

THIRD PARTY SECURITIES AND GUARANTEES

Commentary

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INTRODUCTION

His Honour's paper makes reference to the dimming of traditional black letter law in an era during which the dominant objective of courts has been to achieve what the courts consider to be a just outcome in any particular case. To achieve this objective, the courts have resorted to considerations of policy and the courts' own assessment of commercial morality.

Many guarantees involve a party who has little or nothing to gain from the transaction, making that person's assets available as security for the debts and liabilities of a debtor.

In those circumstances, when things go bad it will inevitably look like a tough deal from the viewpoint of the guarantor. That scenario and the new found zeal of the courts to achieve just outcomes is a potent combination, especially given that it is but a short leap from tough deal to unjust outcome.

Courts thus motivated will invariably tend to intensely scrutinize such transactions. That fundamentally is the nature of the territory of third party securities and guarantees. Lenders must be aware of this and treat the exercise of taking third party securities seriously, particularly in cases where they are placing a significant degree of reliance upon that security.

Difficulties and dangers

In many cases the providers of guarantees or third party securities are motivated by an emotional wish to help or support the debtor and the fact that there is nothing in it for them is, practically speaking, beside the point.

An inherent danger from the advising solicitor's viewpoint is that at the outset of the transaction, motivated by a desire to assist the debtor, guarantors will generally be keen and eager to provide the guarantee and, to a great extent, not too much interested in being told about the downside risk. If, subsequently the deal goes sour and the guarantors are then facing the possible loss of a place of residence, formerly eager and willing guarantors are likely to critically examine the advices give to them and perhaps in some cases to develop a selective recollection as to the advice given to them.

Optimism

Inherent in his Honour's paper is an implicit optimism as to the financier's position. With proper regard for the need to remain judicially impartial, his Honour has been careful to discreetly camouflage his optimism.

The skill used to weave the camouflage is such that it was only after several readings of his Honour's paper that the full measure of his optimism became apparent to me. The implicit optimism is that the application by the court of matters of policy and their perceptions of commercial morality have been confined to redefining the field of exceptions. The important thing being that we are still dealing with fine tunings of the exceptions rather than a rewrite of the fundamental rules.

The other sign of optimism implicit in his Honour's remarks is the still comparatively limited nature of the financier's duty of disclosure which remains relevant in the absence of special disability or other special circumstances.

Fundamental position

The fundamental position still remains that in the absence of misrepresentation or other similar factors, literate persons of sound mind who sign documents, the legal nature of which they broadly understand, are bound by their contract. It is easy to forget this fundamental position when confronted by the intricacies relating to the exceptions.

The failure, on the part of a number of financiers, to understand that the cases are really about the exceptions has produced some unfortunate and unnecessary overreactions in terms of financier practices. For example, one major bank was, and still may be, requiring where a husband and wife are the borrower and a security is being provided by one only of them, that the security provider receive independent advice in relation to the provision of that security. If both husband and wife provide the security no requirement of independent advice is imposed.

Another gross overreaction has been that a significant number of financiers have simply adopted the practice of requiring that independent advice be provided in relation to all guarantees.

Future developments

It is significant in terms of likely future developments in Australia to follow the issue of whether the special treatment for wives' principles adopted in *Yerkey v Jones* ((1939) 63 CLR 649) will prevail over the more general principles expressed in *Barclays Bank PLC v O'Brien* ((1994) 1 AC 180).

From a practical viewpoint both principles produce much the same outcome.

OBJECTIVES

What I will address in this commentary is firstly a number of practical issues that arise from a financier's and practitioner's viewpoint.

Those practical issues are as follows:

- The circumstances where independent advice is prudent - what I will attempt to do is produce some guidance as to the circumstances in which financiers should be requiring independent advice.
- Practical financier procedures.

- What to do if the guarantor refuses to take independent advice.
- The issue of whether there is any requirement for financial or commercial advice.
- The scope of the financial benefits exception.

In the context of guarantees and third party securities from individuals, his Honour's paper centres upon the particular issues relevant to cases involving a wife who has guaranteed the account of her husband.¹ I will be considering these practical issues in a somewhat broader context.

Secondly I will outline the current position in relation to solicitor's certificates and make some comments on the present forms of certificates. Finally, I suggest a possible solution to the dilemmas relating to the area of independent solicitor's certificates.

In the commentary I have used the expressions "guarantor" and "guarantee" to include the provider of third party security and a third party security respectively.

WHEN IS INDEPENDENT ADVICE REQUIRED?

Benefits

If financiers can establish a sensible checklist of circumstances where it is appropriate to require guarantors to obtain independent advice then a number of practical benefits will follow. Those benefits include the following:

- The involvement of solicitors will be limited to appropriate cases.
- Costs relating to provision of independent advices will not be unnecessarily incurred.
- Greater business convenience and less delays.

