



GUIDELINES ON SOLICITORS' DUTIES IN RELATION TO SECURITY TRANSACTIONS WITH POTENTIALLY UNDULY INFLUENCED PARTY

A. PURPOSE AND SCOPE

1. The Law Society has prepared these Guidelines to assist members to fulfil their professional obligations in the conduct of **3-party security transactions**, i.e. transactions between lenders, borrowers and sureties. These transactions are susceptible to claims of “undue influence” resulting in the subsequent failure of the security.
2. These Guidelines do **not** deal with 2-party loan transactions between lenders and borrowers.
3. These Guidelines are **not** meant to be **exhaustive**. There may be additional requirements and each transaction should be considered on its own facts. Members are reminded to familiarise themselves with all relevant judgments, including *O'Brien*, *Pitt*, *Etridge* and *Fung Chin Kan*.
4. Members should carefully consider their position when conducting such transactions in order to prevent exposure to claims and an adverse impact on the Professional Indemnity Scheme.
5. These Guidelines supercede Circular 01-290 (PA) dated 22 October 2001.

B. ABBREVIATIONS

6. In these Guidelines, unless the context otherwise requires, words and expressions importing the masculine gender include the feminine gender, and:

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| “borrower” | includes a debtor or a principal debtor, |
| “ <i>Etridge</i> ” | means the House of Lords decision in <i>Royal Bank of Scotland v. Etridge (No. 2)</i> [2001] 3 WLR 1021, |
| “ <i>Fung Chin Kan</i> ” | means the Court of Final Appeal decision in <i>Bank of China (Hong Kong) Ltd v Fung Chin Kan and another</i> , [2003] 1 HKLRD 181, |
| “HKAB” | means The Hong Kong Association of Banks, |
| “HKAB’s circular” | means HKAB’s circular dated 12 October 2002, |
| “member” | means a member of the Law Society, and, where appropriate, includes his clerks, |
| “ <i>O’Brien</i> ” | means the House of Lords decision in <i>Barclays Bank plc v O’Brien</i> [1994] 1 AC 180, |
| “ <i>Pitt</i> ” | means the House of Lords decision in <i>CIBC Mortgages plc v Pitt</i> [1994] 1 AC 200, |
| “surety” | includes a third party surety, a guarantor, a co-guarantor, a mortgagor and a person who assumes liability as a borrower under the loan documentation, |
| “the Guide” | means The Hong Kong Solicitors’ Guide to Professional Conduct, Volume 1, |
| “undue influence” | includes misrepresentation or other legal |

wrong.

C. THE LAW ON UNDUE INFLUENCE

7. Members will recall that the House of Lords held that whether a transaction was brought about by the exercise of undue influence is a question of fact. The general rule is that the burden of proving an allegation of undue influence rests upon the person who claims to have been wronged. Proof that the complainant placed trust and confidence in the other party in relation to the management of the complainant's financial affairs, coupled with a transaction which calls for explanation, will normally be sufficient, failing satisfactory evidence to the contrary, to discharge the burden of proof. On proof of these two matters there is a rebuttable evidential presumption of undue influence (*Etridge* at paragraphs 13 – 16).
8. In every case where the relationship between the surety and the borrower is non-commercial:
 - the surety obligation will be valid and enforceable by the lender unless the suretyship was procured by the undue influence of the borrower;
 - if there has been undue influence by the borrower, unless the lender has taken reasonable steps to satisfy himself that the surety entered into the obligation freely and in knowledge of the true facts, the lender will be unable to enforce the surety obligation because the lender will be fixed with constructive notice of the surety's right to set aside the transaction. (*Etridge* at paragraph 87. See also *Pitt, O'Brien* at p. 198, *Etridge* at paragraphs 47 – 49; and *Fung Chin Kan* at paragraphs 42, 60 & 61.)

