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The duty to explain a guarantee by the bank: an ephemeral concept?

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The duty to explain a guarantee by the bank: an ephemeral concept?

Abstract

This article looks at the feasibility of imposing a duty on the lender to explain the meaning and effect of a guarantee to the prospective guarantor (to reduce the information asymmetry) - a concept which has traditionally been resisted by the common law. It takes a comparative approach and includes perspectives from English, Australian and New Zealand jurisdictions.

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Bio box

Dr Charles YC Chew is a Barrister and Senior Lecturer in the Faculty of Law in the University of Wollongong, Australia.

Boxes (to be put in appropriate parts of the pages)

The nagging issues concerning the duty of the bank to explain a guarantee to prospective sureties

Where does a bank draw the line between giving sufficient explanation that the document would not be subject to litigation, and taking upon itself a duty of care?

Can a Code of Banking Practice convince sureties that it is possible to make the banks explain to them the nature of the guarantee to enable them to enter the contract with informed consent?

KEY POINTS

There is growing concern about the consequences of the widespread use of guarantees, the most common form of security in banking and finance.

Guarantees are being signed where guarantors have little information about important aspects of the transaction such as its legibility and the financial position of the borrower.

The crucial issue is whether there should be a duty on the bank to explain to address the problems of ambiguity and information asymmetry so that the surety can enter the guarantee with informed consent.

International perspectives take on an examination of developments in English, Australian and New Zealand law which has been tending towards a duty of explanation so antithetical to the traditional common law approach.

Title of article

THE DUTY TO EXPLAIN A GUARANTEE BY THE BANK: AN EPHEMERAL CONCEPT?

OVERVIEW AND BACKGROUND

Guarantees are probably the most common form of security used in the business world. There has been a growing concern about the consequences of the widespread use of guarantees which are contracts in which the guarantor promises to answer to the person in whose favour the guarantee is given (the creditor such as a bank) for a debt of a principal debtor (borrower) if the debtor defaults.

Apart from looking at the guarantor's reasons for entering into the guarantee, it is important to remember that guarantees are contracts with significant legal and financial implications. The financial risks can be great because a guarantee is usually accompanied by, for example, a mortgage over property, commonly the guarantor's family home. Guarantors therefore undertake huge risks with traumatic and unjust consequences, including the possibility of losing their home, without necessarily obtaining any tangible financial benefit from the loan taken out by the borrower. It is apparent, therefore, that the legal system needs to protect guarantors as far as it reasonably can, especially from unfair conduct of lenders and borrowers. Guarantors are sometimes referred to as "third party guarantors" because they are not a party to the loan contract between the borrower and the lender.

Since guarantors are third parties to the loan contract, and are therefore "strangers" to that contract, they are likely to have limited information concerning the events leading to the borrowing arrangement, and the financial details of the primary transaction they are guaranteeing. There are a number of aspects to this information asymmetry including, inter alia, a lack of understanding of the actual and potential liability of the guarantor; the facts of a financial kind required to form a risk assessment; and knowledge on an on-going basis of the financial position of the borrower.

This article looks at the feasibility of imposing a duty on the lender to explain to the prospective guarantor (to reduce the information asymmetry)-a concept which has traditionally been resisted by the common law. It takes a comparative approach and includes perspectives from English, Australian and New Zealand jurisdictions.

INFORMATION ASSYMETRY AND AMBIGUITY

Information asymmetry and ambiguity can arise from the wording of a traditional contract of guarantee which has been characterized as "prolix, confusing and tautological…with great blocks of prose which are oftentimes impenetrable” (R.M. Goode, "Guarantees, Rights, Rites and Rewrites" (1988) 5 *Journal of Business Law* 249 at 264).

Guarantees have been used in banking where they play a vital everyday role, ranging from their use in relation to personal loans and mortgage transactions to the often complex guarantees which form an important part of commercial transactions. Generally, it can be said that a bank guarantee is no different from any other guarantee and there are no special rules which apply in respect of its rights and liabilities. However, there are a number of matters which may be of particular significance to bank guarantees and which therefore require independent discussion.

