When clients provide security for a third party’s benefit: some practical tips

By Matthew Harding and Kaveetha Kumar

The potential exposures that solicitors face when advising on security documents where the person gaining the benefit of the transaction is a third party have again been highlighted in recent cases. A third party guarantor must be given ‘competent, independent and objective’ advice on the purpose and effect of the transaction (Alceon Group Pty Ltd v Rose [2016] NSWSC 671). Where the terms of a loan are harsh and oppressive there is plainly a requirement for advice to be given as to both the legal effect and the risks associated with entering into the security transaction (Bakowski v Lenehan [2014] NSWSC 438). It is necessary to provide advice in terms that the mortgagor or guarantor can understand.

In acting for a mortgagor, guarantor or person providing some other form of security on a loan, particularly a loan to a third party, it is prudent to consider:

- Is there a high degree of risk associated with the loan? Is the borrower in a dire financial position? Are there circumstances alerting you to a likelihood the loan will not be repaid by the borrower? Some indicators of a high risk loan are very high establishment fees, very high interest rates, short terms for repayment, and other short term conditions constituting a breach if there is a default.
- Is the mortgagor or guarantor a person who stands to gain no benefit from the loan agreement?
- Is the borrower gifting or lending the amount advanced to a third party, for example a domestic partner, adult child, grandchild or friend? Seek instructions on why the mortgagor or guarantor is putting their assets at risk.
- Is the client in a position of vulnerability, under external pressure or influence? Is the client being misled by the borrower on the purpose of the loan or the borrower’s ability to repay it?
- Is the guarantor obviously in a position where they cannot repay the loan if the loan is not repaid by the borrower? Is the mortgagor providing security over their only property?

Under rule 11.4 of the Legal Profession Uniform Legal Practice (Solicitors) Rules 2015, the evidence of advice provided to a guarantor by a solicitor must be in the form of the Law Society of NSW Declaration by Third Party Mortgagor, Guarantor, Surety Mortgagor. It must provide that after receiving independent legal advice the third party mortgagor/guarantor has freely and voluntarily signed the security documents. The solicitor must also obtain an acknowledgement that the client advised that the guarantor will be liable to remedy any failure by the borrower to make a payment on time and the lender can sue the guarantor to take possession of their property.

In addition, the solicitor must obtain and keep on file an Interpreter’s Certificate if applicable and a list of the loan and security documents (rule 11.6). The circumstances known to the solicitor may require the solicitor to explain the obvious practical implications of the client’s entry into the relevant transaction. Do not, however, provide financial advice - and make it expressly clear that you are not doing so. Advise the client to obtain independent financial advice.

In Provident Capital Ltd v Papa [2013] NSWCA 36, the solicitor was found to be aware that the borrower, the mortgagor’s son, had defaulted on previous loans. The solicitor allegedly had knowledge of further financial information relating to the mortgagor’s son. The New South Wales Court of Appeal held that the solicitor’s advice on the wisdom of a transaction, the purpose or effect of the guarantee and mortgage transaction was inadequate. In advising mortgagors and guarantors, a prudent solicitor should:
- Advise the security provider independently of the borrower;
- Ask the security provider the reasons why the mortgagor has entered into the transaction, whereby she was to make payments on the loan, and ought the solicitor have met the borrower without his son also being present?
- A solicitor, in negotiating the terms of the loan for a borrower, was fully aware of the reason for the very high interest rate and that the loan was very high risk. It was plain that the solicitor did not clearly explain the purpose or effect of the guarantee and mortgage. The mortgagor and guarantor did not understand the mortgage transaction. The Court found that the solicitor’s advice on the security documents was inadequate.

The following questions arose:
- The solicitor also acted for the son? Was he also receiving instructions from the former daughter-in-law? Was the solicitor aware of the agreement between the father and daughter-in-law?

Some other practical examples in our experience have been:
- A solicitor received instructions to act for a father providing a mortgage on his home, so that his son and daughter-in-law could purchase their own home. The daughter-in-law agreed to be a payer of the loan, but that agreement was not recorded in writing. The solicitor took instructions from the son on behalf of his father and never met the father without his son being present. The daughter-in-law paid the amount advanced by the lender and lost 4. His son and former daughter-in-law subsequently divorced. The father stood to lose his home to the lender. The father and son alleged they were duped by the daughter-in-law.

The Court places on the solicitor’s knowledge of the extent of risk to the client. The Court reiterated the strong focus that should be put on the solicitor’s knowledge of the extent of risk to the mortgagor or guarantor. This knowledge would put the solicitor on notice that the client’s interests may be significantly endangered or at risk (Richtoll Pty Ltd v WW Lawyers (In Liquidation) Pty Ltd [2016] NSWSC 438). A solicitor may come to know of a potential personal liability; and

- Take note of the client confirming the advice.

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