D. IDENTIFY THE CLIENT AND SCOPE OF THE RETAINER

9. In 3-party security transactions, the client can be one or more of the following parties:
 - the lender,
 - the borrower,
 - the surety.
10. Members should ascertain the identity of their client or clients and the precise scope of their retainer in respect of each client.
11. This is an important step in trying to avoid any misunderstanding or complications in enforcement by the lender. It is apparent from recent judgments that someone has to discharge the obligation to bring home to the surety the risks of the transaction and to ensure that his agreement to stand surety has been properly obtained. Where instructions are given by a lender to a solicitor, the solicitor should make sure that there is no misunderstanding between the solicitor and the lender on who is to discharge the obligation.
12. The instructions provided by many banking/financial institutions are unclear on the legal representation arrangements. Some banks may instruct solicitors to do a combination of the following instructions: either act “*exclusively*” for them, whilst also requiring solicitors to explain the documentation, and/or provide legal advice to the other parties.
13. HKAB has been asked by the Law Society and has issued HKAB’s circular (Appendix A) to urge HKAB members to clarify the scope of the instructions to solicitors. In case of doubt on the scope of a solicitor’s retainer in relation to 3-party security transactions, the solicitor should clarify his instructions with the banks before agreeing to act.

E. WHETHER TO ACCEPT INSTRUCTIONS

14. Generally speaking, a solicitor should follow his client's instructions, provided that by doing so, he will not be involved in unlawful activity or be in breach of the principles of professional conduct.
15. In deciding whether to accept instructions to act also for the surety or for more than one party, members should have regard to, inter alia, the following provisions in *the Guide*:
 - a solicitor **must not** accept instructions to act for two or more clients where there is a conflict, or a significant risk of conflict between the interests of those clients (Chapter 9, in particular Principle 9.01);
 - a solicitor **must not** accept instructions where he suspects that those instructions have been given by a client under duress or undue influence (Principle 5.04);
 - where instructions are received not from a client but from a third party purporting to represent that client, a solicitor should obtain written instructions from the client that he wishes the solicitor to act. In any case of doubt, the solicitor should see the client or take other appropriate steps to confirm instructions (Principle 5.06).
16. Members should take note that avoiding conflicts of interest is a fundamental requirement for all solicitors. Given the potentially vulnerable position of a surety, the solicitor will have to consider carefully whether he can and should accept instructions from the lender to act for the surety or whether he can or should act for both borrower and surety. In every case the solicitor must consider carefully whether there is any conflict of duty or interest and, more widely, whether it would be in the best interests of the surety for him to accept instructions to act for the surety.

17. Only if the solicitor is satisfied that there is no conflict of interest, or where he can resolve the conflict of interest should he proceed to act for the surety. If the solicitor is not satisfied, he **must** decline to act.
18. If the solicitor decides to accept instructions, he assumes legal and professional responsibilities to the surety and ought to give the requisite advice fully, carefully and conscientiously. If at any stage the solicitor becomes concerned that there is a real risk that other interests or duties may inhibit his advice to the surety he **must cease** to act for the surety (*Etridge* at paragraph 74).

F. ACTING FOR THE LENDER ONLY

19. Where a solicitor receives specific instructions to act only for the lender but is instructed to explain the character and legal effect of a document, the solicitor should:
 - satisfy himself that the instructions from the lender were given on the basis of Case 3 in HKAB's circular, i.e. the lender will give information and advice to the potentially unduly influenced party;
 - satisfy himself that the lender knows that the solicitor will **not** concern himself at all with the interests of the surety or whether the surety is accepting the obligations freely and with knowledge of the true facts;
 - not proceed with the signing of the documents unless either the solicitor has received a Warning Notice from the lender similar to the sample attached to these Guidelines as Appendix B duly signed by the parties to the security documents or has arranged for a Warning Notice to be signed; and
 - if it has become apparent to the solicitor that neither the lender nor the solicitor will be giving the requisite information and

advice to the potentially unduly influenced party, warn the lender that the security may be set aside in future.

20. One purpose of this Warning Notice is to obtain the surety's acknowledgment in writing that he knows that the solicitor acts for the lender, not the surety. This Warning Notice is **no** substitute for the requisite personal interview by the lender with the surety, in the absence of the borrower, warning the surety of the amount of his potential liability and of the risks involved and advising him to take independent legal advice (*O'Brien* at p. 199).