IS THERE A DUTY TO EXPLAIN?

An issue which is of importance to the lender is whether it owes a duty to a prospective guarantor to explain the meaning and effect of the guarantee. Although this matter is not yet free from doubt, the weight of authority in the common law seems traditionally to be against the existence of such a duty. However, if the bank proffers to explain the nature, effect and security of the guarantee, then it may come under a duty to exercise reasonable care in doing so. Thus in *Cornish* v *Midland Bank plc*3 All ER 513 it was pointed out that where the bank takes upon itself the task of explaining the guarantee documents, and if the bank knows or ought to know that the proposed surety is relying upon the explanation, there is a duty on the part of the bank to exercise care in giving such explanation.

This leads to the question of whether there might exist a duty of care if the prospective surety is in fact a customer of the bank. Such an issue was considered in *Cornish* by Kerr LJ who tentatively suggested that in certain situations, a banker may owe a duty to the guarantor some explanation concerning the nature and effect of the guarantee documents, at least, if they happened to be a customer. (p 517) Implicit in what his Lordship said is the contention that the duty would arise whenever a banker volunteers to offer an explanation, rather than there being the existence of the duty to explain whenever a guarantee is effected.

DUTY OF EXPLANATION: AN EPHEMERAL CONCEPT?

Despite what had been decided in *Cornish,* it has for sometime been an unsettled question whether guarantors can escape liability on the basis that the lender did not explain the guarantee to them. This issue was more recently re-ignited in *Shotter v Westpac Banking Corp* v *Villars* [1988] 2 NZLR 316 where the High Court of New Zealand generated a new duty founded in tort by holding that a duty to explain a guarantee exists in the absence of a fiduciary relationship between the bank and the surety. Here Wylie J looked at the whole question of disclosure which was crucial since the plaintiff Shotter argued that before signing the guarantee, the bank had a duty to explain to him the liabilities which the borrower Unicorn Holdings Ltd had to the bank. Shotter reasoned that such a duty arose because the guarantee secured a large contingent liability, which he was unaware of, and which he would not, in any case naturally expect to exist. (pp 326-327)

Having formulated a tortious duty requiring "explanation, warning or recommendation of separate advice" Wylie J cautioned that the question of whether a duty of explanation exists depends on the relationship of the parties, the knowledge possessed by the bank, and the relative strength or ability of the guarantor to protect their interests. It would be absurd, for example, to impose such a duty if the prospective surety were a highly competent commercial lawyer, or other person of business whom the bank knows is as familiar with the form of guarantees and their associated risks as the bank itself. (p 328) A duty, however, exists when a bank should reasonably suspect that its customer may not fully understand the meaning of the guarantee and the extent of the liability undertaken thereby, or that there is some special circumstance known to the bank, which it should reasonably suspect might not be known to the prospective guarantor, and which might be likely to affect the guarantor's decision to enter into the guarantee.

The concept of the duty of explanation as established in S*hotter* was short-lived. In *Westpac Banking Corporation* v *McCreanor* [1990] 1 NZLR 580, Hardie Boys J declined to follow *Shotter* by reaffirming the earlier principle first espoused in *Hamilton* v *Watson* (1845) 12 Cl and Fin 109 (at p119) which required that a creditor bank is only obliged to disclose to a prospective guarantor matters which are different from what the latter might naturally expect. The defendant McCreanor had given a guarantee to the bank in regard to the indebtedness of Allied Hydraulics Ltd of which he was one of the directors. When the guarantee was given, the company's account was overdrawn, largely due to the fact that Smith, another director, was using company moneys for his own private purposes.