Protection required

In attempting to limit the circumstances in which financiers should legitimately require that guarantors obtain independent advice, the starting point is to consider the exact nature of the circumstances in which financiers need the protection of independent advice. Essentially those circumstances are where there is a significant likelihood that unconscionable conduct or undue influence might be involved. In those circumstances, there is a real likelihood that a presumption of unconscionable conduct or undue influence might arise.

These legal concepts are not ones which readily lend themselves to easy application by financiers. They can however be translated into the following more readily usable questions.

Practical questions

The relevant circumstances can be more readily identified by financiers if they ask themselves the following three questions:

¹ A discussion on the issue of sexually transmitted debt is contained in Chapter 13 in Part 11 of the Law Reform Commission Report No. 69 on "Equality Before the Law: Women's Equality".

1. If the deal goes bad, how will the transaction look from the guarantor's perspective? If the answer to that question is basically that it will look like a terrible deal, then there is a significant prospect that circumstances giving rise to concern exist.
2. How much reliance is being placed upon the guarantee and any supporting securities from the guarantor? If the answer is that there is a high degree of reliance then it is likely to be because the guarantor will be the one putting the most at risk.
3. Has the guarantor any significant involvement in the debtor's affairs and has the guarantor any interest in or will it derive any benefit from the transaction? If the guarantor has no significant involvement in relation to the debtor's affairs and derives no benefit, then there is clearly a greater opportunity that the guarantor may have been misled by the debtor.

Guidelines

The issue is how then do these translate themselves into a basic set of guidelines as to the circumstances where lenders should be requiring that guarantors be independently advised.

Unusual account circumstances

The first instance I will consider is those where there are some unusual circumstances relating to the account which is to be guaranteed.

In this context, it is relevant to consider the extent of disclosure required in the context of guarantees. The relevant cases all involve banks however I can see no reason why the same principles should not apply to financiers generally and my commentary is framed on that basis. Two fundamental principles emerge as follows:

- Guarantees are not contracts of utmost good faith requiring complete disclosure.
- The only obligation of a financier is to disclose unusual matters or ones which a guarantor would not normally expect.

The difficulty is to determine what matters fall within the scope of being unusual or matters which a guarantor would not normally expect.

The court does not however appear to set a particularly onerous standard. In *Commercial Bank of Australia v Amadio* ((1983) 151 CLR 447 at 455), Gibbs CJ stated that "A surety who guarantees a customer's account with a bank will not expect that the account has not been overdrawn or that the bank is satisfied with the customer's credit, for the probable reason why the bank requires the guarantee is that the customer has been overdrawing his account, and wishes to do so again, and that the bank is not satisfied with his credit".

In *Goodwin v National Bank of Australasia Ltd* ((1963) 42 ALJR 110) the fact that the debtor had executed guarantees was held not to be sufficiently unusual as to require disclosure to the guarantor.

On the other hand, in *Amadio*, Gibbs CJ (at 457) found the fact that the arrangement between the bank and debtor provided only for a temporary respite was not a matter which a guarantor would have expected but also indicated (at 456) that the bank would have not been required to make disclosure if the only relevant facts had been "that the company was in gross financial difficulties and was consistently exceeding its overdraft limit and that its cheques were being dishonoured". Deane J in *Amadio* appeared to have a different view and (at 371) noted the distinct difference between the potential liability under a guarantee of a financially sound company and the potential liability under a guarantee of a financially troubled company.

The duty of disclosure still appears to run only to unusual matters as against unusual but nonetheless material matters.

Where the unusual features of an account might not be sufficient in themselves to require disclosure, if those features are combined with some disability on the part of the guarantor then it is likely to contribute to a finding that the conduct of the financier was unconscionable. This is evident in the reasoning of Cohen J in *Guthrie v ANZ* ((1989) NSW Conv R 58, 349). In that case, the bank had advised Mrs Guthrie to obtain independent legal advice before executing a mortgage over the family home to secure a loan to her husband for the purchase of a boat. The bank did not advise Mrs Guthrie or her solicitor that three days previously the husband had guaranteed the debts of a company of which he was a director. The bank was aware that the wife had a drinking problem, that she was not on good terms with her husband and that she was reluctant to sign the mortgage. The decision relied upon the statement of Mason J in *Amadio* (at 463-464) that "A bank though not guilty of any breach of its limited duty to make disclosures to the intending surety, may none the less be considered to have engaged in unconscionable conduct in procuring the surety's entry into the contract of guarantee". The decision also made reference to a similar observation made by Deane J in *Amadio* (at page 481).

The *Guthrie* case and in fact *Amadio* are good examples of cases where there is a real likelihood that even if independent legal advice had been required and obtained, that may not have been sufficient unless the financier had advised the independent advisor of the unusual circumstances. The warning for financiers is that where unusual account circumstances exist, they cannot simply rely on requiring that the guarantor obtain independent advice, they must also ensure that any unusual circumstances are notified to the advisor.

