DUTIES (NOT) OWED TO BORROWERS

By: Jeremy Burke[1]

Beyond good faith, there are at least two distinct categories of duty that a financial institution lender might have to a customer borrower: fiduciary duty (a breach of which is called a "breach of fiduciary duty") and duty of care (a breach of which may be called "negligence"). While the phrase "duty of care" imports the language of negligence law and arises only when a specific legal test is satisfied, the term "fiduciary duty" arises out of equity, a branch of law based on principles of fairness, and is less easily defined.

Under negligence law, a duty of care will be found if the relationship between the parties is sufficiently close (i.e., proximate), if it is reasonably foreseeable that carelessness on the part of one could cause damage to the other (i.e., foreseeable harm), and where both of those are satisfied, whether there are any considerations (often characterized as "policy reasons") that should negate or limit the scope of the duty of care that would otherwise exist. If a duty of care is found to exist then the legal analysis goes on to determine what standard of care is appropriate, whether that standard has been met by the actions or omissions of the alleged wrongdoer and, if there has been a breach, whether injury has resulted.

A fiduciary duty, on the other hand, is a particular type of duty of care arising only where there is, naturally, a fiduciary relationship between the parties. Such a relationship would require the financial institution (the fiduciary) to act in the best interests of the borrower (the beneficiary) without regard for its own interests.[i] There is no definitive test for determining whether a fiduciary relationship exists. However, the *characteristics* of a fiduciary relationship have been described by the Supreme Court of Canada as including those where (1) the fiduciary has scope for the exercise of some discretion or power; (2) the fiduciary can unilaterally exercise that power or discretion so as to affect the beneficiary's interests; and, (3) the beneficiary is peculiarly vulnerable to or at the mercy of the fiduciary holding the discretion or power.[ii] The vulnerability of the beneficiary,[iii] and the reasonable expectations of the parties are critical considerations in determining whether a fiduciary relationship exists.[iv]

In a banking context, courts have held that no fiduciary relationship will exist unless the proposed fiduciary is aware (or ought to have been aware) that its advice was being (and indeed was) relied on by the customer and that there is a relationship of sufficient "confidence" between the parties.[v] Fiduciary relationships have been found to exist between financial institutions and their customers in several situations, including: where the financial institution gives investment or business advice,[vi] provides a credit reference,[vii] or acquires confidential information (in which case it may have a duty not to use that information).[viii]

It is settled law that in the absence of "exceptional circumstances" or a "special relationship" (like those above) the relationship between a financial institution lender and a customer borrower is, generally, a "purely commercial relationship of creditor and debtor" and does not give rise to any duty of care (whether under negligence law or the equitable doctrine that applies to fiduciaries) and in particular does not result in any duty which would require the bank to advise the customer not to undertake the loan.[ix] This standard is characteristic of the typical relationship between lenders and borrowers because each party is looking out for its own best interests and is entitled, within reason, to infer that the other party is

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doing the same.[x] If, however, the circumstances or the relationship between lender and borrower do result in a duty of care, then the lender must take care to satisfy the duty that it owes to the borrower or risk losing its right to repayment of the borrowed funds or suffering some other form of adverse damage award.

BALDWIN V. DAUBNEY

When leave to appeal to the Supreme Court of Canada was denied, the Ontario Court of Appeal's decision to uphold the Superior Court's decision in *Baldwin v. Daubney* established a definitive precedent with regard to the duty of financial institutions to customers who borrow on the advice of financial advisors in order to make leveraged investments in mutual funds.

The plaintiffs were 22 individuals who had obtained loans from one of six financial institutions (B2B Trust, Laurentian Bank of Canada, M.R.S. Trust Company, National Trust Company, Bank of Montreal and The Toronto-Dominion Bank) for the purpose of making leveraged investments in mutual funds. When the value of the mutual funds fell substantially below the amounts borrowed, the investors commenced the subject court action against the two individuals who were their financial advisors, the advisors' employers, several investment dealers alleged to have been involved in the transactions and the six financial institutions.

The plaintiff borrowers claimed that the defendant financial institutions had a duty (both a fiduciary one and a duty of care under negligence law) to advise them of the loan risk created by the leverage feature of their investment loans so as to enable them to understand the risk and assess whether it was one they wanted to take. The financial institutions took the position that they (through standard documents and processes) made full disclosure of the loan risk and had no further duty to advise the borrowers.

The Effect of Disclosure

The decision in *Baldwin v. Daubney* was on a motion for summary judgment by the six financial institutions. This is a motion which allows the party seeking it to avoid having a full trial by asking the court to decide first whether there are any genuine issues of fact that require a trial for resolution. Issues of material fact will require a trial, while previously settled questions of law may be answered through the summary judgment mechanism.

The court's decision granting summary judgment against the borrowers - and dismissing their claim against the six financial institutions - is illustrative with respect to the duty that a lender owes, or rather does not owe, to a borrower. However, had this matter gone to trial, the court's summary judgment ruling hints that the loan documents signed by the borrowers might have, themselves, been sufficient to sink their case. Specifically, the court points out that it is settled (contract) law that not having read loan documents (as the borrowers claimed they did not) is not a defence which allows a party to, without more, avoid his or her contractual obligations.[xi] Also, even if the financial institutions would be otherwise found to owe a duty of care (explored below), provisions within the properly executed loan documents where the borrowers acknowledge their responsibility for borrowing and absolve the lenders of liability may have been sufficient to do just that. The disclaimer provisions would make it difficult to argue that the lenders should have foreseen that the borrowers would rely on them (and suffer harm as a result of that reliance).[xii] If so, the foreseeable harm portion of the duty of care test would not be satisfied and no duty would be found to exist.

