Solicitors Beware — A Practical Guide Advising Guarantors

by Shane Nossal

Introduction

Uncertainty used to surround the question of whether a creditor could enforce a guarantee which had been procured by the wrongful conduct, such as undue influence or misrepresentation, not of the creditor, but of the principal debtor. This uncertainty encompassed two aspects:

- the circumstances under which the creditor would be infected by the wrongful conduct of the principal debtor, and
- in order for the guarantee to be enforceable, whether the creditor had merely to suggest to the guarantor to obtain independent legal advice or whether the creditor had to require that the guarantor actually obtain independent legal advice before entering into the guarantee.

A trinity of English appellate cases (*Barclays Bank plc v O'Brien,*[1] *CIBC Mortgages plc v Pitt,*[2] and *Massey v Midland Bank plc*[3]) has succeeded in diminishing this uncertainty and, by means of a series of straightforward propositions centring on the concept of constructive notice, has articulated the minimum requirements for the enforceability of guarantees in this tri-partite situation. Banks, mortgage companies and other money lenders would be well advised to amend their standard operating procedures in accordance with these cases.

It must be noted, however, that these cases, while clarifying the law, have the side-effect of placing solicitors under increased risks when providing potential guarantors with independent legal advice.

Guarantors need independent legal advice

The propositions

The following propositions have been extracted principally from the judgment of Lord Browne-Wilkinson (giving judgment of the House of Lords) in *Barclays Bank plc v O'Brien,* a case involving a married woman securing her husband's liabilities by a second charge on their matrimonial home:[4]

1 A wife, who has been induced by her husband's wrongful conduct to guarantee his debts, has an equity right against him to set aside the transaction.

2 This right to set aside the transaction is enforceable against a third party creditor if either (a) the husband was acting as the agent of the creditor, or (b) the creditor had actual or constructive notice of the facts giving rise to the wife's equity.

3 Only in very rare circumstances will it properly be held that the husband was acting as the agent of the creditor in procuring the wife to enter the transaction.

4 As between the two innocent parties, the earlier right of the wife will prevail against the later right of the creditor where the creditor knew of the earlier right (actual notice) or would have known of it had he taken proper steps (constructive notice). In other words, where a wife has agreed to guarantee her husband's debts as a result of his wrongful conduct, the creditor will take subject to the wife's equity to set aside the transaction if the circumstances are such as to put the creditor on

inquiry as to the circumstances of her agreement.

5 A creditor is put on inquiry when a wife guarantees her husband's debts by the combination of two factors: (a) the transaction is on its face not to the financial advantage of the wife; and (b) the substantial risk in transactions of this kind that, in procuring the wife to act as guarantor, the husband has committed a legal or equitable wrong that entitles the wife to set aside the transaction.

6 In order to avoid being fixed with constructive notice of the wife's equity, the creditor ought to take reasonable steps to ensure the agreement to enter into the guarantee was properly obtained. More specifically, the creditor ought to (a) meet privately with the wife, that is, in the absence of the husband, (b) explain to her the extent of her liability as guarantor, (c) warn her of the risk she is assuming, and (d) urge her to take independent legal advice.

7 Where the creditor has knowledge of further facts which render the presence of wrongful conduct not only possible but probable, the creditor must insist that the wife actually receives independent legal advice.

8 These propositions, discussed with reference to husbands and wives, are equally applicable to "all other cases where there is an emotional relationship between cohabitees". Their foundation appears to be the recognition that "the capacity for self-management... is frequently impaired by the emotional ties" between the parties.[5] Thus, these propositions will also apply where the creditor has actual knowledge that (a) the guarantor is either cohabiting or simply involved (as in the *Massey* case) with the debtor in either a heterosexual or a homosexual relationship, or (b) the guarantor places trust and confidence in the debtor in relation to his or her financial affairs.

The creditor in *CIBC Mortgages plc v Pitt* was held not to have been put on inquiry as to the prior equity of the wife since the wife in that case had executed the legal charge over the matrimonial home in exchange for a sum of money ostensibly to be used for the purchase of a holiday home and paid by the creditor into the joint bank account of the husband and wife. The two elements set out in proposition 5 above relating to the financial disadvantage to the guarantor and substantial risk of wrongdoing in the procurement of the legal charge were thus absent.

Presumed undue influence

Although not expressly acknowledged in the judgments, there is a striking similarity between proposition 8 above and the category of undue influence termed 'Class 2B'. This is a category of presumed undue influence where, although there does not exist a relationship between the parties that, as a matter of law, raises the presumption of undue influence (eg solicitor and client, medical doctor and patient), the complainant can prove "the existence of a relationship under which the complainant generally reposed trust and confidence in the wrongdoer".[6]

This correspondence is logical. The policy reasons supporting the presumption of undue influence in certain relationships or circumstances, namely the protection of persons from abuse of position,[7] sustain equally the aspiration of the courts to control the ability of creditors to disregard wrongful conduct of the debtor in the procurement of security for their loans. Thus, by merging the concepts of a prior equity to set aside the transaction and presumed undue influence, it may be argued that under *O'Brien* creditors will be fixed with constructive notice of a guarantor's prior equity whenever a guarantor can prove that (a) the transaction is not to his or her financial advantage, and (b) his or her relationship with the debtor is of a kind which could raise a presumption of undue influence.