There are many suggestions in the cases demonstrating that the standard of disclosure is low and that the taking of a guarantee where the debtor is in financial difficulties is not necessarily unconscionable. It will be a matter of degree, in each case, whether the extent of the financial difficulties of the debtor or other unusual account features are strictly such that they fall within the category of "unusual" or are such that a guarantor would not normally expect.

The prudent course where there are any unusual account circumstances is to require that the guarantor be independently advised. At the very least, the financier should ensure that the guarantor is fully advised (independently of the debtor) as to the financial circumstances and the extent of the guarantor's potential liability.

Guarantors with disabilities

Financiers should be wary in any case where the intending guarantor is under some disability that is likely to affect the ability of the guarantor to properly evaluate the guarantor's position and to protect the guarantor's position.

His Honour has discussed the relevant principles. Disability may arise from a number of matters including the following:

- illness or other infirmity whether of mind or body;
- illiteracy, ignorance or a lack of education;
- inexperience;
- impaired faculties due to age or other matters such as alcohol or other drugs;
- financial need;
- language difficulties.

Reliant customers

Where the guarantor is a customer of the financier and is accustomed to relying upon the financier for advice, the financier should proceed with caution. Problems will not arise in all cases involving guarantors who are longstanding clients or where there is some reliance. Problems only arise where the financier is in a dominating position. The facts in *Lloyds Bank Ltd v Bundy* ([1974] 3 All ER 757) is an illustration of this type of situation.

The same sort of relationship of dependency between financier and customer is also manifest in the reasoning of the court in the decision in *Chiarabaglio v Westpac Banking Corporation* ((1989) ATPR 40-971).

Emotionally related guarantors

Independent advice is prudent wherever the guarantor is a family member or is in any other way in an "emotional relationship" with the debtor, ie unmarried co-habitees both heterosexual or homosexual and fiancées etc.

It should be noted that the protections provided on the basis of either the *Yerkey v Jones* principles or the principles in *O'Brien's* case are still confined to cases where the guarantor has no interest or no substantial interest in the borrowing.

I will deal later with the extent of the interest required to fall outside the cases. It is not practical for financiers to try to deal with the niceties of exactly what type of financial interest is required to fall outside the cases. The only practical approach which financiers can adopt is to require all emotionally related guarantors to obtain independent advice.

Catch all measure

In every case, regardless of whether the circumstances fall within the previous categories, the financier should as a "catch all measure" ask the three practical questions mentioned earlier.

PRACTICAL FINANCIER PROCEDURES FOR USE IN ALL CASES

It is worthwhile remembering that the whole purpose of independent advice is simply aimed at ensuring that the financier can demonstrate that the guarantor had a reasonable understanding of the transaction.

There are significant benefits in financiers considering the general adequacy of their own procedures in terms of ensuring that guarantors have a reasonable understanding of transactions. Those benefits include the following:

- In many cases an explanation by the financier may itself be sufficient to ensure that a guarantee which might otherwise be unenforceable is in fact enforceable.
- Procedures will need to be changed to comply with the provision of clause 17 of the *Code of Banking Practice* in relation to the types of guarantee covered by clause 17. A general change to procedures in other cases would be an appropriate response to the extensive public criticisms of bank practices in relation to guarantees which was evident in the Martin Report.

I would recommend that all financiers if they have not already done so, consider implementing standard procedures in relation to the execution of all guarantees. Those standard procedures should include the following features:

- All guarantees should be executed at the offices of the financier or sent to the independent advisor for the guarantor.
- It should never be left to the debtor to explain the guarantee to the guarantor or to arrange execution by the guarantor.
- The guarantee form should if possible be drafted in plain English, especially where it is being utilised in connection with fairly routine transactions and not sophisticated financings.
- A short plain English written explanation of the guarantee should be prepared and which should be read to the guarantor and a copy delivered to the guarantor.
- The guarantor should be allowed ample time to read the documents and the financier should recommend in all cases that they obtain independent legal advice.
- If the guarantor declines to obtain independent legal advice, explain to the guarantor the nature of the transaction with the debtor, the effect of the guarantee and the extent of the guarantor's potential liability. The financier should also check to see that the debtor understands the explanation provided and this procedure should be carried out carefully and appropriate file notes maintained.
- If at any stage during this process any of the warning factors become apparent or it is uncertain whether the guarantor understands the transaction, then separate independent advice should be insisted upon.

Banks may wish to adopt separate procedures in relation to guarantees falling within clause 17 of the *Code of Banking Practice* because the use of limited guarantees required by clause 17 will not be appropriate in all cases.

WHAT IF THE GUARANTOR REFUSES TO TAKE INDEPENDENT ADVICE?

I will now consider what a lender should do if the guarantor refuses to obtain independent legal advice. The obvious answer is to decline to make the loan however, that is not a very practically helpful suggestion.