It was argued by McCreanor that the bank was under a duty to explain to him the above-mentioned matters, and that the damages to which he was entitled as a result of the bank's breach of duty should be set off against his indebtedness to the bank under the guarantee. He contended that he would not have signed the guarantee if he had known that Smith was using company funds; that the guarantee related to past advances, and that nothing of a subsequent advance was made after the guarantee was executed. (p 583) In rejecting the *Shotter* proposition that the bank was under a duty to inform him of the various matters referred to, Hardier Boys J restated the *Hamilton* v *Watson* principle that a creditor may only disclose to the guarantor things that are different from what the latter might naturally expect. His Honour reinforced this argument by discussing similar propositions as stated in *London General Omnibus Co. Ltd* v *Holloway* [1912] 2 KB 72, *Cooper* v *National Provincial Bank Ltd* [1946] KB1 and *Goodwin* v *National Bank of Australasia*1968) 117 CLR 173, pointing out that the absence of any higher duty to explain cannot be circumvented by the introduction of some tortious obligation. His Honour had difficulty in the view that by invoking a tortious duty of care, the court should negate the line of authorities based on equitable principles that a bank is under no duty to explain, except in the circumstances described in *Hamilton* v *Watson* and the authorities following this**. The recent English case of *Northshore Ventures Limited v Anstead Holdings Inc and***

***Ors* [2010] EWCH 1485 (Ch) widened the scope of the *Hamilton v Watson* obligation to disclose as regards guarantees to material facts which the surety could not be reasonably expected to know and which are unusual, thus moving the duty nearer to that required in insurance contracts.**

Another decision that disapproved of the duty to explain in *Shotter* is *Shivas* v *Bank of New Zealand* [1990] 2 NZLR 327. There, as far as the claim in tort is concerned, it was argued that the bank owed a duty of care in ensuring that the plaintiffs be fully advised on the full extent of their liability under the guarantee and that they had independent legal advice before signing the guarantee. (p 330). Tipping J when faced with the two conflicting authorities of *Shotter* and *McCreanor* applied the latter, and proposed that the suggested duty of care did not arise from the contractual relationship between banker and customer. His Honour cited the basic principle laid down in *Tai Hing Cotton Mill* v *Liu Chong Hing Bank Ltd* [1986] AC 80, 107.that no wider duty should be invoked. He explained that the guarantor's position was adequately covered in law already. The importation of any further duty of care would mean that the pendulum would be swinging too far in favour of the proposed guarantor "if one were to permit an action for the tort of negligence on the promise not of advice negligently given but on the basis of a failure to explain, warn or recommend". (p 335)

The arguments raised in *McCreanor* and *Shivas* are useful as a restatement or indeed a re-affirmation of the limited extent of the duty owed by the bank to the prospective surety, and are accordingly in the category of authorities which arrest any further erosion of contractual rights by the use of equities. It appears that the balance of interests between the parties are satisfactorily maintained by the existing law, without the necessity to impose a further duty of care, and there is therefore not much that the bank is obliged to explain or disclose to the surety.

The proposition discussed above was also arrived at in *Barclay's Bank* v *Khaira* [1992] 1 WLR 623.in which Mrs Khaira, the surety, raised the defence of undue influence and alleged that the bank treated her negligently in that it failed to properly explain to her the nature and effect of the legal charge over the property before she signed. She also contended that the bank owed a duty to advise her to seek independent legal advice.

The court held that the bank did not owe Mrs Khaira the alleged duties, although it did say that if the bank took upon itself to explain the effect of the guarantee, it was under a duty to properly explain its nature and the effect of its terms. The court relied on English authorities as well as *McCreanor* and concluded that unless there were special factors which might affect the surety's liability, the bank was not under a duty to proffer any explanations. It also reinforced the proposition that it would be fallacious to suggest that because banks routinely do offer explanations they are under a legal duty to do so. (p 625)

Cases such as *Caparo Industries plc* v *Dickman* [1990] 2 AC 605 and *Bradley West Solicitors Nominee Co Ltd v Keeman* [1994] 2 NZLR 111 etc are imposing more limitations in the creation of "new" duties and reinforcing the principle in *Barclay's Bank* v *Khaira*. They deserve close examination since they encapsulate almost every conceivable plea (except for undue influence) which could be mounted against the bank. These authorities are firmly in the tradition of resisting further diminution and dilution of contractual rights by the interposition of "questionable equities" resurrected by the defendant.

