circumstances the law refuses to enforce consensual rights which, to put the matter in its simplest terms, are against "public policy." Precisely which agreements will be deemed by a court of law to fall within that category, and the effect of such a determination are matters far beyond the scope of this Report. Nonetheless, the impact of illegality on the legal position of guarantors is of obvious concern to us. The basic principle has been set out as follows:

> Collateral transactions may be infected with the illegality of a principal contract if they heir a person to perform an illegal contract, or if they would, if valid, make possible the indirect enforcement of an illegal contract ... a policy of insurance on an illegal venture is illegal. And a bond, bill of exchange or pledge given to secure an illegal debt is illegal.

In the leading case of *Swan* v. *Bank of Scotland* the House of Lords established that a contract rendered *void* by statute cannot be enforced indirectly by bringing an action on a guarantee given to secure its performance. In *Brown* v. *Moore* a guarantor was sued to recover debts which arose out of the unlicensed sale of liquor. Sir Henry Strong C.J. of the Supreme Court of Canada held that:

> It is settled law that contracts entered into in the face of statutory prohibition are void and the prohibition of sales of liquor without license provided by the statute in question has, therefore, the effect of rendering the contract here of no effect.

In *Heald* v. *O'Connor* the effect of illegality was again at issue. In that case the plaintiffs had agreed to sell all of its shares in a company to the defendant. The defendant was unable to raise sufficient funds for the purpose and the plaintiffs agreed to loan him L25,000 in order to allow the deal to go through. The company, now owned by the defendant, issued a debenture to the plaintiff for that sum, and the defendant contracted as a guarantor to secure the indebtedness of the company. The court held that the debenture was illegal under section 54 of the *Companies Act, 1948* which provided that:

> (1) ... it shall not be lawful for a company to give, ... by means of ... the provision of security ... financial assistance for the purpose of or in connection with a purchase ... by any person of ... shares in the company, ... (2) If a company acts in contravention of this section, the company ... shall be liable to a fine ...

It was held that:

> ... the promise [under the contract of guarantee] was to pay the principal moneys which had become due under the debenture if the company did not. If the debenture was void, then no moneys could become due under it.

The action was dismissed. The result may have been different, however, if the security had been construed as an indemnity.

If a court is of the view that a transaction is void for illegality on the grounds of public policy, and that collateral security by way of a contract of guarantee may not be enforced to circumvent the illegality, there seems to be no reasonable justification for a decision that a contract of indemnity given to secure the illegal transaction may be enforced. Recommendation 34 together with the recommended definition of a contract of guarantee would eliminate any confusion in this context.

There is one further difficulty to be resolved. In some instances, a plea of illegality will not be respected to the courts where a party was aware of or had participated in the illegality, and where he is sued by a creditor who is innocent of any wrongdoing. In some cases of illegality the law "not unnaturally takes the view that the innocent party need not be affected by the guilty intent of the other."

The issue which must be resolved here is whether a guarantor, who is blameless should be able to plead the illegality of the principal transaction when the principal debtor cannot. It is our view that creditor ought not to lose his security on occasions where he has not acted in an improper manner. If the law gives him the right to recover against the debtor notwithstanding that the transaction is tainted, then we believe that the law ought not to deprive him of his security. That result follows from recommendation 34 as it is now framed.

H. Inability of the Principal Debtor to Rely on Defences

A consumer borrower or purchaser will sometimes be unable to assert certain matters when sued by the creditor. That inability may arise either because the consumer, at the time he undertook the obligation, waived the right to rely on those matters, or because after discovering those matters, chose to go through with the agreement notwithstanding the right to disaffirm it. Whether a guarantor is affected by these matters is uncertain.

The American position is set out compendiously in a leading text on the law of guarantees:

A surety can make no defence which his principal waives or which his conduct precludes him from making.

Another authority, Williston, argues that a guarantor should not be allowed to rely on possible defences open to his principal where the principal chooses to affirm the transaction. To allow otherwise, it is said, would be to countenance the usurption of the principal's choice to affirm or disaffirm.

With respect, we cannot agree. In the first place, the principal debtor's options ate unaffected by the guarantor's choice to assert a defence such as innocent misrepresentation, fraud, or the like. All that occurs is the loss of the creditor's security, an onerous result perhaps, but one with which the creditor, whose conduct gives rise to the defence, has little status to argue.

It has also been said that if a guarantor is allowed to assert a claim for breach of warranty, where the claim would exceed the guarantor's liability, his principal would lose the right to recover that excess. Surely, that result need not necessarily follow.

For example, take the case of the financing of a residential home through an agreement for sale which, after a substantial deposit has been made by the purchaser, leaves the new home owner liable to repay $20,000. His performance is guaranteed by a member of his family or a friend. Subsequently, it is discovered that the foundations of the house are seriously defective giving rise to a potential claim for damages of $30,000 or a right on the part of the principal debtor to rescind the agreement. The principal debtor, after paying $5,000, discovers the defect and refuses to pay the former owner any further money. The creditor then sues the guarantor for the balance owing. Under recommendation 34 the guarantor could:

(a) rely on his principal's right to rescind the contract, with the result that he (the guarantor) would be discharged, or

(b) rely on his principal's right to sue for damages for breach of contract or negligent misrepresentation, with the result that the guarantor's obligations would be reduced to nothing.

A guarantor would not be able to recover any amount of money from the creditor, for recommendation 34 limits his right to assert the claim of his principal to an amount representing the guarantor's liability.

Let us suppose, however, that for some reason the principal debtor decides to affirm the contract notwithstanding the misrepresentation, or chooses to forego his legal right to sue for breach of contract. The result of allowing a guarantor to assert those defences is the creditor's loss of his rights under the guarantee which could leave a creditor in a manifestly unenviable position. the same time it is clear in such a case, that the creditor is the author of his own misfortune. For that reason we believe that he ought to bear the risk that where he is guilty of misrepresentation, or fails to perform that which he promised, a guarantor will raise that matter as a defence.

A discussion of these matters in a recent article dealing with the principle of co-extensiveness bears on the issue here:

Civil law authorities to the effect that any actionable misrepresentation founds an *exceptio in rem* on which the guarantor can rely even if the debtor affirms the contract, cannot be accorded much persuasive authority for on the whole a surety in the civil law is a more favoured debtor than a guarantor in English law. It may be argued with some force that it is unjust that the question whether the guarantor is released or not should depend on a possibly perverse decision of an insolvent debtor. It is a difficult question. It is submitted, however, that arguments based on such exceptional cases are outweighed by the fundamental policy consideration that it is in the interests of commerce that the effectiveness of guarantees be upheld unless there are compelling reasons for sanctioning a departure from the general rule. Fraud or other unconscionable conduct on the part of the creditor are grounds warranting such a departure but, it is submitted, an innocent misrepresentation is not on balance, therefore, the better

view is that. a guarantor is liable in respect of the principal obligation, which was rendered voidable by an innocent misrepresentation of the creditor, but affirmed by the debtor.