In the Court of Appeal in *Barclays Bank PLC v O'Brien* ([1993] 109 QB 109), Scott LJ (at 139-140) suggested as follows:

"If, however, a creditor has taken reasonable steps such as advising the surety to take independent advice, or, if the surety declines to do so, offering a fair explanation of the security document before the surety signs it, I can see no reason why equity should intervene."

On the other hand in the same case, Purchas LJ held (at 156) as follows:

"If the creditor knew that the surety, while understanding the nature of the liability he or she was accepting, was in fact acting under the influence of the debtor, then it would not be safe for the creditor to rely upon a document executed in these circumstances, unless it believed on reasonable grounds that the surety had in fact received independent legal advice".

I would suggest that the reconciliation of these two apparently divergent positions is that where there are circumstances suggesting undue influence then actual independent advice may be required.

In *O'Brien's* case, in the House of Lords, Lord Browne-Wilkinson adopted a similar position to that of Scott LJ. The relevant part of the case is quoted in his Honour's paper. Lord Browne-Wilkinson did however contemplate that there may be exceptional cases where undue influence was not only

possible but probable. He suggested that in those cases the creditor, to be safe, will have to insist that the wife is separately advised.

In other cases where other unconscionable conduct not involving undue influence is involved, a financier may be able to demonstrate by giving a fair explanation of the transaction and recommending independent legal advice that the financier has not unconscientiously taken advantage of the customer. *Akins v National Australia Bank* ((1994) ASC 56-279) is authority for the proposition that bank officers may provide the advices which afford the guarantor an understanding of the broad nature and extent of the obligations being undertaken.

Despite a number of cases where judges have recommended or suggested the advisability of the financier "insisting" upon independent legal advice, there is still no general requirement that a financier must insist upon independent legal advice in order to be able to establish the enforceability of a guarantee. Financiers are free to demonstrate by any other means that they have not acted unconscionably.

The danger is that in the type of case where the court is likely to suggest that insistence upon independent advice is the recommended procedure, the court is likely to very critically examine the actions of the financier in determining whether the financier has in fact redressed any presumption of unconscionable conduct.

In most cases, with the possible exception of those where undue influence is probable and not just possible, a financier will be able to undertake the required steps to protect its position. In any case, it will be a matter of commercial judgment as to whether the financier declines to make the loan or whether it attempts to provide a sufficient explanation itself. That commercial decision will depend on obvious factors such as the extent of reliance being placed on the guarantee and all the other circumstances of the loan.

Another lesson from the cases is that if the financier is not providing the explanation and is relying upon the guarantor obtaining independent legal advice, the financier should ensure that it obtains a certificate confirming that the independent advice has been given or that the financier can demonstrate that it had reasonable grounds for believing that the surety had in fact received independent advice. This is based upon the judgment of Purchas J in the Court of Appeal in *O'Brien*, the relevant part of which is quoted earlier.

FINANCIAL ADVICE — AN EMERGING REQUIREMENT?

In *Beneficial Finance Corp Ltd v Karavas* ((1993) 23 NSWLR 256 at 268), Kirby P suggested that it "may indeed be that the financier will be well advised to ensure that the guarantors and mortgagors receive effective, independent financial advice on the risks they are running".

On the other hand Meagher JA in the same case (at 276) stated that "There is no duty on a financier to provide either a borrower or a third party guarantor with any commercial advice although if any such advice is tendered, the financier may assume a duty of care".

The same position was taken in *Bosnjak v Farrow Mortgage Services Pty Ltd (in Liq)* ((1993) ASC 56 225) by Cripps JA. Kirby P and Priestly JA reserved their opinion on this issue and considered that it was at least possible that the circumstances of particular relationships between financiers and guarantors might give rise to obligations encompassing either the giving of advice or a duty to warn.

At this stage there does not appear to be any separate general requirement that financiers provide commercial advice or alternatively that they insist that a guarantor obtain independent financial advice.

If the financial affairs of a debtor are complex or there are other circumstances which might put a financier on notice that the proposed guarantor did not have an adequate understanding of the

transaction, then a requirement for independent financial or commercial advice might be necessary in order simply to ensure that the guarantor had a reasonable understanding of the transaction.

It is generally not appropriate or recommended that solicitors embark upon the exercise of providing financial or commercial advice. For that reason, it seems to me that in cases where there are complex financial circumstances it is likely that a legal advisor will recommend that a guarantor obtain independent financial advice. This is not however a separate requirement. It merely arises as part of the general requirement that the guarantor obtain a reasonable understanding of the transaction.

THE SCOPE OF THE FINANCIAL BENEFITS EXEMPTION

Both *Yerkey v Jones* and *O'Brien* involved cases where the wife had no interest in the transaction.

There appears to be a fine line to be drawn in determining whether the required degree of benefit is present in any particular case so as to fall outside the ambit of the principles set out in these cases.

In *European Asian of Australia Ltd v Kurland* ((1985) 8 NSWLR 192), Rogers J held that the fact that the wife had substantial interest as a shareholder in the parent company of the debtor was sufficient to fall outside the principle of *Yerkey v Jones*.

