GUARANTEES

Comment by

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Last Tuesday evening I had the opportunity of speaking to a group of managers recently appointed by my employer, the ANZ Bank, to the position of investment advisors. They were attending a training course prior to taking up their new duties. By the time I got around to speaking to them, they were somewhat depressed by the extent of the knowledge they would require to successfully undertake their new duties. Their combined state of depression deepened considerably after I had spoken to them on the subject of the legal implications of giving negligent investment advice.

I mention the incident for two purposes. First, as guarantees have been discussed in at least two previous sessions at this Conference, and notwithstanding John Howard's advocacy last night of a deregulation of the labour industry, I present it as the basis for a prospective demarcation dispute against panel members involved in those previous sessions. But more importantly, I mention it to illustrate that there is a constant need that exists, to translate the strict principles of law into practical guidelines which will enable bankers to pursue their day to day commercial activities successfully; while at the same time avoiding or at least minimising legal pitfalls.

Now these pitfalls, so far as they relate to guarantees, have been ably elucidated upon by the three preceding speakers. I propose to take the opportunity in this commentary to consider some of the more common fact situations, that I have found in the course of my work, to cause the greatest problems for bankers.

I am glad that Barbara Filipowski mentioned Shylock. He is a great favourite of bankers. Here was a plaintiff who firmly believed that he had a "bond made in heaven". At the same time there was a defence counsel, a "Daniel come to judgment", who argued eloquently about the qualities of mercy and justice, and yet the poor guy lost the case. And I must say that poor old Shylock stands alongside with a lot of other bankers who have unsuccessfully failed in enforcing their guarantees and bonds.

I wonder sometimes, having a look at our own standard form, how guarantors can have any trouble with such a precise and very easy document to contemplate and understand!

I guess that any banker speaking to a group of bankers, will always commence by reiterating that in any lending situation, the creditworthiness of the borrower and his capacity to repay, remain the primary considerations in any lending transaction. No doubt, he would follow up when talking on the subject of guarantees, by saying that if you are going to take a guarantee as security, be careful.

Of course, there are situations where a banker will take a guarantee, not necessarily for security purposes only. Such situations include where directors of private companies are almost universally requested to provide guarantees not only for the security aspect, but often more importantly, to ensure their good faith and commitment towards the success of their private company and its undertakings.

Bankers have long been involved with the legal problems associated with taking guarantees as security. They have always and continue to treat guarantees with a great deal of scepticism. This scepticism is reflected in the regulations banks issue to their staff, what we call in our organization "the standing regulations". Provided bankers generally adhere to those guidelines, they can be reasonably confident that the guarantees they take by way of security, will measure up as a satisfactory security. With one major proviso of course - that in the event that a demand is made under the guarantee, the guarantor has sufficient financial resources to meet that demand.

David Ipp presented an excellent paper on the duty of disclosure, and I would like to take just a few minutes to mention several areas where failure to make proper disclosure by bankers, has led to unnecessary disputation.

The usual form of bank guarantee extends to cover contingent liabilities, including liabilities of a guaranteed customer of the bank as surety on some other account. Now the advice that a banker should follow is, that when there are contingent liabilities in existence at the time the guarantee is executed, or it is considered that they may arise at some later time, such provision should particularly be brought to the attention of the guarantor.

A second area where bankers come to grief, is in failing to advise properly, and sometimes in obtaining the consent of the guarantor, to increased advances to the customer or the release of all or part of the security held from that customer.

The third area is the failure to obtain the consent of co-guarantors to the release of one or more of their numbers.

And a fourth, I guess, after David Ipp's comments, is to ensure that you have the guarantee executed in the branch. Now this, not surprisingly, is a rather standard regulation that banks insist upon. They are also very careful about guarantees being executed in branches other than the branch where the loan is being made. They also generally require that the manager, and with him, at least some other senior officer, such as the accountant or the advance clerk, witness the execution of the guarantee.

A special duty of disclosure is imposed on banks in these areas:

(a) where the special relationship exists between the customer and the guarantor;

(b) where regardless of that relationship it appears that the guarantor may be dominated to the extent that he is not acting freely or exercising independent judgment;

(c) where after Bundy a special relationship exists between the guarantor and his banker;

(d) where the customer is in serious financial difficulties;

(e) where the guarantor seeks from the bank, advice as to the viability of a venture being guaranteed in such a way as to show that he is relying on the banker's advice;

in all these situations, very real difficulties are present for bankers.

No banker likes to sustain a lending loss. It is quite understandable that at the prospect of such, he will clutch at every straw as he watches his customer's financial position deteriorate. And I guess if you look at Bundy, Amadio and all the other cases, the one common theme through them all is that the customer is getting deeper and deeper into financial difficulties. Maybe when it is all boiled down, the bank manager is taking a bet to nothing.

I have spoken on a number of occasions to groups of bankers about the fact situations in the Amadio and Bundy cases, and almost universally, one gets the reaction that they would not have contemplated a guarantee in those situations. I guess it is the human element creeping in, that causes the problems.