Whatever the merits of that argument in the context of commercial guarantees, we have taken the view that a consumer guarantor should not be subject to the caprice of a principal debtor over whom he may have little if any influence, and against whom he may have, as a practical matter, only the most remote chance of recovery in an action for reimbursement.

We note that the principle which renders a judgment obtained by a creditor against the debtor ineffective in so far as it might otherwise be used against a guarantor, supports the view that the effect of a private decision by a principal debtor in favour of a creditor ought to be similarly restricted:

> ... a judgment obtained against the principal debtor ... is not binding on the surety [he not being a party to the action] and this seems clear in principle also, for otherwise a surety would be at the mercy of an impecunious or negligent or dishonest debtor.

In summary, where the principal debtor decides to assert all of his rights, whether by way of rescission or through a claim for damages for breach of warranty or the like, the decision of a guarantor to raise those defences, or assert those claims or to fulfil this obligations under the contract of guarantee, will be irrelevant. Where a principal debtor decides to affirm the transaction, the decision of his guarantor to raise possible defences should be equally irrelevant to the liability of the principal debtor.

Williston also makes the point that if there are a number of guarantors, each ought to have the same right to set up counterclaims. We agree with that proposition, and see nothing in our Recommendations which would prevent it. In the example set out above, any number of guarantors could rely on defences or positive claims ordinarily thought of as ensuring only to the benefit of a principal debtor, and each could reduce his liability accordingly. The principal debtor may act as he pleases.

We are persuaded that little would be gained by insisting that the guarantor be bound by decisions of his principal where those decisions render the guarantor's liability more onerous.

The Commission recommends that:

42. *The right of a guarantor to rely on or assert a matter of fact, law or mixed fact and law, to reduce or extinguish his liability to a creditor should not be in any way limited by any act or omission of the principal debtor which would prevent the principal debtor from relying on op asserting the matter.*

This recommendation should also allow a guarantor to rely on defences or claims of the principal debtor which the principal debtor waived when he entered into the principal transaction. Under the present law it would seem that such a waive a will impose a liability on a guarantor which would not be the case if the principal debtor did not choose to waive his legal rights. In *Metrocan Leasing Ltd*. v. *Virani* Anderson J. of the British Columbia Supreme Court held that a waiver of the rights, benefits and protection given by section 22A of the *Bills of Sale Act* will prevent a guarantor from relying on that Act to reduce his liability to a creditor. It is our view that such waivers ought not to have this effect and recommendation 42 is designed to implement that principle.

CHAPTER X **GUARANTEES BY WAY OF NEGOTIABLE INSTRUMENT**

A. The Issues

All our recommendations thus far have been directed at guarantees that arise by virtue of a contract between the guarantor and the creditor. But as we pointed out initially, a creditor can obtain security comparable to that provided by a conventional guarantee by calling on the person providing the security to make or endorse a negotiable instrument such as a cheque or promissory note. Such an arrangement puts that person in a position similar to that of a guarantor. An instrument may also be provided in conjunction with a contractual guarantee.

It would leave an enormous gap in our recommendations if such arrangements were left untouched for reform. Yet, as we explained, they cannot be brought into the notion of a "guarantee" simply through extending the definition of that term. Section 92(13) of the *British North America Act* endows the provinces with the authority to legislate with respect to "property and civil rights." Those words are generally regarded as covering such matters as the law concerning contracts, thus the provincial legislature is undoubtedly competent to enact laws concerning contracts that create guarantees and rights of indemnity. Section 91(18) of the *British North America Act*, however, confers on the Parliament of Canada exclusive jurisdiction to legislate with respect to "bills of exchange and promissory notes."

The separation of legislative authority with respect to guarantees on one hand and negotiable instruments on the other hand is a source of difficulty. For example, where a negotiable instrument provides the vehicle for the taking of security by way of guarantee, provincial legislation which imposes formality may not accord with federal legislation on the same matter. Under section 17 of the *Bills of Exchange Act* a negotiable instrument is enforceable if it is in writing and is signed by the maker. Essentially the same formality is imposed on guarantors by way of endorsement:

> An accommodation party to a bill is a person who has signed a bill as a drawer, acceptor or endorser, without receiving value therefor, and for the purpose of lending his name to some other person.

There is an authoritative line of cases in which it has been held that formality required by provincial legislation would not affect a guarantee taken in the form of a negotiable instrument. As Falconbridge points out:

> In some circumstances, at least, a person may be liable in an action on a bill in accordance with the intention of the parties as evidenced by their oral agreement, notwithstanding that oral agreement is in one sense a contract of guarantee, and that there is no memorandum under the Statute of Frauds.

The applicability of the *Statute of Frauds* to negotiable instruments was considered in *McCall Brothers* v. *Hargreaves*, where Goddard J. said:

> It would, I am sure, astonish most people to be told that the Statute of Frauds could ever be set up as an answer to a claim under a bill, and I am glad to find that there is nothing in the authorities which obliges me so to hold. It is true, no doubt, that the agreement which has been found to exist in all the cases cited, as well as in this case, is in one sense a contract of guarantee; but none the less an action will lie on the bill against a person who has endorsed it in these circumstances ...

This suggests that at direct attempt to impose formalities such as those recommended in Chapter V on the creation of negotiable instruments would be open to dispute on constitutional grounds.

Yet there is some authority for the view that provincial legislation, notwithstanding an indirect involvement with negotiable instruments, may be *intra vires* a provincial legislature. To begin with, section 10 of the *Bills of Exchange Act* itself provides:

> ... The rules of the common law of England, including the law merchant, save in so far as they are inconsistent with the express provisions of this Act, apply to bills of exchange, promissory notes and cheques.

The interaction of provincial and federal legislation, and English common law is discussed in some detail in Falconbridge:

> The effect of s. 10 appears to be that the *background of law applicable to transactions in which bills, notes or cheques play a part* may be either (1) the common law of England, so far as that background consists of rules of the law of bills and notes, in the strict sense, or (2) *the commercial law of a particular province, outside of the limits of the law of bills and notes in the strict sense*. It is submitted that the law of bills and notes in the strict sense includes the essential elements of that law as such, and that legislation defining those elements is necessarily legislation in relation to a matter coming within item 18 of s. 91 of the *B.N.A. Act*, and therefore that even in the absence of further federal legislation, provincial legislation would be ineffective to change the rules of the common law of England made applicable by s. 10 of the *Bills of Exchange Act*. On the other hand, outside of the limits of the law of bills and notes in the strict sense, as regards transactions more or less involving the use of bills or notes, the applicable law may be the law of a particular province, and not the common law of England, and in this field provincial legislation may be valid, so far as it is legislation in relation to a matter or for a purpose, coming within any of the classes of subjects assigned to the provincial legislatures by s. 92 of the *B.N.A. Act* and so far as it is not inconsistent with valid federal legislation.