Likewise in England in *CIBC Mortgages PLC v Pitt* ([1994] 1 AC 200), the *O'Brien* principle was held not to apply where the relevant loan was for the joint purposes of the husband and wife.

In *Commonwealth Bank of Australia v Cohen* ((1988) ASC 58, 146) a guarantee by a wife of a company was held to be of benefit to her because her husband derived income from the company.

However, in *Beneficial Finance Corporation Ltd v Comer* ((1991) ASC 56, 681) a wife had given a guarantee over an investment property and the matrimonial home to support a loan to her husband's business. Rogers CJ took the view that a possible benefit to her family was not the relevant sort of benefit.

In *Akins*, Clarke JA (at 937-938) found that the mortgages and guarantees provided by the wife were for her benefit in a substantial sense. This was based upon the fact that in relation to an investment property in which the wife had an interest, the funds for the improvement of that property were undoubtedly derived from the business and it was fairly clear that those moneys would not have been available without the proffer of the securities.

In relation to this issue, there are some other useful illustrative cases set out in *Weaver & Craigie, The Law Relating to Banker and Customer*.

The present position appears to be that financiers cannot with any confidence be satisfied that they fall outside the *Yerkey v Jones* principles or the *O'Brien* principles unless the case involves either:

- the husband and wife as joint borrowers; or
- some other direct or tangible benefit flowing to the wife of the kind mentioned in *Kurland's* case or in *Akins* case, ie not merely some nebulous possible benefit to the family unit.

SOLICITOR'S CERTIFICATES - THE CURRENT POSITION²

I will first outline the current position in relation to independent solicitor's certificates and then make some comments on those developments.

Victorian position

The relevant material is set out in the October 1994 issue of "LAWLINES". The Law Institute of Victoria opted to recommend procedures and a form of certificate by means of a practice note rather than a rule. The reason for the implementation of the procedures was a response to the increasingly prevalent practice of banks in requiring independent solicitor's certificates and a concern that many of the forms of certificates which were being required to be signed went much further than was reasonable.

The Victorian procedure provides two different forms of certificates, one dealing with a certification in relation to advices given to a borrower and another, and the significant one for present purposes, is the form of certificate where the person signing is a third party guarantor or surety.

The certificate

Part B provides a certification that the solicitor explained to the guarantor in the absence of the borrower the following:

- the general nature and effect of the documents;
- the obligation of the guarantor to make good any defaults of the borrower including potentially all amounts owed by the borrower and substantial arrears of interest;
- that the giving of the guarantee involves substantial risk including possible loss of any security or other assets.

Part C of the certificate makes express provision in relation to excluded explanations. The certifying solicitor confirms that no opinion was expressed as to various financial aspects of the transaction including the general viability and the borrower's ability to make repayments etc.

Part D includes a certification by the solicitor that the guarantor stated to the solicitor that the guarantor understood the general nature and effect of the documents and the obligations and risks involved. Part D also provides that the certifying solicitor confirms that it appeared to the certifying solicitor that the guarantors did have that understanding.

From the viewpoint of liability to a lender, if it was proved that the guarantor in fact made no such statement or alternatively, that even if the statement was provided, the solicitor had no reasonable basis for making the statement, then the solicitor would be arguably open to an action by the financier.

The form of certificate also includes a certificate from the client certifying that the client received a copy of the certificate and that the information contained in it is true. The procedure recommended by the Law Institute also recommends that an acknowledgment be obtained by the solicitor in a suggested form contained in Schedule 4 to the recommended procedure. That acknowledgment provides that the guarantor acknowledges that the guarantor has received the explanations as to the nature and effect of the documents and that the guarantor has indicated to the solicitor that they understood those explanations.

² I would like to acknowledge the assistance of Ian Gilbert of the Australian Bankers' Association and Steve Edwards of the Australian Finance Conference in providing details of the current NSW and Victorian positions.

Comments on Victorian certificate

Certificate not complete protection

From a practical viewpoint the combined effect of the certificate and the acknowledgment places a hurdle to a client attempting to sue a solicitor. However, there a number of circumstances where it is likely that neither the certificate nor the acknowledgment would afford absolute protection to a solicitor.

Two such circumstances would be as follows:

- if, due to client pressure, the solicitor merely signs up the certificate without providing any real or satisfactory explanation, and the client was able to establish this, then neither the certificate nor the acknowledgment would prevent any action against the solicitor;
- if the solicitor does provide a general explanation, but reasonable enquiry would have revealed some other significant matter, eg that the client believed that the guarantee was limited but it was not in fact limited or the guarantee was unlimited and the solicitor failed to explain that an "all accounts" guarantee would extend to cover guarantees given by the debtor.

The essential point is that the solicitor can still be negligent because the ambit of the solicitor's retainer in most circumstances will go beyond mere compliance with the formalities of the certificate. While it is theoretically possible that a solicitor's instructions might be confined to merely advising on the matters relevant to providing the certificate it is highly unlikely in practice that the ambit of a solicitor's instructions would be so restricted.