LAW STILL EVOLVING

It is inevitable that the law in this area responds to change and is still evolving so that whatever conclusions that can be drawn must be of a tentative nature. As an illustration, if there is an endeavour to explain a security document, where does the bank draw the line between giving a sufficient or adequate explanation to satisfy itself that the document would not be the subject of litigation for undue influence, and taking upon itself a duty of care?

It should be noted that the principles as espoused in *Barclays Bank* v *Khaira* differ somewhat from the developing common law in Australia which, according to the Court of Appeal (NSW) in *Beneficial Finance Corp Ltd* v *Karavas* [1991] 23

NSWLR 256, is that the lender should advise the surety to obtain independent legal advice, and if necessary, financial advice as well. Here, the court recommends the lender to take appropriate precautions, as a matter of "self protection" when dealing with a surety who is in a significantly unequal bargaining position in respect of the banker. The court did not go so far as to stipulate that the lender had a duty to ensure that the guarantor obtained independent legal advice.

It is probably true to say that a lender in Australia, New Zealand and England would be under an obligation to ensure that a surety has an independent and informed judgment vis a vis the guarantee before executing it. Such an obligation may bring with it, as a matter of necessity, a duty to ensure that the surety obtains independent legal advice. In the usual course of events, public policy may not require a lender to be under a duty to ensure that the surety obtains independent advice. Nevertheless, it is only prudent that lenders do not disregard the principles the courts have formulated, and be aware of the restraints imposed therefrom.

In view of what has been said, it appears that, on the whole, current notions about what constitutes independent advice are inadequate to form the basis of an effective protective procedure. Those who advise banks are therefore likely to face many difficult and tricky problems. For example, what would the situation be if the prospective surety refuses to take independent legal advice? Should the bank advise the surety or should it not run such a risk and leave the situation as it is? Would prudence demand that silence is probably the best way out of this dilemma? Whatever course is adopted, it is always wise to ensure that a proper record is kept of any transactions between the bank and the surety. It is now quite common to see a provision in a bank guarantee which the surety has to sign, stating that they understand the guarantee, and that they have been advised to obtain independent legal advice, and that an adequate certificate to this effect is given by the solicitor giving the advice. In "high risk" cases where, for example, the principal's wife is the prospective surety, this precaution is particularly advisable.

DUTY TO EXPLAIN BEING PLACED MORE ON A FIRMER BASIS IN ENGLAND AND AUSTRALIA

The Jack Committee in England in 1989 recommended the introduction of a Code of Banking Practice in respect of the relations between banks, building societies and their customers. This code went through a number of editions, the latest being the 2005 edition which provides in Clause 13.4 that if a borrower wishes to accept guarantees from someone for their liabilities, they may be asked for permission to give confidential information about their finances to the prospective guarantor, or to their legal adviser. It also postulates that it is important that guarantors take independent legal advice to make sure they understand their commitment and the possible consequences of their decision. It points out that it is important that guarantors receive independent legal advice to help them understand the full nature of their commitment and the potential implications of their decision. It goes further by actually making prospective guarantors who refuse to take legal advice to sign a declaration to that effect.