The essential elements of the law of bills and notes, which would be beyond the competence of a provincial legislature to affect, were discussed by Rinfret J. of the Supreme Court of Canada in *AttorneyGeneral for Alberta and Winstanley* v. *Atlas Lumber Co*. He suggested that negotiability, the right to sue, to enforce payment and recover before the courts was the primary quality of bills and notes. The case considered the constitutional validity of section 8 of the Alberta *Debt Adjustment Act,* which precluded any legal action against a resident debtor for recovery of money as a liquidated demand or debt without the permission of the Debt Adjustment Board. The Court held the section *ultra vires* the Province with respect to the rights of holders in due course of promissory notes. The reasons for judgment were various, but the proposition that the rights of a holder in due course of a bill or note set out in the *Bills of Exchange Act* could not be abrogated by provincial legislation, was critical to all.

It is suggested in other cases, however, that provincial jurisdiction to enact legislation affecting negotiable instruments is not wholly lacking, and in 1960, the Supreme Court held that the Province of Saskatchewan had properly exercised that authority. In *Duplain* v. *Cameran* the constitutional validity of certain provisions of the *Securities Act* was in issue. Under that Act, security was defined so as to include a promissory note, and the right to trade in any security was restricted to individuals properly licensed under the Act.

The plaintiff in the *Duplain* case, who was in the business of securing loans and issuing promissory notes to each lender, had his registration cancelled by the Securities Commission, and launched an appeal in which he challenged the cancellation on constitutional grounds. The Supreme Court upheld the legislation since, in the opinion of the Court, the "pith and substance" of the impugned Act was the regulation of trading in securities, and since it was clear that the Act left unaffected the rights of holders of notes issued in contravention of the section.

Guidance as to the manner in which a province could regulate consumer guarantees by way of negotiable instrument may be found in sections 42 of *The Consumer Protection Act* of Ontario, which imposes certain requirements on assignors of negotiable instruments given to secure consumer credit. The relevant subsection provides:

> (3) Where an assignee of a negotiable instrument to which subsection 2 applies is entitled to recover on the instrument from the maker, the maker is entitled to be indemnified therefor by any assignor of the instrument who has not complied with subsection 1 or 2 as the case may be.

While this legislation does not restrict an assignee's right to recover on the instrument it does provide that the maker of am instrument (i.e. a consumer) who is liable to an assignee (i.e. a holder in due course), has a right to be indemnified by an assignor who has not complied with the Act.

The cases setting out the precise nature of provincial jurisdiction with respect to negotiable instruments, and the Ontario legislation referred to above, suggest to us it is possible to implement the policies which we believe necessary; without violating constitutional law. It would seem permissible to impose duties of "disclosure" and an obligation to provide additional documentation, even where the guarantor's liability is crystallized in an instrument, so long as the right of a holder in due course of the instrument is not impaired. Where an instrument is enforced against the guarantor by a holder in due course, a person against whom a defence of unenforceability or abatement of the guarantor's liability may not be raised, then the provincial legislature would also appear to be competent to provide a right of indemnity against the person whose breach would have created such a defence.

Bearing these principles in mind we have reviewed all our previous recommendations from the perspective of guarantees taken by way of negotiable instrument. We have concluded that in so far as they define "duties" of a creditor most may directly be imposed on "instrument creditors." In a few cases minor changes are needed to accommodate the particular legal character of instruments. It is only with respect to those recommendations that specify the consequences Of a breach of a duty that some modification is called for.

Set out in the following section are our recommendations concerning the application of the reforms set out earlier to "instrument" guarantees.

The result of these recommendations is to leave untouched the rights of holders in due course of negotiable instruments, but to afford consumer guarantors who suffer financial liability, recourse against persons who take guarantees in this form and are in breach of the duties imposed on them.

We wish to make it clear that the scheme we recommend is intended to apply only to those negotiable instruments which ;were given to secure another's obligations assumed in the context of consumer transactions. They are not intended to affect negotiable instruments given by third persons as *payment* for another's debt. We are aware that the practical effect may be to limit the utility of consumer guarantees taken through, the use of negotiable instruments alone. Although bills, notes and cheques may continue to be employed by credit grantors, their assimilation to contractual guarantees would make them a much less attractive form of accommodation security.

A final point concerns the defences available to guarantors under the *Bills of Exchange Act*. Our study of this matter has revealed a number of conceptual difficulties with the Act which suggests a need to rationalize the legal effect of the relevant provisions. Since this is a matter that calls for action by the Federal Government, we make no recommendations. We have, however, set out the results of our research as Appendix B to this Report in the hope that it may assist those concerned with the modernization of that Act.

B. Our Recommendations

The Commission recommends that:

43. For the purposes of recommendations 44 to 50

"instrument guarantee" means a negotiable instrument made or endorsed by an individual other than the principal debtor to secure the payment or performance of the obligations of the principal debtor arising under a consumer transaction.

"instrument guarantor" means the maker or endorser of an instrument guarantee.

44. *In every transaction in which an instrument guarantee is sought the supplier should provide to the potential instrument guarantor a disclosure statement that contains:*

(a) *a notice to the instrument guarantor comparable to the following:*

"An instrument such as a bill note or cheque made or endorsed to accommodate another person is a binding legal document that imposes a serious liability. It is not a mere formality. Sign it only if you wish to be bound."

(b) *a statement is comparable to the following:*

"You are liable for the amount set out on the face of the instrument."

(c) *If applicable, a statement comparable to the following:*

"This instrument makes you responsible for the past debts of [principal debtor] in the amount of $ _________."

(d) *If applicable, a statement comparable to the following:*

'This instrument covers debts that may be incurred in the future by [principal debtor] to [creditor].