General concern

A general concern about the use of standard certificates is that, if a solicitor not experienced in dealing with the area is involved and does not have a general awareness of the pitfalls in the area, that solicitor having been presented with the form of the certificate may not check the guidelines and recommendations and may in fact be lulled into merely addressing the matters strictly required by the certificate.

Limited application

The practice note relating to the recommended procedures is drafted in general terms and refers to the procedure as being those "recommended" to be followed by a solicitor when engaged in certifying an explanation given to a person of the general nature and effect of a loan or security document proposed to be signed by that person. My understanding is that the form of certificate is limited to ABA members and further to those ABA members who have agreed to accept the form of certificate. The practice note does not address this qualification on its use.

As a practical matter many other financiers have their own differing practices. I assume that the intention is that Victorian practitioners should endeavour to follow the form of recommended certificate as closely as possible but if necessary they are free to negotiate an acceptable form of certificate. In this regard however, I note that the practice note provides that the certificate to be provided "**shall**" be in the form of the schedule. That suggests the use of the form of the certificate is mandatory, however it seems to me that this ignores the practical realities and is presumably meant to be read down in the light of the fact that the procedures themselves are only "recommended" and not mandatory.

Certification limited to documents?

The certificate provides that the certification in relation to the explanation is confined to the documents specified in the certificate. It does not expressly run to the transaction. It however appears to me that, in practice, an explanation of the general nature and effect of the documents can only be made in the context of the transaction itself and as a consequence the explanation must to some extent extend to the transaction itself.

New South Wales position

The Council of the New South Wales Law Society considered the relevant issues at a meeting on 16 July 1992. That meeting adopted a statement which was published in the New South Wales Law Society Bulletin "CAVEAT" No 111 on 7 August 1992. The statement adopted a fairly robust anti-certificate attitude.

It seems to me that the statement represents a fair response to some of the outlandish forms of certificates which were being required at that stage. With the benefit of hindsight I think it is fair to say that the statement however failed to address the legitimate concerns of financiers to obtain enforceable guarantees.

The New South Wales Law Society issued guidelines relating to Independent Solicitors Certificates. Those guidelines expressed the opinion that financiers were the appropriate party to bear the primary responsibility of:

- evaluating the security;
- assessing the commercial viability;
- assessing the capacities of the borrower and other parties to comply with their obligation;
- ensuring that documentation was valid and enforceable both against borrowers and guarantors.

The guideline took the view that if financiers required certificates, the principal certificates should be given by borrowers and guarantors certifying as to their understanding. That approach, however, overlooks the legitimate need for independent advice in certain cases. The guidelines, however, still recognise in paragraph 5 that financiers may reasonably require a certificate of an independent solicitor recording, amongst other things:

- the fact that the solicitor explained the nature and effect of the loan documents and the legal consequences to the signatory of any breach by any party;
- that the solicitor questioned the signatory as to his understanding of the nature and effect of the documents and the possible consequences of failure and as to whether the documents were signed freely and voluntarily.

Significantly, paragraph 6 of the guidelines expressed the opinion that it is unreasonable for a lender to require a solicitor to express an opinion indicating the fact, or extent, of a signatory's knowledge or understanding of loan documents.

Paragraph 7 of the guidelines expresses the opinion that it is unreasonable for a lender to require a solicitor to furnish a certificate that involves the solicitor in giving financial advice.

Things have moved on since that time and various meetings have taken place between the New South Wales Law Society and the finance industry generally, including the AFC, ABA, CUSCAL and AAPBS, with a view to drafting a mutually acceptable form of certificate.

Drafts have now been produced and my understanding is that it is likely that a mutually acceptable form of certificate will be resolved in the near future.

Based on the drafts which I have seen the form of certificate to be provided by the solicitor providing the independent legal advice to a prospective guarantor or borrower will address the following:

- the identity of the solicitor and the client;
- that legal advice was given;
- the documents on which the advice was given;
- that the solicitor was independent of the lender and borrower and that neither was present at the conference;
- that if appropriate an interpreter was present;
- that if appropriate the solicitor witnessed the execution of the document.

Differences between forms of certificates

The Victorian and New South Wales forms of certificates differ in the following respects:

1. It appears that the New South Wales certificate will not include any certification by the solicitor confirming that the guarantor understood the general nature and effect of the documents and the obligations and risks involved in signing the documents. Further, it will not include any certification that it appeared to the solicitor that the guarantor had such an understanding.

That approach is consistent with the view of the New South Wales Law Society Guidelines that it is unreasonable for a lender to require a solicitor to express an opinion as to the fact or extent of a signatory's knowledge or understanding of documents. My view is that it is certainly objectionable to be required to give a certificate in relation to such a nebulous matter as the understanding that some other person might have.