Fiduciary Duty

The borrowers claimed that the margin call feature of the loan gave the financial institutions the kind of discretionary power that is a characteristic of fiduciary relationships. The court disagreed that a fiduciary relationship was formed for two reasons. First, since the discretionary power did not come into effect until the value of the mutual funds decreased past a certain point, the alleged fiduciary duty to advise the borrowers before the loan transaction was completed would have had to exist in respect of a potential discretionary power, as opposed to a power that existed when the relationship was formed. That is, there would have been a fiduciary duty to advise even before the fiduciary relationship itself arose. Second, the purpose of the discretionary power was not to allow the fiduciary to better serve the interests of the beneficiary (i.e., a fiduciary's duty), but rather to enable the lenders to look out for their own best interests.[xiii] In a typical breach of fiduciary duty where the relationship gives the fiduciary a discretionary power, it is a discretionary power that is wielded on behalf of (or at least with a view to the best interests of) the beneficiary.

General Duty of Care

With respect to duty of care under negligence law, the borrowers claimed that the lenders had a continuing duty of care to advise them about the loan risk. Borrowers' counsel argued that the first two parts of the test for a general duty of care (i.e., proximity of relationship and foreseeability of harm) were met because "the loans were necessary for the risk to arise and it was foreseeable that the risk could [result in] harm to the plaintiffs". The court agreed with this undeniable, if simplistic, assessment, but found that it was not sufficient to satisfy step one of the duty of care test, proximity. The test permits significant judicial discretion when considering circumstances that do not fit into a recognized category of circumstances for which a duty of care has already been held to exist. In the past couple of decades our courts have been hesitant to create new duty of care categories because of the high costs and wide-ranging effects on parties who owe such duties. The problem with the borrowers' assertion was that their logic would result in a financial institution being sufficiently proximate and (assuming the rest of the test was met) having a duty to advise borrowers in almost all loan situations; a position that is directly contrary to the well established principle that a lender does not generally owe a duty of care to a borrower. This principle makes sense because in traditional negligence cases the parties are not connected to each other by agreements which disclose the very terms that give rise to the risk.[xiv]

It is the agreement and the disclosure within the agreement that affects the proximity of the relationship between lender and borrower so as to avoid a duty of care. The loan is not imposed by the lender on the borrower; rather it requires the consent of both. And where the borrower has received proper disclosure (as here) it is the borrower who is best able to assess risk. This is important because "proximity", says the court, "has to do with closeness with respect to the cause of the harm", and it is the borrower (as the person who makes the decision to borrow funds) who is closest to the causing of the harm, followed by the financial advisors and finally by the relatively not-proximate financial institutions.[xv]

Where an agreement between the parties determines what each party can reasonably expect and nothing in the agreement indicates that the lender has a duty to advise the borrower, then the agreement governs and there will be insufficient proximity (for a duty of care) unless there is some special relationship or circumstance which would reasonably give rise to such a duty.[xvi]

CONCLUSION

By refusing to give the borrowers leave to appeal the decision of the Ontario Court of Appeal, the Supreme Court of Canada has confirmed that:

(a) unless the facts indicate special circumstances, a lender in Canada does not owe any fiduciary duty to its borrowers to advise them of risks associated with their loans, and

(b) where a written agreement between a lender and a borrower sets out the respective rights and obligations of the parties regarding a loan and does not give the lender a duty to advise the borrower, the lender is unlikely to owe a general duty of care to the borrower.

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[i] *Baldwin v. Daubney* (2005), 78 O.R. (3d) 693 at para. 66 (Sup. Ct.), affirmed 20 B.L.R. (4th) 204 (Ont. C.A.), leave to appeal refused 2007 CarswellOnt 2853. [*Baldwin v. Daubney*].
[ii] *Frame v. Smith*, [1987] 2 S.C.R. 99 paras. 39-42
[iii] *Lac Minerals Ltd. v. International Corona Resources Ltd.*, [1989] 2 S.C.R. 574 at 599.
[iv] *Hodgkinson v. Simms*, [1994] 3 S.C.R. 377
[v] *Vita Health Co. (1985) Ltd. v. Toronto Dominion Bank*, [1994] 9 W.W.R. 360 (Man. C.A.), leave to appeal refused (1995), 122 D.L.R. (4th) vii (note). The flip-side of the "confidence" referred to is the beneficiary's dependence on or vulnerability to the fiduciary.
[vi] *Hayward v. Bank of Nova Scotia* (1984), 7 D.L.R. (4th) 135, affirmed 19 D.L.R. (4th) 758 (Ont. C.A.).
[vii] *Supra* note 5.
[viii] *Standard Investments Ltd. v. Canadian Imperial Bank of Commerce* (1984), 52 O.R. (2d) 473 (Ont. C.A.).
[ix] *Pierce v. Canada Trustco Mortgage Company* (2005), 254 D.L.R. (4th) 79 at 85 (Ont. C.A.).
[x] *Supra* note 1 at para. 66.
[xi] *Supra* note 1 at para. 48, quoting *Toronto Dominion Bank v. Barsoum*, 1995 CarswellOnt 4234 at para. 12 (Gen. Div).
[xii] *Supra* note 1 at para. 52, quoting *Bank of Montreal v. Witkin*, 9 B.L.R. (4th) 256 at paras. 72-3 (Ont. Sup. Ct.).
[xiii] *Supra* note 1 at paras. 67-8.
[xiv] *Supra* note 1 at paras. 80-2.
[xv] *Supra* note 1 at para. 83.
[xvi] *Supra* note 1 at para. 84.