45. *Regulations should be enacted to prescribe the format and size of type used in disclosure statements.*

46. *The disclosure statement should be contained in a separate document that is delivered to the instrument guarantor before he signs the instrument.*

47. *The* Trade Practices Act *should be amended to provide that a failure to comply with recommendations 44 or 46 or the regulations contemplated by recommendation 45 is a deceptive act or practice.*

48. *Where, with respect to an instrument guarantee,*

(a) *the supplier fails to deliver a disclosure statement in violation of recommendation 46, or*

(b) *the disclosure statement does not comply with recommendation 44*

then the instrument guarantee should not be enforceable by a creditor that is not a holder in due course of the instrument except to the extent that the creditor proves:

(c) *that the noncompliance was not deliberate, and*

(d) *the guarantor was not prejudiced by the noncompliance.*

49. *Recommendations 10 to 43 should apply to instrument guarantees but the rights of a holder in due course of an instrument guarantee should be determined without regard to them.*

50. Where an instrument guarantee is enforced by a holder in due course and, owing to the act, conduct, omission or breach of duty of a previous holder of the instrument, the instrument guarantor is thereby under a more onerous obligation than he would be if it were enforced by a creditor that was not a holder in due course, then the instrument guarantor is entitled to recover from that previous holder an amount equal to the amount by which his "liability to the holder in due course exceeds what his liability would have been if the instrument had been enforced by that previous holder.

CHAPTER XI CONTRACTING OUT

Experience demonstrates that clauses which limit or abrogate consumer rights commonly find their way into the standard forms of agreement used in consumer financing arrangements. The examples of consumer contracts of guarantee now used by major financial institutions, examples of which are set out in Appendix A, provide ample evidence of this fact. Although such terms may be appropriate with regard to contracts which are the product of negotiation between parties who are aware of, and able to protect their rights, their use in consumer contracts is less easy to justify. We are apprehensive that standard form guarantees prepared on behalf of commercial credit grantors, if left unrestricted, would quickly incorporate terms that would abrogate the effect of many of the recommendations put forward in this Report. We do not mean to denigrate such behaviour. It is simply a fact of life in the context of consumer transactions where negotiation must be seen as a myth rather than reality.

Our concern is neither misplaced nor the product of undue cynicism. The advice set out below is all too often well known to creditors:

> Before we proceed to a more detailed consideration of the practice of bankers in relation to guarantees, it seems essential to discuss the rights which a guarantor enjoys if he does not expressly waive them. Then, in the next chapter, we shall see how a banker, when taking a guarantee, proceeds to strip a guarantor of virtually all those rights which the law would otherwise confer upon him at any rate where they conflict with the banker's interests.
>
> In view of the fact that a contract of guarantee is a relatively simple transaction, it may be thought strange that the guarantee forms employed by the banks are such extremely lengthy documents. Even in recent years fresh clauses have been added to them. The highlyskilled legal advisers employed by the banks try to foresee every possible contingency but, alas, even they are not gifted with the wisdom of Solomon, with the result that very occasionally a guarantor is able to escape liability. When that happens, yet another clause is added and, in this fashion, the mesh around future guarantors is drawn tighter and tighter.

Consumer protection legislation now in force in British Columbia and this Province is not unusual in this regard uniformly prohibits the abrogation of consumer rights by terms included in consumer agreements. Thus the benefits of the seizeorsue provisions of the *Conditional Sales Act* and *Bills of Sale Act* cannot be waived by a conditional buyer or mortgagor who is not a corporation. Similarly, the protection afforded Under the *Consumer Protection Act* may not be limited by a term in an agreement regulated by those statutes. The policies that call for a limitation on freedom of contract in that context apply with equal force to consumer guarantees.

Accordingly, it is our view that legislation which embodies our recommendations must also provide that a term which in any way limits those recommendations is of no effect. That view must, however, take into account two areas in which a consensual departure from the recommendations may be appropriate.

The first area concerns the duty of a creditor to appropriate payments first to a guaranteed debt set out in recommendation 27. Consider the following example:

A owes 2 debts of $4 000 each to B. One debt is secured by G's guarantee and the other by a chattel mortgage on A's automobile. A wishes to sell the automobile and give good title to the purchaser.

Even if P, has $4 000 to discharge the chattel mortgage, recommendation 27; would require that such a payment be appropriated to the other debt. Hence, A would be obliged to find $8,000 and pay it to B in order to discharge his goods of a $4000 encumbrance. If G is prepared to agree to the appropriation of such a payment to the nonguaranteed debt, there seems no reason in principle why he should not be able to do so.

The second area relates to changes in the principal transaction. Under recommendation 32 an agreement between the principal debtor and the creditor to vary the terms of the principal transaction will render a guarantee unenforceable unless the variation is necessarily beneficial to the guarantor or is manifestly unsubstantial. There may be other variations, however, which do not fall into the exception set out above but to which the guarantor might reasonably be prepared to agree. We believe he should have the freedom to do so. The same is true of an extension of time to the principal debtor.

In both these cases where it may be acceptable to the guarantor to waive his rights under our recommendations, we are concerned that the waiver should only be given after the circumstances in which it may be sought have arisen. A waiver of the guarantor's rights at the time the guarantee is created should continue to be prohibited.

The Commission recommends that:

51. *Subject to recommendations 52 to 54, any agreement that purports to limit, modify or abrogate any benefit or remedy recommended in the Report should be null and void.*

52. *Notwithstanding recommendation 27, a guarantor should be able to consent to an appropriation, by the principal debtor, of a specific payment to a debt that is not covered by the guarantee.*

53. *Notwithstanding recommendation 31 or 32, a guarantor should be able to consent to an extension of time as to a variation in the principal transaction and if he consents the guarantee should continue to be fully enforceable.*

54. *A consent by a guarantor under recommendation 52 or 53 should not be effective unless given at the time of or after the payment or variation.*

CHAPTER XII CONCLUSION

A. Summary of Recommendations

1. *Legislation be enacted that embodies the recommendations set out below concerning the rights and liabilities of guarantors of consumer transactions.*

2. *The recommended legislation should govern all guarantees other than recourse guarantees.*

3. *In the recommendations set out in this Report:*

"consumer transaction" means an extension of creditor to an individual where the creditor knows or ought to know that the credit proceeds will be used by that individual to purchase, lease or otherwise acquire real or personal property for purposes that are primarily personal, family or household.

"creditor" means the person for the time being entitled to enforce a guarantee.

"guarantee" means an undertaking such as a guarantee, contract of indemnity or suretyship, or security agreement made or given by an individual to secure the payment or performance of the obligations of a principal debtor arising under a consumer transaction.

"guarantor" means an individual who makes or gives a guarantee.

"principal debtor" means the person to whom credit is extended under a consumer transaction.

"recourse guarantee' means a consumer guarantee under which the creditor is an assignee of the guarantor's rights under the consumer transaction.

4 *In every transaction in which a guarantee is sought the creditor should provide to the potential guarantor a disclosure statement that contains:*

(a) a notice to the guarantor comparable to the following

"A guarantee is a binding legal document that imposes a serious liability. It is not a mere formality. Sign it only if you wish to be bound."

(b) a statement is comparable to the following:

"Your maximum liability under this guarantee is $ ___________."

or

"You are liable for an unlimited amount under this guarantee" as the case may be.