It is arguable that the exclusion of this provision does not make a great deal of difference. The draft form of New South Wales certificate provides confirmation from the solicitor to the lender that the solicitor has given legal advices to the guarantor. On that basis financiers might argue that they were entitled to assume that proper legal advice was given. Financiers might also argue that it is implicit that the solicitor would need to be satisfied that the guarantor understood the general nature and effect of the documents. This aspect may be difficult to sustain.

2. The Victorian certificate in Part C expressly provides that the solicitor has informed the Guarantor in very clear terms that the solicitor was not expressing any opinion nor advising on the viability of the transaction, the borrower's ability to make repayments or the guarantor's ability to make payments and confirms a recommendation that the guarantor, if in doubt, should seek independent financial advice.

The New South Wales draft certificate does not provide any express exclusions but the certification is merely that legal advice has been given in respect of certain specified documents.

I think the certificates result in much the same position. At a practical level the inclusion in the Victorian certificates of the excluded explanations may act as a reminder to solicitors to not provide financial advice and to specifically ensure that they advise guarantors of this

exclusion from their advices. A further possible benefit is that the Victorian procedure also includes a certificate from the client that the information in the certificate (including the excluded explanations) is correct. The effect of this certificate combined with an acknowledgment from the guarantors will provide prima facie evidence that the ambit of the solicitor's instructions has been appropriately limited.

3. The Victorian certificate provides for a certificate by the client certifying receipt of a copy of the statement, that the guarantor has read the certificate and that the information contained in it is true. Additionally, the Victorian practice note recommends that a form of acknowledgment be obtained and that form of acknowledgment confirms that the explanations were provided and that the guarantor stated to the solicitor that the guarantor understood the explanations.

Again these seem to be useful prima facie evidence which will assist in limiting the possible liability of solicitors in many cases.

As I have stated above, if there is some fundamental flaw in the advices given then neither the certificate nor the acknowledgment will save the solicitor. It will remain a question of fact in any case whether appropriate advice has in fact been given.

4. The New South Wales form of certificate does not include confirmation that the guarantors indicated to the solicitor that the documents were being given freely, voluntarily and without pressure from the borrower or any other person.

In this regard it seems to me the fact that independent legal advice has been provided separately and apart from the borrower and other persons should suffice to negate suggestions of undue influence in the majority of cases. Notwithstanding that, it does not seem to me to be unduly onerous to require solicitors to enquire whether the documents are being signed freely and voluntarily and to certify to this. What is objectionable is if the certificate requires certification that the documents have in fact been freely and voluntarily given or requires the solicitor to express the opinion that the documents appear to have been freely and voluntarily given.

Recommended possible changes to draft New South Wales form of certificate

I preface my remarks by indicating that I certainly do not wish to be seen to be taking sides in any interstate differences on this topic.

While favouring the rather more elegant simplicity of the draft form of New South Wales certificate it appears to me that it would be worthwhile considering incorporating into the New South Wales draft certificate the following features:

1. the express inclusion of excluded explanations;
2. a possible extension to provide that the guarantor confirms that the guarantor has understood the explanation and that the guarantor was freely and voluntarily signing the documents;
3. the inclusion of an appropriate form of certification or acknowledgment by the guarantor.

My reasons for the inclusion of these features have been outlined previously.

Australia-wide uniformity of certificate

There are compelling reasons for attempting to achieve Australia-wide uniformity in relation to the form of certificate. Those reasons include the following:

- most financiers operate in all States; and
- the relevant law is essentially the same in all States (this is ignoring the niceties of specific State legislation such as the New South Wales Contracts Review legislation which may impinge to some extent).

Law Council discussion paper

In March 1995 the Banking Finance and Consumer Credit Committee of the Law Council of Australia issued a discussion paper on the topic of "Independent Solicitor's Certificates in respect of Guarantees - an Alternative Approach". By way of introduction the paper notes the following:

- the increase in litigation in relation to the enforceability of guarantees;
- the more cautious approach being adopted by financiers and the increasing requirement for certificates of independent advice;
- the apparently divergent approaches being taken by professional bodies in the guidelines issued to members and the likelihood of a uniform approach being adopted;
- the concerns of solicitors as to potential liability under guarantor's certificates especially in the light of the fact that market expectations as to a reasonable fee do not adequately compensate for the work and risks involved;
- the concerns being expressed by professional indemnity insurers as to possible claims in this area.