The decision of the House of Lords in *Royal Bank of Scotland v Etridge (No 2*) (No 2) [2002] AC 773 has now established that in any case where the guarantee is “non-commercial” (as is the case where the wife is standing as guarantor to a husband’s possible future debts) it is incumbent on the bank to take certain steps (set out in para 79 of Lord Nicholls’s speech) which are designed to require the guarantor to take independent legal advice before entering into the contract of guarantee. These steps go beyond what is set out in the Code, but not to the extent that is unduly onerous on the bank. One area which remains open to debate is what the financial institution should do if the surety refuses to take independent legal advice. Prior to *Etridge,* obtaining written confirmation (as the Code suggests) may well have been sufficient to protect the bank, but Lord Nicholls appears to contemplate that unless the surety responds in a satisfactory manner to the bank's initial letter, the transaction should not proceed, and so if the bank goes ahead in the face of even a written refusal, it does so at its own risk.

The House of Lords in *Etridge* followed its earlier decision in *Barclays Bank* v *O'Brien* [1994] 1 AC 180 from which much of Lord Browne-Wilkinson's formulation of the law was cited with approval. Lord Nicholls, whose judgment had the concurrence of the whole court, restated the proposition that the steps, which the bank put on inquiry is required to take, are aimed not at finding out whether there had been misconduct by the principal debtor, but rather at minimising the risk that such a wrong had been committed (at para 63). What is crucial here is that the guarantor wife understood the nature and effect of the contract of guarantee. Lord Nicholls discussed (at paras 64 and 65) the responsibilities of giving advice to the guarantor, and considered that as a "core minimum", the advising solicitor would need to:

(1) Explain the nature of the document and the practical consequences of signing them, namely, the possibility of the guarantor losing her home and being made a bankrupt;

(2) Point out the seriousness of the risks involved. He must tell her the purpose, amount and terms of the proposed loan, and that the bank may increase its amount, or change its terms, or grant a new facility without reference to her. He must tell her the amount of her liability under the guarantee and her financial position, the value of the property charged, and whether she or her husband has any other assets out of which repayment could be made if the husband's business should fail resulting in defaults on the loan.

(3) State clearly that the wife had a choice and that the decision is hers and hers alone; (4) He should check if she wished to proceed with the transaction, and explain the nature of the documents and their practical implications or whether, for example, she would prefer the borrower to negotiate with the bank the terms of the transaction.

It can be said that, on a practical level, *Etridge* provides guidance to both banks and legal practitioners, and gives them a warning that they ignore this at their own peril. The steps Lord Nicholls set out are more exacting than those required under the various financial industry codes, and following them would be useful to both bankers and solicitors.

The Australian Code of Banking Practice in its latest revised version, effective from August 2004, adopted an approach similar to that in *Etridge*, and accordingly, under clause 28.4 9a) (iii) requires full disclosure, and presumably explanation by the bank of all the information to the prospective guarantor, including relevant details about the financial position of the debtor and the transaction being guaranteed.

The Australian Code, like the English Code, provides in clause 28.4 (a) (i) that the bank will give a prospective guarantor "prominent notice" that they should seek independent legal and financial advice on the effect of the guarantee. Compliance with this requirement would not protect a bank against liability for unconscionable conduct if the guarantor did not actually obtain independent advice. The Code in clause 28.5 further allows the guarantor a one-day cooling off period after being provided with the requisite financial information and before signing the guarantee

Rule 45 of the Professional Conduct and Practice Rules of the Law Society of New South Wales (largest state in Australia) *Professional Conduct and Practice*

Rules (2001) gives guidelines for the content of the advice to be given by solicitors to guarantors. Rule 45 makes it clear that solicitors must advise the client they are not qualified to provide financial (as distinct from legal) advice and that if the guarantor has any questions about financial aspects of the transaction they should seek further advice from an accountant or financial counsellor. (r 45.6.4.1, 45.6.4.2). Rule 45 rule also includes clear guidelines about conflict. It provides that the solicitor who advises a borrower or guarantor must not also act for the lender and that, in cases where there is potential conflict between parties to the transaction (that is, the borrower and guarantor), the solicitor cannot provide advice to more than one of those parties without the written consent of each party (r 45.4, 45.9).