(c) If applicable a statement comparable to the following:

"This guarantee makes you responsible for the past debts of [principal debtor] in the amount of $ __________."

(d) If applicable a statement comparable to the following:

"This guarantee makes you responsible for debts incurred in the future by [principal debtor] to [creditor] .

(e) Any matter to be included in the disclosure statement under other recommendations. [See recommendation No. 21.]

5. *Regulations should be enacted to prescribe the format and size of type used in disclosure statements and the placement of the guarantor's signature.*

6. *(1) The disclosure statement should form part of the document that creates the guarantee.*

(2) A copy of the document that creates the guarantee should be delivered to the guarantor forthwith after its execution by him.

7. A guarantee is not enforceable where:

(a) the disclosure statement is omitted from a guarantee in violation of recommendation 6, or

(b) the disclosure statement does not comply with recommendation 4, or

(c) the creditor fails to deliver a copy of the document that creates the guarantee in violation of recommendation 6(2).

unless the creditor proves that the guarantor was not prejudiced by the noncompliance.

8. Where a guarantee is not enforceable:

(a) the guarantee should be treated as never having had any effect;

(b) any property of the guarantor which was taken by the creditor should be returned to the guarantor, and if the creditor is unable to return the property, the creditor should compensate the guarantor accordingly;

(c) the creditor should be required to take appropriate action to remove or cancel any entry on any register so far as it relates to the guarantee, and

(d) any money received by or on behalf of the creditor pursuant to the guarantee should be repaid to the guarantor.

9. The Trade Practices Act *should be amended to provide that a failure to comply with recommendations 4, 6 or regulations contemplated by recommendation 5 is a deceptive act or practice.*

10. (1) A guarantee should be specified by law to be ii transaction of utmost good faith under which a creditor is obliged to disclose to the guarantor all facts and matters material to the guarantor's liability or risk.

(2) The obligation imposed by (1) should exist both before and after the creation of a guarantee and should not be limited by or detract from any other recommendation, statute or rule of law relating to disclosure.

11. (1) The creditor should be under a duty to disclose to the guarantor

(a) the existence and amount of all outstanding obligations due from the principal debtor to any person, and

(b) particulars of any other guarantees or security taken in respect of such obligations

that are known, or reasonably ought to be known to the creditor.

(2) The obligation imposed by (1) should arise before the creation of the guarantee and continue so long as the guarantee remains in force.

12. A creditor seeking a guarantee should be under a duty to provide to the potential guarantor

(a) a copy of any document or documents evidencing the transaction under which the principal debt arises, and

(b) particulars of any other security given by the principal debtor.

13. (1) A guarantor should be able to demand. and the creditor should be under a duty to provide in writing

(a) a statement of the amount owing under the principal transaction as of the date specified in the demand, and

(b) particulars of any additional security taken in respect of the principal transaction

or either within 15 days of receipt of the demand.

(2) Where the person receiving a demand under (1) no longer has an interest in the principal transaction or collateral, he should be under a duty to disclose, within 15 days of receipt of the demand, the name and address of the latest successor in interest if known to him.

14. Where the consumer transaction is an extension of "variable credit" as defined in the Consumer Protection Act *the creditor should deliver a statement of account to the guarantor at least as often as a statement of account is delivered to the principal debtor in the usual course of the creditor's business,*

(2) A statement of account delivered to a guarantor under (1) should specify

(a) the total amount owing by the principal debtor at the statement date, and

(b) the amount paid to the creditor since the previous statement.

15. Where a creditor, without reasonable excuse, has failed to comply with a duty imposed by any of recommendations 10 to 14, the liability of the guarantor under the guarantee should be reduced to the extent that the guarantor establishes that he has been prejudiced by the failure.

16. A guarantor should be able, where the principal debtor has defaulted on the consumer transaction, to demand by notice in writing that the creditor commence an action against the principal debtor, or to enforce his security interest in any collateral given by the principal debtor to secure the principal obligation, or both.

17. A creditor should be required to provide notice of the default of a principal debtor to any guarantor of the obligation in respect of which the default occurs, within 45 days of the default.

18. Where a creditor has failed to comply with the duty imposed by Recommendation 17, without reasonable excuse, or lias failed to comply with a demand delivered under Recommendation 16 then the li-

ability of the guarantor under the guarantee should be reduced to the extent that the guarantor establishes he has been prejudiced by the failure.

19. (1) *11 guarantor should be able to revoke a contract of guarantee with respect to obligations of a principal debtor incurred after the creditor receives the notice of revocation.*

(2) *The death of the guarantor should be deemed to revoke a contract of guarantee with respect to future obligations of the principal debtor.*

20. *A notice of revocation need be in no specific form and should be effective upon receipt by the creditor.*

21. *Where a guarantee covers future debts of the principal debtor, then the disclosure statement referred to in Recommendation 4 should contain a statement comparable to the following:*

"You may revoke this guarantee with respect to future debts at any time by delivering or communicating a notice of revocation to [creditor]

22. *A guarantor who pays the debt, or fulfils the obligations of a principal debtor, in whole or in part, should be able to bring an action for reimbursement from the principal debtor for the amount that he has paid to the creditor, for all liability sustained in meeting his obligations under the contract of guarantee and reasonable expenses incurred in so doing. (57)*

23. *The recommended legislation should contain a provision comparable to section 24 of the* Laws Declaratory Act.

24. *The right to reimbursement should not be affected by any matter of fact, law or mixed facts and law, upon which the guarantor could have relied, to reduce or extinguish his obligations to the creditor.*

25. *Where a guarantor brings an action for reimbursement, the principal debtor should not be able to rely on any matter of fact, law or mixed fact and law, upon which he could have relied to reduce or extinguish his obligations to the creditor.*

26. *Where a principal debtor is precluded under Recommendation 25 from relying upon any matter, he should be able to recover from the creditor an amount of money equal to the amount his liability to the consumer guarantor would have been reduced had he been able to rely on the matter.*

27. *Where a principal debtor has made a payment to a creditor, or has otherwise performed all or part of an obligation due to a creditor, which payment or performance could have been applied to reduce or extinguish those obligations secured by a guarantee, the creditor should be required to apply the payment or performance to reduce or extinguish the obligation in respect of which the guarantee was given.*

28 *Where a principal debtor owes more than one debt to a creditor, each of which is secured by a guarantee, any payment or performance by the principal debtor must be applied to reduce or extinguish the debts in the order in which they were guaranteed.*

29. *Notwithstanding a reservation by a creditor of his rights against a guarantor, a release, covenant not to sue, or an agreement to discharge, to extinguish, or to otherwise reduce the obligation of a principal debtor to a creditor, entered into by a creditor and principal debtor, should reduce or extinguish*

the liability of a guarantor of those obligations, to the extent that the principal debtor's obligations are reduced or extinguished.

