

## WHEN CLIENTS PROVIDE SECURITY FOR A THIRD PARTY'S BENEFIT: SOME PRACTICAL TIPS

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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* [2015] NSWSC 868).

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 (*Bakovski v Lenehan* [2014] NSWSC 671).

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

### Snapshot

- Advice on mortgages and guarantees should not be cursory, superficial or incomplete.
- It is necessary to explain clearly the purpose and effect of guarantees or mortgages.
- Solicitors should be wary when asked to advise clients who are borrowing for the benefit of family members or other third parties when the clients' home is offered as security.
- Always advise on risks, especially where the client is providing security for a third party's benefit.

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 she/he 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 solicitors are not ordinarily required to provide advice on the wisdom of a transaction, but a solicitor in those particular circumstances ought to have formed the view that the mortgagor's home was significantly endangered and recommended that the mortgagor obtain independent financial advice.

In *Zakka v Elias* [2013] NSWCA 119, the Court of Appeal held that the solicitor did not need to spell out in detail the ways in which the mortgagor might lose his home. The solicitor did, however, owe a duty to bring the risks of the transaction to his attention.

The NSW Supreme Court recently reiterated the strong focus that the Court places 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 liq) Pty Ltd* [2016] NSWSC 438). A solicitor may come under a duty to advise a client of matters of which the solicitor is aware that might be relevant to the decision to provide security.

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 make payments on 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. His daughter-in-law gambled the amount advanced by the lender and lost it. 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 following questions arose: was the solicitor also acting 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

whereby she was to make payments on the loan?; and ought the solicitor have met the father 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 mortgagor knew none of this. 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.

In advising mortgagors and guarantors, a prudent solicitor should:

- advise the security provider independently of the borrower;
- ask the security provider the reasons they are entering into the transaction;

- ask the security provider about their relationship with the borrower, for what purpose the borrower intends to use the loan monies and how the loan is to be repaid. Explain the nature and effect of providing the security in the simplest language possible. Advise the client about the key elements of the transaction documents and the worst case scenario;
- consider whether the client understands your explanation of the transaction and the risks. Does the client have a good grasp of English? Ask the client to tell you what they understood your explanation to mean and record their response. Do they understand they could lose their asset? Do they understand the extent of their potential personal liability?; and
- write to the client confirming the advice. **LSJ**

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