



## Standard Form Security Agreements and Guarantees and the Courts' Willingness to Rewrite: Royal Bank of Canada v. El-Bris Limited and James Ellis<sup>1</sup>

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In a September, 2008 decision of the Ontario Court of Appeal (the "**Court of Appeal**"), the Court of Appeal affirmed a lower-court decision that the Royal Bank of Canada ("**RBC**") could not rely on the terms of its standard form personal guarantee and collateral mortgage agreements to enforce on a personal guarantee and a collateral mortgage as separate and independent obligations. Where the terms of such agreements were inconsistent with the common intention of RBC and the borrower, El-Bris Limited ("**El-Bris**"), being that the collateral mortgage was to stand as security for the personal guarantee and not as a separate obligation in addition to the personal guarantee, the Court of Appeal denied RBC further recovery.

### Facts

In 1992, El-Bris, a company operating in Windsor, Ontario, negotiated an increase in a loan from its banker, RBC, from \$200,000 to \$700,000. As security for this loan increase, James Ellis ("**Ellis**"), the president and sole shareholder of El-Bris, personally guaranteed the loan and pledged a \$700,000 collateral mortgage on property that he owned. Ellis signed two standard form RBC security documents – a personal guarantee for \$700,000 and a \$700,000 collateral mortgage – on the same day.

By 2003, El-Bris had become insolvent and owed RBC approximately \$3.5 million. RBC called the loan and claimed against Ellis under its security. Ellis paid \$700,000 to RBC and requested a discharge of the personal guarantee and the collateral mortgage. RBC discharged the collateral mortgage, but demanded an additional \$700,000 under Ellis' personal guarantee, claiming that Ellis' obligation under the personal guarantee was separate from his obligation under the collateral mortgage. Ellis, however, claimed that the collateral mortgage was pledged as support for or security for his guarantee

and that the discharge of the collateral mortgage, discharged his obligations under the guarantee. RBC sued Ellis and El-Bris when Ellis refused to pay the additional \$700,000.

### Reasons

At trial, the court noted that the collateral mortgage did not contain a term stating that Ellis was giving the collateral mortgage in support of his personal guarantee, but instead included a clause that explicitly stated that the collateral mortgage was *in addition to* any other security held by RBC. The trial judge recognized that under ordinary circumstances, the collateral mortgage and personal guarantee would be treated as separate and independent obligations. The trial judge, however, did not consider this to be an ordinary circumstance and rejected RBC's claim that the collateral mortgage and the guarantee were intended to be discrete, independent documents.

Based on the evidence before him, the trial judge found that the documents did not accurately reflect the agreement between RBC and Ellis, which demonstrated the parties' intention that the collateral mortgage be pledged in support of Ellis' personal guarantee. The trial judge stated that "it was emphatically not the intention of the parties that in exchange for a \$700,000 line of credit for El-Bris, Mr. Ellis would create a personal guarantee in the amount of \$1,400,000." As a result, the trial judge concluded that to permit RBC to collect \$1,400,000 on the collateral mortgage and personal guarantee for a \$700,000 loan would amount to unfair dealing and would unjustly enrich RBC at Ellis' expense.

The Court of Appeal affirmed the trial judge's finding as reasonable based on the evidence before him, and offered that in reaching his decision the trial judge had applied the equitable remedy of rectification, wherein a court may rectify an inaccurately drawn written agreement by essentially rewriting it, so that it conforms to the agreement that the parties intended to make. The Court of Appeal, citing its 1996 decision in *Downtown King West Development Corp. v. Massey Ferguson Industries Ltd.*, explained the underlying rationale for and the proper application of this remedy:

The remedy of rectification is available only in certain defined circumstances and cannot be invoked to correct every mistake. In principle, rectification is

<sup>1</sup> (2008), 92 O.R. (3d) 779 [El-Bris].

permitted, not for the purpose of altering the terms of an agreement, but to correct a contract which has been mistakenly drawn so as to carry out the common intention of the parties and have the contract reflect their true agreement. The remedy is normally granted only where the mistake is mutual or common to the contracting parties.

The Court of Appeal, having accepted the trial judge's finding that when entering into the written security agreements neither party intended to create two independent \$700,000 obligations, declared that as Ellis had paid off the collateral mortgage, he was entitled to a discharge of his obligation under the personal guarantee.

### **Conclusion**

While rectification cannot be used to correct every mistake, in the event of common or mutual mistake of contracting parties in the drafting of a written contract, lenders should be aware of the potential for the courts to use the remedy of rectification to correct a contract so as to carry out the common intention of the parties and have the contract reflect their true agreement. It is, therefore, prudent for lenders to consult with counsel to ensure the terms of their standard form agreements are appropriate in the circumstances and whether any transaction specific amendments or modifications are required to accurately reflect the parties' intentions and to avoid the risk of court rectification.

***This update is intended as a summary only and should not be regarded or relied upon as advice to any specific client or regarding any specific situation.***

***If you would like further information regarding the issues discussed in this update or if you wish to discuss any aspect of this commentary, please feel free to contact us.***

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