30. *Any dealing with or alteration of the security held by the creditor, or any act or omission of the creditor that affects the value of the security, should discharge a guarantor to the extent that he has been prejudiced.*

31. *An agreement to extend the time for a principal debtor to fulfill his obligations under a consumer transaction, should discharge a guarantor to the extent that he has been prejudiced.*

32. *Subject to Recommendations 30 and 31, any variation of the principal transaction should, unless the variation is manifestly unsubstantial or necessarily beneficial to the guarantor, render the guarantee unenforceable.*

33. *Where a guarantee is unenforceable under Recommendation 32, Recommendation 8 should apply.*

34. *Where an action is brought to enforce a guarantee, a guarantor should be able to rely on, or raise, in diminution of his liability, any matter or fact, law, or mixed fact and law, which the principal debtor could have relied on or raised in an action on the consumer transaction, so long as the matter of fact, law, or mixed fact and law, is related to, or connected with the consumer transaction.*

35 *Notwithstanding section 5(7) of the* Limitations Act*, a guarantor who seeks to rely on the defence of a principal debtor arising from that Act, should be bound by any confirmation which binds the principal debtor.*

36. *Notwithstanding section 5(7) of the* Limitations Act*, a guarantor who seeks to rely on that Act, otherwise than pursuant to Recommendation 34, should be bound by any confirmation which binds the principal debtor.*

37. *Notwithstanding Recommendation 34, a guarantor of an obligation of a minor should be bound by his guarantee to the same extent that he would be bound if the principal debtor were an adult.*

38. *Consumer protection legislation which is designed to complement the* Personal Property Security Act*, and which preserves the "seize orsue" provisions now set out in the* Conditional Sales Act *and the* Bills of Sale Act*, should provide that an action against a guarantor be deemed to be an action against the principal debtor where*

    (a) *the secured party takes proceedings against a guarantor after repossession, or*

    (b) *where the secured party attempts to repossess after taking proceedings against a guarantor.*

39. *Where a guarantor has made a request under Recommendation 16, and a creditor has acted on the request, the guarantor should not be able to rely on the 'seizeorsue' provisions to reduce or extinguish his obligation to the creditor.*

40. *Consumer protection legislation which is enacted to complement the* Personal Property Security Act*, and which provides for judicial supervision where a creditor seeks to repossess goods when a debtor has paid twothirds or more of the principal obligation fixed by the consumer agreement, should impose the same restriction where the creditor seeks to enforce a security interest in a guarantor's property.*

41. *The* Trade Practices Act *be amended by including a definition of guarantee which corresponds with the definition set out in recommendation 2.*

42. *The right of a guarantor to rely on or assert a matter of fact, law or mixed fact and law, to reduce or extinguish his liability to a creditor should not be in any way limited by any act or omission of the principal debtor which would prevent the principal debtor from relying on or asserting the matter.*

43. *For the purposes of recommendations 44 to 50*

“instrument guarantee” means a negotiable instrument made or endorsed by an individual other than the principal debtor to secure the payment or performance of the obligations of the principal debtor arising under a consumer transaction.

"instrument guarantor" means the maker or endorser of an instrument guarantee.

44. *In every transaction in which an instrument guarantee is sought the supplier should provide to the potential instrument guarantor a disclosure statement that contains:*

(a) a notice to the instrument guarantor comparable to the following:

"An instrument such as a bill note or cheque made or endorsed to accommodate another person is a binding legal document that imposes a serious liability. It is not a mere formality. Sign it only if you wish to be bound.”

(b) a statement is comparable to the following:

"You are liable for the amount set out on the face of the instrument."

(c) If applicable, a statement comparable to the following:

“This instrument makes you responsible for the past debts of [principal debtor] in the amount of $ ______________.”

(d) If applicable, a statement comparable to the following:

This instrument covers debts that may be incurred in the future by [principal debtor] to [creditor].

45. *Regulations should be enacted to prescribe the format and size of type used in disclosure statements.*

46. *The disclosure statement should be contained in a separate document that is delivered to the instrument guarantor before he signs the instrument.*

47. *The* Trade Practices Act *should be amended to provide that a failure to comply with recommendations 44 or 46 or the regulations contemplated by recommendation 45 is a deceptive act or practice.*

48. *Where, with respect to an instrument guarantee,*

(a) the supplier fails to deliver a disclosure statement in violation of recommendation 46, or

(b) the disclosure statement does not comply with recommendation 44

then the instrument guarantee should not be enforceable by a creditor that is not a holder in due course of the instrument except to the extent that the creditor proves:

(c) that the noncompliance was not deliberate, and

(d) the guarantor was not prejudiced by the noncompliance.

49. Recommendations 10 to 43 should apply to instrument guarantees but the rights of a holder in due course of an instrument guarantee should be determined without regard to them.

50. Where an instrument guarantee is enforced by a holder in due course and, owing to the act, conduct, omission or breach of duty of a previous holder of the instrument, the instrument guarantor is thereby under a more onerous obligation than he would be if it were enforced by a creditor that was not a holder in due course, then the instrument guarantor is entitled to recover from that previous holder an amount equal to the amount by which his to the holder in due course exceeds what his liability would have been if the instrument had been enforced by that previous holder.

51. Subject to recommendations 52 to 54, any agreement that purports to limit, modify or abrogate any benefit or remedy recommended in the Report should be null and void.

52. Notwithstanding recommendation 27, a guarantor should be able to consent to an appropriation, by the principal debtor, of a specific payment to a debt that is not covered by the guarantee.

53. Notwithstanding recommendation 31 or 32, a guarantor should be able to consent to an extension of tune as to a variation in the principal transaction and if he consents the guarantee should continue to be fully enforceable.

54. A consent by a guarantor under recommendation 52 or 53 should not be effective unless given at the time of or after the payment or variation.

B. Acknowledgements

The preparation of this Report would have been impossible without the dedicated work and exhaustive scholarship of Mr. David Cohen, formerly Legal Research Officer to the Commission. Mr. Cohen was responsible for the research involved in this project, and for the preparation of the Working Paper which preceded this Report; and we wish here to record our considerable indebtedness to him.

At the Working Paper stage of this project our former Chairman, Mr. Justice Lambert, played a large role in our consideration and debate of the issues. We are grateful to him for his participation.

We also wish to extend our thanks to all those persons and bodies that considered and responded to the Working Paper. The submissions received were all valuable in sharpening our views on the issues as our final recommendations were developed.

PETER FRASER
Acting Chairman
PAUL D. K. FRASER
LEON GETZ
KENNETH C. MACKENZIE

June 1, 1979.