Advice to banks and other money lenders

In the light of this trinity of cases and the foregoing discussion, creditors seeking to ensure the enforceability of guarantees to secure their loans would be well advised to have regard to the following points:

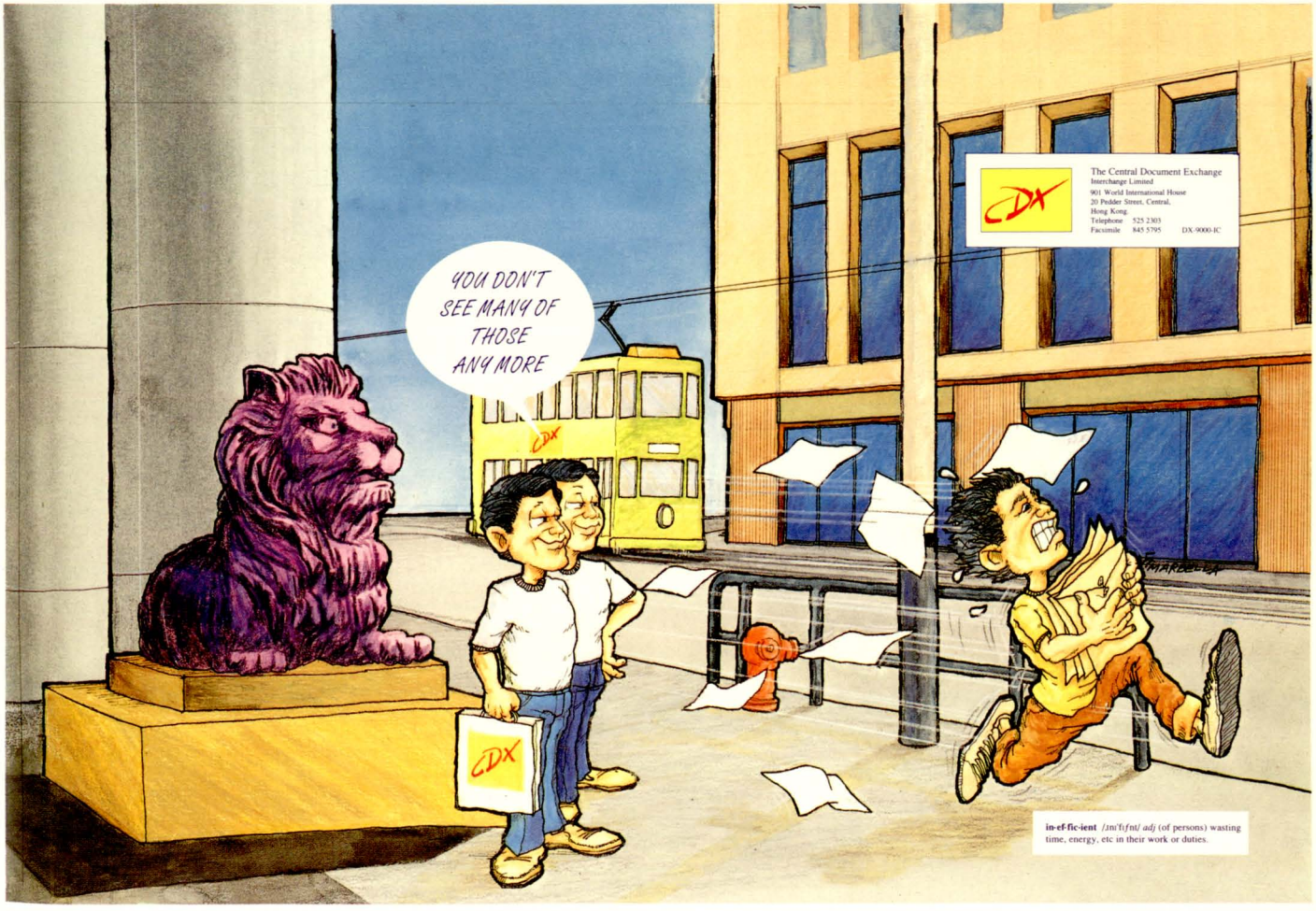
- the obligation will be on the creditor at the time of the proposal of the guarantor to inquire as to the nature of the relationship between the debtor and the guarantor
- where the proposed guarantor is the wife or husband of the debtor, or is a cohabitee or involved in a sexual and emotional relationship (whether heterosexual or homosexual) with the debtor, then the creditor must follow the steps set out in proposition 6 above to ensure the enforceability of its guarantee
- where the proposed guarantor has some close familial or personal relationship with the debtor that could raise a presumption of undue influence, then the creditor should follow the steps set out in proposition 6 above. Such situations may cover, for example, a son proposing his elderly parents to be his guarantors
- where a creditor or its representative possesses further knowledge that renders the existence of wrongful conduct on the part of the debtor not only possible but probable, then the creditor ought to

insist that the proposed guarantor actually receives independent legal advice
- where the creditor has decided that the proposed guarantor ought actually to receive independent legal advice, the following procedures should be adopted: A representative of the creditor should meet privately with the proposed guarantor, discuss the details set out in proposition 6 above, and then urge him or her to obtain independent legal advice. The creditor should leave to the proposed guarantor the arrangements as to the retention of a solicitor, and does not have to stipulate the nature or extent of the advice to be given, this being a matter for the solicitor. The creditor should accept the guarantee only if satisfied that it was executed by the guarantor after the receipt of independent legal advice.