G. ACTING FOR THE LENDER AND THE SURETY

21. Where the lender instructs the solicitor to also act for the surety, the solicitor must first be satisfied that he may properly so act under Section E above on "Whether to accept instructions".
22. In deciding whether to accept instructions, the solicitor must bear in mind that the lender is likely to have a much better picture of the borrower's financial affairs than the solicitor and consider whether to invite the lender to proceed on the basis of Case 3, instead of Case 2, in HKAB's circular.
23. If the solicitor decides to accept instructions, the solicitor should then ascertain whether the lender intends to rely on the solicitor's role in acting for the surety.
24. If the lender intends to rely on the solicitor's role in acting for the surety, the solicitor's role in acting for the lender must be essentially administrative, e.g. seeing to the security document being validly executed, and, if necessary, seeing to its registration, and obtaining documents of title and holding them to the lender's order (*Etridge* at paragraphs 167 and 173).

25. Where a solicitor receives instructions from the lender to act for the surety, the solicitor should:
- ensure that a Warning Notice containing terms similar to the one attached to this Guidelines as Appendix C has been signed by the surety at least one working day prior to the date of execution of documents (see paragraph 26 below);
 - obtain confirmation from the surety that he wishes the solicitor to act for him (see paragraph 27 below);
 - obtain financial information from the lender (see paragraphs 28 – 31 below);
 - advise the surety in a face-to-face meeting in the absence of the borrower (see paragraphs 32 – 36 below);
 - make and keep a sufficiently comprehensive and contemporaneous note of the face-to-face meeting (see paragraph 37 below);
 - obtain signed written confirmation by the surety on the detailed advice given (see paragraph 38 below);
 - where authorised by the surety, give written confirmation to the lender (see paragraphs 39 – 41 below).

Warning Notice

26. The solicitor should ensure that a Warning Notice containing terms similar to the one attached to these Guidelines as Appendix C be received by the solicitor from the lender at least one working day prior to the execution of the documents or arrange for a Warning Notice to be signed at least one working day before execution of the documents. If the solicitor receives no Warning Notice from the lender or where the lender requires the solicitor to arrange for the same to be signed by the surety at the solicitor's office, the surety must be given at least one

working day after the signing of the Warning Notice at the solicitor's office to consider the matter, including whether to instruct his own solicitor, before the face-to-face meeting. In case of doubt, the solicitor should insist on the surety seeking separate representation, notwithstanding the lender's instructions.

Obtaining the surety's instructions

27. In addition to obtaining a Warning Notice, the solicitor must explain and confirm his instructions from the surety, by explaining to the surety the purpose for which he has become involved at all and that, should it ever become necessary, the lender will rely upon his involvement to counter any suggestion that the surety was influenced by the borrower or that the surety did not properly understand the implications of the transaction. The solicitor must obtain confirmation from the surety that the surety wishes him to act for the surety in the matter and to advise the surety on the legal and practical implications of the proposed transaction (*Etridge* at paragraph 64).

Obtaining financial information from the lender

28. The lender must provide the solicitor with the financial information he needs for this purpose. What is required must depend on the facts of the case. Ordinarily this will include:
- the purpose of the proposed new facility,
 - the current amount of the borrower's indebtedness,
 - the amount of the borrower's current overdraft facility,
 - the amount and terms of any new facility,
 - a copy of the written application (if any) by the borrower for a facility,

- any belief or suspicion that the surety has been misled by the borrower or is not entering into the transaction of his own free will (*Etridge* at paragraph 79).
 - the market value of any mortgaged property.
29. The solicitor **must** be satisfied that he has the expertise to interpret or advise on the detailed financial information to the surety.
30. If the lender fails for any reason to provide information requested by the solicitor, the solicitor **must decline** to provide the confirmation sought by the lender (*Etridge* at paragraph 67).
31. If the borrower is an existing client of the firm, or where the solicitor has financial information by virtue of the other transactions that he may have previously acted for the borrower, the solicitor may not disclose such information without the borrower's authority. If there is a real risk of any conflict of interest, the solicitor **must cease** to act for the surety.