APPENDICES

Appendix A
Guarantee

TO:

FOR VALUABLE CONSIDERATION, the undersigned herely guarantees payment to you forthwith after demand therefor cf the total amount of the indebtedness of the Mortgagors named in the within chattel mortgage secured or intended to the secured by the within chattel mortgage including without limiting the generality of the foregoing, the principal amount of the loan and any cost payable thereon.

You may grant extensions of time or other indulgences, take or give up securities, abstain from taking or perfecting the same, accept compositions, grant releases and discharges and otherwise deal with the Mortgagors or either of them and with other parties and securities as you may see fit. Without prejudice or in any way limiting or lessening the liability of the undersigned under this guarantee, you shall not be bound to exhaust your recourse against the mortgagors or either of them or the security you may hold before being entitled to payment from the undersigned under this guarantee. Any loss of or in respect of any security received to you from the Mortgagors or any other person, whether occasioned through your fault or otherwise, shall not discharge pro tanto or limit or lessen the liability of the undersigned under this guarantee.

Any demand shall be deemed to have been effectually made when an envelope containing it addressed to the undersigned at the last address of the undersigned known to you is deposited, postage prepaid in the post office, and the liability of the undersigned shall bear interest at the agreed rate of cost of loan set forth in the within chattel mortgage from the date of such demand.

GIVEN under seal at ______________________________ this __________________________ day of ____________________________________, 19 ______ .

____

Guarantee

IN CONSIDERATION of the
making the Loan referred to above, the undersigned and if more than one, each of them, having first read the foregoin; Note and Agreement and the application relating thereto, hereby guarantee(s) payment to the Bank on demand

of the liability of the borrower to the Bank under the foregoing Note and any note or notes which may be delivered by the borrower and accepted by the Bank by way of substitution for the same and agree(s):

(a) To pay to the Bank the amount of such liability forthwith after written demand therefor is sent to each of the undersigned by depositing the same in the Post Office, postage paid, and bearing the address last known to the Personal Loan Department of the Bank; and

(b) That the Bank shall not be bound to exhaust its recourse against such borrower or other parties or securities before being entitled to payment from the undersigned under this Guarantee and that this guarantee and the obligation of the undersigned hereunder shall not be prejudiced or affected by any extension of time granted to the borrower or by any act or thing whereby as a guarantor only the undersigned would or might be discharged.

SIGNATURE OF GUARANTOR ______________________________
(Wife or Husband if any)

SIGNATURE OF GUARANTOR ______________________________

SIGNATURE OF GUARANTOR ______________________________

Appendix B

______Defences Open to Guarantors Under the *Bills of Exchange Act*

The provisions of the federal *Bills of Exchange Act* setting out the rights of a guarantor, apply only where the guarantor makes or endorses a negotiable instrument which is issued in respect of a consumer purchase. Under section 191 of the Act, the right of a creditor to enforce a contract of guarantee is subject to "any defence or right of setoff, other than counterclaim, that the purchaser would have had in an action by the seller on the consumer bill consumer note."

Presumably a "defence" as that term is used section 191, refers to such matters as illegality, from duress, minority, lack of compliance with statutory requirements of formality, a defence based on the *Limitations Act* or the like. These are matters of fact, law, or mixed fact and law, which do not give rise to any positive claim on the part of the defendant, but which merely reduce, extinguish or render unenforceable the creditor's rights on the principal transaction.

Section 191 goes on to provide guarantors with any right of setoff that the principal debtor could have raiser against the seller, but excepts from that general proposition, any right which could be raised by way of counterclaim. It is not at all clear what is meant by those terms.

In Ontario, the right of setoff is extremely limited. The right first appeared in 1729, and was designed remedy serious procedural inadequacies that existed at time. The rules relating to setoff are now provided in *The Judi-*

cature Act and put in their simplest terms, restrict "setoff" to the case of mutual debts. The rules relating to the right to counterclaim in Ontario are entirely different from the rules relating to setoff:

> The counterclaim is a creature of the Judicature Act reforms. It was devised in order to overcome the restrictions that applied to set-off. Now at defendant; may counterclaim for any relief to which he claims to be entitled from the plaintiff, whatever the nature of the claim and the date of its accrual, and whether it arises out of the same transaction as that relied on by the plaintiff or not. In short, provided it is substantively adequate, the defendant may assert any claim he has against the plaintiff am ii counterclaim. This right is subject only to the discretionary power in the court to sever the claims where the trial of claim and counterclaim together might be inconvenient or cause unfairness.

To the rights of setoff and counterclaim must be added a third procedural right the right to plead the *defence* of breach of warranty:

> ... the defendant in an action for the price of goods sold and delivered or of work and labour done can plead in his defence a breach of warranty in extinction or reduction of the plaintiff's recovery. However, if the damages for the breach exceed the price claimed by the plaintiff, the defendant should also plead the breach by way of counterclaim. This will enable him to recover the excess from the plaintiff.

The procedural complexities of the law relating to defences, setoffs and counterclaims in the Province of Ontario have been summarized as follows:

> The position today, then, is that the defendant can plead at breach of warranty in extinction or diminution of a claim for the price of goods sold and delivered or of work and labour done in accordance with the original rule at common law ... Also, he can setoff a mutual debt that became due before the commencement of the action as provided by ss. 131133 of *The Judicature Act*. In all other cases, the defendant can assert his claim against the plaintiff by way of counterclaim.
>
> Today a defendant can counterclaim against the plaintiff or any relief which he could claim against the plaintiff in an independent action, subject to the power of the court to direct a separate trial of the counterclaim, or to exclude the counterclaiin alogether and so require the defendant to commence a fresh action, where the claim and counterclaim cannot be conveniently dealt with together ...
>
> As already noted, setoff is much narrower in scope than the counterclaim. In almost every case where a defendant has a claim against the plaintiff, the claim can be asserted by way of counterclaim. However, he can plead by way of setoff only in situations of mutual debts. But apart from the different forms of judgment that are pronounced according to whether the defendant has pleaded a setoff or delivered a counterclaim, does the distinction toddy produce any important practical consequences? As we will see belour the distinction is still important as regards limitation periods and it may be signficant on the question of costs.

In British Columbia the law as to defences, setoffs and counterclaims is different from the law in Ontario. In British Columbia, Rule 19(13) of the recently revised Supreme Court Rules of Practice provides that:

> 19. (13) A defendant in an action may set off or set up by way of counterclaim any right or claim, whether the setoff or counterclaim is for damages or not, so as to enable the Court to pronounce a final judgment on all claims in the same action.

That rule does not differ significantly from its predecessor, order 19, Rule 3 of the 1960 Supreme Court Rules of Practice.