The responsibilities of solicitors

Solicitors providing independent advice to proposed guarantors ought to consider the following points: [8]

- it goes without saying that the advice given to the proposed guarantor must be independent. The proposed guarantor should therefore be the sole client of the solicitor (unlike in *BCCI International SA v Aboody* [9] where it was held the solicitor was acting for both the creditor and the guarantor), notwithstanding that the solicitor's fees may be paid by the debtor.
- the independent advice must be given 'with a knowledge of all relevant circumstances'.[10] Accordingly, the solicitor ought to inform the creditor that he or she has accepted instructions to advise the proposed guarantor and to request that the creditor send directly to the solicitor the guarantee documents and all relevant information regarding the loan and the debtor. The solicitor should also obtain from the debtor all such relevant information.
- the solicitor should then meet with the proposed guarantor in private and explain clearly to him or her the nature and effect of the guarantee, that is, the



terms of the documents, the effect of the transaction on the guarantor, and the extent of the potential liabilities under the guarantee. Adequate independent advice should extend beyond explanation and should encompass advice as to the propriety of the guarantor entering into the transaction, taking into account the nature of the liabilities guaranteed, the state of those liabilities, and the extent of the risk undertaken by the guarantor.

- depending on his or her instructions, the solicitor may then either witness the guarantor's execution of the guarantee or certify that the guarantor had been advised as to the nature and effect of the guarantee, the risks involved in the transaction and the propriety of entering into it, and that the guarantor appeared to understand, and told the solicitor that he or she did understand, the advice before he or she executed the guarantee.[11]
- where the guarantor insists on executing the guarantee contrary to the independent legal advice to refrain from doing so, the solicitor should recommend that the guarantor reflect further on his or her decision for a day or two. If the guarantor returns to the solicitor's office for the execution of the guarantee after this cooling-off period, the solicitor should repeat his or her advice and, if requested again by the guarantor, witness the execution of the guarantee or complete the certificate. The solicitor should then prepare and send to the guarantor a letter setting out the advice given and confirming that the guarantor decided to proceed with the execution of the guarantee contrary to that advice.
- if the solicitor knows of the wrongful conduct inducing the proposed guarantor to enter into the guarantee, he or she ought not to witness the execution of the guarantee or to complete the certificate without modification. The reason is that, by witnessing the execution of the guarantee or certifying that the guarantee had been entered into after the receipt of independent advice, the creditor will not be fixed with constructive notice of the guarantor's prior equity to set aside the transaction and the guarantee will thus be enforceable by the creditor against the guarantor.[12] Under such circumstances, the guarantor may seek to recover his or her losses (that is, the total amount owing under the guarantee) from the solicitor through a professional negligence action.

Conclusion

This trinity of cases has clarified the law regarding the enforceability by creditors of guarantees procured by the wrongful conduct of principal debtors, and has struck a balance between the utilisation of family assets (the most important being the matrimonial home) as security for commercial ventures and the protection of persons within emotional relationships. The obligations imposed on creditors are not onerous and, if creditors are in doubt in any given situation, they can always follow procedures which exceed the minimum requirements set out in the trinity by insisting that the guarantor actually receives independent legal advice before entering into the transaction.

The cases have also produced a couple of negative side-effects. Where independent legal advice is deemed necessary by the creditor, the incurrence of solicitors' fees will increase the cost of borrowing money. More importantly, solicitors must question whether it is worthwhile to undertake this guarantee certification work at all. The amount which can be charged for the provision of independent legal advice to guarantors will be trivial in comparison to the potential risk of a professional negligence action involving the entire sum covered by the guarantee. ❖

Shane Nossal is a lecturer in the Department of Law, University of Hong Kong

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1 [1993] 4 All ER 417 (HL)
2 [1993] 4 All ER 433 (HL)
3 unrep 18 Mar 1994 (CA)
4 n1 above, pp428-32
5 *Massey*, n3 above, p6
6 *O'Brien*, n1 above, p423
7 *Allcard v Skinner* (1887) 36 Ch D 145, 182-83
8 for a fuller discussion, see M Sneddon "Unfair conduct in taking guarantees and the role of independent advice" (1990) 13 UNSWLJ 302
9 [1989] 2 WLR 759, 789
10 *Inche Noriah v Shaik Allie Bin Omar* [1929] AC 127, 135-36
11 Sneddon, n8 above, pp320-24; PJM Fidler, Practice and Law of Banking (London: ELBS, 11th ed 1982), p339
12 This is not to say that the transaction could not be set aside on other grounds (such as duress or the creditor's actual notice of the wrongdoing), which may be unaffected by independent legal advice.