Advising in a face-to-face meeting

32. In advising the surety, the solicitor assumes responsibilities directly to the surety, both at law and professionally, is acting for the surety **alone** and is concerned **only** with his interests, and should give the requisite advice fully, carefully and conscientiously (*Etridge* at paragraph 74).
33. The advice which a solicitor is expected to give depends on the particular facts of each transaction including the solicitor's retainer.
34. The solicitor's discussion with the surety should take place at a face-to-face meeting, in the absence of the borrower, couched in suitably non-technical language (*Etridge* at paragraph 66).
35. Members should take note of the following "*core minimum*" advice that should be given, as outlined by Lord Nicholls in paragraphs 64 and 65 of his judgment in *Etridge*:

- (a) **explain the nature of the document and practical consequence of signing**, i.e. the risk that the surety will lose the home and even the possibility that the surety could be made bankrupt;
- (b) **point out the seriousness of the risk involved** by reference to:
- the purpose, amount and principal terms of the new facility;
 - the fact that the lender may increase the amount of the facility, or change its terms, or grant a new facility, without reference to the surety;
 - the amount of the surety's liability under the security transaction;
 - by discussing the surety's financial means including his understanding of the value of the security being provided;
 - by discussing whether there are any other assets out of which repayment could be made if the borrower's business should fail;
- (c) **state clearly to the surety that the surety has a choice and the decision is his and his alone as to whether or not to proceed with the transactions.** This would involve some discussion of the present financial position, including the amount of the borrower's indebtedness, and the amount of the borrower's current facility;
- (d) **ascertain whether the surety wishes to proceed.** The solicitor should ask whether the surety is content for the solicitor to write to the lender confirming that the solicitor has explained the nature of the documents to the surety and the practical implications they may have for the surety, or whether, for instance, the surety would prefer the solicitor to negotiate with the lender on the

terms of the transaction which could include the sequence in which the various securities will be called upon or a specific or lower limit to his liabilities. Members are reminded that Lord Hobhouse questioned whether anyone who had a proper regard to the surety's interest would ask a surety to sign an unlimited guarantee or charge (*Etridge* at paragraph 112).

36. Members should also bear in mind the general requirements of the explanation in the normal case as stated in Lord Scott's speech (*Etridge* at paragraph 169) and any new case law development.

Proper attendance note

37. The solicitor must make and keep a sufficiently comprehensive and contemporaneous note of the face-to-face meeting so that if the need should arise, he may use the note to refresh his memory of the meeting and the advice which he in fact gave. Where the solicitor is satisfied that the signed written confirmation by the surety on the advice given is a sufficiently comprehensive and contemporaneous note of the face-to-face meeting, he may adopt it as his attendance note. Where the solicitor makes and keeps an attendance note, he must check the note with the signed written confirmation by the surety on the advice given for accuracy and consistency.

Signed written confirmation by the surety on the advice given

38. The solicitor should obtain written confirmation, in the appropriate language, signed by the surety on the detailed advice given. A sample written confirmation letter is attached to these Guidelines at Appendix D. The sample is not intended to be exhaustive and a solicitor is required to apply his professional judgment having regard to the facts and the documentation in each case in preparing the written confirmation by the surety.

Written confirmation to the lender

39. The solicitor **must not** give any confirmation to the lender without the surety's authority.
40. The solicitor's confirmation to the lender will depend on the terms of his retainer but should generally include:
 - the surety instructs him to advise on the transaction;
 - he has fully explained the nature and effect of the documents and the practical implications they will have for the surety;
 - he has also explained that the confirmation would have the effect that the surety should not be able to dispute the surety's binding obligation under the document; and
 - he has authority from the surety to issue the confirmation to the lender.
41. A solicitor should not accept instructions to confirm to the lender that the solicitor has satisfied himself that the surety's consent has not been procured by undue influence (*Etridge* at paragraph 53).

H. ACTING ONLY FOR THE SURETY

42. As stated above, a solicitor must **not** accept instructions where he suspects the instructions have been given by a client under duress or undue influence (Principle 5.04 of the *Guide*).
43. Solicitors acting for the surety alone should follow the Guidelines under Section G above on "Acting for the Lender and the Surety" and will have to obtain the necessary financial information from the lender's solicitors rather than the lender.

I. ACTING FOR THE BORROWER AND THE SURETY

44. A solicitor may act for both the borrower and the surety provided that the solicitor is satisfied that this is in the surety's interests and that this will not give rise to any conflicts of interests (*Etridge* at paragraphs 72 – 74).
45. The solicitor must be satisfied that he may properly so act under Section E above on “Whether to accept instructions”.
46. The solicitor should follow the Guidelines under Section G above on “Acting for the Lender and the Surety”.