It is perhaps timely to import a note of warning on the subject of the efficacy of letters of independent advice. I think that bankers have tended too readily to rely upon such letters, and as some of the cases mentioned by David Ipp indicate, you cannot rely totally upon a letter of independent advice. I was speaking yesterday to some of the South Australian delegates at luncheon, who made mention of a case, (I believe McNamara and The Commonwealth Bank). The problem I understand involved a solicitor who had in fact not fulfilled his duty to provide a proper letter of independent advice. Perhaps if anyone present knows the facts of the situation, they might like to elaborate at question time.

The danger for bankers is that whilst reliance on a letter of independent advice may assist them against allegations of undue influence, and maybe in the case of inequality of bargaining power, it really can never be presumed to assist the bank where the real problem is a failure in relation to the special duty of disclosure so far as it relates to the financial status of the account guaranteed. And so, in those situations, where the financial position of the debtor is deteriorating, the advice must be clear for a banker - he not only needs to provide that independent advice for the guarantor, but he must also advise him fully on details of the account.

If there is one final lesson to be learned from the discussion on duty of disclosure, it is to reinforce the need for bankers on all occasions, when they are taking guarantees by way of security, to accurately and adequately record in diary notes all the events surrounding the taking of that guarantee, including references to any opportunities they may have given the guarantor to obtain independent advice, together with details of the explanation they have given him as to the terms and conditions that confront him when he signs a bank's form of guarantee. These are vital in any event, in giving evidence should a dispute arise.

Now there are two matters, in Bruce Debelle's paper, that I would like briefly to comment upon. I think they raise a very interesting point for bankers. When I first read his paper yesterday, I posed both of those questions to my colleagues, and at present the debate still rages whether they present a real difficulty to bankers.

The first one relates to the question of perusal of memoranda and articles. I think there would be a lot of auditors and lending inspection officers of banks who would be disturbed at the thought that a branch did not take a copy of the memorandum and articles of a corporate customer. It has always been a traditional practice of bankers to take these, not only in respect of the question of what are the powers of the company, but also what powers the company has in relation to execution of documentation; and who can operate the banking accounts on behalf of the customer.

It is my own opinion, at the moment, that the safer course still remains to peruse the memorandum and articles. The danger always is that you may be trapped in perusing them, and fail to notice restrictions etc included therein. Nevertheless I still would favour that course of action, rather than ignore their existence, and rely upon the exemptions in section 68 of the Companies Code.

The second aspect relates to the potential problems for directors of subsidiaries that guarantee their parent company. Now in all group situations, banks will invariably request cross guarantees between all members of the group, if for no other reason than to commit every member of the group in respect of the financial accommodation provided to the group. Further, banks seek to ensure that assets are not transferred between subsidiaries to the detriment of the bank's position.

It certainly would be a very real problem for banks, if in fact those securities could be upset on the basis that directors of the subsidiary companies were not acting in good faith, and in accordance with their duties as directors, in giving those securities. My own view is that in a group situation, where the interests of each member of the group are inextricably bound up with the interests of the group as a whole, cross guarantees will provide successful securities for banks.

It is perhaps worth noting that the potential problem raised by Bruce Debelle might also create difficulties in those common situations now, where banks provide common account facilities for groups of corporations; where each member of the group becomes jointly and severally bound in respect of the common account. These accounts are opened basically to facilitate the cash management purposes of the group and possibly to minimise financial institutions duty.

There are two other final matters I would like to briefly comment upon. The first relates to the question of subrogation. Now most bank standard forms of guarantee, contain provisions similar to the one appearing in the ANZ form, which I have here and which provides that "the guarantor will not in any way or at any time claim the benefit or seek or require a transfer of any such security or guarantees of any part thereof respectively".

We have run into a number of arguments with guarantors who have paid the outstanding debts of the debtor and who claim rights of subrogation to the securities the bank holds from the debtor. They generally base their claim under statutory rights pursuant to the Supreme Court Act. I believe that any bank who does have similar provisions in its form of guarantee can successfully resist such a claim.

Perhaps I should just mention quickly the subject of letters of comfort, or letters of awareness or similar such documents by whatever name you might call them. They have been described by bankers in the following terms. "They are something far less than a legal obligation made by a parent company in relation to a subsidiary. And an example of one might be as follows:

> 'Dear Banker,
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> We know you have made credit available to our subsidiary, which admittedly is something less than fully creditworthy, and we appreciate it. However, if our subsidiary gets into difficulties and can't pay, you have a problem, and we will be aware of it.
>
> PS We may or may not help out.'"

I, along with many other bankers after starting out with a certain degree of pessimism, have finished this session with considerable optimism particularly after David Ipp's paper. Bankers ought be confident that provided they follow instructions correctly, and avoid the taking of guarantees in situations similar to Amadio and Bundy, then in the vast majority of cases, guarantee securities will stand up as valid securities. It is a matter of knowing what you wish to achieve - unlike the erratic Irish driver who when pulled over by a police officer replied to the comment "you're drunk driver!" with the retort "t'ank god for that, I t'ought it was the steering wheel".