In *Stucki* v. *Reed*, Smith C.C.J. held that a defendant could setoff an unliquidated sum representing damages which arose out of the plaintiff's breach of contract:

> The position is, therefore, that since the *Judicature Acts* there may be (1) a setoff of mutual debts; (2) in certain cases a setting up of matters of complaint which, if established, reduce or even extinguish the claim, and (3) reliance upon equitable setoff and reliance as a matter of defence upon matters of equity which formerly might have called for injunction or prohibition.
>
> These being, in my view, the substantive rights of a defendant in the circumstances here, in addition to his right to counterclaim, does it matter in which form the allegations are raised? In my view it does not. The matter is concluded, so far is this Province is concerned, by the judgment of the Court of Appeal in *Victoria Saanich Co.* v. *Wood Motor Co. Ltd.* (1915), 23 D.L.R. 79, 21 B.C.R. 515, 8W.W.R. 1124, where the problem of the construction of what Martin, J.A., at p. 1129 referred to as "the embarrassing and obscure 199" was directly in question and where the Court unanimously held, to quote Macdonald C.J.A. at p. 83:
>
> ... the right of setoff, in the wide sense of the language of the first part of the rule, is left untrammelled, and would enable any cross-claim to be pleaded by way of defence and not necessarily by way of counterclaim ... the lastmentionedi construction is the only feasible one, and ... a defendant may elect in what form he will plead his crossclaim, whether as a setoff or by way of counterclaim.

In *Gulf and Fraser Fisherman's Credit Union* v. *Calm C. Fish Ltd. et al.* the British Columbia Court of Appeal held, in an action brought by a mortgagee for an amount owing from the mortgagor after sale, that the defendant could *setoff* an amount representing that the plaintiff ought to have received if he had carried out the sale according to law.

The law of setoff and counterclaim in England is similar to the law of British Columbia. Section 39(l)(a) of the *Judicature Act, 1925*, and its subsidiary rules now provide, *inter alia*, that:

> 17. Where a claim by a defendant to a sum of money (whether of an ascertained amount or not) is relied on as a defence to the whole or part of a claim made by the plaintiff, it may be included in the defence and setoff against the plaintiff's claim, whether or not it is also added as a counterclaim.

The meaning of that provision was considered in *Hanak* v. *Green*, where a defendant, in an action for breach of contract, successfully *setoff* a sum by way of *quantum meruit* and a sum for damages for trespass. Morris J. noted that:

> The position is, therefore, that since the *Judicature Acts* there may be (1) a setoff of mutual debts; (2) in certain cases a setting up of matters of complaint which, if established, reduce or even extinguish the claim, and (3) reliance upon equitable setoff and reliance as a matter of defence upon matters of equity which formerly might have called for injunction or prohibition. The basis of (1) was explained in *Stooke* v. *Taylor*, in which case Cockburn C.J. pointed out that in the case of a setoff, the existence and the amount of a setoff must be taken to be known to a plaintiff who should give credit for it in his action against the defendant. He pointed out that that reasoning did not apply to a counterclaim, which to all intents and purposes is an action by the defendant against the plaintiff, and in which the claims are not conf ined to debts or liquidated damages ...
>
> The cases within group (2) are those within the principle of *Mondel* v. *Steel* to which I have referred. In these cases there is a defence to the claim which the law recognizes (compare *Sale of Goods Act, 1893*, s. 53,). The cases within group (3) are those in which a court of equity would have regarded the crossclaims as entitling the defendant to be protected in one way or another against the plaintiff's claim. Reliance may be placed in a court of law upon any equitable defence or equitable ground for relief: so also any matter of equity on which an injunction against the prosecution of a claim might formerly have been obtained may be relied on as a defence. This may involve that there will have to be an ascertainment or assessment of the monetary value of the crossclaim which, as a matter of equity, can be relied on by way of defence. But this does not mean that all crossclaims may be relied on as defences to claims ...
>
> [S]ince the *Judicature Acts* the position is that matters of equity on which such injunctions might formerly have been obtained may now be relied on by way of defence. Lord Alverstone C.J., in his judgment said: "If grounds exist which formerly would have entitled a defendant to file a bill in Chancery to restrain the plaintiff from proceeding with his action, I think a defendant is now enabled to rely on these grounds as a defence to the action." Channell J., in his judgment, pointed at that if the defendant's claim had been for a liquidated amount

> then, as the plaintiff was suing as trustee for her son, there could even before the *Judicature Acts* have been a setoff. Channell J. added: 'Then the Judicature Act, and more especially the rules, distinctly put an unliquidated claim on the same footing as a liquidated claim for the purposes of setoff; and consequently the defendant's claim against the plaintiff's son, which, as a setoff to the plaintiff's claim, can now, although unliquidated, be relied on as a defence to the extent of the claim.

The English Court of Appeal was faced with this issue more recently in *Henriksens Rederi A/S* v. *T.H.Z. Rolimper*. In that case, Denning M.R. attempted to set out the law relating to defences, setoff and counterclaim, and in so doing explained the relationship among *legal* setoffs, equitable defences, counterclaims, the defence of breach of warranty, and equitable setoffs. The discussion of the history of these rights and their relationship to one another in England is both exhaustive and justifiably complex. It illustrates the difficulties *inherent* in any attempt to use those terms in defining the rights of consumer guarantors in the twentieth century.

To ascertain the precise meaning of the term "setoff, other than counterclaim" as it is used in section 191 of the federal *Bills of Exchange Act* is, in the light of the foregoing analysis, no easy task. On the one hand, the section might refer to matters which could be *pleaded* by way of defence, setoff or counterclaim under the procedural rules of the province in which the action on the negotiable instrument is brought. In that case a guarantor by way of a consumer note, if sued in British Columbia, could rely on matters to reduce his liability which a guarantor in Ontario or Alberta could not raise if sued on the consumer note in either of those Provinces.

On the other hand, the section might refer to matters which could have been raised by way of defence, setoff or counterclaim under the procedural rules of England in 1910. Section 10 of the *Bills of Exchange Act* provides that:

The rules of the common law of England, including the law merchant, save in so fat as they are inconsistent with the express provisions of this Act, apply to bills of exchange, promispory notes and cheques.

Although the precise meaning of the federal legislation is not clear, its general intent is, and those responsible for its administration might consider modifying it to eliminate the difficulties highlighted in this analysis.

Appendix C

The following persons and bodies submitted comments on the Working Paper:

National Trust Company

Legal Aid Society

Real Property Section, Canadian Bar Association

Commercial Law Section, Canadian Bar Association

Royal Trust Company

Consumer Action League

Consumers' Association of Canada (B.C. Branch)

Federal Business Development Bank

Retail Merchants Association of Canada

Association of Canadian Financial Corporations

Dr. Gilbert Kennedy

David Cohen