Areas of concern

The paper notes that the following concerns have been identified:

- the uncertainty as to the nature and extent of satisfactory independent advice and the absence of clear guidelines and the issue of whether adequate guidelines can be devised;
- whether even a full and independent explanation by a solicitor will enable guarantors to understand fully the nature and effect of complex features of a guarantee;
- the disagreement between financiers and solicitors as to who bears the primary responsibility for explaining the nature and effect of a guarantee;
- the possible difficulties of competent general practitioners not expert in the area providing advice;
- the commercial delays resulting from the necessity to have independent solicitor's certificates;
- the reluctance of guarantors to undertake this further step;
- the obtaining of a certificate does not ensure that the guarantor understands the obligations incurred nor that it will be enforceable - it will not protect financiers where the financier has failed to reveal relevant information;

- the fact that the provisions of certificates in some cases interfere with the normal solicitor/client relationship and may in some cases render a solicitor liable to the financier if the guarantor is discharged. Alternatively, guarantors may sue the solicitors for misstatement;
- disclaimer clauses will not always be effective;
- independent solicitors will never know the unusual or peculiar features of the principal transaction and in those cases a certificate will not exempt the financier from complying with his duty of disclosure under the general law and section 52 of the *Trade Practices Act*.

Alternative approach

The discussion paper proposes an alternative approach, namely the enactment of legislation to provide for a prescribed "Guarantor's Acknowledgment of Rights and Obligations Under a Guarantee". This acknowledgment is to confirm that the guarantor has read and understood the acknowledgment prior to signing the guarantee and is signing both it and the guarantee voluntarily. The acknowledgment is to refer to the advisability of obtaining independent legal advice before signing the guarantee.

The discussion paper includes a proposed form of guarantor's acknowledgment.

The intention is that proposed legislation would have the effect that where a guarantor signs the acknowledgment the guarantor will be liable unless:

- (a) there is a misrepresentation made by the financier or with the actual knowledge of the financier;
- (b) there is unconscionable dealing by the financier or with the actual knowledge of the financier; or
- (c) the terms of the guarantee are harsh, oppressive, unconscionable, unjust, unfair or unequitable.

It is proposed that the acknowledgment be in the form of a statutory declaration and that the attestation provision for signing by the witness would state that the guarantor has confirmed to the witness that the guarantor understood the acknowledgment and was not accompanied by any other person and signed the acknowledgment and the guarantee voluntarily. The objective of the proposal is to provide a cost efficient method of achieving procedural fairness.

My view

While I would be absolutely delighted if the proposed alternative approach were to be successful I would be extremely surprised if any government is interested in implementing the necessary legislation. The legislation would need to interfere with the current entitlements of guarantors to relief. The most significant factor is that legislation of that nature is simply not likely to be politically attractive to any political party. It is not an issue likely to attract many votes and it carries a significant risk of attracting an adverse reaction from a potentially significant number of voters. It could easily be seen as the Government siding with the interests of financiers.

Suggested solution

Uniformity

While it is difficult to achieve uniformity it seems to me that this is still not an impossible goal.

- The first area where uniformity of approach is desirable is in relation to a set of suitable circumstances where the requirement of independent solicitor's certificates is appropriate. While there would be no means of compelling all financiers to comply with this standard it seems to me that there would be strong commercial motivations for them to follow generally accepted standard practices. To impose more stringent requirements than their competitors may make them commercially uncompetitive.

Even if complete uniformity of approach is not achieved in this area any significant move toward confining the requirement for independent advice to appropriate cases would be a significant improvement. Complete uniformity in this area is merely desirable, it is not critical.

- The second area where uniformity is certainly desirable is in relation to the form of certificate. Ideally a form of certificate should be settled for use on an Australia-wide basis. A cooperative effort between the representative bodies of various banks and other financiers and the Law Societies of each of the States and Territories could achieve this objective.
- The third area to address is the issue of the nature and extent of advice required to be given to satisfy the solicitor's duty in advising guarantors. In this regard there have been a number of checklists published and it seems to me that an extensive checklist of matters to be considered and addressed when solicitors provide advice to guarantors could be prepared.³ The checklist could never cover every case and there will always be exceptional cases. A comprehensive checklist would however cover the vast majority of cases and would achieve a generally satisfactory result.

There is an added benefit in settling such a standard checklist. That benefit is that such a checklist would presumably have the approval of a significant number of expert lawyers throughout Australia confirming that it represented a proper standard of advice. If practitioners followed the checklist, it would be unlikely in most cases that a judge would take issue with that professional standard. That is not to say that the courts would not always have the right to a final say, but if the checklist did responsibly set a proper standard then it would only be in an exceptional case that the court would find it necessary to take issue.

Finally, the Law Council discussion paper calls for comments and I have been requested by Rowan Russell, the Chairman of the committee, to urge you to consider the discussion paper and to make any appropriate submissions.

CONCLUSION

The requirement for solicitors certificates is not likely to disappear. It is presently fairly and squarely on the agenda as a matter requiring immediate response. It is imperative that an efficient and workable solution acceptable both to financiers and solicitors is achieved. For that reason, I urge you all to consider the issue and to make any useful input which you might have. It seems to me that any efforts made now to achieve a workable solution are likely to be more than amply rewarded in the long term.

³ See Article by J Poulson in the *Australian Banking Law Bulletin* Vol 10 No 4 on "Solicitor's Certificates Duties and Liabilities". It includes a copy of a suggested checklist.